HOAT09

SELF-STUDY CONTINUING PROFESSIONAL EDUCATION

Companion to PPC's Guide to

Homeowners' Associations and Other Common Interest Realty Associations

Fort Worth, Texas
(800) 323-8724
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INTRODUCTION

The Companion to PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations consists of four interactive self-study CPE courses. These are companion courses to *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations* designed by our editors to enhance your understanding of the latest issues in the field. To obtain credit, you must complete the learning process by logging on to our Online Grading System at **OnlineGrading.Thomson.com** or by mailing or faxing your completed **Examination for CPE Credit Answer Sheet** for print grading by **September 30, 2010**. Complete instructions are included below and in the Test Instructions preceding the Examination for CPE Credit Answer Sheet.

Taking the Courses

Each course is divided into lessons. Each lesson addresses an aspect of common interest realty associations. 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 which follow each lesson**. You may either record your answer choices on the printed **Examination for CPE Credit Answer Sheet** or by logging on to our Online Grading System.

Qualifying Credit Hours—QAS or Registry

PPC is registered with the National Association of State Boards of Accountancy as a sponsor of continuing professional education on the National Registry of CPE Sponsors (Registry) and as a Quality Assurance Service (QAS) sponsor. Part of the requirements for both Registry and QAS membership include conforming to the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the standards). The standards were developed jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the standards. Each course is designed to comply with the standards. For states adopting the standards, recognizing QAS hours or Registry hours, credit hours are measured in 50-minute contact hours. Some states, however, require 100-minute contact hours for self study. Your state licensing board has final authority on accepting Registry hours, QAS hours, or hours under the standards. Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program or have adopted the standards and allow QAS CPE credit hours. Alternatively, you may visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours or 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.

Obtaining CPE Credit

Online Grading. Log onto our Online Grading Center at **OnlineGrading.Thomson.com** to receive instant CPE credit. Click the purchase link and a list of exams will appear. You may search for the exam using wildcards. Payment for the exam is accepted over a secure site using your credit card. For further instructions regarding the Online Grading Center, please refer to the Test Instructions preceding the Examination for CPE Credit Answer Sheet. A certificate documenting the CPE credits will be issued for each examination score of 70% or higher.

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If more than one person wants to complete this self-study course, each person should complete a separate **Examination for CPE Credit Answer Sheet.** Payment of $75 must accompany each answer sheet submitted. We would also appreciate a separate **Course Evaluation** from each person who completes an examination.

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

COURSE 1

AUTHORITATIVE ACCOUNTING LITERATURE FOR CIRAS (HOATG091)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course explains the authoritative accounting literature that applies to common interest realty associations (CIRAs), including the guidance from the AICPA, and certain authoritative pronouncements of the FASB and APB. Additionally, this course provides an overview of the specific accounting standards that apply to all aspects of a CIRA's accounts, as well as how specific transactions may be treated differently for financial reporting purposes.

PUBLICATION/REVISION DATE: July 2009

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** QAS Hours, **8** Registry Hours

Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours.

FIELD OF STUDY: Accounting

EXPIRATION DATE: Postmark by **September 30, 2010**

KNOWLEDGE LEVEL: Basic

Learning Objectives:

Lesson 1—Overview of Accounting for CIRAs

Completion of this lesson will enable you to:

- Demonstrate how to apply the GAAP hierarchy to accounting literature relating to common interest realty associations (CIRAs).

Lesson 2—Accounting Treatment of Specific Transactions for Financial Reporting and Tax Purposes

Completion of this lesson will enable you to:

- Apply accounting standards related to specific transactions into which a CIRA might enter.
- Compare how the accounting treatment for certain transactions may be different for tax and financial reporting purposes.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

Thomson Reuters
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HOATG091 Self-study CPE
36786 Treasury Center
Chicago, IL 60694-6700

See the test instructions included with the course materials for more information.

ADMINISTRATIVE POLICIES:

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Lesson 1: Overview of Accounting for CIRAs

INTRODUCTION

This lesson gives a basic overview of accounting for a common interest realty association (CIRA). It focuses on the authoritative accounting literature that is relevant to CIRAs and the GAAP hierarchy.

Learning Objectives:

Completion of this lesson will enable you to:

- Demonstrate how to apply the GAAP hierarchy to accounting literature relating to common interest realty associations (CIRAs).

AUTHORITATIVE ACCOUNTING LITERATURE THAT AFFECTS CIRAs

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 course's objectives include increasing the comparability of CIRAs' financial statements, making them more useful and informative to financial statement users, and providing necessary guidance to accountants on the accounting principles that apply to CIRAs and on providing services to them. The principal focus of the course is the accounting issues that are unique to CIRAs, including 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 the course apply to *all* types of residential and nonresidential common interest realty associations, including condominium associations, homeowners' associations, cooperative housing corporations, and timeshare associations.

GAAP on CIRAs

The only accounting pronouncement that specifically applies to CIRAs is the AICPA Audit and Accounting Guide, *Common Interest Realty Associations*. Because this course primarily deals with transactions and events that are unique to CIRAs, however, accountants will also need to consider other accounting pronouncements in determining generally accepted accounting principles for CIRAs.

In June 2009, the FASB issued SFAS No. 168, *The Hierarchy of Generally Accepted Accounting Principles* (FASB ASC 105-10), which replaces SFAS No. 162 and authorizes the *FASB Accounting Standards Codification ™* as the single source of authoritative U.S. accounting and reporting standards for non-SEC companies. The AICPA has issued a Financial Reporting Alert, *FASB Codification Developments*, which provides an overview of the FASB Codification project and several case studies to assist accountants when navigating the Codification. The Financial Reporting Alert is available at **www.cpa2biz.com**. In addition, an archived webcast that discusses the transition to the FASB Codification is available from the FASB at **www.fasb.org**. The authoritative version of the Codification, which was officially released on July 1, 2009, is effective for annual and interim periods ending after September 15, 2009. Accordingly, as of that date, there are 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. The Codification also includes relevant authoritative content issued by the SEC and select SEC staff interpretive and administrative guidance, which is applicable to issuers. An "S" precedes the SEC section codes. Thus, the FASB Codification supersedes all of the existing GAAP guidance, including the accounting and financial reporting guidance presented in other publications such as the AICPA Audit and Accounting Guides, which will be presented and maintained in the Codification. The AICPA Guide, *Common Interest Realty Associations*, has been codified at FASB ASC 972.

Any change in accounting as a result of applying SFAS No. 168 (FASB ASC 105-10) should be accounted for as a change in accounting principle or correction of an error, as appropriate.

Framework for Determining Appropriate Accounting Principles for CIRAs

The AICPA guide (FASB ASC 972) prescribes the appropriate accounting treatment for many transactions and events encountered by CIRAs, but since it is not comprehensive, accountants must also look to other GAAP in the FASB codification, in deciding how to account for transactions and events that are not addressed in the AICPA guide.

Are CIRAs Nonprofit Organizations? When using the FASB codification, it is first necessary to consider whether CIRAs should be classified as nonprofit entities. FASB literature broadly classifies entities as *business enterprises* or *not-for-profit organizations*. The FASB's Statement of Financial Accounting Concepts (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 Appendix D of SFAS Nos. 116, *Accounting for Contributions Received and Contributions Made*, and 117, *Financial Statements of Not-for-Profit Organizations* (FASB ASC 958). Thus, although SFAC No. 4 and the two FASB statements do not specifically exclude condominium associations, homeowners' associations, housing cooperatives, and timeshare 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 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. The AICPA guide, Common Interest Realty Associations (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 (for example, the AICPA CIRA guide), CIRA's should look to accounting principles for similar transactions of events within other authoritative GAAP in the FASB Codification. Thus, as a general rule, if CIRAs' 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 APB Opinion No. 22 (FASB ASC 235-10) and any contingencies should be recorded and disclosed in the financial statements in conformity with SFAS No. 5 (FASB ASC 450-10). 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.

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, SFAS No. 168 (FASB ASC 105-10-05-2 and 105-10-05-3) 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.

Grandfathered Guidance. Some of the guidance specified by industry practices may be considered as "grandfathered" under SFAS No. 168 (FASB ASC 105-10-05-70). 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 AICPA guide (or other guidance in the FASB Codification whose effective date was before March 15, 1992). (However, all CIRAs should follow the provisions of the AICPA guide (FASB ASC 972) 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. In addition, all CIRAs initially adopting an accounting principle after March 15, 1992, including CIRAs formed after March 15, 1992, must conform with the Codification.

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—

- Practices that are widely recognized and prevalent either generally or in the industry
- FASB Concepts Statements
- AICPA Issues Papers
- Technical Information Service Inquiries and Replies included in AICPA Technical Practice Aids
- 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 nonauthori-

tative 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 would normally be more influential than other sources.

Using Present Value Information in Accounting Measurements

Statement of Financial Accounting Concepts (SFAC) No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements* (FASB ASC 820-10), provides a framework for using future cash flows as the basis for measuring assets and liabilities. In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (FASB ASC 820-10), which incorporates aspects of and clarifies the guidance in SFAC No. 7 for using present value techniques to measure fair value. In addition, SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an Amendment of FASB Statement No. 115* (FASB ASC 825-10), provides entities an election to use fair value measurement for certain financial assets and liabilities upon their initial recognition or when events give rise to new-basis accounting.

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.

Difference in Treatment of Specific Transactions for Financial Reporting and Tax Purposes

Accountants should be aware that 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.

SELF-STUDY QUIZ

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

1. FASB literature broadly classifies entities as business enterprises or not-for-profit organizations. Specifically, SFAC No. 4, *Objectives of Financial Reporting by Nonbusiness Organizations*, Paragraph 6, distinguishes not-for-profit organizations from business enterprises by their characteristics. Which of the following is a characteristic of a not-for-profit organization?

   a. Receipts of significant amounts of resources from resource providers who 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. Existence 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.

   d. Operating purpose that includes the economic benefit of its members or shareholders.

2. Which of the following is authoritative guidance in GAAP after the effective date of the FASB Codification?

   a. FASB Concept Statements.

   b. Generally accepted practices that are widely recognized and widely prevalent in the industry.

   c. AICPA Issues Papers.

   d. Accounting Principles included in the Codification.

3. Statement of Financial Accounting Concepts (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. Which of the following statements about cash flows is correct?

   a. Preparers must always use the "expected" cash flow method to reflect the range of possible outcomes.

   b. The "expected" cash flow method can be used to measure present value when the timing of cash flows is uncertain.

   c. Preparers should use a single "most likely" estimate when arriving at the present value of cash flows.

   d. The effect of a debtor's credit standing does not affect the present value measurement of a liability.

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. FASB literature broadly classifies entities as business enterprises or not-for-profit organizations. Specifically, SFAC No. 4, *Objectives of Financial Reporting by Nonbusiness Organizations*, Paragraph 6, distinguishes not-for-profit organizations from business enterprises by their characteristics. Which of the following is a characteristic of a not-for-profit organization? **(Page 4)**

   a. Receipts of significant amounts of resources from resource providers who expect to receive either repayment or economic benefits proportionate to resources provided. [This is the incorrect answer. According to SFAC No. 4, one characteristic of a not-for-profit organization is the receipt of significant amounts of resources from providers who DO NOT Expect to receive repayment or other economic benefits.]

   b. Operating purposes that are other than to provide goods or services at a profit or profit equivalent. [This is the correct answer. According to SFAC No. 4, it is one of the characteristics of a not-for-profit organization.]

   c. Existence 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. [This is the incorrect answer. According to SFAC No. 4, the absence of such ownership interests is a characteristic of a not-for-profit organization.]

   d. Operating purpose that includes the economic benefit of its members or shareholders. [This is the incorrect answer. According to paragraph 7 of SFAC No. 4, organizations that provide such benefits to members are excluded from the statement. Consequently, they are not considered not-for-profit organizations.]

2. Which of the following is authoritative guidance in GAAP after the effective date of the FASB Codification? **(Page 5)**

   a. FASB Concept Statements. [This answer is incorrect. The FASB Concept Statements are considered nonauthoritative guidance in the two levels of GAAP.]

   b. Generally accepted practices that are widely recognized and widely prevalent in the industry. [This answer is incorrect. Even if the accounting practice is widely accepted within the industry, it is nonauthoritative guidance under GAAP and an accountant may consider it when accounting for a transaction or event not addressed in the FASB Codification.]

   c. AICPA Issues Papers. [This answer is incorrect. The AICPA Issues Papers are nonauthoritative guidance under GAAP. If an accountant uses nonauthoritative guidance, it should consider the appropriateness of the guidance and the relevance to the circumstances.]

   d. Accounting Principles included in the Codification. [This answer is correct. There are two levels of GAAP under the new FASB Codification, nonauthoritative and authoritative. The accounting principles included in the Codification are the only authoritative guidance.]

3. Statement of Financial Accounting Concepts (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. Which of the following statements about cash flows is correct? **(Page 6)**

   a. Preparers must always use the "expected" cash flow method to reflect the range of possible outcomes. [This is the incorrect answer. Preparers may consider cost-benefit constraints when deciding whether to use the "expected" cash flow method. Therefore, if it is too costly, they are not required to use that method in developing the present value of its assets or liabilities.]

   b. The "expected" cash flow method can be used to measure present value when the timing of cash flows is uncertain. [This is the correct answer. When the timing of cash flows is uncertain, SFAC No. 7 states that a single interest rate that reflects the risk associated with future cash flows cannot reflect uncertainties in timing; in that case, the "expected" cash flow method can be used to measure present value.]

   c. Preparers should use a single "most likely" estimate when arriving at the present value of cash flows. [This is the incorrect answer. Even though preparers have traditionally used this approach, 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.]

   d. The effect of a debtor's credit standing does not affect the present value measurement of a liability. [This is the incorrect answer. 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.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (HOATG091)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. When auditing CIRAs, accountants need only concern themselves with the AICPA Audit and Accounting Guide, *Common Interest Realty Associations,* since that it the only accounting pronouncement that specifically applies to CIRAs.

    a. True.

    b. False.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

2. The SFAS No. 162 was replaced by:

    a. FASB Accounting Standards Codification.

    b. SFAC No. 4.

    c. SFAS No. 168.

    d. SFAS No. 162 has not been superseded.

3. Sally is auditing a CIRA that has been in existence since 1975 and has following an accounting treatment that conforms to industry practice since that time. The accounting treatment does not follow the guidance in the FASB Codification. Which of the following is true?

    a. Sally should have her client change their accounting practice immediately, since the Codification became effective on July 1, 2009.

    b. The CIRA has a time period to become compliant with the new accounting practices, so they are fine for right now and Sally does not have to worry about it.

    c. Since the CIRA has been following the accounting practice since 1975, the guidance is "grandfathered" under SFAS No. 168 and the CIRA can continue to follow it.

    d. Sally has no choice but to issue a adverse opinion on the financial statements since it does not follow the guidance in the FASB Codification.

Lesson 2: Accounting Treatment of Specific Transactions for Financial Reporting and Tax Purposes

INTRODUCTION

This lesson covers the accounting treatment CIRAs use for specific transactions for financial reporting and tax purposes. Topics covered include cash and cash equivalents, marketable securities, member assessments, other income, receivables, common property, other real property, prepaid insurance, other assets, funds for future major repairs and replacements, capital improvement funds, reserve studies, debt and other liabilities, members' equity, and income taxes. Relevant authoritative literature is discussed throughout.

Learning Objectives:

Completion of this lesson will enable you to:

- Apply accounting standards related to specific transactions into which a CIRA might enter.
- Compare how the accounting treatment for certain transactions may be different for tax and financial reporting purposes.

ACCOUNTING FOR 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 be disclosed. For example, if the withdrawal of long-term certificates of deposit prior to maturity is subject to a substantial penalty, the CDs should be segregated from the cash caption 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, the CDs may be included with "Cash." The CDs need not be separately disclosed in that case; however, disclosure is not prohibited. 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.

- *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, it may be offset against positive balances in other financial institutions. However, if it is material, it is recommended that the net negative balance (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.

Distinguishing between Cash, Cash Equivalents, and Investments

A statement of cash flows prepared in conformity with SFAS No. 95 (FASB ASC 230-10) is one of the basic financial statements that CIRAs are required to present. CIRAs should distinguish between cash, cash equivalents, and investments when preparing financial statements because SFAS No. 95 (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, SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (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. SFAS No. 95 (FASB ASC 230-10-20) defines cash and cash equivalents as follows:

CASH	CASH EQUIVALENTS
Definition (SFAS No. 95, Paragraph 7, footnote 1) (FASB ASC 230-10-20)	*Definition* (SFAS No. 95, Paragraph 8) (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 SFAS No. 95 (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 SFAS No. 95, 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, SFAS No. 95 (FASB ASC 230-10-50-1) requires financial statements to disclose the policy for determining which items are treated as cash equivalents. Disclosing that information in the accounting policies note to the financial statements is recommended.

Financial Statement Presentation. All cash accounts should be presented as a single line item in the balance sheet. (If the amounts include cash equivalents, the caption "Cash and cash equivalents" should be used.) 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 additional 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 are similar to legally restricted funds since the CIRA's board of directors does not have the authority to decide how those funds are to be used nor does the board have the authority to reverse the decisions of the unit owners. Thus, they believe such funds should 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, however, this course recommends disclosing funds designated by the unit owners for specific purposes, for example, by using a descriptive caption such as "Cash for future repairs and replacements." In addition, such amounts should be reported as a separate classification of members' equity on the balance sheet (or disclosed in the notes) such as follows:

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, that the term "restricted" should not be used in conjunction with them.

Additional disclosures about 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. The AICPA guide also requires a CIRA's financial statements to disclose assessments that were used for purposes other than those for which they were designated. (FASB ASC 972-605-50-1)

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 should 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. If CIRAs present classified balance sheets, cash that is *legally restricted* (for example, in certain HUD assisted CIRAs) should be excluded from current assets and presented with other assets unless it is considered to offset debt that is classified as a current liability. For example, classifying restricted cash as a current asset would be appropriate when the cash is restricted to repay specific debt. The amount classified as a current asset should not exceed the amount of the related liability that is classified as current.

Required Disclosures

In addition to the required financial statement disclosures related to cash equivalents and restricted cash as discussed in the preceding paragraphs, SFAS No. 107, *Disclosures about Fair Value of Financial Instruments* (FASB ASC 825-10-50), as amended, 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.

Decisions about whether miscellaneous collections should be recorded in the CIRA's financial statements should be based 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, should 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 are not required to undertake should not be recorded in their financial statements, even if the CIRA authorizes the events, or 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). Those collections should be segregated 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, and the association and its board of directors exercise no control over disposition of the funds. 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 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 recommended that cash 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.

SELF-STUDY QUIZ

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

4. Accounting for cash and cash equivalents of common interest realty associations is virtually the same as accounting for similar assets in commercial businesses. All of the following types of transactions, even if material, should be included in cash and cash equivalents **except** for:

   a. Demand deposits with financial institutions.

   b. Bank overdrafts.

   c. Change funds and undeposited receipts.

   d. Money market funds.

5. There are several accounting considerations that relate to a CIRA's disclosures regarding cash and cash equivalents. All of the following statements are true **except**:

   a. Material "held checks" dated at or before the balance sheet date should be included in cash and cash equivalents.

   b. Material bank overdrafts may be included with account payable if the CIRA has sufficient balances in the same bank to offset the overdrafts.

   c. Certificates of deposit subject to withdrawal limitations may continue to be included in cash and cash equivalents.

   d. Cash designated for special purposes should be segregated from cash available for general operations and normally excluded from current assets if the CIRA presents a classified balance sheet.

6. CIRAs must present a statement of cash flows when presenting financial statements. All of the following statements appropriately describe accounting standards with respect to a statement of cash flows **except** for?

   a. A statement of cash flows prepared in conformity with SFAS No. 95 is one of the basic financial statements that CIRAs are required to present.

   b. CIRAs should distinguish between cash, cash equivalents, and investments when preparing financial statements because SFAS No. 95 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.

   c. The classification of cash-type accounts as either cash or investments has little effect on the CIRA's balance sheet or on its statement of cash flows.

   d. 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.

7. CIRAs should distinguish between cash, cash equivalents, and investments when preparing financial statements. According to SFAS No. 95, cash equivalents are 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. All of the following are examples of cash equivalents **except** for:

   a. Treasury bills.

   b. Repurchase agreements.

   c. Commercial paper.

   d. Short-term investments whose original maturity is three months or less.

8. Some CIRAs collect and hold funds as an accommodation to their members. Accordingly, such funds 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. Funds collected from all of the following activities should be recorded in the CIRA's financial statements **except** for:

   a. Deposits collected from members when they purchase units and receive their keys, which are later refunded to unit owners on the return of their keys when they sell their units.

   b. Annual passes allowing members access to recreational facilities, such as a swimming pool or tennis court.

   c. Fees estimated to cover members' share of the cost of picnics, parties, or other social events.

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. Accounting for cash and cash equivalents of common interest realty associations is virtually the same as accounting for similar assets in commercial businesses. All of the following types of transactions, even if material, should be included in cash and cash equivalents **except** for: **(Page 11)**

   a. Demand deposits with financial institutions [This is the incorrect answer. Demand deposits should be included in a CIRA's cash and cash equivalents.]

   b. Bank overdrafts [This is the correct answer. Material bank overdrafts should be presented as a separate caption among liabilities in the CIRA's balance sheet. If immaterial, however, they may be netted against positive cash balances, even if the accounts are with different banks.]

   c. Change funds and undeposited receipts [This is the incorrect answer. Change funds and undeposited receipts are cash on hand, which should be included in a CIRA's cash and cash equivalents.]

   d. Money market funds. [This is the incorrect answer. Money market funds should be included in a CIRA's cash and cash equivalents.]

5. There are several accounting considerations that relate to a CIRA's disclosures regarding cash and cash equivalents. All of the following statements are true **except**: **(Page 11)**

   a. Material "held checks" dated at or before the balance sheet date should be included in cash and cash equivalents. [This is the correct answer. Such checks should be reclassified as accounts payable.]

   b. Material bank overdrafts may be included with account payable if the CIRA has sufficient balances in the same bank to offset the overdrafts. [This is the incorrect answer. Material bank overdrafts should be presented as a separate caption among liabilities and, if the CIRA presents a classified balance sheet, should be included with current liabilities. If the CIRA has sufficient free balances in the same bank to offset the overdrafts, however, some accountants include the cash overdrafts with accounts payable.]

   c. Certificates of deposit subject to withdrawal limitations may continue to be included in cash and cash equivalents. [This is the incorrect answer. 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, the CDs may be included with "Cash." However, if withdrawal of long-term CDs prior to maturity is subject to a substantial penalty, the CDs should be segregated from the cash caption and the restrictions, if material, should be disclosed in the notes to the financial statements.]

   d. Cash designated for special purposes should be segregated from cash available for general operations and normally excluded from current assets if the CIRA presents a classified balance sheet. [This is the incorrect answer. Cash designated for special purposes should be segregated from cash available for general operations and normally, if it is legally restricted, should be excluded fro current assets if the CIRA presents a classified balance sheet.]

6. CIRAs must present a statement of cash flows when presenting financial statements. All of the following statements appropriately describe accounting standards with respect to a statement of cash flows **except** for? **(Page 13)**

   a. A statement of cash flows prepared in conformity with SFAS No. 95 is one of the basic financial statements that CIRAs are required to present. [This is an incorrect answer. SFAS No. 95 requires a CIRA to present a statement of cash flows as one of its basic financial statements.]

   b. CIRAs should distinguish between cash, cash equivalents, and investments when preparing financial statements because SFAS No. 95 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. [This is an incorrect answer. CIRAs should distinguish between cash, cash equivalents, and investments when preparing financial statements for the reasons cited.]

c. The classification of cash-type accounts as either cash or investments has little effect on the CIRA's balance sheet or on its statement of cash flows. [This is the correct answer. According to SFAS No. 95, 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. Thus, 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.]

d. 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. [This is the incorrect answer. A CIRA that follows fund accounting should present cash, cash equivalents, and investments in this manner.]

7. CIRAs should distinguish between cash, cash equivalents, and investments when preparing financial statements. According to SFAS No. 95, cash equivalents are 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. All of the following are examples of cash equivalents **except** for: **(Page 12)**

   a. Treasury bills. [This is the incorrect answer. Treasury bills are cash equivalents.]

   b. Repurchase agreements. [This is the correct answer. Repurchase agreements that have the general characteristics of demand deposits are considered cash, not cash equivalents.]

   c. Commercial paper. [This is the incorrect answer. Commercial paper is a cash equivalent.]

   d. Short-term investments whose original maturity is three months or less. [This is the incorrect answer. Such short term investments are cash equivalents.]

8. Some CIRAs collect and hold funds as an accommodation to their members. Accordingly, such funds 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. Funds collected from all of the following activities should be recorded in the CIRA's financial statements **except** for: **(Page 14)**

   a. Deposits collected from members when they purchase units and receive their keys, which are later refunded to unit owners on the return of their keys when they sell their units. [This is the incorrect answer. Decisions about whether miscellaneous collections should be recorded in the CIRA's financial statements should be based 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 relate to the CIRA's primary responsibilities and, thus, should be recorded in the CIRA's financial statements. Accordingly, such deposits collected from members should be included in the CIRA's financial statements.]

   b. Annual passes allowing members access to recreational facilities, such as a swimming pool or tennis court. [This is the incorrect answer. Because such fees result from activities associated with the CIRA's responsibilities of managing and maintaining the development's common property, they should be included in the CIRA's financial statements.]

   c. Fees estimated to cover members' share of the cost of picnics, parties, or other social events. [This is the correct answer. Amounts that CIRAs do not budget or collections from activities that CIRAs are not required to undertake should not be recorded in their financial statements, even if the CIRA authorizes the events, or they include all of its members, or the CIRA bills and collects fees that are charged for the event.]

MARKETABLE SECURITIES (EQUITY AND DEBT 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 SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (FASB ASC 320-10). SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an Amendment of FASB Statement No. 115* (FASB ASC 825-10), provides entities an election to use fair value measurement for certain financial assets and liabilities including available for sale and held to maturity securities, upon their initial recognition or when events give rise to new-basis accounting. Under the Statement, the fair value option (a) may be applied on an instrument by instrument basis, with a few exceptions, (b) is irrevocable, unless a new election date occurs, and (c) is applied only to entire instruments and not to portions of instruments. The SFAS also sets forth specific presentation and disclosure requirements, amending the presentation and disclosure requirements of SFAS No. 115 (FASB ASC 320-10). SFAS No. 159 is effective for fiscal years beginning after November 15, 2007, with earlier application permitted for entities also electing early adoption of SFAS No. 157's provisions. 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 SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FASB ASC 815), rather than SFAS No. 115 (FASB ASC 320-10).)

Categorization of Securities. Accounting for investments under SFAS No. 115 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 SFAS No. 133 (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.

Exhibit 2-1 presents the accounting for investments required by SFAS No. 115 (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. SFAS No. 130, *Reporting Comprehensive Income* (FASB ASC 220-10), 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 shall 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

SFAS No. 115 (FASB ASC 320-10) Requirements for Accounting for Investments

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

* * *

How SFAS No. 115 (FASB ASC 320-10) Affects CIRAs

Most CIRAs invest primarily in debt securities. Under SFAS No. 115 (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. Debt securities held by CIRAs may not meet the "held to maturity" criterion although the CIRA may intend to hold the securities for a long term or an indefinite period. Thus, at least a portion of the CIRA's investments in debt securities often should be classified as "available for sale" under SFAS No. 115 (FASB ASC 320-10) and, accordingly, be accounted for at fair value. Under SFAS No. 115 (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 Debt Securities Should Be Classified 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. As stated before, 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 (SFAS No. 115, Paragraph 59) (FASB ASC 320-10-25-3)
- An entity has the intent to hold the securities for only an indefinite period (SFAS No. 115, Paragraph 9) (FASB ASC 320-10-25-4)
- The security would be sold in response to changes in any of the following (SFAS No. 115, Paragraph 9) (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 explained above, 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 should 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, it is believed 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 listed criteria.

SFAS No. 115, Paragraph 59 (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. In addition, SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, states the following (AU 332.57):

- When considering investment activities, the auditor ordinarily should inspect documentation of management's intent. Documentation of the classification of debt and equity securities may be informal.
- In evaluating an entity's ability to hold a debt security to maturity, . . . the auditor should consider factors such as the entity's financial position, working capital needs, operating results, debt agreements,

guarantees, alternate sources of liquidity, and other relevant contractual obligations, as well as laws and regulations.

SFAS No. 115, Paragraph 8 (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.

Question 31 of the FASB's Special Report (Q and A) on SFAS No. 115, *A Guide to Implementation of Statement 115 on Accounting for Certain Investments in Debt and Equity Securities* (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, Question 32 of the Special Report (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 above, 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, the sale might 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 SFAS No. 115 (FASB ASC 320-10-25). In those circumstances, Question 12 of the Q & A on SFAS No. 115 (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, Question 14 (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 SFAS No. 115, Paragraph 59 (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.

SELF-STUDY QUIZ

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

9. Marketable securities consist of equity securities and debt securities. Examples of equity securities include which of the following?

   a. U.S. Treasury securities.

   b. U.S. government agency securities.

   c. Stock rights and warrants.

   d. Municipal securities.

10. If a security is not intended to be held and are bought primarily for the purpose of selling them in the near future, they should be classified as:

   a. Trading.

   b. Available for sale.

   c. Held to maturity.

11. SFAS No. 115 presents the accounting for investments. All of the following statements about accounting for investments are correct **except** for:

   a. Debt and equity securities classified as available for sale should be recorded at fair value, and realized gains and losses should be recorded in the statement of revenues and expenses in the period that they are earned.

   b. SFAS No. 130, *Reporting 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".

   c. Debt securities classified as held to maturity should be carried in the balance sheet at fair value, and realized gains and losses are recorded in the statement of revenues and expenses in the period that they are earned.

12. Under SFAS No. 115 , debt securities may be classified as *held to maturity* only if an entity satisfies two criteria. What are the two required criteria?

   a. (1) The ability to hold them to maturity (2) Intent to hold to maturity is uncertain.

   b. (1) The ability to hold them to maturity (2) A positive intent to hold them to maturity.

   c. (1) The ability to hold them to maturity (2) Intent to sell them if there were a change in circumstances, such as a change in liquidity demands.

   d. (1) The ability to hold them to maturity (2) Intent to hold them to maturity is only for an indefinite period.

13. SFAS No. 115 provides 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. Three of those, in rare cases, might apply to CIRAs. Which of the following is **not** one of those exceptions?

    a. Evidence of a significant decline in the securities value.

    b. Evidence of a significant deterioration in the issuer's creditworthiness.

    c. A change in tax law that eliminates or reduces the tax-exempt status of interest on the debt security.

    d. A change in statutory requirement significantly modifying what constitutes a permissible investment in certain kinds of securities, thereby causing an enterprise to dispose of a held to maturity security.

SELF-STUDY ANSWERS

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

9. Marketable securities consist of equity securities and debt securities. Examples of equity securities include which of the following? **(Page 21)**

    a. U.S. Treasury securities. [This is the incorrect answer. U.S. treasury securities are a form of debt security.]

    b. U.S. government agency securities. [This is the incorrect answer. U.S. government agency securities are a form of debt security.]

    c. Stock rights and warrants. [This is the correct answer since stock rights and warrants are a form of equity security.]

    d. Municipal securities. [This is the incorrect answer. Municipal securities are a form of debt security.]

10. If a security is not intended to be held and are bought primarily for the purpose of selling them in the near future, they should be classified as: **(Page 22)**

    a. Trading. [This answer is correct. 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 should be classified as trading.]

    b. Available for sale. [This answer is incorrect. Available for sale securities are debt and equity securities that do not meet the criterion to be classified as held to maturity or trading. They should be recorded in the financial statements at fair value.]

    c. Held to maturity. [This answer is incorrect. Investments classified as held to maturity are securities in which the entity has the intent and ability to hold to maturity. Debt securities are the only types of investments in this category.]

11. SFAS No. 115 presents the accounting for investments. All of the following statements about accounting for investments are correct **except** for: **(Page 21)**

    a. Debt and equity securities classified as available for sale should be recorded at fair value, and realized gains and losses should be recorded in the statement of revenues and expenses in the period that they are earned. [This is the incorrect answer. SFAS No. 115 requires that the category of traded debt and equity that will be for sale in the near term be recorded in this manner.]

    b. SFAS No. 130, *Reporting 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". [This is the incorrect answer. SFAS No. 115 requires that the category of debt and equity that is available for sale, but not traded in the near term be recorded in this manner.]

    c. Debt securities classified as held to maturity should be carried in the balance sheet at fair value, and realized gains and losses are recorded in the statement of revenues and expenses in the period that they are earned. [This is the correct answer. Unlike debt securities classified as available for sale, securities classified as held to maturity should be 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).]

12. Under SFAS No. 115, debt securities may be classified as *held to maturity* only if an entity satisfies two criteria. What are the two required criteria? **(Page 23)**

    a. (1) The ability to hold them to maturity (2) Intent to hold to maturity is uncertain. [This is the incorrect answer. In addition to an ability to hold the securities to maturity, an entity also has to have one other positive intention.]

    b. (1) The ability to hold them to maturity (2) A positive intent to hold them to maturity. [This is the correct answer. 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. These criteria must be more rigorous than "the mere absence of intent to sell."]

    c. (1) The ability to hold them to maturity (2) Intent to sell them if there were a change in circumstances, such as a change in liquidity demands. [This is the incorrect answer. In addition to an ability to hold the securities to maturity, the intention cannot be to sell in this circumstance.]

    d. (1) The ability to hold them to maturity (2) Intent to hold them to maturity is only for an indefinite period. [This is the incorrect answer. 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.]

13. SFAS No. 115 provides 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. Three of those, in rare cases, might apply to CIRAs. Which of the following is **not** one of those exceptions? **(Page 24)**

    a. Evidence of a significant decline in the securities value. [This is the correct answer. Although SFAS No. 115, paragraph 8, permits the sale or transfer of a held to maturity security in response to events that are "isolated, nonrecurring, and unusual for the reporting enterprise that could not have been reasonably anticipated," evidence of a significant decline in a security's valuation is NOT an example of such an event. An example of a qualifying event might be an extremely remote disaster scenario such as a run on a bank.]

    b. Evidence of a significant deterioration in the issuer's creditworthiness. [This is the incorrect answer. This change in circumstances could apply to a CIRA. However, Question 31 of the FASB's Special Report on SFAS No. 115 points out that it is not appropriate to apply the exception to situations that are similar but not the same.]

    c. A change in tax law that eliminates or reduces the tax-exempt status of interest on the debt security. [This is the incorrect answer. This is an exemption that may apply to a CIRA. However, the change in tax law can not be one that revises the marginal tax rates applicable to interest income.]

    d. A change in statutory requirement significantly modifying what constitutes a permissible investment in certain kinds of securities, thereby causing an enterprise to dispose of a held to maturity security. [This is the incorrect answer. This change in circumstances might apply to a CIRA. In addition, it could be a change in a regulatory requirement significantly modifying the maximum level of investments in certain kinds of securities, thereby causing an enterprise to dispose of a held to maturity security.]

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 should be 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 should be 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 should be 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.		

As discussed above, 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, the authors surmise that IRC Section 454's approach of not accreting probably stems 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 preferable to accrete the discount because that is consistent with the general accounting for other discounts, such as that required by APB Opinion No. 21 (FASB ASC 835-30) for discounts on certain receivables. As a practical matter, however, since T bills normally have low yields and mature over short periods, the effect of discount accretion normally will not be material to the financial statements.

To illustrate the accounting considerations, if the discount on the T bill 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, SFAS No. 115 (FASB ASC 320-10) 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 a separate component of equity.

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). Using the last bid price on the balance sheet date to estimate the fair value is recommended. 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

As indicated, if the T bill were classified as available for sale, an entry debiting investments and crediting a separate component of equity should 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.

An illustration of how to present unrealized gains and losses in the financial statements follows.

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

Every six months, the CIRA would record interest on the note and amortization of premium or discount. If the note had a coupon rate of $13\frac{3}{8}$, semiannual interest and premium amortization for the first six months would be recorded as follows:

Cash	$ 668.75	
Premium on Treasury notes		$ 250.15
Interest income		418.60
To record semiannual income on Treasury note ($10,000 × $\frac{0.13375}{2}$) 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

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. This should 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

* * *

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 date that financial statements are prepared. 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 date of the financial statements, 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, they are required 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 a separate component of equity.

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. An illustration of how to present unrealized gains and losses in the equity section of the balance sheet is included in this lesson.

Presenting Unrealized Gains and Losses in Equity. As explained earlier, 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. SFAS No. 115 (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) aggregate fair value, (b) total gains for securities with net gains recorded in accumulated other comprehensive income, and (c) 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) the aggregate fair value, (b) gross unrecognized holding gains, (c) gross unrecognized holding losses, (d) the net carrying amount, and (e) 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.

SFAS No. 130, *Reporting Comprehensive Income* (FASB ASC 220-10-45-13), requires that unrealized gains and losses on available for sale securities be reported as a separate component of equity titled *accumulated other comprehensive income*.

SELF-STUDY QUIZ

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

14. One type of debt security is a U.S. Treasury security, which includes bills, notes, and bonds. All of the following statements about U.S. Treasury bills (T bills) are correct **except** for?

    a. 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.

    b. T bills are obligations of the U.S. government with a term that exceeds one year or more.

    c. T bills require a minimum investment of $10,000.

    d. The difference between the purchase price and the par value of a T bill is called "accreted interest," which is paid when the T bill matures.

15. The rules governing accounting for T bills differ for tax and financial reporting purposes. Which of the following statements about accounting for T bills is **not** correct?

    a. Since T bills normally have low yields and mature over short periods, the effect of discount accretion normally is not material to the financial statements.

    b. When purchased, T bills should be recorded at cost, which will be a discount from their $10,000 par value.

    c. Even though T bills do not pay coupon interest, the discount represents interest at the yield quoted at the date of acquisition.

    d. According to IRC Section 454(b)(2), the discount should be accreted and over the life of the bill.

16. Stephen is calculating the fair value of a T bill that his homeowner's association has on the books. The HOA originally purchased the T bills for $10,000. He has the following information:

Maturity	Days to Maturity	Bid	Asked	Yield
Dec 15 'X9	85	5.25	5.20	5.30

    What is the fair value of the T bills?

    a. $9,874.86.

    b. $9,876.04

    c. $9,877.22.

    d. $10,000.00.

17. SFAS No. 115 requires that CIRAs disclose certain information in the notes to the financial statements for major security types. Which of the following is one of the disclosures required for available for sale securities?

    a. Gross unrecognized holding losses.

    b. Gains and losses, grossed up and recorded in accumulated other comprehensive income.

    c. Total gains for the securities, with the net gains recorded in accumulated other comprehensive income.

SELF-STUDY ANSWERS

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

14. One type of debt security is a U.S. Treasury security, which includes bills, notes, and bonds. All of the following statements about U.S. Treasury bills (T bills) are correct **except** for? **(Page 29)**

    a. 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. [This is the incorrect answer. The statement is correct. Based on the quoted yield, the discount is similar to an interest rate.]

    b. T bills are obligations of the U.S. government with a term that exceeds one year or more. [This is the correct answer. A T bill is an obligation of the U.S. government with a term that is one year or LESS.]

    c. T bills require a minimum investment of $10,000. [This is the incorrect answer. This statement is correct. The T bills have scheduled maturities at 3 months, 6 months, or 12 months.]

    d. The difference between the purchase price and the par value of a T bill is called "accreted interest," which is paid when the T bill matures. [This is the incorrect answer. The statement is correct. T bills are issued in book form only; there are no physical certificates.]

15. The rules governing accounting for T bills differ for tax and financial reporting purposes. Which of the following statements about accounting for T bills is **not** correct? **(Page 30)**

    a. Since T bills normally have low yields and mature over short periods, the effect of discount accretion normally is not material to the financial statements. [This is the incorrect answer. This statement is correct. In rare circumstances, the effect would be material to the financial statements. In this rare case the accountant should accrete the discount because that would be consistent with the general accounting for other discounts.]

    b. When purchased, T bills should be recorded at cost, which will be a discount from their $10,000 par value. [This is the incorrect answer. This statement is correct. For example, if a CIRA purchased a 91-day T bill on July 30, 20X1, at 96, the accountant would debit short-term investments and credit cash for $9,600.]

    c. Even though T bills do not pay coupon interest, the discount represents interest at the yield quoted at the date of acquisition. [This is the incorrect answer. This statement is correct. For example, if a CIRA purchased a 91 day T bill on June 1, 20X1, at 97, the discount of $300 ($10,000 maturity value minus $9,700 cost at acquisition) represents the interest.]

    d. According to IRC Section 454(b)(2), the discount should be accreted and over the life of the bill. [This is the correct answer. According to IRC Section 454(b)(2), the discount is not accreted; instead, all of the discount should be reported as interest income if the T bill is held to maturity.]

16. Stephen is calculating the fair value of a T bill that his homeowner's association has on the books. The HOA originally purchased the T bills for $10,000. He has the following information:

Maturity	Days to Maturity	Bid	Asked	Yield
Dec 15 'X9	85	5.25	5.20	5.30

What is the fair value of the T bills? **(Page 31)**

a. $9,874.86. [This answer is incorrect. This is the calculation of fair value using the yield price. The fair value calculation is not based on the yield.]

b. $9,876.04 [This answer is correct. The fair value calculation would be computed as follows: Fair value = $10,000 – (($10,000 x .0525 x 85)/360). The calculation uses the bid price and the days to maturity.]

c. $9,877.22. [This answer is incorrect. Fair value calculation does not use the asked price, which is used in this calculation. While GAAP does not specify which price to use, this is not the recommended price.]

d. $10,000.00. [This answer is incorrect. This is the current value of the T bills, but not the current fair value based on the market.]

17. SFAS No. 115 requires that CIRAs disclose certain information in the notes to the financial statements for major security types. Which of the following is one of the disclosures required for available for sale securities? **(Page 35)**

a. Gross unrecognized holding losses. [This answer is incorrect. This is a disclosure requirement for held to maturity securities, not available for sale securities.]

b. Gains and losses, grossed up and recorded in accumulated other comprehensive income. [This answer is incorrect. The gross gains and losses recorded should be recorded in accumulated other comprehensive income for any derivatives that hedge the forecasted acquisition of the held to maturity securities. This disclosure is required in SFAS No. 115.]

c. Total gains for the securities, with the net gains recorded in accumulated other comprehensive income. [This answer is correct. One item required to be disclosed in the notes to the financial statements for available for sale securities is the total gains for the securities with net gain recorded in accumulated other comprehensive income. The two other disclosures required are the aggregate fair value and the total losses for securities with net losses recorded in accumulated other comprehensive income.]

Derivative Instruments

SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* (as amended) (FASB ASC 815), establishes accounting and reporting standards for derivative instruments and hedging activities. SFAS No. 133 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 SFAS No. 133 (FASB ASC 815) need not be applied to immaterial items. For example, a CIRA is not required to comply with SFAS No. 133 (FASB ASC 815) if its only derivative instrument is an immaterial speculative investment in a derivative.

Statement on Auditing Standards (SAS) No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, provides guidance on auditing financial statement assertions about derivatives accounted for following the requirements of SFAS No. 133. (FASB ASC 815) In addition, the AICPA issued a companion audit guide with the same title, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*. Although designed as audit guidance, the guidance in SAS No. 92 and the companion audit guide is often helpful in other engagements as the audit guide has a variety of case studies that include illustrative accounting considerations. CIRAs do not commonly use derivatives to manage risk.

What Is a Derivative? SFAS No. 133 (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 SFAS No. 133. SFAS No. 133 (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 (1) issued or held by the reporting entity, (2) indexed to Its own stock, and (3) 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 SFAS No. 123 (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. However, CIRAs do not commonly use derivatives to manage risk.

General Measurement Considerations. SFAS No. 133 (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. Interpretation 1 to AU Section 332 (AU 9332.01–.04), "Auditing Investments in Securities Where a Readily Determinable Fair Value Does Not Exist," provides guidance to auditors when a readily determinable fair value cannot be obtained.

Types of Derivative Instruments. SFAS No. 133 (FASB ASC 815) defines the following three types of hedging instruments, for which the accounting for gains and losses from hedging transactions vary:

a. *Fair Value Hedge.* Fair value hedges are intended to hedge the exposure to changes in the fair value of a recognized asset or liability (or an unrecognized firm commitment) due to a particular risk.

b. *Cash Flow Hedge.* Cash flow hedges are intended to hedge the exposure to variability in expected future cash flows due to a particular risk. The exposure may relate to an existing asset or liability (such as future interest payments on variable-rate debt) or a forecasted transaction (such as a forecasted sale).

c. *Foreign Currency Hedges.* An entity may designate the following types of hedges of foreign currency exposure:

   - A fair-value hedge of an unrecognized firm commitment or a recognized asset or liability (including an available-for-sale security).
   - A cash-flow hedge of a forecasted transaction, an unrecognized firm commitment, the forecasted equivalent functional currency cash flows related to a recognized asset or liability, or a forecasted intercompany transaction.
   - A hedge of a net investment in a foreign operation.

   SFAS No. 133 (FASB ASC 815) provides detailed requirements that must be met in order to use fair value or cash flow hedge accounting and detailed accounting requirements for each type of hedge. Additionally, the operation of foreign currency hedges and the considerations in accounting for them are complex and difficult to follow. Since CIRAs do not commonly use derivatives to mange risk, further information about accounting for these hedging instruments is not provided within this discussion.

General Disclosure Considerations. SFAS No. 133 (FASB ASC 815-10-50-1) 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 SFAS No. 115 (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 SFAS No. 107 (FASB ASC 825-10). SFAS No. 107 (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 and the decline is determined to be other than temporary, the security's fair value at the measurement date becomes its new cost basis. The decline in value below cost should be accounted for the same as a realized loss with the amount of the write-down included in earnings.

FSP FAS 115-1 and FAS 124-1, "*The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*," (FASB ASC 320-10) provides guidance regarding the meaning of other-than-temporary impairment and its application to debt and equity securities within the scope of SFAS No. 115 (FASB ASC 320-10). The FSP provides guidance for (a) determining when an investment is considered impaired, (b) determining whether the impairment is other than temporary, and (c) measuring and recognizing 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 basis for accretion, amortization, previous other-than-temporary impairments, 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 should 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. The FSP 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 paragraph 16 of SFAS No. 115 (FASB ASC 320-10-35-18), paragraph 6 of APB Opinion No. 18 (FASB ASC 323-10-35-31), or EITF Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets (FASB ASC 325-40)."

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 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.

GAAP requires certain disclosures for investments in an unrealized loss position for which an other-than-temporary impairment has not been recognized.

To illustrate the accounting for impairment of 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 should 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 should be recognized in other comprehensive income. Subsequent recoveries in value are not recognized in excess of revenues over expenses until they are realized.

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 equity, 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. Accounting for income taxes in the financial statements is discussed later in this lesson.

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.

18. SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, establishes accounting and reporting standards for derivative instruments. Which of the following is **not** a derivative in accordance with SFAS No. 133?

    a. Investments in life insurance.

    b. Interest rate swaps.

    c. Options to establish a range of interest rates.

    d. Forward contracts to buy foreign currency.

19. CIRAs sometimes 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. Which of the following statements best describes accounting for annuities?

    a. Annuities should be recorded at fair market value in the financial statements.

    b. Because they are financial instruments, annuities are within the scope of SFAS No. 115.

    c. The fair value of annuity contracts at the date of the financial statements should be disclosed in accordance with SFAS No. 107.

    d. Variable annuities specify the payments to be made in units rather than in dollars. When payment is due, the amount is determined based on the cost of the investments in the annuity fund.

20. Happy Homeowners, an HOA for a subdivision in Happy, TX, purchased some securities in year 1 and needs to record an impairment for the securities at the end of year 2. An available for sale security costing $60,000 was adjusted to its $75,000 fair value through a $15,000 increase in other comprehensive income during year 1. By the end of year 2, the fair value of the security declined by $20,000, and the decline is determined to be other than temporary. Which of the following is correct?

    a. Only gains in fair values are recorded in the financial statements.

    b. The financial basis of the security at the end of year 2 should be $60,000.

    c. The change in other comprehensive income for year 2 will be a loss of $15,000.

    d. No decrease in excess of revenues over expenses should be recognized for the decrease in value from the security.

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. SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, establishes accounting and reporting standards for derivative instruments. Which of the following is **not** a derivative in accordance with SFAS No. 133? **(Page 40)**

    a. Investments in life insurance. [This is the correct answer. SFAS No. 133 excludes some common types of contracts from its scope that, depending on the facts and circumstances, otherwise might be considered derivatives. An investment in life insurance is one of those contracts that is excluded.]

    b. Interest rate swaps. [This is the incorrect answer. An interest rate swap is an example of a derivative instrument.]

    c. Options to establish a range of interest rates. [This is the incorrect answer. An option to establish a range of interest rates is an example of a derivative instrument.]

    d. Forward contracts to buy foreign currency. [This is the incorrect answer. A forward contract to buy foreign currency is an example of a derivative instrument.]

19. CIRAs sometimes 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. Which of the following statements best describes accounting for annuities? **(Page 41)**

    a. Annuities should be recorded at fair market value in the financial statements. [This is an incorrect answer. Annuities should be recorded at cost in the financial statements.]

    b. Because they are financial instruments, annuities are within the scope of SFAS No. 115. [This is an incorrect answer. Because they are not securities, annuities are not within the scope of SFAS No. 115.]

    c. The fair value of annuity contracts at the date of the financial statements should be disclosed in accordance with SFAS No. 107. [This is the correct answer. Because annuities are financial instruments, the fair value of annuity contracts at the date of the financial statements should be disclosed in the financial statements in accordance with SFAS No. 107.]

    d. Variable annuities specify the payments to be made in units rather than in dollars. When payment is due, the amount is determined based on the cost of the investments in the annuity fund. [This is the incorrect answer. When payment is due, the amount is determined based on the value, not the cost, of the investments in the annuity fund.]

20. Happy Homeowners, an HOA for a subdivision in Happy, TX, purchased some securities in year 1 and needs to record an impairment for the securities at the end of year 2. An available for sale security costing $60,000 was adjusted to its $75,000 fair value through a $15,000 increase in other comprehensive income during year 1. By the end of year 2, the fair value of the security declined by $20,000, and the decline is determined to be other than temporary. Which of the following is correct? **(Page 42)**

    a. Only gains in fair values are recorded in the financial statements. [This answer is incorrect. Impairment losses should be recognized in earnings if the impairment is deemed to be other than temporary.]

    b. The financial basis of the security at the end of year 2 should be $60,000. [This answer is incorrect. The financial basis of the security should be decreased to $55,000 from its year 1 fair value of $75,000 to value the security at its current fair value since the decline in value is other than temporary.]

    c. The change in other comprehensive income for year 2 will be a loss of $15,000. [This answer is correct. The security was increased $15,000 in other comprehensive income in year 1 and the loss of $20,000 should be recorded at the end of year 2. The change in comprehensive income for year 2 will be a decrease of $15,000, and the remaining $5,000 decrease will be recorded as a decrease in excess of revenues over expenses.]

    d. No decrease in excess of revenues over expenses should be recognized for the decrease in value from the security. [This answer is incorrect. If the security's cost to its current fair value is a decrease, then a decrease in excess of revenues over expenses should be recognized.]

RECEIVABLES, MEMBER ASSESSMENTS, AND OTHER INCOME

Overview of Accounting Standards

Accounting standards for receivables relate primarily to 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.

Disclosure Requirements from SOP 01-6. SOP 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others* (primarily FASB ASC 310-10-50 and 860-20-50 as it relates to the financing activities of most entities), applies to any entities, including CIRAs, that lend to or finance the activities of others. Trade receivables are a type of financing activity for purposes of the SOP. A financing arrangement may involve extending credit relating to the CIRA's programs. Receivables may relate to any activity or facility that serves the CIRA community, such as a restaurant, clubhouse, marina, etc.

One of the reasons that the SOP was issued was to provide consistent accounting and reporting for like transactions. For trade receivables, SOP 01-6 (FASB ASC 310-10-35-47) requires entities to report receivable balances on the statement of financial position less an allowance for uncollectibles. This is consistent with current accounting guidance. The SOP (FASB ASC 310-10-45; 310-10-50) also provides certain presentation and disclosure requirements for all entities and certain additional requirements for financial institutions, credit unions, and other specialized entities. (FASB ASC 942 and 948)

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, timeshare developments typically bill their dues on a quarterly or annual basis.) In certain circumstances, 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. The members' tax election should be treated as follows in the CIRA's financial statements:

- If the members elect to refund the excess assessments, it is believed that the refund should 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. In other words, equity should be debited, and cash or a payable account should be credited.

- If the members elect to apply the excess against the following year's assessments, no entry should 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 should be shown as a Schedule M-1 or M-3 adjustment if the CIRA files Form 1120.)

Most 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 usually are not 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 should be recorded in a separate

income account, such as "Late fees" or "Interest on delinquent assessments." (If they are not material, however, fees for delinquent assessments may be added to revenue from member assessments.) The CIRA's accounting records should 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 documents may provide that default in payment of assessments accelerates the remaining assessments for the year, and the entire balance is due and payable.

SFAS No. 5, *Accounting for Contingencies* (FASB ASC 310-10-35-9 through 35-11), requires 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. Some accountants believe, however, that an allowance for uncollectible receivables need not be recorded in a CIRA's financial statements since their 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, liens do not ensure the collectibility of the receivables. Since liens filed by the CIRA for unpaid assessments generally are 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 timeshare 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. Optimistically, however, the recent passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 is expected to have a positive impact for CIRAs by increasing the amount of delinquent assessments that will be collectible from unit owners who file for bankruptcy.

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.

APB Opinion No. 12 (FASB ASC 310-10-45-4) states that allowances for losses on receivables should be deducted from the related receivables (rather than reporting them as liabilities) and that the allowances should 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

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. Many members prepay the entire amount. Prepaid amounts at the balance sheet date should be classified as a liability—deferred revenue. (If a classified balance sheet is presented, it generally would be appropriate to classify assessments received in advance as a current liability.) Amounts billed but not received by year end should not be recorded as receivables. This is believed to be proper because the services the assessments pay for will not have been rendered by year end.

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. Amounts assessed for normal operations should 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.

Special Assessments

CIRAs generally have the authority to levy special assessments, subject to unit owner approval in some circumstances, as specified in their governing documents or state statutes. Frequently, CIRAs levy special assessments to fund future major repairs and replacements as an alternative to or in addition to regular monthly assessments. They also may levy special assessments to cover operating deficits or other significant expenses, such as litigation costs, or to provide for unanticipated expenses (sometimes referred to as *contingency reserves*). Unanticipated expenses can include (a) funds to cover a specific unanticipated event, such as to replace leaking pipes, and (b) funds to build up or repay the CIRA's contingency reserves. Special assessments should be reported as revenue in the CIRA's financial statements in the period they are levied unless the special assessments are designated for specific expenditures that have not yet been incurred. 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 should be 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 generally are recorded in the replacement fund.

The AICPA guide (in Paragraph 4.12) (FASB ASC 972-430-25-1) does not provide detailed guidance on the criteria for recognizing special assessments as either revenue or deferred revenue beyond stating that deferred revenue may be recorded for special assessments designated for specific costs that have not yet been incurred, and that such amounts should not be reported as revenue unless the corresponding liabilities and expenses are reported. The key to determining whether it is appropriate to defer special assessment revenue depends on the specificity of the need to make future expenses. 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. In contrast, if the CIRA levies special assessments periodically over the estimated life of the common property for as yet undetermined repairs that will be required in some future period, the special assessment revenue generally should be reported as revenue in the period levied.

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 should be deferred in that case and recognized as revenue as the related litigation costs are incurred. This is recommended even though settlement is not expected until several years in the future.

Applying the preceding criteria obviously involves judgment, and gray areas exist. However, special assessments levied for the following purposes should 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

Financial Statement Disclosures. Paragraph 4.22 of the AICPA guide (FASB ASC 972-605-50-1) requires the proposed use for funds collected from special assessments to be disclosed. If special assessment revenue is deferred, the authors also recommend disclosing an estimate of when the related expenses are expected to be incurred.

Refunds of Excess Special Assessments. Sometimes special assessments may exceed the specific expenses for which they were levied, and the CIRA may elect to return the excess to its members. In those circumstances, the authors believe that the refund should be reported 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 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. In addition, the calculation of assessments due from the developer may vary with the phases of the development project. Accordingly, accountants should 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.

SFAS No. 57, *Related Party Disclosures*, (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 (i.e., assessments revenue from the developer on unsold lots), that fact and the amount of revenue from each such source should be disclosed. (FASB ASC 972-605-50-2)

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 SFAS No. 5 (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 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, financial statements should not 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.

SELF-STUDY QUIZ

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

21. Member assessments usually are due and payable on the first of the month. Thus, at the balance sheet date, assessments receivable usually are not 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. Which of the following statements best describes accounting for delinquent member assessments?

    a. Fees for delinquent payments should be recorded in a separate income account, such as "Late fees" or "Interest on delinquent assessments."

    b. Revenues from late fees and interest on delinquent accounts may be combined into one account in the accounting records.

    c. An allowance for uncollectible receivables need not be recorded in a CIRA's financial statements if their governing documents provides for the filing of liens as a remedy.

    d. Generally accepted accounting principles require uncollectible accounts to be accounted for using the specific write-off method.

22. A CIRA's annual budget generally will specify the portion of the annual assessments to be allocated for replacement funds. Which of the following statements about accounting for assessments for replacement funds is **not** correct?

    a. Amounts assessed for normal operations should be accounted for separately from amounts assessed for future major repairs and replacements.

    b. As assessments are billed, assessment revenue should be allocated between operations and the replacement fund as budgeted (regardless of the amount transferred to the replacement fund).

    c. 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.

    d. Because assessment revenue is allocated between operations and repairs and replacements, assessments receivable, assessments received in advance, and late charges and interest for delinquent assessments also should be allocated between operations and repairs and replacements.

23. CIRAs generally have the authority to levy special assessments to fund future major repairs and replacements as an alternative to or in addition to regular monthly assessments. Sometimes, there are questions as to whether the special assessments should be recognized as revenue or deferred revenue in the CIRA's financial statements. Revenue from special assessments should be recognized in the period the assessment is levied in **all but which** of the following circumstances?

    a. Special assessments to cover operating deficits or to raise additional working capital.

    b. Special assessments for unanticipated expenses (that is, for "contingency reserves").

    c. Special assessment to cover a future roof repair.

    d. Special assessments to cover any expenses that have already been incurred.

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. Member assessments usually are due and payable on the first of the month. Thus, at the balance sheet date, assessments receivable usually are not 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. Which of the following statements best describes accounting for delinquent member assessments? **(Page 48)**

    a. **Fees for delinquent payments should be recorded in a separate income account, such as "Late fees" or "Interest on delinquent assessments." [This is the correct answer. Fees for delinquent payments should be recorded in a separate income account, such as "Late fees" or "Interest on delinquent assessments." If they are not material, however, fees for delinquent assessments may be added to revenue from member assessments.]**

    b. Revenues from late fees and interest on delinquent accounts may be combined into one account in the accounting records. [This is the incorrect answer. The CIRA's accounting records should 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.]

    c. An allowance for uncollectible receivables need not be recorded in a CIRA's financial statements if their governing documents provides for the filing of liens as a remedy. [This is the incorrect answer. Liens do not ensure the collectibility of the receivables. Since liens filed by the CIRA for unpaid assessments generally are 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.]

    d. Generally accepted accounting principles require uncollectible accounts to be accounted for using the specific write-off method. [This is the incorrect answer. 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.]

22. A CIRA's annual budget generally will specify the portion of the annual assessments to be allocated for replacement funds. Which of the following statements about accounting for assessments for replacement funds is **not** correct? **(Page 50)**

    a. Amounts assessed for normal operations should be accounted for separately from amounts assessed for future major repairs and replacements. [This is an incorrect answer. Amounts assessed for normal operations should be accounted for separately from amounts assessed for future major repairs and replacements.]

    b. As assessments are billed, assessment revenue should be allocated between operations and the replacement fund as budgeted (regardless of the amount transferred to the replacement fund). [This is an incorrect answer. As an assessment is billed, assessment revenue should be allocated between operations and the replacement fund as budgeted (regardless of the amount transferred to the replacement fund.]

    c. 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. [This is the incorrect answer. 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."]

d. Because assessment revenue is allocated between operations and repairs and replacements, assessments receivable, assessments received in advance, and late charges and interest for delinquent assessments also should be allocated between operations and repairs and replacements. [This is the correct answer. Although assessment revenue is allocated between operations and repairs and replacements, 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.]

23. CIRAs generally have the authority to levy special assessments to fund future major repairs and replacements as an alternative to or in addition to regular monthly assessments. Sometimes, there are questions as to whether the special assessments should be recognized as revenue or deferred revenue in the CIRA's financial statements. Revenue from special assessments should be recognized in the period the assessment is levied in **all but which** of the following circumstances? **(Page 50)**

a. Special assessments to cover operating deficits or to raise additional working capital. [This is the incorrect answer. Special assessments should be reported as revenue in the CIRA's financial statements in the period they are levied unless the special assessments are designated for specific expenditures that have not yet been incurred. Therefore, since the CIRA has already incurred the operating deficit to which the special assessment relates, it should record the special assessment as revenue in the period it is levied.]

b. Special assessments for unanticipated expenses (that is, for "contingency reserves"). [This is the incorrect answer. If the CIRA levies special assessments periodically over the estimated life of the common property for as yet undetermined repairs that will be required in some future period, the special assessment revenue generally should be reported as revenue in the period levied.]

c. Special assessment to cover a future roof repair. [This is the correct answer. The AICPA guide states that deferred revenue may be recorded for special assessments designated for specific costs that have not yet been incurred; further, it states that such amounts should not be reported as revenue unless the corresponding liabilities and expenses are reported. Generally, special assessments should be recorded as revenue in the period they are levied EXCEPT when the CIRA has identified the need for specific future expenses, but they have not yet been incurred. The key to determining whether it is appropriate to defer special assessment revenue depends on the specificity of the need to make future expenses. 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.]

d. Special assessments to cover any expenses that have already been incurred. [This is the incorrect answer. Special assessments should be reported as revenue in the CIRA's financial statements in the period they are levied unless the special assessments are designated for specific expenditures that have not yet been incurred. Therefore, a special assessment levied to cover expenses that have already been incurred should be recorded as revenue in the CIRA's financial statements.]

Disclosing Concentrations of Credit Risk

SFAS No. 107, *Disclosures about Fair Value of Financial Instruments* (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. Following are discussions of the definition of a financial instrument; credit risk and market risk; and a discussion of the unique issues related to financial instrument disclosures related to CIRAS.

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. SFAS No. 107 (FASB ASC 825-10-50-20 through 50-22) requires 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 prevailing opinion is that 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 represent fees due 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 SFAS No. 107 (FASB ASC 825-10-50). The authors believe, however, the disclosures required by SFAS No. 57, *Related Party Disclosures* (FASB ASC 850-10-50), provide all of the information required by SFAS No. 107 (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. SFAS No. 107 requires 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*. Best practices indicate that whether concentrations of credit risk are significant should be evaluated in the context of the maximum loss that could result. Thus, they 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, the credit risk for cash deposits is believed to be 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 is 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 such a negligible risk should be ignored for purposes of disclosing concentrations of credit risk. Furthermore, in a Technical Practice Aid (TIS 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 the aggregate materiality of numerous immaterial uninsured cash balances on deposit with several banks should be disclosed. 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, the authors believe that insurance provided by the SIPC is 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 footnotes 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, the authors believe the practitioner should 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 footnote should 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. Best practices indicate that disclosures are not required for amounts invested in Treasury bills. Because the face amount of the Treasury bill is guaranteed, the investment can be considered 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. Certain disclosures are required by SFAS No. 115. (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 should 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* describes 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. In general, however, the AICPA guide (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. 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 should develop adequate accounting systems to account for such revenues. This places a much greater burden on the association's accounting system, and 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 should not only be able to provide 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. Information related to the financial and reporting considerations of food and beverage operations is included in *PPC's Guide to Restaurants and Bars*, which is available by calling (800) 323-8724, or online at **ppc.thomson.com**.

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 what amount should 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 should be accounted for as costs related to the ancillary operation. The association should 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 should determine if and how it should allocate such indirect costs.

Capitalization and Depreciation. Capitalization of common real property is unique in the CIRA industry. 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 the AICPA guide. (FASB ASC 972)

- 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, 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. 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 mere fact that revenue is recognized differently 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. Reserves should be established for all association maintained assets (whether capitalized or not). It is the responsibility of the board of directors to assess an adequate amount to cover operating and reserve 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 reserve for maintenance and replacement of income-producing assets, irrespective of revenues generated by the underlying ancillary activity.

Normally, reserves for assets used in ancillary activities should be accounted for as part of that activity.

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;
- Nonrefundable fees, such as key fees;
- Transfer fees and flip taxes; and
- 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. There are three basic approaches to recovering those costs from the members.

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 a. in above is the same as accounting for member assessments. In practice, accounting for separately billed utility costs such as those in b. and c. (above) may be handled in 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.

There is no authoritative guidance on accounting for utility pass-throughs. If the amounts are material, disclose the approach used in the notes to the financial statements.

SELF-STUDY QUIZ

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

24. 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. Which of the following is **not** a financial instrument?

    a. Investments in common stock.

    b. Accrued expenses receivable.

    c. Loan commitments.

    d. Deferred revenue for membership assessments received in advance, when settled by providing services for the period covered by the payment.

25. Capitalization of common real property is unique in the CIRA industry. Assume that Association XYZ is a planned development with a golf course valued at $10,000,000. Although Association XYZ has title to the golf course property, it only charges green fees to members' guests; revenue received is not significant to the association. How should Association XYZ account for the common real property?

    a. Association XYZ should not capitalize this $10,000,000 asset.

    b. Association XYZ should capitalize the $10,0000,000 asset. However, it should not depreciate it.

    c. Association XYZ should capitalize the $10,0000,000 asset and record depreciation on it.

    d. Association XYZ should expense the $10,000,000 asset in the period in which construction is completed.

26. 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 CIRAs are billed for the total cost of the service at a reduced rate. The CIRA then has to decide how to account for those pass-through costs. Which of the following is **not** one of the three basic approaches a CIRA might use to recover such costs?

    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.

    c. Levy a special assessment to cover these pass through costs.

    d. Estimated allocated costs may be billed to the members annually to avoid possible unfavorable tax treatment.

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.)**

24. 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. Which of the following is **not** a financial instrument? **(Page 56)**

    a. Investments in common stock. [This is the incorrect answer. An investment in common stock represents ownership interest in an entity which is paid for by the exchange of cash or other financial instrument. Accordingly, it meets the definition of a financial instrument.]

    b. Accrued expenses receivable. [This is the incorrect answer. Accrued expenses receivable represent a contractual obligation that requires the exchange of cash or other financial instrument. Therefore, it meets that definition of a financial instrument.]

    c. Loan commitments. [This is the incorrect answer. A loan commitment represents a contractual obligation that requires the exchange of cash or other financial instrument. Therefore, it meets that definition of a financial instrument.]

    d. Deferred revenue for membership assessments received in advance, when settled by providing services for the period covered by the payment. [This is the correct answer. Since settlement is not for cash, the deferral revenue is not a financial instrument. But assessments receivable recognized by the CIRA for expired periods would be considered financial instruments.]

25. Capitalization of common real property is unique in the CIRA industry. Assume that Association XYZ is a planned development with a golf course valued at $10,000,000. Although Association XYZ has title to the golf course property, it only charges green fees to members' guests; revenue received is not significant to the association. How should Association XYZ account for the common real property? **(Page 60)**

    a. Association XYZ should not capitalize this $10,000,000 asset. [This is the correct answer. Excluding cooperatives, CIRAs capitalize common real property only if the CIRA has title or other evidence of ownership of the property, and 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 or (2) the property is used by the CIRA to generate significant cash flows from members on the basis of usage or from nonmembers. While Association XYZ has title to the golf course property, it does not charge green fees to its members. Furthermore, 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. 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 XYZ does not capitalize this $15,000,000 asset.]

    b. Association XYZ should capitalize the $10,0000,000 asset. However, it should not depreciate it. [This is the incorrect answer. The golf course does not meet the conditions for capitalization. If it did, however, the association should record depreciation on it based upon estimated useful lives of the underlying assets.]

    c. Association XYZ should capitalize the $10,0000,000 asset and record depreciation on it. [This is the incorrect answer. The golf course does not meet the conditions for capitalization.]

    d. Association XYZ should expense the $10,000,000 asset in the period in which construction is completed. [This is the incorrect answer. Since the association's golf course does not meet the capitalization criteria, it would record the expense in the period incurred.]

26. 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 CIRAs are billed for the total cost of the service at a reduced rate. The CIRA then has to decide how to account for those pass-through costs. Which of the following is **not** one of the three basic approaches a CIRA might use to recover such costs? **(Page 61)**

    a. Basic monthly assessments may be increased to cover the allocated costs. [This is the incorrect answer. Increasing basic assessments to cover such costs is a common approach.]

    b. The allocated costs may be billed to the members separately from the monthly assessments. [This is the incorrect answer. Allocating costs to members separately from the monthly assessments is a common approach to recovering such costs.]

    c. Levy a special assessment to cover these pass through costs. [This is the correct answer. A CIRA generally would not levy a special assessment to recover pass through costs from its members.]

    d. Estimated allocated costs may be billed to the members annually to avoid possible unfavorable tax treatment. [This is the incorrect answer. Billing estimated costs annually is a common way in with a CIRA might recover such costs.]

ACCOUNTING FOR COMMON PROPERTY AND OTHER REAL PROPERTY

Probably the most controversial issue that arose during the development of the AICPA guide concerned how to account for common property. A fundamental difference of opinion between the AICPA's Accounting Standards Executive Committee (AcSEC) and the FASB delayed the issuance of the guide for more than a year. Unfortunately, the two standards-setting bodies were ultimately unable to reach a compromise. Accordingly, the AICPA guide does not establish requirements or provide recommendations for accounting for common *real* property. Rather, the guide describes "prevalent industry practice" in that regard. This section discusses the AICPA guide's descriptions of 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. The AICPA guide (FASB ASC 972-10-05-4) defines common property as follows:

- 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 exclusive use of the common property within the development. 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 should capitalize common property as assets in their financial statements.

Capitalizing Common Real Property

Categories of Common Real Property. Paragraph 2.07 (FASB ASC 972-360-25) of the AICPA guide 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 the AICPA guide (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, the AICPA guide states at Paragraph 2.10 (FASB ASC 972-360-25-3) 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 as described in the AICPA guide.

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	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

* * *

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.

The AICPA guide (FASB ASC 972-360-25-4) notes, however, that 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. 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 2-5

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 timeshare 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.

As stated previously, 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, some accountants believe that CIRAs need not 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.

CIRAs should conform to the prevalent industry practice described in the AICPA guide 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 is believed the CIRA should capitalize it. Most CIRAs will probably 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 should 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 should 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 should 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 should 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, the recommendation is to capitalize the roads as soon as the CIRA 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.

CIRAs should 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, the CIRA should record a prior period adjustment by restating the prior-period financial statements for the correction of an error in accordance with SFAS No. 154, *Accounting Changes and Error Corrections* (FASB ASC 250-10), if the error would be material to the financial statements.

Capitalizing Common Personal Property

Certain types of CIRAs may have material common personal property. For example, timeshare associations may own the interior furnishings in the units, and large-scale commercial condominium projects usually own considerable maintenance equipment and lobby furniture. Paragraph 2.11 of the AICPA guide 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 described previously. (Furthermore, during the deliberations of the AICPA guide, both the AcSEC and the FASB believed that CIRAs should capitalize common personal property.)

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 stating a minimum useful life and a minimum dollar amount that is required to be spent before an expenditure is capitalized. It should also address 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 should 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, the AICPA guide requires purchased common property to 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. Paragraph 2.12 of the AICPA guide (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 should be determined in conformity with SFAS No. 157, *Fair Value Measurements* (FASB ASC 820-10). The AICPA guide suggests that it may be helpful to consider the developer's cost, if known, in determining fair value.

SFAS No. 157 Fair Value Measurements, (FASB ASC 820-10) defines *fair value*, provides a framework for measuring fair value within GAAP, and modifies disclosures about fair value required by other pronouncements. The Statement 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.

SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. However, FSP FAS 157-2, *Effective Date of FASB Statement No. 157,* permits delaying the application of SFAS No. 157 for nonfinancial assets and nonfinancial liabilities except those items that are recognized or disclosed at fair value in the financial statements on a recurring basis at least annually. If SFAS No. 157 has not previously been adopted, the delayed effective date for applicable items would be fiscal years beginning after November 15, 2008, and interim periods within those years.

Until CIRAs adopt SFAS No. 157, they should continue to follow the fair value guidance in ABP Opinion No. 29, *Accounting for Nonmonetary Transactions.* Paragraph 25 of APB 29 states that fair value can be determined "by referring to estimated realizable values in cash transactions of the same or similar exchange, and other available evidence."

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 or foreclose on units for nonpayment of delinquent assessments. It is believed that transactions in which condominium and homeowners' associations receive units for nonpayment of delinquent assessments are, in essence, in-substance foreclosures as defined by SFAS No. 15 (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.

In both cases, the units should 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. A gain on the transfer of a unit would probably 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, the authors believe the unit should nonetheless 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.

Common Property Leased by the CIRA. Real or personal property that is leased by the CIRA should be reported following the guidance in SFAS No. 13, *Accounting for Leases* (FASB ASC 840), and related pronouncements on leasing transactions. Two additional pronouncements that may provide valuable leasing arrangement information to CIRAs include FASB Technical Bulletin 85-3, *Accounting for Operating Leases with Scheduled Rent Increases* (FASB ASC 840), and FSP No. FAS 13-1, "Accounting for Rental Costs Incurred during a Construction Period (FASB ASC 840)." FASB Technical Bulletin 85-3 provides guidance to determine how to allocate rental costs over the lease term. FSP No. FAS 13-1 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 SFAS No. 34. (FASB ASC 835-20)

Impaired Assets. SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (FASB ASC 360-10; 205-20), provides 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 should be 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 contained within the guidance of SFAS No. 144 (FASB ASC 360-10). FSP No. FAS 144-1 (FASB ASC 310-40-30-2), 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 SFAS No. 144 subsequent to foreclosure.

Asset Retirement Obligations. SFAS No. 143, *Accounting for Asset Retirement Obligations* (FASB ASC 420), and FASB Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations (FASB ASC 410-20)," 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 SFAS No. 144, *Accounting for Impairment or Disposal of Long-Lived Assets* (FASB ASC 205-20; 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 Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations—an Interpretation of FASB Statement No. 143 (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, SFAS No. 143 (FASB ASC 410-20-50-2) requires disclosure of that fact and the reasons for it. The CIRA also must make certain financial statement disclosures.

Reporting Common Property in Financial Statements

If a CIRA presents its financial statements using fund accounting, capitalized common property should be reported as assets in the operating fund or a separate fund established for that purpose. Accounting entries should be made if expenditures for asset acquisitions are made by the replacement fund.

Financial Statement Disclosures

The AICPA guide (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, CIRAs often 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. The 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 would not differ materially from GAAP provided salvage value is not material. Large acquisitions other than real estate and three-year and five-year property should 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.

SELF-STUDY QUIZ

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

27. According to the AICPA guide, 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 individual units. Furthermore, the AICPA guide states that most condominium and homeowners' associations capitalize common real property not directly associated with the units only in certain circumstances. Which of the following statements best summarizes prevalent industry practice for condominium and homeowners' associations for capitalizing common real property?

    a. Exterior walls, roofs, and driveways should be capitalized.

    b. Managers' apartments should be capitalized if the condominium association or HOA has title to the manager's apartment and would be able to sell and retain proceeds from the sale.

    c. Recreational equipments should not be capitalized.

    d. Greenbelts should be capitalized.

28. The AICPA guide provides guidance on how CIRAs should value common and other real property. Which of the following statements best describes how a CIRA should account for common property acquired?

    a. Common property purchased by a CIRA should be recorded at fair market value.

    b. Common property acquired in a nonmonetary transaction, such as by a nonreciprocal transfer from the developer, should be recognized at cost.

    c. A unit transferred from the developer to a condominium association in settlement of litigation should be recorded at the fair value on the date of transfer plus actual closing costs.

    d. Units foreclosed on for nonpayment of delinquent assessments should be recorded at the amount of the delinquent assessments.

29. The Meadowbrook Homeowners' Association presents its financial statements using fund accounting and all of its common property is capitalized. List all of the following disclosures that the CIRA should make about the common property in its financial statements.

        i. Responsibility held by the CIRA for maintenance and preservation of the common property.
        ii. The CIRA's accounting policies for recognizing and measuring the common property.
        iii. Any restrictions on disposition or use of the common property.
        iv. Any terms and conditions related to the existing land or recreation leases.
        v. Description of the property that the CIRA has title to or any other evidence of ownership that is not capitalized.
        vi. Description of capitalized property.

    a. v. and vi.

    b. i., ii., and iii.

    c. i., ii., iii., iv., and v.

    d. i., ii., iii., iv., and vi.

30. If CIRAs capitalize common property, GAAP requires that it be depreciated based on the property's estimated useful life using the same accounting principles that apply to commercial businesses. However, depreciation rules differ for tax purposes. Which of the following statements about depreciation for financial reporting and tax purposes is **incorrect**?

    a. 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.

    b. GAAP requires depreciating asset cost over its estimated useful life using an acceptable method such as straight-line or declining balance.

    c. For tax purposes, 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.

    d. If CIRAs elect straight-line depreciation for tax reporting, there would be no difference between MACRS and GAAP.

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.)**

27. According to the AICPA guide, 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 individual units. Furthermore, the AICPA guide states that most condominium and homeowners' associations capitalize common real property not directly associated with the units only in certain circumstances. Which of the following statements best summarizes prevalent industry practice for condominium and homeowners' associations for capitalizing common real property? **(Page 68)**

    a. Exterior walls, roofs, and driveways should be capitalized. [This is the incorrect answer. These are examples of real property directly associated with the unit; as such, they usually should not be capitalized by the HOA or condominium.]

    b. Managers' apartments should be capitalized if the condominium association or HOA has title to the manager's apartment and would be able to sell and retain proceeds from the sale. [This is the correct answer. In the unlikely event that the condominium association or HOA does not own the apartment or is not authorized to sell it and keep the proceeds, the apartment should not be capitalized.]

    c. Recreational equipments should not be capitalized. [This is the incorrect answer. Recreational equipment is an example of personal property that is owned by the CIRA and used on the common real property. Therefore, it should be capitalized.]

    d. Greenbelts should be capitalized. [This is the incorrect answer. Greenbelts are real property directly associated with the units. As such, they should not be capitalized.]

28. The AICPA guide provides guidance on how CIRAs should value common and other real property. Which of the following statements best describes how a CIRA should account for common property acquired? **(Page 72)**

    a. Common property purchased by a CIRA should be recorded at fair market value. [This is an incorrect answer. Similar to other businesses, the AICPA guide requires purchased common property to 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.]

    b. Common property acquired in a nonmonetary transaction, such as by a nonreciprocal transfer from the developer, should be recognized at cost. [This is the incorrect answer. The CIRA should recognize the property using fair values at the date of its acquisition. Fair value should be determined in conformity with SFAS No. 157, *Fair Value Measurements*.]

    c. A unit transferred from the developer to a condominium association in settlement of litigation should be recorded at the fair value on the date of transfer plus actual closing costs. [This is the correct answer. Transactions in which condominiums receive units for nonpayment of delinquent assessments are, in essence, in-substance foreclosures as defined by SFAS No. 15 and the association takes 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 any debt assumed.]

    d. Units foreclosed on for nonpayment of delinquent assessments should be recorded at the amount of the delinquent assessments. [This is the incorrect answer. This is considered an in-substance foreclosure and should be 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 any delinquent assessments.]

29. The Meadowbrook Homeowners' Association presents its financial statements using fund accounting and all of its common property is capitalized. List all of the following disclosures that the CIRA should make about the common property in its financial statements. **(Page 73)**

    i. Responsibility held by the CIRA for maintenance and preservation of the common property.

    ii. The CIRA's accounting policies for recognizing and measuring the common property.

    iii. Any restrictions on disposition or use of the common property.

    iv. Any terms and conditions related to the existing land or recreation leases.

    v. Description of the property that the CIRA has title to or any other evidence of ownership that is not capitalized.

    vi. Description of capitalized property.

    a. v. and vi. [This answer is incorrect. This answer does not include any of the general disclosures that all CIRAs must make about common property in their financial statements. Also, based on the description of Meadowbrook above, disclosures v. and vi. would be mutually exclusive in this scenario.]

    b. i., ii., and iii. [This answer is incorrect. This list does not include all of the general common property disclosures that are required of Meadowbrook under the AICPA guide. Also, it does not include any disclosures specific to the property that is capitalized or not capitalized.]

    c. i., ii., iii., iv., and v. [This answer is incorrect. In this scenario, Meadowbrook capitalizes all of its common property; therefore, it would not need to include disclosure v. in its financial statements.]

    d. i., ii., iii., iv., and vi. [This answer is correct. According to the AICPA guide, CIRAs are required to make general disclosures about their common property (disclosures i., ii., iii., and iv) and they are required to make specific disclosures about common property that is capitalized or not capitalized. Since all of Meadowbrook's common property is capitalized in this scenario, these are the disclosures the CIRA needs in its financial statements.]

30. If CIRAs capitalize common property, GAAP requires that it be depreciated based on the property's estimated useful life using the same accounting principles that apply to commercial businesses. However, depreciation rules differ for tax purposes. Which of the following statements about depreciation for financial reporting and tax purposes is **incorrect**? **(Page 74)**

    a. 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. [This is the incorrect answer. In that case, a CIRA should record depreciation in the operating fund or other fund that reports the assets. Because depreciation is a noncash expense, a CIRA often would 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."]

    b. GAAP requires depreciating asset cost over its estimated useful life using an acceptable method such as straight-line or declining balance. [This is the incorrect answer. A CIRA would depreciate common property over its estimated useful life using a method acceptable under GAAP.]

    c. For tax purposes, 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. [This is the incorrect answer. Both MACRS and ACRS are acceptable methods of depreciation under the tax laws.]

d. If CIRAs elect straight-line depreciation for tax reporting, there would be no difference between MACRS and GAAP. [This is the correct answer. Because MACRS prescribes a recovery period and does not consider salvage value, there would always be a difference between MACRS and GAAP. 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, a CIRA could use MACRS for financial reporting since it would not differ materially from GAAP (provided salvage value is not material). The CIRA should evaluate large acquisitions other than real estate and three-year and five-year property to determine whether different depreciation lives should be used for financial reporting.]

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. Two significant factors affect the recording of monies received and disbursed:

- the timing of the receipt in relation to the related expenditures, and
- whether the proceeds relate to association-owned property.

The concept of recording damage or defect settlement monies received and disbursed is based upon the matching principle, the objective of which is to match revenues received with expenditures incurred.

Unfortunately, it is not always possible to match revenue and related expenditures in the same accounting period as stated within this discussion of damage and defects settlements. 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 Practice Aid (TPA) 5400.05, "Accounting and Disclosures Guidance for Losses from Natural Disasters—Nongovernmental Entities." While the TPA does not address unique CIRA concerns as a result of natural disasters, Issue 4 of the TPA states, "It is important to note that in some circumstances, losses and costs might be recognized in the statement of operations in a different period (earlier) than the related recovery." Issue 5 of the TPA addresses required disclosures regarding the impact of a natural disaster. The TPA is available from the AICPA website at **www.cpa2biz.com**.

Unless the damage or defect settlement proceeds are received at the same time that the corrective work is being performed, and the timing and cost of the work can be accurately projected, the CIRA will be faced with one of the following scenarios:

a. The settlement is received before corrective work begins, and the timing and total cost of the restoration project can be reasonably projected (perhaps because a fixed-fee construction contract exists).

b. The settlement is received before corrective work begins, but no reasonably accurate projection can be made as to the timing or total cost of the restoration project (or even if certain parts of the work will be performed at all).

c. Construction has already begun or is completed, and although the settlement process is not complete, there are strong indicators as to the amount of the settlement to be received.

d. Construction has already begun or is completed, but the settlement process is not complete, and there is no guarantee as to how much money, if any, will be received.

Additional considerations related to damage or defect settlements include:

- Accounting for settlements related to members' property.
- Accounting for expenditures for litigation expenses.
- Determining whether to capitalize or expense repair expenditures.
- The CIRA board's responsibilities related to settlement proceeds.

Settlements Received Prior to Incurring Expenses and Total Expenses Are Estimable. Sometimes, the damage or defects are of a cosmetic rather than structural nature, or the CIRA is unable to make the repairs because the CIRA does not have the necessary monies available and is unable to obtain them through either a special assessment or financing. In either of those instances, the CIRA may choose to make the repairs after the settlement proceeds are received. Once the amount of the settlement is determined, the CIRA would record revenue for the settlement proceeds. The CIRA would also record a liability for the related repairs. SFAS No. 5, Accounting for Contingencies, Paragraph 8 (FASB ASC 450-20-25-2), requires the CIRA to record a liability if as of the balance

sheet date it is both probable that a liability has been incurred and the amount can be reasonably estimated. If the CIRA has significant damage, it is probable that the CIRA will make necessary repairs, and the CIRA can reasonably estimate the amount of the repairs, the CIRA should record a liability for the repairs. The CIRA must determine on a case-by-case basis whether there is a liability associated with all or some portion of the settlement.

If the CIRA receives a material settlement, recording the activity in a separate fund that accounts for both settlement receipts and expenditures related to repairing the damage is recommended. Alternatively, the transactions may be recorded in the replacement fund. Separate bank accounts should be set up for settlement monies to avoid commingling them with association monies or spending funds for a purpose for which they were not received.

Settlements Received Prior to Incurring Expenses and Total Expenses Are Not Estimable. Sometimes, the CIRA may receive the settlement proceeds prior to beginning the necessary repairs but has no way of reasonably estimating the liability associated with those repairs. In that situation, the CIRA should defer the revenue from the settlement proceeds and any construction costs incurred until such time as the remaining construction costs can be reasonably estimated. Once the total remaining construction costs are determined, the CIRA should record a liability for the remaining costs and recognize the revenue and expenses in the statement of revenues and expenses.

Settlements Received after Incurring Expenses and Total Revenue and Expenses Are Estimable. Often, construction defect litigation, and sometimes insurance claims, take several years to complete. In some instances, the CIRA is required to make necessary repairs immediately. Those repairs may be paid for with proceeds from a special assessment or financing or from operating fund or replacement fund monies. Particularly if litigation is involved, the CIRA may not receive any settlement proceeds for several years. The ultimate settlement may or may not be the same amount as the CIRA's actual expenditures. In those instances, construction costs should be deferred until such time as the settlement is received (or may be recognized as revenue). At the time the CIRA recognizes the settlement proceeds as revenue, the CIRA should record the deferred expenses and any accrual for uncompleted items as expense.

Many times the settlement proceeds are not adequate to make all of the necessary repairs. In that case, the additional repair monies come from either a special assessment that is levied, financing is obtained, or the replacement fund. The CIRA is required to record a liability if it is both probable that a liability has been incurred and the amount can be reasonably estimated. Thus, if the CIRA expects the settlement proceeds to be less than the related repairs, the CIRA should recognize a liability for the repairs.

Settlements Received after Incurring Expenses and Total Revenue and Expenses Are Not Estimable. Sometimes the CIRA will make the necessary repairs while still pursuing litigation or insurance settlements. Often associations have entered into a settlement negotiation process that has ended up with the CIRA not only not receiving any type of a settlement, but also being "out" the CIRA's own legal fees. If the CIRA will not be able to determine whether the CIRA will receive a settlement or, even if a settlement is likely, is unable to determine the amount or timing of a settlement, the CIRA should expense all costs when incurred. The CIRA may choose to record the settlement activity in a separate fund, but may also choose not to do so since there may be no associated settlement revenue to offset the expenses.

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 the portion of the settlement proceeds related to the members' individually owned property should be paid to them 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.)

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

generally are expensed as they are incurred. Many times the CIRA is reimbursed for those expenditures as part of the settlement. However, until the negotiation process is completed and the final settlement is determined, there often is no guarantee that the expenditures will be recovered by the CIRA. SFAS No. 5, *Accounting for Contingencies*, Paragraph 17 (FASB ASC 450-30-25-1), notes that gain contingencies should generally not be recorded to avoid recognizing revenue before it is realized.

Material damage and defect settlements should be recorded in a separate fund. In that case, once a settlement is reached, the CIRA would record the presettlement expenditures in that separate fund. If restoration expenditures were recorded in the operating or replacement fund before presettlement funds were received, a transfer generally would be recorded from the separate fund to the fund in which the expenditures were recorded to reimburse it.

Capitalizing vs. Expensing Repair Expenditures. Whether repair expenditures should be capitalized or expensed depends on the nature of the expenditures and whether the CIRA or its members have title to the underlying property. Exhibit 2-6 presents the CIRA accounting treatment for damage and defect settlements based on the types of property and the ownership of funds received.

Exhibit 2-6

Accounting Treatment for Damage or Defect Settlements

Type of Property	Ownership of Funds Received	Recommended Accounting Treatment
Common property—title held by association (homeowners' associations and cooperatives)	CIRA.	Record disbursements of funds as expenses or capitalize as assets if repairs relate to capitalized assets.
Common property—title held by members (condominiums)	Members. The CIRA generally acts as an agent to execute repairs on behalf of members.	Record disbursements of funds as expenses.
Separate property of members (condominium interiors)	Members. The CIRA generally acts as an agent to execute repairs on behalf of members. This is normally done only when funds for members are received as part of a master insurance policy.	Record disbursements of funds as expenses.

* * *

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, the CIRA should consider any legal consequences of not making 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 should 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. Such distributions should only be done 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 should 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.)

PREPAID INSURANCE 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, it is not believed that they 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, the authors believe that GAAP requires 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 should 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 it is unlikely that the premium finance agreement meets 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 beginning in the previous paragraphs 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. Accounting for inventories is similar to commercial businesses—the same lower of cost or market pricing and obsolescence considerations apply. ARB No. 43, as amended (FASB ASC 330-10-20), 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 should be recorded as noncurrent assets unless they are expected to be refunded within the next year.

SELF-STUDY QUIZ

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

31. Insurance premiums represent a significant expense for most CIRAs. Thus, prepaid insurance often is a material asset at the balance sheet date. Assume a CIRA with a calendar year end enters into an insurance contract on November 1 at a total premium of $36,000. The CIRA pays a $7,000 cash downpayment, and finances the remaining premium of $29,000 through a premium finance agreement that requires ten monthly payments in the amount of $2,900 beginning December 1. (To simplify the illustration, interest on the unpaid premiums is ignored.) What amount should the CIRA report as prepaid insurance in its year end financial statements?

    a. $29,000.

    b. $7,000.

    c. $3,900.

    d. $36,000.

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.)**

31. Insurance premiums represent a significant expense for most CIRAs. Thus, prepaid insurance often is a material asset at the balance sheet date. Assume a CIRA with a calendar year end enters into an insurance contract on November 1 at a total premium of $36,000. The CIRA pays a $7,000 cash down payment, and finances the remaining premium of $29,000 through a premium finance agreement that requires ten monthly payments in the amount of $2,900 beginning December 1. (To simplify the illustration, interest on the unpaid premiums is ignored.) What amount should the CIRA report as prepaid insurance in its year end financial statements? **(Page 83)**

    a. $29,000. [This is the incorrect answer. This is the amount due on the finance contract, which should not be recorded as prepaid insurance.]

    b. $7,000. [This is the incorrect answer. Although this is the amount paid as the down payment, it should not be recorded as prepaid insurance.]

    c. $3,900. [This is the correct answer, as illustrated below:]

Total premium paid ($7,000 + $2,900)	**$**	**9,900**
Premium related to expired policy period (November 1 to December 31, or 1/6 × $36,000)		**6,000**
Prepaid insurance at December 31	**$**	**3,900**

    d. $36,000. [This is the incorrect answer. This represents the total premium for the year under the insurance contract, but not the amount that the CIRA has paid.]

FUNDS FOR MAINTAINING COMMON PROPERTY

One of the principal objectives of CIRAs is to maintain the development's common property. Paragraph 3.03 of the AICPA guide states that 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

CIRAs are most likely to account for major repairs and replacements in a separate fund (replacement fund) or by appropriating operating funds if they elect to fund the costs of major repairs and replacements over extended periods of time. 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.

Accounting for Assessments and Expenses

Assessments for major repairs and replacements should be reported separately from assessments for operations in the period assessed as specified in the budget. 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 should be recorded as revenue. Accordingly, 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 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, expenses should be reported in the fund in which they were budgeted. However, CIRAs need to 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. 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 should be 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 should record a receivable from the replacement fund, and the replacement fund should 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 allocated via budget to the operating 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 should 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

The AICPA guide (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 should be 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 the authors' opinion, 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, budgeted but unfunded assessments (or any other types of interfund borrowings) should be recorded in the CIRA's financial statements as interfund receivables and payables rather than as transfers only if 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:

- 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, all interfund borrowings must be documented by actions such as the following:

- Board minutes should document the reason for the borrowings and the repayment terms.
- A written note specifying the amount of the loan, the repayment terms, and the rate of interest to be charged should be created to document the agreement.
- The budget should be modified to reflect the loan, and notification of the change should be sent to the members.
- The reserve study should be modified to reflect the altered cash flow.

If the CIRA uses a nonfund approach, the AICPA guide (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, the transfer should 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 should be capitalized as assets, such as pool furnishings. As explained previously, 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 should record a transfer to the operating fund, and the assets should 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

As explained earlier, 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. Paragraph 4.27 of the AICPA guide (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

The AICPA guide states that 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 discussed in the AICPA guide: 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, Paragraph 4.33 of the AICPA guide (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 SFAS No. 5 (FASB ASC 450-20-55-3 through 55-5), *Accounting for Contingencies* (FASB ASC 450-10). However, Paragraphs 27 and 28 of SFAS No. 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 enterprise's financial statements. Fires, explosions, and other similar events that may cause loss or damage of an enterprise'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.

FUNDS FOR CAPITAL IMPROVEMENT

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 for a CIRA that did not have one, 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. 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.

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 of reserve funds. Other states have no similar

requirement. Additionally, CIRAs may be required by mortgage documents or their governing documents to set aside funds on a systematic basis for future major repairs and replacements. When the AICPA guide was issued, it included disclosure requirements for reserves that, in essence, require associations to perform reserve studies to make the disclosures.

The Community Associations Institute (CAI) most recently revised its *Guide for Association Practitioners* in 2005—titled *Reserve Funds: How & Why Community Associations Invest Assets*. In 2001, the Community Associations Institute Research Foundation published its *Best Practices, Report #1, 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 should 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, 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 should—

- Review the governing documents, mortgages, bonds, 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) should be listed to determine what should appropriately be included 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 should 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), the authors recommend that policy be disclosed in a note to the required supplementary information about future major repairs and replacements. Also, the CIRA should consider whether circumstances indicate the need to adjust the estimated remaining useful life of a "permanent" component. For example, a CIRA might decide to reduce the remaining useful lives of sidewalks and swimming pools that have suffered earthquake damage. In that case, the CIRA would begin accumulating funds for their repair or replacement at an earlier date than originally planned.

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. Sometimes, 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 should 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 should include 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.

The possibility of replacing components in need of repair with alternate materials should be explored. 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. All information should 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.

The AICPA guide recommends that a CIRA reevaluate its funding level each year based upon changes to the common property, replacement costs, and the condition of the components.

Financial Analysis

Preparers should be aware of the association's options in replacing its common property components. They should be familiar with—

- Limitations in the association's governing documents, mortgages, 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 most cases, accountants or those with significant financial experience should perform financial analyses. Others may lack the necessary technical training to complete the required analyses.

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 should 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 should 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 must be 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 should review it with association management. 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 should 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 best. 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)

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 2-7 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.

Exhibit 2-7

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
		*	*	*		

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 2-8 shows illustrative calculations.

Exhibit 2-8

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 should be reviewed annually by the CIRA's board of directors and an updated study may be warranted.

Time Value of Money

Reserve study preparers disagree over whether interest earned on replacement funds and inflation should be taken into account when calculating reserve requirements. Some take the position that they need not be considered because they offset each other. Generally this is not the case over longer periods, however. Accordingly, more sophisticated calculation methods take one or more of the following into account:

- Inflation and interest earned (compounded either annually or monthly)
- 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 should consider having the study updated frequently to reflect the changes in interest and inflation rates.

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

Reserve studies should 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 should ordinarily update its reserve study every year.

In deciding how often (or when the next) reserve study should be performed, the association should consider the following factors:

- 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 has one or more of these factors occurring, it should strongly consider conducting 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. Additionally, some jurisdictions have statutory requirements that dictate how often reserve study updates must be performed.

DEBT AND OTHER LIABILITIES RELATED TO CIRAS

Historically, CIRAs have had difficulty in obtaining routine bank financing, particularly for improvements to existing associations. Banks have been reluctant to lend due to lack of collateral and repayment sources. Additionally, some states have prohibitions against imposing liens on common property or association governing documents may require a high majority of owners and first lien holders to consent to such a transaction. Today more sources of funding for associations are available, particularly among commercial lenders. In states that have significant numbers of CIRAs, commercial banks that specialize in lending money to community associations have developed. Various types of bank loans, from lines of credit to fixed term loans with either fixed or variable interest rates, are available to associations. More complicated types of loans are also available, such as loans that begin as a revolving line of credit and later convert to a fixed term loan. Those more complicated loans generally are used for special reconstruction projects.

Secured and Unsecured Debt

Whether CIRAs may incur unsecured and secured debt (even if a financing source is available) generally is based on their legal form and the provisions of their governing documents and applicable state laws. For most CIRAs, the future stream of assessments from unit owners collateralize the association's loans. (Cooperatives are an exception since cooperative associations do not collect special assessments from their residents.) While the association applies for the loan, repayment is the unit owners' responsibility. Generally, all owners are assessed the full amount of their allocated portion of the debt at the same time. The full amount usually includes an interest allocation based on the interest rate in the loan. The following payment options are often extended to the unit owners:

- Owners may pay off their portions at once. Some CIRAs offer their owners a discount, which excludes some or all of the interest, to pay the entire special assessment immediately. (Owners who cannot pay the amount in full may take out home equity loans to assure the deductibility of interest on their personal income tax returns.)

- Owners may pay principal and interest (if charged by the association) monthly as special assessments. If interest is charged, the interest rate in the loan contract is generally passed through to the owners.

Assuming the purpose of the loan is for property repair or replacement due to damage, some owners may have loss assessment coverage through an insurance policy that will reimburse them for their portions.

Loan compliance often requires the association to keep subsidiary receivable records that clearly show the account history for each unit. That process may be complicated by the fact that some unit owners pay in full while others pay monthly. Also, if a unit that has an outstanding loan balance is sold, the new owner may assume the obligation, or either the special assessment terms or the sales contract may require that the outstanding balance be paid in full at the time of the sale.

Unique Issues for Certain Types of CIRAs

Condominium Associations. Condominium 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. This form of ownership has made it difficult for many condominium associations to obtain outside financing because some states prohibit the imposition of a lien on common property. In other states, although mortgaging common property is not prohibited by state law, the condominium association's governing documents require a very high majority of unit owners and their first lien holders to consent to the transaction. However, some banks have begun specializing in providing banking services to CIRAs and are allowing condominium associations to pledge a special assessment or the future stream of assessments as security for borrowings. Bank loans for condominium associations continue to become more commonplace.

Homeowners' Associations. Even though homeowners' associations generally have title to all of the common property, they also traditionally have had difficulty in obtaining outside financing because the HOA's common property can rarely be used as collateral since it can not be separated from the association. Some homeowners' associations may pledge a special assessment or future assessment revenue streams as security for borrowings. However, borrowings often must be approved by a specified percentage of homeowners and the amount the HOA is authorized to borrow may be limited.

Cooperatives. Cooperatives in most states are governed by the state's corporation law and, similar to commercial corporations, may pledge their property or equipment to secure borrowings without approval from tenant-shareholders. A few states, however, have adopted specific statutes to regulate the operation and management of cooperatives, and those statutes are similar to laws regulating condominium associations in that they either prohibit liens on property owned by the cooperative corporation or require virtually unanimous tenant-shareholder consent to liens.

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.

More CIRAs may issue bonds in the future because they offer 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. Payments to the SBA generally begin 5 months after the date of the note. 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. During the first 4 months, since no payments are being made, interest is accrued based on the full principal amount. Beginning with the fifth month, 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 should record a payable only for the amount of the loan that has been advanced. The details of the loan and the repayment terms should be disclosed in the notes to the financial statements.

SBA loans (and bank loans) are typically secured by future assessments to be received by the CIRA from unit owners. There is a variance of opinion among accountants about whether a CIRA should record a receivable from owners for the amount of the loan. Some accountants believe that receivables from owners should only be recognized when annual assessments for owner payments of principal and interest are made. However, since repayment of the loan is the unit owners' responsibility, an association should record assessments receivable from unit owners as funds are drawn down. The receivable is based on the principal amount only. For convenience, annual interest expense generally is recorded based on the most recent amortization schedule. However, if the loan

balance changes significantly during the year (due to draws or pay off of individual assessments by unit owners), the CIRA should request a revised amortization schedule from the SBA and record interest expense accordingly.

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 should be recorded depends on the purpose of the borrowings. For example, if funds are borrowed for repairs and replacements, the authors believe that the debt should 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, the debt should be recorded in the operating fund.

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 secured and unsecured debt are the same as for commercial businesses. Thus, amounts should be appropriately classified as current and long-term if the CIRA presents a classified balance sheet, and 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, SFAS No. 107, *Disclosures about Fair Value of Financial Instruments* (FASB ASC 825-10-50-10; 825-10-50-16), requires 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.

- 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.

SFAS No. 157, *Fair Value Measurements* (FASB ASC 820-10), defines *fair value*, establishes a formal framework for measuring fair value, and expands disclosures about fair value measurements. Although SFAS No. 157 applies to (and amends) the provisions of existing pronouncements, including SFAS No. 107, it does not require any new fair value measurements. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Additionally, SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (FASB ASC 825-10), provides entities an election to use fair value measurement for certain financial assets and liabilities upon their initial recognition or when events give rise to new-basis accounting. Under the Statement, the fair value option (a) may be applied on an instrument by instrument basis, with a few exceptions, (b) is irrevocable, unless a new election date occurs, and (c) is applied only to entire instruments and not to portions of instruments. The SFAS also sets forth specific presentation and disclosure requirements.

The following is an example of the disclosure a cooperative might include with respect to its mortgage payable if it meets the criteria of SFAS No. 107 (FASB ASC 525-10):

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 should 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 should 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. Additionally, chlorofluorocarbons (CFCs) were to have been phased out by the year 2000.

- *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:

- SFAS No. 5, *Accounting for Contingencies* (FASB ASC 450-20), provides general guidance on accruing liabilities for loss contingencies.
- SFAS No. 143, *Accounting for Asset Retirement Obligations* (FASB ASC 410-20), 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. The issuance of SFAS No. 143 partially nullified the consensuses reached in EITF Issue Nos. 89-13 and 90-8. However, environmental remediation costs and obligations that result from *other than normal* operation of an asset are not covered by SFAS No. 143 and may be subject to the provisions of SOP 96-1 or EITF Issue Nos. 89-13 and 90-8. SFAS No. 143 as well as a newly issued Interpretation of SFAS No. 143.
- SOP 96-1, *Environmental Remediation Liabilities* (FASB ASC 410-30), provides specific guidance for recognizing, measuring, and disclosing environmental remediation liabilities.
- EITF Issue No. 89-13, "Accounting for the Cost of Asbestos Removal (FASB ASC 410-30)," provides guidance on determining whether the cost of asbestos removal from buildings should be capitalized.
- EITF Issue No. 90-8, "Capitalization of Costs to Treat Environmental Contamination (FASB ASC 410-30)," provides guidance for determining whether environmental cleanup costs should be capitalized.
- EITF Issue No. 95-23, "The Treatment of Certain Site Restoration/Environmental Exit Costs when Testing a Long-Lived Asset for Impairment (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, EITF Issue No. 90-8 (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 lessen 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).

Accountants should be aware that condominium associations and timeshare associations generally do not own real common property. Thus, those associations have no capitalized real property on their books. If environmental cleanup costs are incurred by those associations, the authors believe they should be expensed rather than capitalized.

Capitalization of Asbestos Removal Costs. EITF Issue No. 89-13 (FASB ASC 410-30) provides guidance on accounting for the cost of removing asbestos from a building. Costs incurred to treat or remove asbestos should be capitalized regardless of whether a building was acquired with a known asbestos problem or the problem was discovered in an existing building. It should be noted that the EITF reconsidered that consensus after Issue No. 90-8 was addressed. The EITF reaffirmed their consensus because they believe that asbestos removal would meet criterion b.(2) in the list above.

Accruing Environmental Remediation Liabilities

Environmental remediation liabilities can be challenging to account for. 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. SOP 96-1 (FASB ASC 410-30) provides specific guidance for recognizing, measuring, and disclosing liabilities for legally required environmental remediation. In summary, the SOP (FASB ASC 410-30-30) provides that environmental remediation liabilities should—

- Be accrued on a site-by-site basis when the criteria of SFAS No. 5 (FASB ASC 450-20-25-2) are met, using the benchmarks in the SOP (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.

In addition, GAAP points out that environmental remediation obligations are not unusual in nature and do not meet the criteria for classification as extraordinary items.

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 where detail exists, the association has lost track of the member. When either a member fails to request the refund, or the association fails to properly account for the deposit refund, the amount left on the general ledger becomes unclaimed property.

Many states have escheat rules that govern unclaimed property. Auditors should 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 should 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 should 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 timeshare developments)
- Income taxes payable

SELF-STUDY QUIZ

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

32. The Hollyhock Homeowners' Association collects funds through a special assessment for repairs to the swimming pool. The swimming pool is common property maintained by the CIRA. For financial reporting purposes, how should the CIRA account for the assessment?

    a. Funds should be combined with assessments for operation.

    b. Funds should be recorded as revenue.

    c. Funds should be treated as contributions of capital.

33. CIRAs have historically had difficulty in obtaining routine bank financing, particularly for improvements to existing associations. Which of the following reasons does **not** explain why banks and other financial institutions have been reluctant to lend CIRAs money?

    a. Some states prohibit the imposition of a lien on common property owned by a condominium association.

    b. Cooperatives cannot pledge their property or equipment to secure borrowings without approval from tenant-shareholders.

    c. In other states, although mortgaging common property is not prohibited by state law, a condominium association's governing documents require a very high majority of unit owners and their first lien holders to consent to the transaction.

    d. A HOA's common property can rarely be used as collateral since it can not be separated from the association.

34. Sometimes, CIRAs are able to obtain financing through revenue bonds secured by assessments. Which of the following statements best describes financing obtained in this manner?

    a. Bonds are generally issued in stated denominations of $500 or $1,000.

    b. 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.

    c. The sale of bonds is regulated by statues in the municipality in which the CIRA is located.

    d. One disadvantage of bond financing is that the association cannot lock in its finance costs.

35. CIRAs 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. Which of the following best describes loans obtained from the SBA?

    a. The loan contract is between the unit owners and the SBA.

    b. Disaster loan terms may be as long as 10 years, but interest rates are generally higher than other lender rates.

    c. Simple interest is charged by the SBA only on funds actually advanced.

    d. Generally, no payments are made during the first year.

36. The accounting and disclosure requirements that apply to a CIRA's secured and unsecured debt are the same as for commercial businesses. Which of the following does **not** describe a disclosure requirement that applies to a CIRA's debt?

    a. If the CIRA presents a classified balance sheet, amounts should be appropriately classified as current and long-term.

    b. The CIRA's 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 ten years following the date of the most recent balance sheet.

    c. SFAS No. 107, *Disclosures about Fair Value of Financial Instrument*s, requires some CIRAs to disclose the fair value of financial instruments.

    d. For CIRAs that are required to disclose fair value, if it is not practicable to estimate the fair value of a financial instrument, they are required to disclose (a) information pertinent to estimating the fair value of the financial instrument, such as the carrying amount, effective interest rate, and maturity, and (b) the reasons why it is not practical to estimate fair value.

37. CIRAs may be exposed to environmental remediation liabilities. Which of the following statements about a CIRA's responsibilities for such liabilities is **incorrect**?

    a. 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.

    b. A CIRA that has underground gasoline storage should monitored the tanks 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.

    c. Under the Clean Air Act, some condominiums with centrifugal chillers have to meet tough emissions and disposal standards.

    d. CIRAs must comply with regulations regarding the use or disposal of a number of products including paint solvents, fertilizers, and pesticides. Generally, such laws deal only with the types of containers in which the wastes should be stored.

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.)**

32. The Hollyhock Homeowners' Association collects funds through a special assessment for repairs to the swimming pool. The swimming pool is common property maintained by the CIRA. For financial reporting purposes, how should the CIRA account for the assessment? **(Page 87)**

    a. Funds should be combined with assessments for operation. [This answer is incorrect. Assessments for major repairs and replacements should be reported separately from assessments for operations in the period assessed as specified in the budget.]

    b. Funds should be recorded as revenue. [This answer is correct. For financial reporting, the assessments should be recorded as revenue. Accordingly, 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.]

    c. Funds should be treated as contributions of capital. [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.]

33. CIRAs have historically had difficulty in obtaining routine bank financing, particularly for improvements to existing associations. Which of the following reasons does **not** explain why banks and other financial institutions have been reluctant to lend CIRAs money? **(Page 99)**

    a. Some states prohibit the imposition of a lien on common property owned by a condominium association. [This is the incorrect answer. There are some states that prohibit banks and other financial institutions from imposing a lien on common property owned by a condominium association.]

    b. Cooperatives cannot pledge their property or equipment to secure borrowings without approval from tenant-shareholders. [This is the correct answer. In most states, cooperatives are governed by the state's corporation law and, similar to commercial corporations, may pledge their property or equipment to secure borrowings without approval from tenant-shareholders.]

    c. In other states, although mortgaging common property is not prohibited by state law, a condominium association's governing documents require a very high majority of unit owners and their first lien holders to consent to the transaction. [This is the incorrect answer. In some states, the governing documents of a condominium association require a large percentage of unit owners to consent to a borrowing transaction.]

    d. A HOA's common property can rarely be used as collateral since it can not be separated from the association. [This is the incorrect answer. Because a HOA can not separate its common property from the association, it is difficult if not impossible to use such common property as collateral.]

34. Sometimes, CIRAs are able to obtain financing through revenue bonds secured by assessments. Which of the following statements best describes financing obtained in this manner? **(Page 100)**

    a. Bonds are generally issued in stated denominations of $500 or $1,000. [This is an incorrect answer. Bonds are generally issued in stated denominations of $5,000 or $10,000.]

    b. 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. [This is the correct answer. The ability of a CIRA to issue bonds generally depends on those two factors.]

c. The sale of bonds is regulated by statues in the municipality in which the CIRA is located. [This is the incorrect answer. 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.]

d. One disadvantage of bond financing is that the association cannot lock in its finance costs. [This is the incorrect answer. In fact, 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.]

35. CIRAs 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. Which of the following best describes loans obtained from the SBA? **(Page 100)**

a. The loan contract is between the unit owners and the SBA. [This is the incorrect answer. The loan contract is between the association (not the unit owners) and the SBA.]

b. Disaster loan terms may be as long as 10 years, but interest rates are generally higher than other lender rates. [This is the incorrect answer. Disaster loan terms may be as long as 30 years, and interest rates are generally *lower* than other lender rates.]

c. Simple interest is charged by the SBA only on funds actually advanced. [This is the correct answer. The SBA charges simple interest on the amount of funds actually advanced on the loan.]

d. Generally, no payments are made during the first year. [This is the incorrect answer. Payments to the SBA generally begin 5 months after the date of the note. 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.]

36. The accounting and disclosure requirements that apply to a CIRA's secured and unsecured debt are the same as for commercial businesses. Which of the following does **not** describe a disclosure requirement that applies to a CIRA's debt? **(Page 101)**

a. If the CIRA presents a classified balance sheet, amounts should be appropriately classified as current and long-term. [This is the incorrect answer. A CIRA is required to classify its debt as current and long-term when in presents a classified balance sheet.]

b. The CIRA's 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 ten years following the date of the most recent balance sheet. [This is the correct answer. A CIRA's financial statements must include all of these disclosures; however, its financial statements need to disclose the amount of principal maturities for all long-term borrowings for each of the *five* years (not ten) following the date of the most recent balance sheet.]

c. SFAS No. 107, *Disclosures about Fair Value of Financial Instrument*s, requires some CIRAs to disclose the fair value of financial instruments. [This is the incorrect answer. SFAS No. 107 requires such disclosures.]

d. For CIRAs that are required to disclose fair value, if it is not practicable to estimate the fair value of a financial instrument, they are required to disclose (a) information pertinent to estimating the fair value of the financial instrument, such as the carrying amount, effective interest rate, and maturity, and (b) the reasons why it is not practical to estimate fair value. [This is the incorrect answer. SFAS No. 107 requires a CIRA to make such disclosures when it is not practicable to estimate the fair value of a financial instrument.]

37. CIRAs may be exposed to environmental remediation liabilities. Which of the following statements about a CIRA's responsibilities for such liabilities is **incorrect**? **(Page 102)**

    a. 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. [This is an incorrect answer. A CIRA may be held responsible in an environmental claim, whether or not it has been directly involved in generating, disposing of, or transporting hazardous materials.]

    b. A CIRA that has underground gasoline storage should monitor the tanks 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. [This is an incorrect answer. Remediation of the soil and replacement or repair of the leaking tank are very costly and only partially covered in typical CIRA insurance policies; therefore, CIRAs should carefully monitor such tanks for leaks.]

    c. Under the Clean Air Act, some condominiums with centrifugal chillers have to meet tough emissions and disposal standards. [This is an incorrect answer. Condominiums with centrifugal chillers have to meet such standards.]

    d. CIRAs must comply with regulations regarding the use or disposal of a number of products including paint solvents, fertilizers, and pesticides. Generally, such laws deal only with the types of containers in which the wastes should be stored. [This is the correct answer. Laws on regulated substances deal not only with the types of containers the wastes are stored in, but also with the land and structures surrounding the containers, among other things.]

EQUITY HELD BY CIRA MEMBERS

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, the following transactions should 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 month's 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 reporting purposes. Accordingly, they should be reported as revenue in the financial statements.

Similarly, contributed capital should 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 or (b) the excess of member assessments over the CIRA's expenses. 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 should 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.

SFAS No. 129, *Disclosure of Information about Capital Structure* (FASB ASC 505-10-50-3 through 50-5 and 505-10-50-11), requires all entities that issue securities to make certain disclosures about their capital structure. The

Statement defines securities as "the evidence of debt or ownership or a related right" and, thus, would apply to stock cooperatives and timeshare cooperatives since they issue securities (stock) to tenant-shareholders. Although it is unclear whether nonstock cooperatives must comply with these disclosure requirements, they should 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. SFAS No. 129 (FASB ASC 505-10-50-3 through 50-5 and 505-10-50-11) would not apply to condominium associations, homeowners' associations, or other types of timeshare associations because their members do not have "evidence of ownership" of those entities.

The required disclosures 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 AND RELATED CONCERNS

Accounting for Income Taxes

Similar to commercial businesses, income taxes for financial reporting should be based on amounts shown in the CIRA's financial statements. Deferred taxes should be provided if transactions are included in the determination of accounting income in one period and in taxable income in a different period. Deferred taxes generally are not as complex for CIRAs as they are for commercial businesses, however, because, in most respects, accounting for financial and tax purposes is the same or is attributed to permanent differences. Nevertheless, if differences exist between accounting and taxable income, deferred taxes should be recorded in conformity with SFAS No. 109, *Accounting for Income Taxes* (FASB ASC 740).

FASB Interpretation (FIN) No. 48, Accounting for Uncertainty in Income Taxes (FASB ASC 740), affects the recognition and measurement of both current and deferred income taxes under SFAS No. 109 (FASB ASC 740). The interpretation 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 that a tax position would be sustained.

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.

FIN 48 (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 should assess 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, as noted in paragraph 503.50, 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 paragraph 8 of FIN 48 (FASB ASC 740-10-30-7), the recognized tax benefit should be 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 should also 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 should recognize a tax benefit for only that portion that is ultimately accepted. That determination can be made qualitatively or quantitatively.

Thus, even though the CIRA would treat the assessments for future repairs and replacements as capital contributions in preparing its current year tax return, the related tax benefit would not be recognized in the CIRA's statement of revenues and expenses as a reduction of the current tax provision. Instead, the tax benefit related to the amount

that did not meet the greater than 50% threshold would be accrued as a liability. Paragraph 17 of FIN 48 (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 the requirements of the interpretation." 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.

Interest and Penalties. If interest would be paid on any tax underpayment that might result from a tax position, the interest should be accrued starting in the first period it would begin accruing under the tax law. The amount that should 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 should 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 should be recognized, the amount should be adjusted in the period in which the change occurs.

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. SFAS No. 109 (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 appropriate tax rate.

f. Compute the deferred tax asset by multiplying total deductible temporary differences and the operating loss carryforwards by the appropriate 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. SFAS No. 109 (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 should be used if no changes have been enacted for future years, and any changes in tax rates should be recognized in the period that they become known. SFAS No. 109 requires that a flat tax rate (generally 34% for CIRAs that file Form 1120) be used unless graduated rates are a significant factor. In those cases, the rate used is the average tax rate that would apply to the estimated average annual taxable income during the period the temporary differences are expected to reverse. Graduated tax rates would often be significant for CIRAs that file Form 1120; therefore, they would use an average tax rate to calculate deferred taxes. On the other hand, graduated taxes are never a factor for CIRAs that file Form 1120-H, and deferred taxes would be calculated using a flat rate of 30% for condominium and homeowners' associations and 32% for timeshare associations.

How FIN 48 Affects the Deferred Tax Provision. Once FIN 48 (FASB ASC 740) is implemented, the tax basis of an asset or liability will no longer be determined solely based on positions taken, or expected to be taken, in tax returns. Instead, only tax positions that meet the more-likely-than-not criterion will be considered in determining the tax basis of an asset or liability.

To illustrate, 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. Prior to the implementation of FIN 48 (FASB ASC 740), the CIRA would conclude that—

a. The tax basis of the liability is zero, and

b. The difference between the carrying amount of the liability for financial statement reporting and its zero tax basis is a deductible difference because payment of the liability will result in a deduction

FIN 48 (FASB ASC 740) requires a different approach. Once the interpretation is implemented, 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. [This is the same result that would be obtained before implementation of FIN 48 (FASB ASC 740).]

- 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 under the interpretation 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 net income derived from sources unrelated to its function as a CIRA or on income received from nonmembers. 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, deferred taxes generally should not be provided for any temporary differences related to membership income or membership loss. Thus, 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 Revenue Ruling 70-604 should be considered as permanent differences because tax rules effectively exempt CIRAs from tax on net membership income. SFAS No. 109, Paragraph 14 (FASB ASC 740-10-05-9; 740-10-25-30), states 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.

Interpreting Revenue Ruling 70-604 as allowing only a one-year carryover of excess membership income is recommended. If a CIRA has excess membership income in the year following a 70-604 election, the authors advise 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 should 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, CIRAs should 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 should 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. The related deferred tax benefit reported in the CIRA's statement of revenue and expenses generally should not be classified as an extraordinary item. Generally, material temporary differences would be most likely to arise if the CIRA has significant commercial operations. Once FIN 48 (FASB ASC 740) is adopted, 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), deferred taxes generally should not be provided for the excess of patronage income over patronage expenses that is refunded as patronage dividends. Those amounts should be considered permanent differences, using the rationale discussed. 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 2-9 lists temporary differences and permanent differences that CIRAs are most likely to encounter.

Exhibit 2-9

Common Permanent and Temporary Differences for CIRAs

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

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 FIN No. 48 (FASB ASC 740).

* * *

Reporting Income Taxes in Financial Statements

If a CIRA presents its financial statements using fund accounting, income taxes should generally be allocated between funds to the extent that they relate to those funds, if material.

FIN 48 (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. Paragraph 4.14 of the AICPA guide 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.

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

SFAS No. 109 (FASB ASC 740-10-50) requires certain disclosures about current and deferred income taxes. SFAS No. 130, *Reporting Comprehensive Income* (FASB ASC 220-10), requires disclosure of the income tax expense or benefit allocated to each component of other comprehensive income.

In addition, FIN 48 (FASB ASC 740-10-50-15) requires certain disclosures, including the following:

- The amounts of interest and penalties recognized in the statement of revenues and expenses and in the balance sheet. 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 $250)

- The tax years that remain subject to examination by major tax jurisdictions. For example, a note to the financial statements might state:

  The Association's federal income tax returns for 20X1, 20X2, and 20X3 are subject to examination by the Internal Revenue Service, generally for three years after they were filed.

- A tabular reconciliation of the carrying amount of the liability for unrecognized tax benefits as of the beginning and end of the year.

SELF-STUDY QUIZ

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

38. 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. Which of the following transactions can be reported as contributed capital for tax purposes, but not financial reporting purposes?

    a. Property and equipment transferred from the developer or sponsor to the CIRA.

    b. 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.

    c. Litigation proceeds from developers for warranty claims.

    d. Property purchased by members with social or other funds and donated to the CIRA.

39. CIRAs should record deferred taxes in conformity with SFAS No. 109, *Accounting for Income Taxes*. Which of the following best describes permanent and temporary differences for purposes of recording deferred taxes?

    a. Deferred income taxes under SFAS No. 109 represent the tax effects of the difference between income taxes reported in the financial statements and the tax return that results from permanent differences.

    b. Deferred income taxes are recorded for permanent differences.

    c. 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.

    d. Deferred taxes should be provided if transactions are included in the determination of accounting income in one period and in taxable income in the same period.

40. 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. Which of the following transactions represent a permanent difference for which a CIRA would **not** record deferred taxes?

    a. Special assessments for specific capital improvements or the replacement of personal property.

    b. Unrealized gains and losses that are not deductible for tax purposes.

    c. Property transferred by the developer or sponsor with different bases for financial and tax purposes.

    d. Leases that are capitalized for financial and tax purposes but have different amortization periods.

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.)**

38. 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. Which of the following transactions can be reported as contributed capital for tax purposes, but not financial reporting purposes? **(Page 112)**

    a. Property and equipment transferred from the developer or sponsor to the CIRA. [This is the incorrect answer. Property and equipment transferred from the developer or sponsor to the CIRA can only be reported as contributed capital for financial reporting purposes.]

    b. 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. [This is the incorrect answer. Funds contributed to the initial start-up of the CIRA can only be reported as contributed capital for financial reporting purposes.]

    c. Litigation proceeds from developers for warranty claims. [This is the correct answer. Tax rules allow CIRAs to treat such proceeds as contributions of capital for tax purposes in certain circumstances. The preceding items do not, however, meet the definition of contributed capital for financial reporting purposes. Accordingly, they should be reported as revenue in the financial statements.]

    d. Property purchased by members with social or other funds and donated to the CIRA. [This is the incorrect answer. Donated property can only be reported as contributed capital for financial reporting purposes.]

39. CIRAs should record deferred taxes in conformity with SFAS No. 109, *Accounting for Income Taxes*. Which of the following best describes permanent and temporary differences for purposes of recording deferred taxes? **(Page 115)**

    a. Deferred income taxes under SFAS No. 109 represent the tax effects of the difference between income taxes reported in the financial statements and the tax return that results from permanent differences. [This is the incorrect answer. Deferred 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).]

    b. Deferred income taxes are recorded for permanent differences. [This is the incorrect answer. 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. Deferred income taxes are *not* recorded for permanent differences, only for temporary differences.]

    c. 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. [This is the correct answer. CIRAs should not record deferred income taxes for such differences.]

    d. Deferred taxes should be provided if transactions are included in the determination of accounting income in one period and in taxable income in the same period. [This is the incorrect answer. 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.]

40. 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. Which of the following transactions represent a permanent difference for which a CIRA would **not** record deferred taxes? **(Page 118)**

    a. Special assessments for specific capital improvements or the replacement of personal property. [This is the correct answer. Amounts recognized as revenue for financial reporting and as contributions of capital for tax reporting, such as special assessments, are permanent differences for which deferred taxes should not be recorded.]

    b. Unrealized gains and losses that are not deductible for tax purposes. [This is the incorrect answer. Unrealized gains and losses that are not deductible for tax purposes are an example of a transaction that leads to a timing difference, for which a CIRA would record deferred taxes.]

    c. Property transferred by the developer or sponsor with different bases for financial and tax purposes. [This is the incorrect answer. Property transferred by the developer or sponsor that has a different bases for financial and tax purposes would lead to a timing difference, for which a CIRA would record deferred taxes.]

    d. Leases that are capitalized for financial and tax purposes but have different amortization periods. [This is the incorrect answer. Leases that are capitalized for financial and tax purposes but have different amortization periods would lead to a timing difference, for which a CIRA would record deferred taxes.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (HOATG091)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

4. LongHorn Estates (LHE) is a common interest realty association (CIRA). In which of the following situations of accounting for LHE's cash and cash equivalents, would Jules Adams, CPA, be correct?

   a. Jules segregates cash designated for special purposes from general use cash.

   b. Jules records "held checks" as a deduction from cash on the balance sheet.

   c. Jules records accrued interest in the financial statements when received.

   d. Jules includes legally restricted cash in current assets on LHE's classified balance sheet.

5. SFAS No. 95, which requires CIRAs to present a statement of cash flows as a basic financial statement, defines cash and cash equivalents. According to that statement, which of the following is a cash equivalent?

   a. Certificate of deposit.

   b. Treasury bill.

   c. Repurchase agreement.

   d. Equity security.

6. A CIRA owns a money market account whose stated terms restrict withdrawal of the funds before a year. Into which financial statement classification should the CIRA include the money market account?

   a. Cash.

   b. Investments.

   c. Cash equivalent.

   d. Marketable security.

7. A CIRA's bylaws stipulate that $15,000 of the annual member assessments should be set aside for future major repairs and replacements of common property. Which of the following best describes how this stipulation affects the CIRA's financial statements?

   a. The $15,000 is not legally restricted since a majority of the owners may decide to use the funds for other purposes. Thus, the $15,000 does not have to be segregated from cash available from operations in the CIRA's financial statements.

   b. The $15,000 is legally restricted by the CIRA's governing documents; therefore, it should be segregated from cash from operations in the CIRA's financial statements.

   c. The $15,000 is not legally restricted since a majority of unit owners may subsequently decide to use those funds for other purposes. However, those funds are similar to legally restricted funds since the CIRA's board of directors does not have the authority to decide how those funds are to be used nor does the board have the authority to reverse the decisions of the unit owners. Thus, the $15,000 should be segregated from cash available for current operations in the CIRA's financial statements.

   d. The $15,000 may be included with cash from operations in the CIRA's financial statements, even if the CIRA uses a nonfund approach for its financial statements.

8. Determining whether a CIRA should record in their financial statements certain funds obtained from its members is often difficult. Which of the following statements best describes how a CIRA should determine whether to include such funds in their financial statements?

    a. Miscellaneous collections should be recorded in the CIRA's financial statements when they result from activities associated with the CIRA's responsibilities of managing and maintaining the development's common property.

    b. Amounts that are budgeted as part of the CIRA's annual revenues or are included as part of members' annual assessments usually should not be recorded in the CIRA's financial statements.

    c. If a CIRA collects funds for an event it is not required to undertake, it should record such amounts in its financial statements unless it authorizes the event.

    d. If social funds used to purchase personal property are not recorded in the CIRA's financial statements, the property should be recorded as an expense 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.

9. SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, contains guidance for accounting for investments in marketable securities. Which of the following statements about accounting for investments in marketable securities is **incorrect**?

    a. At acquisition, investments should be classified into one of the following categories: held to maturity, trading, or available for sale.

    b. 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.

    c. Realized gains and losses on debt securities classified as available for sale should be recognized in the period that they are earned.

    d. If a CIRA has marketable equity securities, it generally classifies them as held to maturity.

10. CIRAs should account for investments in marketable securities in conformity with SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. According to SFAS No. 115, how should a CIRA account for an unrealized loss related to a security classified in the trading category?

    a. Report the unrealized loss in the statement of revenue and expenses.

    b. Do not report the unrealized loss.

    c. Report the unrealized loss as a separate component of other comprehensive income.

    d. Report the unrealized loss as a reduction of the basis of the security.

11. According to SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities,* which of the following would the auditor **not** consider when evaluating the entity's ability to hold a debt security to maturity?

    a. The entity's current ratio.

    b. The entity's financial position.

    c. The entity's working capital needs.

    d. The entity's alternate sources of liquidity.

12. An entity should reconsider whether a marketable security is properly categorized at each reporting date. All of the following statements about transferring securities between categories are correct **except** for:

    a. Security transfers between categories of investments are accounted for in the new portfolio at cost.

    b. 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.

    c. For debt securities transferred to the held to maturity category from the available for sale category, the difference between the face value of the securities and their fair value at the date of the transfer should be treated as a premium or discount and amortized over future years as a yield adjustment.

    d. 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.

13. One type of Treasury security is a note. Which of the following statements about Treasury notes is **not** correct?

    a. Treasury notes pay semiannual coupon interest.

    b. Treasury notes repay par value at maturity.

    c. Treasury notes are short-term obligations of the U.S. government with a term of one year or less.

    d. Treasury notes are initially issued at par value and can be purchased in $1,000 denominations.

14. A CIRA purchases a $10,000 91-day Treasury bill for $9,500 on November 1, 20XX. What is the amount of accreted discount it should record as of its year end?

    a. $250

    b. $335

    c. $350

    d. $500

15. A CIRA purchases a T bill for $20,000 on December 1, 20X1. A financial publication lists the asked and bid prices of the T bill, which matures in June 1, 20X2, at $5.15 and $5.18 respectively. What is the best approximation of the fair value of the T bill which the CIRA should record?

    a. $18,500.

    b. $19,500.

    c. $18,000.

    d. $19,000.

16. A CIRA purchases 10 five-year Treasury notes at 135. What is the amount of premium, if any, the CIRA should record on the purchase?

    a. $3,500.

    b. $3,000.

    c. $2,500.

    d. $0.

17. SFAS No. 115 requires the CIRAs include certain disclosures about marketable securities in its financial statements. Which of the following is **not** a disclosure that a CIRA is required to make with respect to marketable securities, by major security type, in the available for sale category?

    a. Aggregate fair value.

    b. Total losses for securities with net losses recorded in accumulated other comprehensive income.

    c. Total gains for securities with net gains recorded in accumulated other comprehensive income.

    d. The net carrying amount.

18. SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, establishes accounting and reporting standards for derivative instruments and hedging activities. Which of the following statements best describes accounting for derivative instruments and hedging activities in accordance with that standard?

    a. CIRAs are required to measure derivative instruments at cost.

    b. CIRAs are required to recognize derivative instruments as either assets or liabilities in the balance sheet.

    c. CIRAs are required to comply with SFAS No. 133, even if their only derivative instruments are immaterial speculative investments in a derivative.

    d. CIRAs should record gains and losses (i.e., changes in fair value) in the statement of revenues and expenses in the period of the change in fair value.

19. SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* (as amended), establishes accounting and reporting standards for derivative instruments and hedging activities. According to SFAS No. 133, which of the following is a characteristic of a derivative instrument?

    a. A financial instrument requiring no initial net investment.

    b. A financial instrument with more than one underlying and more than one notional amount.

    c. A financial instrument with terms that disallow net settlement.

    d. A financial instrument requiring an initial net investment more than required for other types of contracts expected to respond similarly to changes in market factors.

20. According to SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, which of the following is **not** a type of derivative instrument?

    a. Cash flow hedge.

    b. Fair value hedge.

    c. Foreign currency hedge.

    d. Net investment hedge.

21. BackYard Properties (BYP), a CIRA, invests funds in annuities. What would be the proper way for Jeff Mark, CPA, to record these investments on the financial statements?

    a. Jeff records the annuities at fair market value at the time payment is received.

    b. Jeff records the annuities at cost and does not disclose fair market value.

c. Jeff records the annuities at cost and discloses fair market value.

d. Jeff records the annuity at fair market value at the time payment is due.

22. Assume a time-share development bills its unit owners annually for their assessments. Further, assume that the development bills its members two months before year end, and that some unit owners pay those amounts before the development's year end. Which of the following best describes how the development should account for those assessments?

a. Prepaid amounts at the balance sheet date should be classified as an asset.

b. If the development presents a classified balance sheet, it generally should classify assessments received in advance as a current asset.

c. Amounts billed but received by year end should be recorded as receivables.

d. Assessments received before year end should be classified as a liability—deferred revenue.

23. 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. Which of the following statements about recording developers' receivables is **not** correct?

a. SFAS No. 57, *Related Party Disclosures*, 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."

b. Certain disclosures about related party transactions is required. For example, if the developer or any other individual party provides 10% or more of a CIRA's total revenue (i.e., assessments revenue from the developer on unsold lots), that fact and the amount of revenue from each such source should be disclosed in the notes to the financial statements.

c. If a CIRA files suit on behalf of the unit owners against the developer for damages arising from defective construction, it should not report the settlement as revenue in the financial statements until the developer has consented to the judgment and is not appealing the verdict.

d. For income tax purposes, developer settlements may be treated as a form of recovery of capital in certain circumstances; in that case, a permanent difference between financial and tax reporting is created and deferred income taxes should be recorded.

24. Which of the following is considered a financial instrument?

a. A probable loss from a lawsuit that is accrued on the balance sheet.

b. A liability that has been accrued for compensation to employees.

c. Prepaid expenses for an advance payment of an insurance premium.

d. A contract obligation that will be settled for consideration that is not cash.

25. SFAS No. 107 requires certain disclosures related to credit risk and encourages other disclosures related to market risk. Disclosures required by SFAS No. 107 generally will be limited to concentrations of credit risk associated with all of the following financial instruments **except** for:

a. Cash invested in certificates of deposits that are not insured.

b. Member assessments receivable.

c. Investments in Treasury bills.

d. Developer receivables.

26. The term ancillary operations describes any association activities other than the ordinary maintenance, security, governance, and administrative activities common to most associations. Which of the following is **not** an example of an ancillary operation of an association?

a. Golf course.

b. A day-care center that rents space in the association clubhouse.

c. A restaurant in the association clubhouse.

d. A greenbelt area adjacent to the association clubhouse.

27. Other income reported in the CIRA's financial statements varies depending on the nature of the CIRA's operations. Which of the following is **not** an example of other income?

a. Income from valet parking.

b. Income from maid services.

c. Income from green fees.

d. Vending machine income.

28. 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. Which of the following is **not** an example of common property of a homeowner's association?

a. Land, such as front entrance walkways, landscaped areas, parking lots, and roads.

b. Recreational facilities, such as clubhouses, tennis courts, and swimming pools.

c. Roofs.

d. Personal property used on common property, such as pool furnishings, clubhouse furnishings, and landscaping equipment.

29. 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.* According to that statement, CIRAs must recognize as an asset an item that possesses all of the following characteristics **except** for:

a. The transaction or other event giving rise to the entity's right to or control of the benefit will occur in the near future.

b. 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.

c. A particular entity can obtain the benefit and control others' access to it.

d. The transaction or other event giving rise to the entity's right to or control of the benefit has already occurred.

30. A CIRA purchases furniture totaling $50,000 to be placed in the association's clubhouse. Assuming the CIRA holds title to the furniture, which statement best describes how the CIRA should account for the $50,000 purchase?

a. The CIRA should expense the $50,000 purchase since the property does not qualify for asset recognition under the criteria in SFAC No. 6.

b. The CIRA should capitalize the $50,000 furniture.

c. The CIRA is not required to capitalize the $50,000 purchase since the board of directors usually is unable to sell personal property at its discretion and retain the proceeds.

d. The CIRA may elect to, but is not required to, capitalize the $50,000 furniture.

31. SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, provides guidance on identifying and valuing an impaired asset. Which of the following statements best describes a CIRA's impairment of long-lived assets?

a. An impaired asset is 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.

b. Impaired assets that will continue to be used are generally reported at the lower of carrying amount or cost.

c. The amount by which the carrying amount of a long-lived asset exceeds its cost equates to the impairment loss.

d. The cost 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.

32. SFAS No. 143, *Accounting for Asset Retirement Obligations*, and FASB Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations," provide accounting requirements for obligations associated with the retirement of tangible long-lived assets. All of the following statements relating to the requirements of Statement No. 143 are correct **except** for:

a. The statement applies to retirements due to acquisition, construction, development, or the normal operation of assets.

b. The statement requires that the fair value of a liability for an asset retirement obligation be recognized when incurred if a reasonable estimate of fair value can be made.

c. The liability should be recorded in the period that the obligations are paid, even if they are paid over more than one reporting period.

d. Asset retirement costs should be capitalized as part of the carrying amount of the long-lived asset.

33. A CIRA receives an insurance settlement for significant damage caused by a hurricane to its clubhouse. It has not yet begun the necessary repairs, which are estimable as of the CIRA's year end. Which of the following statements best describes how the CIRA should account for such settlement?

a. The CIRA should record a material settlement received in its operating fund.

b. The CIRA should record a liability as of the balance sheet date.

c. The CIRA should defer the revenue from the settlement proceeds until the repairs are done.

d. The CIRA may decide to not make the needed repairs and spend those funds for constructing a new swimming pool. In that case, the CIRA would capitalize the asset.

34. Whether a CIRA's repair expenditures related to damage and defect settlements should be capitalized or expensed depends on the nature of the expenditures and whether the CIRA or its members have title to the underlying property. Which of the following is **not** a recommended accounting treatment for damage and defect settlements based on the types of property and the ownership of funds received?

a. Separate property with title held by association should capitalize as assets if repairs relate to capitalized assets.

b. Common property with title held by association should record disbursements of funds as expenses or capitalize as assets if repairs relate to capitalized assets.

c. Common property with title held by members should record disbursements of funds as expenses.

d. Separate property with title held by members should record disbursements of funds as expenses.

35. One phase of a reserve study is the long range funding plan, or financial analysis. Preparers engaged in a financial analysis should be familiar with all but which of the following items?

a. Limitations in the association's governing documents, mortgages, or bonds on investment alternatives.

b. The existing financial structure of the association.

c. Local conditions affecting wear and tear on components.

d. The component's cost of repair.

36. A reserve study is a plan for setting aside funds for the future major repair or replacement of the association's common property. The physical analysis phase of a reserve study requires all of the following steps **except**:

a. Inventory the common property components.

b. Assess the current condition of the components.

c. Estimate projected cost inflation rates.

d. Estimate the repair or replacement cost of the components.

37. EITF Issue No. 90-8 provides guidance on capitalization of environmental cleanup costs. Which of the following best describes a situation in which a CIRA should **not** capitalize environmental cleanup costs?

a. The costs are recoverable and incurred in preparing for sale property currently held for sale.

b. The costs are recoverable and extend the life of the property.

c. The costs are recoverable and improve the safety of the property.

d. The costs are recoverable.

38. SOP 96-1 provides guidance for recognizing, measuring, and disclosing liabilities for legally required environmental remediation. Which of the following statements about accounting for environmental remediation liabilities is **not** correct?

a. Such liabilities should be accrued on a site-by-site basis when the criteria of SFAS No. 5 are met, using the benchmarks in the SOP for determining when those criteria are met.

b. Such liabilities should exclude costs for the CIRA's specific share of costs that will not be paid by the government.

c. Such liabilities should include incremental direct costs, as well as compensation and benefit costs for employees who devote significant time to remediation activities.

d. Such liabilities should be estimated based on enacted laws and regulations.

39. To qualify as a cooperative housing corporation for tax purposes, among other requirements, cooperatives may issue only one class of stock. Like other commercial businesses, the cooperative housing corporation must make disclosures regarding common stock in their financial statements. Which of the following disclosures is required by SFAS No. 129?

a. The title of the stock issue (for example, common stock or capital stock).

b. The names and addresses of the stocks' owners.

c. The par or stated value of the stock.

d. The number of shares issued.

40. CIRAs generally are taxed under either IRC Section 528 or 277 of the Internal Revenue Code. Which of the following statements best describes how a CIRA should account for deferred taxes?

a. Since a significant portion of a CIRA's income is not exempt from taxation, in many cases deferred taxes will be material and need to be recorded.

b. Under IRC Section 528, deferred taxes should be provided for any temporary differences related to the CIRA's exempt function income.

c. Deferred tax assets and liabilities should not be recognized for temporary differences that will not result in taxable or deductible amounts in future years.

d. Deferred taxes should not be provided if the temporary differences relate to the CIRA's nonexempt function income.

GLOSSARY

Ancillary Operations: Ancillary operations describe any association activities other than the ordinary maintenance, security, governance, and administrative activities common to most associations including, but not limited to, golf courses, food and beverage operations, marinas, equestrian operations.

Annuity: An annuity is a fixed sum payable to a person at specified intervals for a specific period of time or for life. Payments represent a partial return of capital and a return on the capital investment. Therefore, an exclusion ratio generally must be used to compute the taxable and nontaxable amounts.

Available for Sale Security: 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.

Capital Improvement Funds: Capital improvement funds are funds designated for the acquisition or construction of new common area components.

Cash: Cash is currency on hand and demand deposits with banks or other financial institutions. It also includes other kinds of accounts that have the general characteristics of demand deposits in that the entity may deposit additional funds at any time and withdraw funds at any time without prior notice or penalty.

Cash Equivalents: Cash equivalents are negotiable, highly liquid items that are the equivalent of cash in value and availability (e.g., checks, bank drafts, cashier's checks, certified checks, and money orders) and, in a broader sense, any short-term, highly liquid investment, such as commercial paper, Treasury notes, and marketable equity securities. Cash equivalents are classified as current assets.

Cash Flow Hedge: Cash flow hedges are intended to hedge the exposure to variability in expected future cash flows due to a particular risk. The exposure may relate to an existing asset or liability or a forecasted transaction.

Common Interest Realty Associations (CIRAs): Residential and nonresidential common interest realty associations, including condominium associations, homeowners' associations, cooperative housing corporations, and timeshare associations.

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. AICPA defines common property as real property owned by individual members in common, real property owned by the CIRA, and personal property owned by the CIRA and used on common real property.

Credit Risk: Credit risk is the possibility that a loss may occur from the failure of another party to perform according to the terms of a contract.

Deferred Tax: Deferred tax is 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 instrument: A derivative instrument is a financial instrument or other contract with all three of the following characteristics: (1)It has one or more underlyings and one or more notional amounts or payment provisions or both. (2) It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. (3)Its terms require or permit net settlement, it can readily be settled net by a means outside the contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

Developer Receivables: Assessments due from developers who are the legal owners of any unsold units and are generally responsible for their proportionate share of the assessments relating to those units.

Discount: A discount is the excess of face value over the proceeds (cash paid) for a bond (i.e., the borrower receives proceeds *less* than the face value), which is contrasted to a premium. A discount results when the stated interest rate is *less* than the effective (market) rate. It is amortized over the life of the bond with the amount of amortization reported as interest and is the difference between the present value of the bond and its face value (where the face value is higher). It is a contra account inseparable from the bond that gives rise to it. It must be disclosed on the statement of financial position as a direct deduction from the face amount of the bond.

Fair Value: Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. A fair value measurement is for a particular asset of liability. Therefore, the measurement should consider attributes specific to the asset or liability.

Fair Value Hedge: A fair value hedge is an instrument designated by an entity as hedging the exposure to changes in the fair value of an asset or a liability or an identified portion thereof (hedged item) that is attributable to a particular risk. (FASB definition)

Financial Accounting Standards Board (FASB): The Financial Accounting Standards Board (FASB) is an independent authoritative body created in 1973 to replace the American Institute of Certified Public Accountants (AICPA) Accounting Principles Board and authorized by the AICPA *Code of Professional Conduct* as a promulgator of generally accepted accounting principles (GAAP), primarily for nongovernmental entities.

Financial Instrument: A financial instrument is cash, evidence of an ownership interest in an entity, or a contract that both: (A) imposes on one entity a contractual obligation (1) to deliver cash or another financial instrument to a second entity or (2) to exchange other financial instruments on potentially unfavorable terms with the second entity and (B)provides the second entity a contractual right (1) to receive cash or another financial instrument from the first entity or (2) to exchange other financial instruments on potentially favorable terms with the first entity.

Foreign Currency Hedges: A transaction designed to protect against the risk of foreign currency exposure.

Generally Accepted Accounting Principles (GAAP): As defined by SAS No. 69, GAAP is a technical accounting term that encompasses the conventions, rules, and procedures necessary to define accepted accounting practice at a particular time. GAAP includes not only broad guidelines of general application, but also detailed practices and procedures. Those conventions, rules, and procedures provide a standard by which to measure financial presentations.

Hedging: Hedging is a transaction that is designed as protection against the risk of an adverse movement in price, rate, or specific outcome. Hedging is done to manage the risk of price change or currency fluctuation with respect to ordinary income property that is held in the normal course of business.

"Held" Checks: Held checks are the 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. They should be reclassified as accounts payable, if material.

Held-to-Maturity Securities: Per SFAS 115, held-to-maturity securities are debt securities that the enterprise has the positive intent and ability to hold to maturity. Held-to-maturity securities are reported at amortized cost. Related dividend and interest income, amortization of any premium or discount from their acquisition, and realized gains and losses from their sale are included in earnings.

Impaired Asset: An impaired asset is 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.

Market Risk: Market risk is the possibility that future changes in market prices may make a financial instrument less valuable or more onerous.

Marketable Security: Marketable securities are 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.

Member Assessments: Amounts typically payable monthly required from each unit owner to cover the CIRA's operating expenses, plus a potential allocation to the replacement fund. These are sometimes referred to as "maintenance fees", "carrying charges", or in the case of cooperatives, "rent".

Notional Amount: A notional amount is a specified number of currency units, shares, bushels, pounds, or other units.

Payment Provision: A payment provision specifies a fixed or determinable settlement to be made if the underlying performs in a specified manner.

Permanent Component: Permanent components are those with remaining useful lives of 30 years or more.

Pooling Method: 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.

Prepaid Expenses: Prepaid expenses are advance payments for products or services that will be used in operations during the year.

Reserve Fund: Reserve funds are accumulated for the major repair or replacement of existing common area components.

Reserve Study: 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) and the preparation of a long range funding plan (the financial analysis).

Special Assessments: Additional funds assessed of members to fund future major repairs and replacements as an alternative to or in addition to regular monthly assessments.

Statements on Auditing Standards (SAS): The 10 generally accepted auditing standards (GAAS) are interpreted and expanded upon in Statements on Auditing Standards (SAS), issued periodically by the Auditing Standards Board of the American Institute of Certified Public Accountants (AICPA). They provide the detail and guidance needed to meet the 10 GAAS standards.

Straight-line Segregated Method: 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.

Traded Security: 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.

Treasury Bill (T bill): A Treasury bill (T-bill) is issued by the U.S. government and has a maturity as short as 13 weeks and as long as 52 weeks. Hence, a T-bill is a short-term debt obligation. Treasury bills are considered the lowest risk investment (short-term) as they are obligations of the U.S. government and are readily convertible to cash.

Treasury Bond: A Treasury bond is a government issue with a longer maturity than a T-bill or a Treasury note. Treasury bonds have maturities of 10–30 years. These obligations can be obtained from the Federal Reserve Bank, brokerage houses, or commercial banks. Like T-bills, they have an active secondary market and provide liquidity.

Treasury Note: A Treasury note is a security issued by the federal government with a longer maturity than a T-bill but a shorter maturity period than a Treasury bond. Treasury notes have maturity periods ranging from 2 to 10 years. These obligations can be obtained from the Federal Reserve Bank, brokerage houses, or commercial banks. Like T-bills, they have an active secondary market and provide liquidity.

Unrealized Holding Gain or Loss: An unrealized holding gain or loss is the difference between the fair value of an asset and its aggregate cost at any given date, usually said of marketable equity securities, and means that *no sale* has taken place. It is recognized only at the end of an accounting period by an adjusting entry (SFAS 115).

Unrealized loss means that the fair value of the security at the end of the accounting period is less than the original. Accounting treatment for unrealized loss depends on the classification of the related asset:

Trading security: Reported in the net income of the current period and accumulated in a valuation allowance

Available-for-sale: Reported as a separate (negative) component of stockholders' equity and accumulated in a valuation allowance, which may be debit or credit balance

Unrealized gain means the current fair value of the security is *above* the cost.

Underlying: 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).

Variable annuity: This type of annuity will pay out a variable amount in regular installments. The amount of payout varies with the value of the account. All capital and investment proceeds that remain inside the annuity accumulate tax-deferred.

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

COURSE 2

INCOME TAXES FOR CIRAS (HOATG092)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course provides an overview of the tax laws that apply to common interest realty associations (CIRAs). Additionally, this course describes the specific tax principles and regulations that apply to CIRAs, as well as the tax filing options available to them. Finally, the course describes how to file the appropriate tax forms.

PUBLICATION/REVISION DATE: July 2009

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

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of taxes

CPE CREDIT: 8 QAS Hours, 8 Registry Hours

8 CTEC Federal Hours, 0 CTEC California Hours

Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours.

Enrolled Agents: This course is designed to enhance professional knowledge for Enrolled Agents. PPC is a qualified CPE Sponsor for Enrolled Agents as required by Circular 230 Section 10.6(g)(2)(ii).

FIELD OF STUDY: Taxes

EXPIRATION DATE: Postmark by **September 30, 2010**

KNOWLEDGE LEVEL: Basic

Learning Objectives:

Lesson 1—Overview of Tax Law for CIRAs

Completion of this lesson will enable you to:

- Describe the tax filing options for CIRAs and summarize the intent and purpose of the tax law of CIRAs.
- Assess the tax law principles common to all common interest realty associations (CIRAs).

Lesson 2—Taxation under IRC Sections 528 and 277

Completion of this lesson will enable you to:

- Identify the tax filing options available to a CIRA based on whether it is a condominium association, homeowners' association, cooperative housing corporation, or timeshare association.
- Summarize how to file Form 1120 and Form 1120-H.
- Cite the complex tax regulations affecting such CIRAs, including recent revenue rulings, tax court cases, and private letter rulings.

Lesson 3—Unique Tax Issues Relating to Other Types of CIRAs

- Identify the unique tax issues surrounding tax-exempt CIRAs, master associations, timeshare developments, and commercial associations.
- Describe how to file Form 990 and Form 990-T for such CIRAs.
- Cite the complex tax regulations affecting such CIRAs, including recent revenue rulings, tax court cases, and private letter rulings.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

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See the test instructions included with the course materials for more information.

ADMINISTRATIVE POLICIES:

For information regarding refunds and complaint resolutions, dial (800) 431-9025 for Customer Service and your questions or concerns will be promptly addressed.

Lesson 1: Overview of Tax Law for CIRAs

INTRODUCTION

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 available tax options depend, in part, on the specific type of CIRA—condominium association, homeowners' association, cooperative housing corporation, or timeshare association.

This course provides an overview of the tax laws for CIRAs. It also discusses the many tax law principles that apply to CIRAs, including:

- 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.

Learning Objectives:

Completion of this lesson will enable you to:
- Describe the tax filing options for CIRAs and summarize the intent and purpose of the tax law of CIRAs.
- Assess the tax law principles common to all common interest realty associations (CIRAs).

TAX LAW FOR CIRAS: AN OVERVIEW

Tax Filing Options

All CIRAs generally are taxed as corporations, but the available tax options depend, in part, on the specific type of CIRA—condominium association, homeowners' association, cooperative housing corporation, or timeshare association.

- Residential condominium associations, homeowners' associations, and timeshare associations may be taxed either under IRC Section 277, which applies to *certain membership organizations*, or may elect to be taxed under IRC Section 528, which applies specifically to homeowners' associations as that term is defined for tax purposes. Qualified CIRAs that elect to be taxed under IRC Section 528 file Form 1120-H, *U.S. Income Tax Return for Homeowners Associations*. CIRAs that are taxed under IRC Section 277 file the standard Form 1120 (or 1120-A).
- Commercial condominium associations file Form 1120.
- Cooperatives are subject to subchapter T and file Form 1120-C (beginning in 2007).
- 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, 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. (See Exhibit 2-3.)

The taxation of condominium associations, homeowners' associations, and timeshare associations presents an option that is not available in any other area of taxation: the ability to choose which tax form to file and, therefore, which tax rate applies. The decision, however, is not as clear-cut as it may appear at first glance. Form 1120-H is a relatively simple form to prepare but has certain qualification requirements and a higher tax rate for most associations than the alternative Form 1120. On the other hand, Form 1120 is extremely complex. While it will normally result in a lower tax rate than Form 1120-H (for example, 15% for the first $50,000 of taxable income), its complexity and the lack of specific rulings in several areas create a much higher tax exposure risk when using that form. The ultimate decision is the association's, not the accountant's. Few associations, however, will be knowledgeable enough to make the decision alone. Rather, they will rely on the professional advice of their tax preparer. Exhibit 1-1 presents the tax filing options and tax treatments available to CIRAs.

Exhibit 1-1

Tax Filing Options and Tax Treatments

	IRC Section 277	
Applies to:	Condominium associations, homeowners' associations, and timeshare associations.	
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.	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 corporate 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. 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. 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 Course

The tax posture adopted in this course 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, 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 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 authors are aware of several such instances occurring.

Positions may change from year to year because tax law affecting CIRAs is still evolving. Some positions taken in the past are no longer viable, either because new rulings are issued or new interpretations are made of existing rulings. Informal contact with employees is maintained 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 updates to this course. The "List of Substantive Changes and Additions" that is sent with each update should be carefully studied so that all new recommendations are considered. Accountants are also urged to challenge interpretations and recommendations 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. 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.

The updates of this course 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 a companion *Guide*, *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. The *Guide* may be ordered by calling (800) 323-8724 or via the website at **ppc.thomson.com**. Most of the citations in this course are included in *PPC's Homeowners' Association Tax Library*. Those citations have been referenced to the appendix in *PPC's Homeowners' Association Tax Library* where the content of the citation is located. For example, a discussion of IRC Section 277 in this course is linked to Appendix 2F in *PPC's Homeowners' Association Tax Library* (HTL).

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.

TAX LAW PRINCIPLES THAT APPLY 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 non-capital 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 71-21 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 71-21, 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. Perhaps 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 71-21.

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.

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 discussed below.

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 1-2 lists the guidance applicable when determining whether a receipt is a capital contribution.

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. However, if the CIRA classifies receipts as exempt function income that should have been capital contributions, the CIRA would not properly calculate the 60% income test to determine whether the CIRA qualifies to file Form 1120-H.

A CIRA that files Form 1120 should be careful to comply with the IRS requirements discussed beginning on the next page 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; and 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, failing to fully comply is a higher risk position now than it was in the past.

Exhibit 1-2

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
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 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. For ordering information, call (800) 323-8724 or visit the website at **ppc.thomson.com**.

[b] See discussion of factors below.

[c] However, the Courts held in *Chicago Board of Trade* that nonvoluntary transfer fees may qualify as capital contributions.

* * *

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 1-2 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 1-2 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." (See later in this lesson for a further discussion of capital expenditures.)

Many accountants argue that major expenditures for painting the common elements should qualify as capital in nature because normally they are being "reserved" for in the replacement fund. However, it is the nature of the activity that is controlling. Painting does not meet the criteria for capitalization under IRC Section 263, and several court cases hold that painting is a deductible expense. Also, Revenue Ruling 75-370 explicitly states that funds collected "to provide the services for which [The Association] was formed such as maintenance of the common elements" are not considered as contributions of capital but are includable in the association's gross income. The revenue ruling states that funds for painting the common elements and for repairs, gardening, and janitorial services are not considered as contributions of capital. In addition, Revenue Ruling 75-371 states that any funds accumulated for contingencies are includable in the association's gross income since they are not set aside for specific capital improvement purposes.

The issue of treating reserve fund assessments for painting as capital contributions continues to be raised. The basic forces driving that issue are:

- Treating painting reserve assessments as *capital* in nature allows most associations to take advantage of the lower corporate tax rates of only 15% on the first $50,000 of taxable income by filing Form 1120. Since *capital* assessments may be excluded from member income, treating the painting reserve assessments as capital contributions excludes them from member income and treats them like any other capital reserve assessment (such as for roofing or streets). By excluding the painting reserve assessments from membership income, it is much easier to arrive at excess membership deductions for tax purposes.

- Treating painting reserve assessments as *noncapital* in nature generally results in excess net membership income for any year except the year the monies are expended. That net membership income is subject to taxation on Form 1120 under IRC Section 277. Consequently, treating painting as noncapital in nature is more likely to result in a decision to file Form 1120-H to avoid being taxed on net membership income. The downside of that decision is that the association is subject to a 30% tax rate on Form 1120-H (or 32% for timeshare associations), which is at least double the lowest tax rate on Form 1120.

Those accountants who treat painting reserve assessments as capital in nature base their decisions on the following criteria:

- Painting is a reserve item as are a variety of other common area components that clearly qualify as capital in nature.

- Painting is generally a very large dollar expenditure, and the IRS typically requires capitalization of large dollar expenditures rather than allowing current deductions for them.

- The specific mention of painting in Revenue Ruling 75-370 does not constitute absolute authority to consider painting to be noncapital in nature.

None of those criteria are based on supportable tax law, and they ignore the most critical element; i.e., the nature of the activity. The IRS has made it clear that it considers painting to be *noncapital* in nature. There is a considerable body of tax law supporting the IRS position. Exhibit 1-3 summarizes those laws and regulations.

Exhibit 1-3

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*."

Citation	Applicable Quotation
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.
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 1-3 lends weight to the IRS position that painting is not capital in nature. Furthermore, Exhibit 1-4 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 1-4

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.

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The cases in Exhibit 1-4 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. As indicated in the contributed capital discussion, 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 should 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. 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, it may be that the lack of a reserve study increases 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, CIRAs should 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 (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. A conservative position that strictly complies with tax law may be best. 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, perhaps they should be considered 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. (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 1-2) *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 should 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 1-2) 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, best practice indicates that the CIRA 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.

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 1-5 is an example of how to apply the seven factors discussed 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 provides the most effective documentation in the event the CIRA faces an IRS audit.

Exhibit 1-5

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.
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 a 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. If not, the fee should be recorded as membership or exempt function income. In the example given, 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 are discussed earlier, and are not discussed in the following paragraphs.

Consequences of Not Complying with IRS Regulations. While additional bank accounts may be an extra administrative burden on the CIRA, they are critical in demonstrating intent to the IRS in the event of an audit. All of the discussions 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. (Amending a Form 1120 to change to Form 1120-H is further discussed later.)

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. Read discussion about the effect such a transfer may have on the 60% test.) 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 1-3) 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 1-2 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."

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 1-6 illustrates the tax effect of several types of transfers between operating and reserve funds.

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.

Exhibit 1-6

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 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 described 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.
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 Regulations 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 it has $50,000 in excess reserve funds.

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.
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.

* * *

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.) As stated in the discussion of legal settlements, 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. (Designated settlement funds are discussed further.)

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. (See a discussion of the effect of litigation proceeds on a unit owner's basis.)

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), 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.

Structured Settlements. *Structured settlements* are a relatively new 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.

A few CIRAs are actively attempting to structure settlements in the preceding manner, and at least three associations that have applied the "structured settlement" concept to lump sum settlements they have received in amounts in excess of $10 million. The benefits are substantial if structured settlements in construction defects litigation are held to be nontaxable; however, caution is advised 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 (see IRC Section 468B).

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 book to tax difference as would any depreciation expense recorded for book purposes.

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* (HTL—Appendix 4J), 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* (HTL—Appendix 4B) and *Washington Athletic Club v. United States* both reached the opposite conclusion. The arguments raised in the latter two cases are believed to be more persuasive than in the *Lake Petersburg* case and best practices indicate that tax practitioners should generally take the conservative position and assume that assets purchased from reserves have no tax basis.

An aggressive 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. Practitioners should 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 and those asset purchases will not have to reduce 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.

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 structural differences and the differences 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.

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 course, 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.

SELF-STUDY QUIZ

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

1. All CIRAs generally are taxed as corporations, but the available tax options depend, in part, on the specific type of CIRA. Which of the following types of CIRAs can **not** file a Form 1120?

   a. Qualified electing timeshare association.

   b. Commercial condominium associations.

   c. Homeowners' association exempt under IRC Section 501(c)(4).

   d. Cooperative housing corporation.

2. The decision about which tax return a CIRA should file is a complex one that requires a full understanding of the tax treatment of the components of a CIRA's income and expenses. Which of the following statements affecting a CIRA's decision is **incorrect**?

   a. CIRAs without taxable income are not required to file an income tax return.

   b. A condominium or homeowners' association that elects to be taxed under IRC Section 528 must allocate its income and expenses between its exempt function activities and its activities for the production of gross income (or nonexempt function activities), since it is taxed only on its nonexempt function income.

   c. A qualifying timeshare association that elects to be taxed under IRC Section 528 is taxed on its net nonexempt function income.

   d. Condominium associations, homeowners' associations, and timeshare associations have an option not available in any other area of taxation: the ability to choose which tax form to file.

3. When deciding which tax form to file, a CIRA must understand the pros and cons of filing each tax form. Which of the following statements about the pros and cons of each form is correct?

   a. Form 1120 -H is extremely complex to prepare.

   b. Form 1120-H has a lower tax rate for most associations than the alternative Form 1120.

   c. Form 1120 is a relatively simple form to prepare.

   d. The lack of specific rulings in several areas creates a much higher tax exposure risk when using Form 1120.

4. Listed below are statements regarding the historical perspective of CIRA taxation and the enactment of IRC Section 528. Choose the statement that is most accurate.

   a. The intention was to tax a CIRA the same as the individual homeowners.

   b. IRC Section 528 is now mandatory.

   c. CIRA Reserves are now taxed.

   d. The tax return became more complex.

5. 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 and 528 when determining taxable income for a CIRA. Although certain types of gross income may be treated differently depending upon the tax filing option selected, all **but which** of the following types of income generally are treated as gross income for tax purposes?

   a. Nonmember fees for services.

b. Member operating assessments.

c. Passive income, such as interest income.

d. Litigation settlements.

6. One of the statutes that CIRAs must consider when determining whether to claim a deduction for a capital expenditure is IRC Section 263. Which of the following statements about IRS Section 263 is correct?

a. IRC Section 263 allows a deduction for "any amount expended in restoring property or in making good the exhaustion thereof for which an allowance [for depreciation] has been made."

b. IRC Section 263 is an elective section.

c. IRC Section 263 is an 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.

d. IRC Section 263 allows a deduction 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. Views differ among accountants as to whether painting the common elements qualifies as capital in nature. Which of the following arguments supports this view?

a. Painting does not meet the criteria for capitalization under IRC Section 263.

b. Several court cases hold that painting is a deductible expense—not a capital contribution.

c. 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 considered contributions of capital and, thus, are not includable in the association's gross income.

d. 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.

8. A CIRA should document its intent for an assessment to qualify as a capital contribution for tax purposes. Which of the following is **not** a necessary step that a CIRA should take when considering whether the assessment has been accounted for as a capital contribution?

a. The CIRA's general ledger and financial statements should clearly delineate capital assessments from operating assessments.

b. The CIRA's budget and reserve study should support the amount collected for capital assessments.

c. Assessments recorded as contributions to capital for tax purposes should be recorded in the same manner for financial reporting purposes.

d. There should be clear tax return reconciliation (on Schedule M-1 or Schedule M-3) separating capital transactions from operating transactions.

9. One of the criteria a CIRA must meet for recording an assessment as a contribution to capital for tax purposes is to show its *intent* to make such an assessment. One of the factors that should be considered when documenting the CIRA's intent is that members or unit owners must have advance notice as to the intent of the purpose of the contribution. Which of the following statements about such advance notice is **incorrect**?

a. Distributing copies of the budget and replacement fund study to members and unit owners, although recommended, does not constitute advance notice of intent.

b. The budget signals the CIRA's intent in making the assessment.

c. The replacement fund reserve study should agree to and support the budget.

d. 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.

10. One of the criteria a CIRA must meet for recording an assessment as a contribution to capital for tax purposes is to show its *intent* to make such an assessment. One of the factors that should be considered when documenting the CIRA's intent is that the money collected is held for that purpose and no other. Which of the following statements best describes the need for a CIRA to segregate funds to meet this criteria?

a. Segregating funds for future major repairs and replacements from operating funds is sufficient to create a contribution to capital.

b. Since the IRS does not technically require that separate bank accounts be maintained for capital funds, a CIRA does not have to segregate funds for capital funds from funds for operating funds.

c. Failure to segregate funds for future major repairs and replacements for operating funds can call into a CIRA's intent to hold such funds for the specific purposes authorized by IRC Section 118.

d. Earmarking of funds does not require segregation of funds.

11. Assume a CIRA wants to consider an assessment made for an addition to the reserve fund for repairs to the roof of its clubhouse as a capital contribution. Which of the following would **not** demonstrate the CIRAs intent?

a. The CIRA accounts for the money received as a reserve capital contribution.

b. The funds, once segregated by the accounting process and deposited in a separate bank account, are not commingled with any noncapital reserve funds or operating funds.

c. 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.

d. When it was time to replace or repair the roof, the CIRA spent the money for repairing the new roof, painting the clubhouse, and upgrading the surrounding landscaping.

12. 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. Which of the following statements about amending a prior-year return is correct?

a. Treasury Regulations Section 301 allows the CIRA to amend the returns if (a) the CIRA acted reasonably and in good faith and (b) the IRS will not prejudice the interests of the government in allowing the change.

b. Guidance for making such an amendment is set forth in Treasury Regulation Section 118.

c. Treasury Regulation Section 301 provides an automatic 90 day extension for amending a return and no reason must be specified.

d. For periods of time beyond the automatic 90 day extension period, the CIRA must request permission from the Commissioner to change from one form to the other.

13. A CIRA that files Form 1120 discovers that it has $50,000 excess reserve funds it wishes to transfer to its operating fund. Which of the following statements best describes the tax treatment of such a transfer?

a. Accountants agree that the $50,000 transferred between operating and reserve funds may be made tax free because the taxability of assessments is determined based on their original purpose and intent in making the contribution.

b. Accountants agree that reserve funds are taxable when transferred to operating funds.

c. The *Maryland Country Club* case supports the view that monies transferred between operating and reserve funds may be made tax free.

d. Both the original intent in making the contribution and the expenditure of funds are critical to safely establishing a CIRA's capital contribution. Thus, the $50,000 reserve funds would be converted from a capital contribution to membership operating income.

14. Associations may receive construction defects litigation settlements, many times on a pre-trial basis within 10 years after their formation. While litigation proceeds are typically recorded as income in the financial statements of the association, the tax treatment of the proceeds is generally different. Which of the following statement about different types of proceeds and their tax consequences is correct?

    a. Payments in lieu of dues are generally considered to be nonmembership income or nonexempt function income.

    b. Punitive damages are generally considered to be membership income or exempt function income

    c. 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.

    d. Cumulative interest awards are generally considered to be membership income or exempt function income because they are not received from members.

15. A CIRA receives $500,000 in damage awards in settlement of a lawsuit against the developer, after attorney fees. Because the members were previously assessed amounts needed to perform the necessary repairs, the $500,000 represents excess awards funds. Which of the following statements related to the $500,000 award is correct?

    a. It is not necessary for this transaction to be included in the association's financial statements for financial reporting purposes.

    b. For tax purposes, the $500,000 settlement proceeds are taxable to the association since it is the taxpayer in this instance.

    c. Even though the association has received the $500,000 settlement proceeds, it is not responsible for determining the tax impact of the transaction; that is up to the individual members.

    d. The $500,000 disbursed to members represents a capital distribution from the association's perspective. To the members, the $500,000 is a nontaxable recovery of capital, unless such amount exceeds the member's basis in their property.

16. IRC Sections 351 and 362 provide that assets received from a developer will have the same basis in the hands of a cooperative association as they did in the hands of the developer if the developer receives membership shares in exchange for the assets contributed. Which of the following statements about the basis in assets received from a developer is **incorrect**?

    a. IRC Section 351 is a mandatory section.

    b. It is common for a developer to receive membership shares in exchange for the assets contributed.

    c. The timing of the transfer and whether "control" requirements are met ultimately determine if IRC Section 351 applies.

    d. Since the developer'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.

17. Although some cooperative associations and condominium or homeowners' associations look alike, the differences in legal structure, nature of activities, and tax laws result in vastly different tax results for such organizations. Which of the following statements best describes the differences between cooperative associations and condominium or homeowners' associations?

    a. Cooperative associations, condominiums, and homeowners' associations operate as businesses.

    b. While condominiums and homeowners' associations own operate, and lease to members (primarily) residential real estate property, cooperatives do not.

    c. A cooperative association should generally capitalize and depreciate its capital expenditures.

    d. Condominium and homeowners' associations may legitimately claim tax deductions for capital expenditures and depreciation expense, even if those expenditures are related to activities not engaged in for profit.

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. All CIRAs generally are taxed as corporations, but the available tax options depend, in part, on the specific type of CIRA. Which of the following types of CIRAs can **not** file a Form 1120? **(Page 143)**

   a. Qualified electing timeshare association. [This answer is incorrect. Timeshare associations may elect to be taxed either under IRC Section 277, which applies to certain membership organizations, or under IRC Section 528, which applies specifically to homeowners' associations as that term is defined for tax purposes. If it elects to be taxed under IRC Section 528, it would 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)]

   b. Commercial condominium associations. [This answer is incorrect. Commercial condominium associations are required to file Form 1120.]

   c. Homeowners' association exempt under IRC Section 501(c)(4). [This answer is correct. Homeowners' associations that qualify as tax-exempt organizations file Form 990, not Form 1120.]

   d. Cooperative housing corporation. [This answer is incorrect. Cooperative are subject to subchapter T and file Form 1120-C.]

2. The decision about which tax return a CIRA should file is a complex one that requires a full understanding of the tax treatment of the components of a CIRA's income and expenses. Which of the following statements affecting a CIRA's decision is **incorrect**? **(Page 143)**

   a. CIRAs without taxable income are not required to file an income tax return. [This answer is correct. 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.]

   b. A condominium or homeowners' association that elects to be taxed under IRC Section 528 must allocate its income and expenses between its exempt function activities and its activities for the production of gross income (or nonexempt function activities), since it is taxed only on its nonexempt function income. [This answer is incorrect. 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*).]

   c. A qualifying timeshare association that elects to be taxed under IRC Section 528 is taxed on its net nonexempt function income. [This answer is incorrect. A qualifying timeshare association electing to be taxed under IRC Section 528 is subject to a 32% tax rate on its net nonexempt function income.]

   d. Condominium associations, homeowners' associations, and timeshare associations have an option not available in any other area of taxation: the ability to choose which tax form to file. [This answer is incorrect. In some cases, such organizations may choose which tax form to file. However, the decision is not always an easy one.]

3. When deciding which tax form to file, a CIRA must understand the pros and cons of filing each tax form. Which of the following statements about the pros and cons of each form is correct? **(Page 144)**

   a. Form 1120 -H is extremely complex to prepare. [This answer is incorrect. Form 1120-H is a relatively simple form to prepare.]

   b. Form 1120-H has a lower tax rate for most associations than the alternative Form 1120. [This answer is incorrect. Form 1120-H has a *higher* tax rate for most associations than the alternative Form 1120.]

c. Form 1120 is a relatively simple form to prepare. [This answer is incorrect. Form 1120 is extremely complex.]

d. The lack of specific rulings in several areas create a much higher tax exposure risk when using Form 1120. [This answer is correct. The lack of specific rulings in several areas is one of the drawbacks to filing Form 1120.]

4. Listed below are statements regarding the historical perspective of CIRA taxation and the enactment of IRC Section 528. Choose the statement that is most accurate. **(Page 146)**

a. The intention was to tax a CIRA the same as the individual homeowners. [This answer is correct. Congress had the intention of taxing the CIRA 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.]

b. IRC Section 528 is now mandatory. [This answer is incorrect. IRC Section 528 may generally be considered an *elective*, *beneficial* code section, as it is elective.]

c. CIRA reserves are now taxed. [This answer is incorrect. Specifically, the CIRA is allowed to build reserves with no tax consequences other than taxation of the interest earned on such amounts.]

d. The tax return became more complex. [This answer is incorrect. One of the benefits provided to CIRAs under IRC Section 528 is that they were given a simple method of filing their tax returns. The other benefit is that exempt function income that was inadvertently being taxed on Form 1120 was exempted from taxation.]

5. 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 and 528 when determining taxable income for a CIRA. Although certain types of gross income may be treated differently depending upon the tax filing option selected, all **but which** of the following types of income generally are treated as gross income for tax purposes? **(Page 148)**

a. Nonmember fees for services. [This answer is incorrect. Nonmember fees for services generally are included in gross income for tax purposes.]

b. Member operating assessments. [This answer is incorrect. Member operating assessments generally are treated as gross income for tax purposes.]

c. Passive income, such as interest income. [This answer is incorrect. Generally, gross income includes passive income for tax purposes.]

d. Litigation settlements. [This answer is correct. IRC Section 118 excludes litigation proceeds from income and treats them as contributions to capital.]

6. One of the statutes that CIRAs must consider when determining whether to claim a deduction for a capital expenditure is IRC Section 263. Which of the following statements about IRS Section 263 is correct? **(Page 152)**

a. IRC Section 263 allows a deduction for any amount expended in restoring property or in making good the exhaustion thereof for which an allowance [for depreciation] has been made. [This answer is incorrect. IRC Section 263 does not allow such a deduction.]

b. IRC Section 263 is an elective section. [This answer is incorrect. IRC Section is not elective—it is a mandatory section.]

c. IRC Section 263 is an 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. [This answer is correct. This is the purpose of IRC Section 263.]

d. IRC Section 263 allows a deduction for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. [This answer is incorrect. Such a deduction is not allowed by IRC Section 263.]

7. Views differ among accountants as to whether painting the common elements qualifies as capital in nature. Which of the following arguments supports this view? **(Page 152)**

a. Painting does not meet the criteria for capitalization under IRC Section 263. [This answer is incorrect. IRC Section 263 states a number of criteria for capital expenditures, and painting does not meet any of them. Therefore, this statement argues against the view that painting should be considered a capital contribution.]

b. Several court cases hold that painting is a deductible expense—not a capital contribution. [This answer is incorrect. A number of court cases cited in Exhibit Page 155 hold this view. Therefore, this statement argues against the view that painting should be considered a capital contribution]

c. 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 considered contributions of capital and, thus, are not includable in the association's gross income. [This answer is correct. As stated, this statement supports the view that painting should be considered a capital contribution. However, this statement is incorrectly stated. Revenue Ruling 75-370 actually says that such funds *are not considered as contributions of capital but are includable in the association's gross income.*]

d. 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.[This answer is incorrect. Revenue Ruling 75-371 supports the view that painting is not a capital contribution.]

8. A CIRA should document its intent for an assessment to qualify as a capital contribution for tax purposes. Which of the following is **not** a necessary step that a CIRA should take when considering whether the assessment has been accounted for as a capital contribution? **(Page 156)**

a. The CIRA's general ledger and financial statements should clearly delineate capital assessments from operating assessments. [This answer is incorrect. Ensuring that the CIRA's general ledger and financial statements clearly delineate capital assessments from operating assessments go a long way to support the CIRA's intent to account for the assessment as a capital contribution.]

b. The CIRA's budget and reserve study should support the amount collected for capital assessments. [This answer is incorrect. Ensuring that the budget and reserve study support the amount collected for capital assessments go a long way to supporting the CIRA's intent to account for the assessment as a capital contribution.]

c. Assessments recorded as contributions to capital for tax purposes should be recorded in the same manner for financial reporting purposes. [This answer is correct. 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.]

d. There should be a clear tax return reconciliation (on Schedule M-1 or Schedule M-3) separating capital transactions from operating transactions. [This answer is incorrect. A reconciliation separating capital from operating transactions supports the CIRA's intent to record the assessment as a capital contribution.]

9. One of the criteria a CIRA must meet for recording an assessment as a contribution to capital for tax purposes is to show its *intent* to make such an assessment. One of the factors that should be considered when documenting the CIRA's intent is that members or unit owners must have advance notice as to the intent of the purpose of the contribution. Which of the following statements about such advance notice is **incorrect**? **(Page 156)**

    a. Distributing copies of the budget and replacement fund study to members and unit owners, although recommended, does not constitute advance notice of intent. [This answer is correct. 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.]

    b. The budget signals the CIRA's intent in making the assessment. [This answer is incorrect. The CIRA's intent is signaled by the budget.]

    c. The replacement fund reserve study should agree to and support the budget. [This answer is incorrect. A replacement fund that agrees to and supports the budget constitutes advance notice of intent.]

    d. 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. [This answer is incorrect. A reserve study supports the purpose of the assessment.]

10. One of the criteria a CIRA must meet for recording an assessment as a contribution to capital for tax purposes is to show its *intent* to make such an assessment. One of the factors that should be considered when documenting the CIRA's intent is that the money collected is held for that purpose and no other. Which of the following statements best describes the need for a CIRA to segregate funds to meet this criteria? **(Page 157)**

    a. Segregating funds for future major repairs and replacements from operating funds is sufficient to create a contribution to capital. [This answer is incorrect. Segregating such funds is one of seven criteria a CIRA should consider when documenting its desire to record an assessment as a capital contribution.]

    b. Since the IRS does not technically require that separate bank accounts be maintained for capital funds, a CIRA does not have to segregate funds for capital funds from funds for operating funds. [This answer is incorrect. While 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 funds solely for purposes authorized by the statute. In *Maryland Country Club*, this had the effect of invalidating the exemption of the entire sum collected, because an earmarking of funds never took place.]

    c. Failure to segregate funds for future major repairs and replacements for operating funds can call into a CIRA's intent to hold such funds for the specific purposes authorized by IRC Section 118. [This answer is correct. While physically segregating capital bank accounts is not required, the fact that other rulings specific to homeowners associations *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 should dissuade an association from knowingly running the risk by not segregating the funds in a separate bank account.]

    d. Earmarking of funds does not require segregation of funds. [This answer is incorrect. GCM 35929 notes that simply earmarking funds, by itself, is not sufficient to create a contribution to capital.]

11. Assume a CIRA wants to consider an assessment made for an addition to the reserve fund for repairs to the roof of its clubhouse as a capital contribution. Which of the following would **not** demonstrate the CIRAs intent? **(Page 158)**

    a. The CIRA accounts for the money received as a reserve capital contribution. [This answer is incorrect. Accounting for the funds received as a reserve capital contribution would demonstrate that the purpose of the assessment is capital in nature.]

b. The funds, once segregated by the accounting process and deposited in a separate bank account, are not commingled with any noncapital reserve funds or operating funds. [This answer is incorrect. Segregating the funds and not commingling them with operating funds would indicate that the money is held solely for that purpose of repairing the roof.]

c. The CIRA has a 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. [This answer is incorrect. Having two reserve bank accounts is the best way to ensure that the funds for roof repairs are not commingled with operating funds.]

d. When it was time to replace or repair the roof, the CIRA spent the money for repairing the new roof, painting the clubhouse, and upgrading the surrounding landscaping. [This answer is correct. Using the money for other purposes, such as painting and landscaping, invalidates the CIRA's claim that the money was set aside solely for that purpose. In addition, it fails the criterion that requires the money to be expended for the intended purpose.]

12. 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. Which of the following statements about amending a prior-year return is correct? **(Page 159)**

a. Treasury Regulations Section 301 allows the CIRA to amend the returns if (a) the CIRA acted reasonably and in good faith and (b) the IRS will not prejudice the interests of the government in allowing the change. [This answer is correct. Treasury Regulation Section 301.9100-2 includes those provisions.]

b. Guidance for making such an amendment is set forth in Treasury Regulation Section 118. [This answer is incorrect. Guidance for amending the return is contained in Treasury Regulations Section 301.9100-1 through 3.]

c. Treasury Regulation Section 301 provides an automatic 90 day extension for amending a return and no reason must be specified. [This answer is incorrect. Treasury Regulation Section 301 provides an automatic *12-month* extension for amending a return and no reason must be specified.]

d. For periods of time beyond the automatic 90 day extension period, the CIRA must request permission from the Commissioner to change from one form to the other. [This answer is incorrect. Treasury Regulation Section 301 provides an automatic *12-month* extension for amending a return; thus, a CIRA must request permission from the Commissioner for periods of time beyond one year.]

13. A CIRA that files Form 1120 discovers that it has $50,000 excess reserve funds it wishes to transfer to its operating fund. Which of the following statements best describes the tax treatment of such a transfer? **(Page 160)**

a. Accountants agree that the $50,000 transferred between operating and reserve funds may be made tax free because the taxability of assessments is determined based on their original purpose and intent in making the contribution. [This answer is incorrect. Accountants *disagree* on whether the $50,000 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 seem to support that position. Others disagree with that view.]

b. Accountants agrees that reserve funds are taxable when transferred to operating funds. [This answer is incorrect. Some 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. For instance, 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.]

c. The *Maryland Country Club* case supports the view that monies transferred between operating and reserve funds may be made tax free. [This answer is incorrect. The *Maryland Country Club* case supports the view that a CIRA cannot divert capital funds to operating expenses; rather, it should use the funds for the purpose for which the funds were originally collected.]

d. Both the original intent in making the contribution and the expenditure of funds are critical to safely establishing a CIRA's capital contribution. Thus, the $50,000 reserve funds would be converted from a capital contribution to membership operating income. [This answer is correct. In addition, the IRS may view such a transfer 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.]

14. Associations may receive construction defects litigation settlements, many times on a pre-trial basis within 10 years after their formation. While litigation proceeds are typically recorded as income in the financial statements of the association, the tax treatment of the proceeds is generally different. Which of the following statement about different types of proceeds and their tax consequences is correct? **(Page 163)**

a. Payments in lieu of dues are generally considered to be nonmembership income or nonexempt function income. [This answer is incorrect. Payments in lieu of dues (past, present, or future) and for under-assessments are generally considered to be *membership income or exempt function income.*]

b. Punitive damages are generally considered to be membership income or exempt function income. [This answer is incorrect. Punitive damages are generally considered to be *nonmembership income or nonexempt function income*.]

c. 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. [This answer is correct. In fact, that tax treatment is consistent regardless of whether the members or the association is the "taxpayer."]

d. Cumulative interest awards are generally considered to be membership income or exempt function income because they are not received from members. [This answer is incorrect. As supported by Revenue Ruling 9038018, cumulative interest awards are generally considered to be *nonmembership income or nonexempt function income* because they are not received from members.]

15. A CIRA receives $500,000 in damage awards in settlement of a lawsuit against the developer, after attorney fees. Because the members were previously assessed amounts needed to perform the necessary repairs, the $500,000 represents excess awards funds. Which of the following statements related to the $500,000 award is correct? **(Page 164)**

a. It is not necessary for this transaction to be included in the association's financial statements for financial reporting purposes. [This answer is incorrect. Chapter 4 of the AICPA guide requires that this transaction be included in the association's financial statements for financial reporting purposes.]

b. For tax purposes, the $500,000 settlement proceeds are taxable to the association since it is the taxpayer in this instance. [This answer is incorrect. 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.]

c. Even though the association has received the $500,000 settlement proceeds, it is not responsible for determining the tax impact of the transaction; that is up to the individual members. [This answer is incorrect. 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.]

d. The $500,000 disbursed to members represents a capital distribution from the association's perspective. To the members, the $500,000 is a nontaxable recovery of capital, unless such amount exceeds the member's basis in their property. [This answer is correct. The $500,000 is a capital distribution from the CIRA.]

16. IRC Sections 351 and 362 provide that assets received from a developer will have the same basis in the hands of a cooperative association as they did in the hands of the developer if the developer receives membership shares in exchange for the assets contributed. Which of the following statements about the basis in assets received from a developer is **incorrect**? **(Page 165)**

    a. IRC Section 351 is a mandatory section. [This answer is incorrect. This section is mandatory.]

    b. It is common for a developer to receive membership shares in exchange for the assets contributed. [This answer is correct. It is rare for a developer to receive membership shares in this manner. A more common occurrence is that the developer/sponsor does not transfer the common area assets to the association in exchange for membership shares.]

    c. The timing of the transfer and whether "control" requirements are met ultimately determine if IRC Section 351 applies. [This answer is incorrect. These two factors determine whether IRC Section 351 applies.]

    d. Since the developer'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. [This answer is incorrect. The association also will be able to depreciate any depreciable assets contributed to the association.]

17. Although some cooperative associations and condominium or homeowners' associations look alike, the differences in legal structure, nature of activities, and tax laws result in vastly different tax results for such organizations. Which of the following statements best describes the differences between cooperative associations and condominium or homeowners' associations? **(Page 167)**

    a. Cooperative associations, condominiums, and homeowners' associations operate as businesses. [This answer is incorrect. Cooperative associations operate as businesses. 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.]

    b. While condominiums and homeowners' associations own, operate, and lease to members (primarily) residential real estate property, cooperatives do not. [This answer is incorrect. Cooperative associations perform these activities.]

    c. A cooperative association should generally capitalize and depreciate its capital expenditures. [This is the correct statement. 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.]

    d. Condominium and homeowners' associations may legitimately claim tax deductions for capital expenditures and depreciation expense, even if those expenditures are related to activities not engaged in for profit. [This is the incorrect statement. 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. 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 allow the association to then capitalize and depreciate capital expenditures.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (HOATG092)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. Many CIRAs choose which tax form to file by selecting the form that yields the lowest tax. Which of the following statements best describes how a CIRA is taxed on a particular tax form?

   a. If a condominium or homeowners' association elects to be taxed under IRC Section 528, it is taxed at the rate of 20% on its net nonexempt function income.

   b. If a qualifying timeshare association elects to be taxed under IRC Section 528, it is taxed at the rate of 34% on its net nonexempt function income.

   c. Under IRC Section 277, a CIRA must allocate its income and expenses between membership and nonmembership activities; only its net nonmembership income is taxed at regular corporate tax rates.

   d. Commercial condominium associations never file Form 1120.

2. The purpose of IRC Section 277 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 a mandatory anti-abuse section because it automatically applies if the CIRA meets all **but which** of the following criteria specified in the section?

   a. The entity was formed primarily to provide services to its members.

   b. The entity is a membership organization.

   c. The entity does not provide any services to nonmembers.

   d. The entity is not exempt under any other section of the IRS Code.

3. The following are receipts of a typical condominium or homeowners' association. While most are treated as gross income for tax purposes, IRC Section 118 treats one of them as a contribution to capital instead. Which one does IRC Section 118 treat as a capital contribution?

   a. Replacement of personal property.

   b. Member replacement fund assessments.

   c. Member fees for services.

   d. Passive income, such as dividend income.

4. The receipt of funds for a specific limited purpose from which the association will derive no benefit may result in an agency relationship for tax purposes. If a CIRA receives disaster insurance proceeds on behalf of its members, the CIRA may perform all **but which** of the following activities in its capacity as agent for its members?

   a. Commingle the funds with CIRA funds.

   b. Collect the funds.

   c. Account for the funds in its financial records.

   d. Disburse the funds in accordance with the members' wishes.

5. An assessment for special capital improvements or the replacement of personal property may be classified as contributed capital if the CIRA complies with certain factors. However, there may be consequences associated with misclassifying receipts as contributions to capital vs. income, depending on the tax form that is filed. Which of the following does **not** adequately describe what those consequences might be?

   a. 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, since exempt function income is not taxable under IRC Section 528.

   b. If a CIRA filing Form 1120 fails to fully comply with the IRS requirements, 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.

   c. If a CIRA classifies receipts as exempt function income when they should have been classified as capital contributions, the CIRA would not properly calculate the 60% income test to determine whether the CIRA qualifies to file Form 1120-H.

   d. For a CIRA that files Form 1120-H, the tax consequences of misclassifying receipts as contributions to capital that should be reported as nonexempt function income can be great, since nonexempt function income is taxed at a 30% rate according to IRC Section 528.

6. A homeowners' association records the receipt of an assessment as a contribution to capital for tax purposes. To justify its treatment of the proceeds, 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 CIRA should consider all **but which** of the following factors when documenting the CIRA's intent for an assessment to qualify as a capital contribution?

   a. The money must be actually expended for the intended purpose.

   b. The purpose of the assessment must be capital in nature.

   c. Members or unit owner-stockholders must receive notice as to the intent of the purpose of the contribution within 30 days.

   d. The money must be held in separate bank accounts from the operating (noncapital) monies of the CIRA.

7. The homeowner's association for the Spring Woods Country Club subdivision decides it is going to repaint its clubhouse when it refurbishes the entire golf course. They have decided to capitalize the cost of the painting in their financial statements. Which of the following court cases would support that decision?

   a. *R.O. Watts*, 34 TCM 613, Dec, 33,184(M), TC Memo 1975-131.

   b. *J.M. Jones*, (CA-5) 57-1 USTC P9517.

   c. *Haverty Furniture Co*., (CA-5) 1927 CCH P7012, 15 F.2d 345.

   d. *Markovits*, 11 TCM 823, Dec 19,138(M).

8. The proper segregation of funds is a crucial procedure in demonstrating a CIRA's intent to classify certain assessments as contributions of capital. For that reason, a CIRA planning to classify certain assessments as capital contributions should, for tax purposes, maintain all **but which** category of cash accounts?

   a. Operating bank account(s).

   b. Operating reserve bank account(s).

   c. Noncapital replacement fund bank account(s) for items such as painting, tree trimming, and contingencies.

   d. Capital replacement fund bank account(s) for items that are clearly capital in nature.

9. Sometimes, it is difficult to distinguish contributions to capital and membership income. Assume a CIRA charged a membership fee of $500 to hook up a homeowner's existing electric service when a new unit is occupied for the first time. All **but which** of the following elements would support the conclusion that the $500 should be accounted for as membership income?

    a. The fees were recorded in the CIRA's operating bank account.

    b. The fees were used to fund the replacement of a new roof for the clubhouse.

    c. The fees were used to fund operating expenses of the CIRA.

    d. The fees were not designated for future major repairs and replacements.

10. *Structured settlements* are a relatively new concept sometimes applied to CIRAs in cases of construction defects litigation. In those circumstances, the payout of the construction defects settlement is structured into a number of annuity payments. Which of the following statements about tax law surrounding structured settlements as it applies to CIRAs is **incorrect**?

    a. While using a structured settlement may help a CIRA reduce its tax burden, structuring a settlement in this manner is usually more expensive for the developer.

    b. Guidance on structured settlements for CIRAs is borrowed from IRC Section 104(a)(2) which treats any awards for personal injury (other than punitive damages) as nontaxable awards for the recipients.

    c. Revenue Rulings 79-220 and 79-313 extend the guidance in IRC Section 104 (a)(2) 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.

    d. If a CIRA elects to receive an annuity rather than a lump sum payment in settlement of a construction defect litigation, some accountants believe that the annuity payments would not be taxable.

11. The construction defects litigation process may stretch over a period of several years. If the association receives the proceeds and invests them prior to making any necessary repairs, it would earn interest on its investment. IRC Section 468B, "Special Rules For Designated Settlement Funds," establishes procedures for the tax treatment of designated settlement funds. Which of the following best describes the tax consequences of a designated settlement fund?

    a. Generally, the amounts transferred to the fund are taxable.

    b. Any interest earned on the fund is generally not taxable.

    c. Distributions or payments on behalf of claimants are deductible.

    d. Legal fees incurred on behalf of plaintiffs are specifically excluded from the fund's deductible expenses.

12. Interest or dividends earned from investing the proceeds of a settlement or award can often be significant. Which of the following best describes the tax effect of such earnings to a CIRA?

    a. Whether the earnings are taxable depend upon the nature of the underlying award.

    b. Unless the proceeds are invested in tax free securities, the earnings will always represent taxable income.

    c. Since most investment earnings are not taxable, they should be retained in the fund that earned the income.

    d. An association's tax exempt status would not be affected by a distribution of interest income from compensatory damages to its members.

Lesson 2: Taxation Under IRC Sections 528 and 277

INTRODUCTION

This lesson discusses taxation under IRC Secs. 528 and 277, and how those regulations apply to CIRAs. The discussion includes an analysis of the different tax filing options available for the different types of CIRAs (condominium association, homeowners' association, cooperative housing corporation, or timeshare association). The lesson also covers the advantages and disadvantages of filing Form 1120 and Form 1120-H. The complex tax regulations that affect CIRAs, including recent revenue rulings, tax course cases, and private letter rulings, are also discussed.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify the tax filing options available to a CIRA based on whether it is a condominium association, homeowners' association, cooperative housing corporation, or timeshare association.
- Summarize how to file Form 1120 and Form 1120-H.
- Cite the complex tax regulations affecting such CIRAs, including recent revenue rulings, tax court cases, and private letter rulings.

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.

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. (See discussion concerning the advantages and disadvantages of filing Form 1120-H. Also, see discussion of risk analysis with association tax return.)

- *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. (See later discussion of the 90% expenditure test.) If the association does not meet all of the tests listed, it will be taxed under IRC Section 277 and must file Form 1120. (See next section.)

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. Perhaps 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. Based on professional experience, 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. 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.

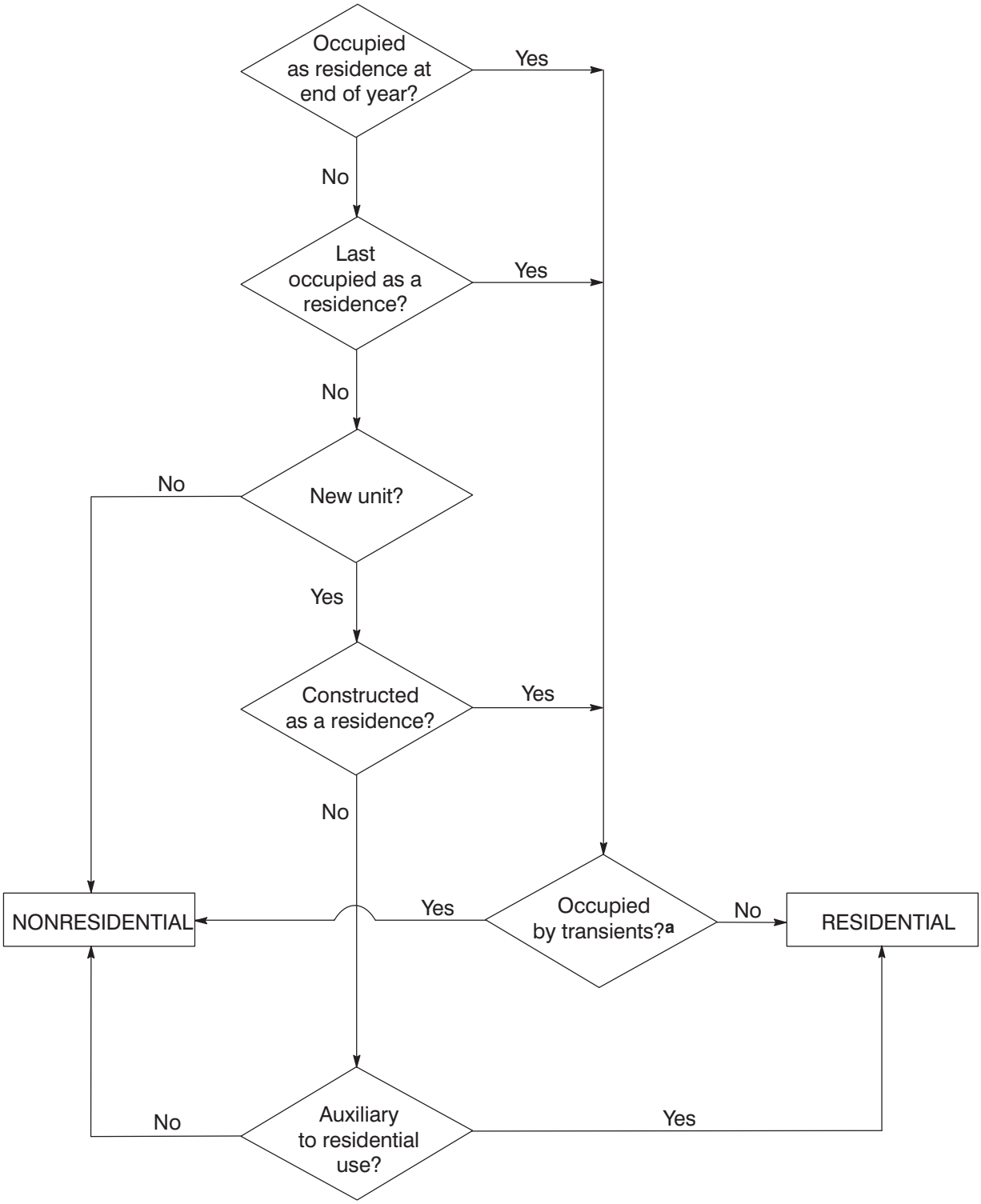
How does the residential test affect a purely recreational association that consists only of a pool, tennis courts, and other recreational facilities for the use of its members? Developers occasionally form two associations rather than one, with one association for recreational purposes and the other 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 the 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 2-1 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 2-1

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, exercise caution against transferring 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.

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 as described earlier.)

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.

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. 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 2-2 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 2-2

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. (The presentation of qualifying expenditures on Form 1120-H is discussed in this section.)

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." Estimates of 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, documenting the basis for the allocations is recommended.

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.

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.

SELF-STUDY QUIZ

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

18. IRC Section 528 applies to homeowners' associations as that term is defined by the IRS. According to the IRS, which of following is **not** a homeowners' association?

    a. 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.

    b. Timeshare associations in which the members hold rights to use or ownership interests in real property of the association.

    c. Cooperative association organized to acquire, build, manage, and care for a development of homes for individuals.

    d. 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.

19. IRC Section 528 specifies a number of provisions under which homeowners' associations must qualify before they may file Form 1120-H. Which of the following does **not** describe one of those provisions?

    a. Substantially residential test

    b. 60% income test

    c. 80% expenditure test

    d. Lack of Private Benefit Test

20. If a condominium association, homeowners' association, or timeshare association meets the tests in IRC Section 528, it may elect to have that section apply. In that case, which of the following best describes the CIRA's responsibilities under IRC Section 528?

    a. The CIRA must make the election to be taxed under IRC Section 528 biannually.

    b. Treasury Regulation 1.528-8 requires that the election be made simply by filing Form 1120 on a timely basis.)

    c. 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.

    d. Treasury Regulation Section 301.9100-2 grants an automatic 6-month extension to make the election to have IRC Section 528 apply.

21. One of the provisions specified in IRC Section 528 under which those associations must qualify to file Form 1120-H is the substantially residential test. This test states that substantially all of the units must be held for residential purposes. Which of the following associations would meet this provision?

    a. A condominium association with at least 75% of the square footage of all of the units in the association used as residences on the last day of the association's taxable year.

    b. A homeowner's association with at least 75% of the lots zoned for residential use.

    c. A high-rise association with both office or retail space on lower floors and parking and residential space on upper floors, where the square footage for each different type of usage meets the 85% substantially residential test.

    d. A timeshare association with at least 85% of the units in the association used as residences.

22. An association (other than a timeshare association) cannot qualify under IRC Section 528 unless at least 90% of its expenditures are qualifying expenditures. Which of the following does **not** describe qualifying expenditures under IRC Section 528?

    a. Current operating expenditures are qualifying expenditures for condominium associations.

    b. Capital expenditures made for the acquisition, construction, management, maintenance, and care of association property are qualifying expenditures for condominium associations but not for homeowners' associations.

    c. Current operating expenditures are qualifying expenditures for homeowners' associations.

    d. For timeshare associations, qualifying expenditures are those made for activities provided to or on behalf of their members.

23. As defined in IRC Section 528, association property is not precisely the same as common property. Generally, association property is all property that provides benefits to the association members, regardless of who actually owns the property. According to IRC Section 528, association property includes all **but which** of the following:

    a. Property owned by a governmental unit that benefits all of the members, such as roads, sidewalks, and streetlights.

    b. 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.

    c. Property leased to a group of nonmembers for a meeting place.

    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 related to the timeshare project.

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. IRC Section 528 applies to homeowners' associations as that term is defined by the IRS. According to the IRS, which of following is **not** a homeowners' association? **(Page 185)**

    a. 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. [This answer is incorrect. According to the IRS, this is a homeowners' association.]

    b. Timeshare associations in which the members hold rights to use or ownership interests in real property of the association. [This answer is incorrect. According to the IRS, this is a homeowners' association.]

    c. Cooperative association organized to acquire, build, manage, and care for a development of homes for individuals. [This answer is correct. The IRS definition of homeowners' associations includes residential condominium associations, homeowners' associations, and timeshare associations, but it excludes cooperative housing corporations.]

    d. 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. [This answer is incorrect. According to the IRS, this is a homeowners' association.]

19. IRC Section 528 specifies a number of provisions under which homeowners' associations must qualify before they may file Form 1120-H. Which of the following does **not** describe one of those provisions? **(Page 185)**

    a. Substantially residential test. [This answer is incorrect. Substantially all of the units must be held for residential purposes (except in the case of timeshare associations).]

    b. 60% income test. [This answer is incorrect. At least 60% of the association's gross income for the tax year must consist of exempt function income.]

    c. 80% expenditure test [This answer is correct. 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.]

    d. Lack of Private Benefit Test. [This answer is incorrect. No member may profit from the association's net earnings.]

20. If a condominium association, homeowners' association, or timeshare association meets the tests in IRC Section 528, it may elect to have that section apply. In that case, which of the following best describes the CIRA's responsibilities under IRC Section 528? **(Page 186)**

    a. The CIRA must make the election to be taxed under IRC Section 528 biannually. [This answer is incorrect. The CIRA must make the election annually.]

    b. Treasury Regulation 1.528-8 requires that the election be made simply by filing Form 1120 on a timely basis. [This answer is incorrect. Treasury Regulation 1.528-8 requires that the election be made simply by filing *Form 1120-H*, not Form 1120, for the tax year on a timely basis.]

    c. 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. [This answer is correct. The tax preparer should specify Form 1120 if no decision has been made by the filing date.]

d. Treasury Regulation Section 301.9100-2 grants an automatic six-month extension to make the election to have IRC Section 528 apply. [This answer is incorrect. Regulations Section 301.9100-3 provides guidance for extensions of time to make an IRC Section 528 election past a *12-month* period. Generally, 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.]

21. One of the provisions specified in IRC Section 528 under which those associations must qualify to file Form 1120-H is the substantially residential test. This test states that substantially all of the units must be held for residential purposes. Which of the following associations would meet this provision? **(Page 186)**

a. A condominium association with at least 75% of the square footage of all of the units in the association used as residences on the last day of the association's taxable year. [This answer is incorrect. 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. In order for the condominium to meet the 85% test, 85% of the square footage of all of the units must be used for residential purposes.]

b. A homeowner's association with at least 75% of the lots zoned for residential use. [This answer is incorrect. For a 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. In order for the association to meet the 85% test, 85% of the lots must be zoned for residential use.]

c. A high-rise association with both office or retail space on lower floors and parking and residential space on upper floors, where the square footage for each different type of usage meets the 85% substantially residential test. [This answer is correct. In such a case, the square footage for each different type of usage must be determined to properly calculate the 85% test. In this example, parking space may also require an allocation between residential and nonresidential use. Although each situation is unique and must be examined individually, the assumption here is that the 85% substantially residential test is met.]

d. A timeshare association with at least 85% of the units in the association used as residences. [This answer is incorrect. The substantially residential test does not apply to timeshare associations.]

22. An association (other than a timeshare association) cannot qualify under IRC Section 528 unless at least 90% of its expenditures are qualifying expenditures. Which of the following does **not** describe qualifying expenditures under IRC Section 528? **(Page 189)**

a. Current operating expenditures are qualifying expenditures for condominium associations. [This answer is incorrect. For condominium associations, current operating expenditures are qualifying expenditures.]

b. Capital expenditures made for the acquisition, construction, management, maintenance, and care of association property are qualifying expenditures for condominium associations but not for homeowners' associations. [This answer is correct. For condominium *and* homeowners' associations, qualifying expenditures are capital expenditures that are made for the acquisition, construction, management, maintenance, and care of association property.]

c. Current operating expenditures are qualifying expenditures for homeowners' associations. [This answer is incorrect. Current operating expenditures are qualifying expenditures for homeowners' associations for purposes of the 90% test.]

d. For timeshare associations, qualifying expenditures are those made for activities provided to or on behalf of their members. [This answer is incorrect. Qualifying expenditures for timeshare associations are those made for activities provided to or on behalf of members.]

23. As defined in IRC Section 528, association property is not precisely the same as common property. Generally, association property is all property that provides benefits to the association members, regardless of who actually owns the property. According to IRC Section 528, association property includes all **but which** of the following: **(Page 189)**

    a. Property owned by a governmental unit that benefits all of the members, such as roads, sidewalks, and streetlights. [This answer is incorrect. Such property is included in the definition of association property under IRC Section 528.]

    b. 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. [This answer is incorrect. Such property is included in the definition of association property under IRC Section 528.]

    c. Property leased to a group of nonmembers for a meeting place. [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.]

    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 related to the timeshare project. [This answer is incorrect. Such property is included in the definition of association property under IRC Section 528.]

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.

Determining Exempt Function Income. As explained earlier, 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. 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 2-3 provides examples of classifying various income amounts as either exempt function income or nonexempt function income for condominium and homeowners' associations.

Exhibit 2-3
Tax Treatment of Certain Income Items
for Condominium and Homeowners' Associations

	SECTION 528		SECTION 277	
	Exempt Function Income	**Nonexempt Function Income**	**Member-ship Income**	**Non-membership Income**
Type of income:				
Member operating assessments	X		X	
Member assessments for major repairs and replacements (noncapital in nature)[a]	X		X	
Interest on delinquent member assess-ments[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. 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. They are exempt function income.

[d] Interest on state or local government obligations is not taxable by statute [IRC Section 103(a)].

[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.

[i] Litigation proceeds from developers for construction defect warranty claims may be contributions of capital in certain circumstances.

* * *

Nonexempt Function Activities

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 2-3 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 2-4 illustrates expenditures that may be allocated to various categories of nonexempt function income. The types of expenditures illustrated in Exhibit 2-4 may cause associations problems in meeting the 90% test if they exceed 10% of gross expenditures.

Exhibit 2-4

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.

* * *

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, perhaps estimates of employee time devoted to specific activities, asset usage, or consumption would constitute a reasonable basis. IT is recommended that the basis for the allocations be documented 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.)

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, professionals believe that the preceding decision is 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.

Utility Pass-throughs

The differences in accounting for utility pass-throughs are discussed later. 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."

It is most appropriate to report gross utility revenues and expenses.

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.

Perhaps the same concept and language in tax law upon which the IRS is relying can 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 may 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.)
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.)	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.	

Accountants should consider whether the income tax liability of their CIRA clients may be reduced through tax planning and filing Form 1120. If the financial affairs of a qualifying homeowners' association are properly structured, Form 1120-H, although simpler, rarely yields a lower tax than Form 1120. Even so, the additional risk associated with filing Form 1120 may not outweigh the tax savings. (Tax-planning opportunities for Form 1120 are discussed later.)

Generally, filing Form 1120-H should be considered in the following circumstances:

- The difference between the tax calculated on Form 1120 and Form 1120-H does not warrant the additional risk assumed by filing Form 1120.
- The risk of filing Form 1120 is too great due to a lack of compliance with IRS regulations and rulings.
- Cost-benefit considerations make filing the simpler return the better alternative.
- The association's taxable income is either (a) $100 or less or (b) approximately $186,200 or greater. In those circumstances, the 30% tax rate for condominium and homeowners' associations on Form 1120-H yields a lower tax than the regular corporate rates on Form 1120. (The breakeven point for timeshare associations, which are taxed at a 32% rate, would be different.)

- Form 1120-H may be preferable because of the effect of the alternative minimum tax on large associations when Form 1120 is filed.

- The association's total tax liability is lower because it can avoid state income taxes.

In most circumstances, a decision to file either Form 1120-H or Form 1120 is made by considering a combination of the preceding factors. An overall tax plan for an association might include alternate use of both Form 1120-H and Form 1120 is explained later in this lesson.

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.

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.

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 under which Filing Form 1120-H (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.

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.

Similar to other corporate returns, Form 1120-H is due on the fifteenth day of the third month after the end of the association's taxable year. Associations may file Form 7004 to receive an automatic six-month 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).

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 except under the provisions of Treasury Regulation 301.9100-3, if the revocation occurs within a 12-month period from the original due date of the return. In Revenue Ruling 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.

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, perhaps appropriate procedure for revocation of election should be followed.

Exhibit 2-5 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 2-5

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			
8824029			
8827054			
8831043			
8910024			
8940025			
8944029			
9003031			
9007022			
9042045			
9045019			
9102008			
9214020			
9233025			
9242018			
9315020			
9406032			
200034006			
200344017			
200652004			

* * *

SELF-STUDY QUIZ

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

24. Qualifying associations that elect to be taxed under IRC Section 528 are not taxed on the income from their *exempt function activities*. To qualify as exempt function income, one of the tests that the association's income must meet is the source test. All **but which** of the following sources of income meet the requirements of the source test?

    a. Interest income on membership assessments.

    b. Assessments from owners of residential units, for a condominium association.

    c. Residential lots, for a homeowners' association.

    d. Rights to use or ownership interests in association property, for a timeshare association.

25. The gross income test under IRC Section 528 excludes from exempt function income any amounts that the tax rules exclude from gross income. Which of the following is considered exempt function income?

    a. Tax-exempt interest.

    b. Punitive damages included in litigation proceeds.

    c. Assessments for capital improvements that are treated as capital contributions for tax purposes.

    d. Excess assessments refunded to members.

26. Under IRC Section 528, associations are not taxed on their exempt function activities. Instead, they are taxed only on income from their nonexempt function activities. Nonexempt function income results primarily from all **but which** of the following sources?

    a. Amounts charged to nonmembers for use of association property.

    b. Revenue from nonassociation property.

    c. Annual fees for use of recreational facilities.

    d. Amounts charged to association members for specific services.

27. If an association decides it is preferable to file Form 1120-H rather than Form 1120, 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 which of the following methods?

    a. Increasing user fees for facilities and decreasing member assessments to compensate for the increase in income.

    b. Charging special-use fees only once during a 12-month period rather than on a per use basis.

    c. Increasing user fee income to the point that the activity generates a profit.

    d. Allocate a larger share of expenses against nonexempt function income.

28. When filing Form 1120-H, which of the following might the association be entitled to?

    a. Net operating loss deduction.

    b. Credit for fuels produced from nonconventional sources.

    c. Investment credit.

    d. Dividends received deduction.

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.)**

24. Qualifying associations that elect to be taxed under IRC Section 528 are not taxed on the income from their *exempt function activities*. To qualify as exempt function income, one of the tests that the association's income must meet is the source test. All **but which** of the following sources of income meet the requirements of the source test? **(Page 196)**

    a. Interest income on membership assessments. [This answer is correct. Income on membership assessments, such as interest, is not exempt function income.]

    b. Assessments from owners of residential units, for a condominium association. [This answer is incorrect. Income from this source meets the source test under IRC Section 528.]

    c. Residential lots, for a homeowners' association. [This answer is incorrect. Income from this source meets the source test under IRC Section 528.]

    d. Rights to use or ownership interests in association property, for a timeshare association. [This answer is incorrect Income from this source meets the source test under IRC Section 528.]

25. The gross income test under IRC Section 528 excludes from exempt function income any amounts that the tax rules exclude from gross income. Which of the following is considered exempt function income? **(Page 196)**

    a. Tax-exempt interest. [This answer is incorrect. Tax exempt interest is not considered exempt function income.]

    b. Punitive damages included in litigation proceeds. [This answer is correct. Punitive damages included in litigation proceeds are considered *nonexempt* function income.]

    c. Assessments for capital improvements that are treated as capital contributions for tax purposes. [This answer is incorrect Such assessments are not considered exempt function income.]

    d. Excess assessments refunded to members. [This answer is incorrect. Such assessments are not considered exempt function income.]

26. Under IRC Section 528, associations are not taxed on their exempt function activities. Instead, they are taxed only on income from their nonexempt function activities. Nonexempt function income results primarily from all **but which** of the following sources? **(Page 199)**

    a. Amounts charged to nonmembers for use of association property. [This answer is incorrect. Amounts such as guest fees and other amounts received from nonmembers are considered nonexempt function income.]

    b. Revenue from nonassociation property. [This answer is incorrect. Amounts such as income from commercial operations and interest income (on both operating and replacement funds) are considered nonexempt function income.]

    c. Annual fees for use of recreational facilities. [This answer is correct. IRS regulations allow 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 and the privilege obtained from the payment of those amounts lasts for the entire 12-month period. Thus, fees for recreational facilities paid annually are considered *exempt* function income.]

    d. Amounts charged to association members for specific services. [This answer is incorrect. All special use charges that are not assessed ratably to all members are considered nonexempt function income.]

27. If an association decides it is preferable to file Form 1120-H rather than Form 1120, 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 which of the following methods? **(Page 203)**

    a. Increasing user fees for facilities and decreasing member assessments to compensate for the increase in income. [This answer is incorrect. Eliminating user fees for facilities and increasing member assessments to compensate for the loss of income, however, would be one way of converting nonexempt income into exempt income.]

    b. Charging special-use fees only once during a 12-month period rather than on a per use basis. [This answer is correct. This would be one way of converting nonexempt income into exempt income.]

    c. Increasing user fee income to the point that the activity generates a profit. [This answer is incorrect. Reducing user fee income to the point that the activity breaks even, however, would be one way of converting nonexempt income into exempt income.]

    d. Allocate a larger share of expenses against nonexempt function income. [This answer is incorrect. IRS regulations state that expenses with elements of both exempt and nonexempt activities should be allocated between them on a "reasonable basis." The desire to convert nonexempt income into exempt income would not fall into that category.]

28. When filing Form 1120-H, which of the following might the association be entitled to? **(Page 204)**

    a. Net operating loss deduction. [This answer is incorrect. Associations are not entitled to a net operating loss deduction.]

    b. Credit for fuels produced from nonconventional sources. [This answer is correct. Associations might qualify for this credit.]

    c. Investment credit. [This answer is incorrect. Associations do not qualify for the investment credit.]

    d. Dividends received deduction. [This answer is incorrect. Associations are not entitled to the dividends received deduction.]

TAXATION UNDER IRC SECTION 277: FORM 1120

Applicability of IRC Section 277

Condominium and Homeowners' Associations. 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, 2007, 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. 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.

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 in the previous 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 2-3.) 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 2-3 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, 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.

It appears as though the decision in *Concord Consumers Housing Cooperative* gives 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. It is recommended 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, expenses such as insurance, utilities, repairs and maintenance, security, and janitorial services often may 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*.

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 is not recommended because the CIRA might conclude it had an IRC Section 277 carryover when, in fact, the loss might be masking taxable membership income. Consequently, treating 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 ("excess membership assessments" and "net membership income" may be used interchangeably and have used them that way in this course). 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.

Use caution in applying Revenue Ruling 70-604 because the IRS is currently reconsidering Revenue Ruling 70-604. The IRS has also specifically stated that the ruling allows only a *one-year* carryover of excess membership income.

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 the recommendations 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, associations may interpret the wording of Revenue Ruling 70-604 literally and make the election in the form of a resolution adopted by the membership. It is recommended that the board of directors of the association 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 recommended that associations 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. A specific dollar amount need not be included in the resolution because Revenue Ruling 70-604 literally states that "any excess assessments" may be carried over or refunded. Some 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.*

The carryover should be shown as a Schedule M-1 (or M-3) adjustment since (as a tax-only election) it is not recorded in the financial statements. Associations that file Form 1120 will have either a Revenue Ruling 70-604 net membership income carryover (70-604 carryover) or an IRC Section 277 net membership loss carryover (277 carryover) at the end of each tax year. Only if the association had net membership income equal to zero at the end of the tax year could a different situation result. Since that situation is highly unlikely to occur at any given year end, either a 70-604 carryover or a 277 carryover will generally result. The two carryovers cannot coexist at year-end, as the larger carryover will offset (or use up) the other carryover. For example, a 70-604 carryover from Year 1 gets carried into Year 2. It may remain unchanged (if the net membership income equals zero, which is unlikely), it may increase as the result of additional net membership income generated in Year 2 [and assuming that you subscribe to the theory that 70-604 carryovers continue indefinitely (see point e.)], or it may decrease as a result of being offset (reduced) by net membership losses generated in Year 2. If the IRC 277 losses generated in Year 2 exceed the 70-604 carryover from Year 1, then a 277 loss carryover will exist at the end of Year 2 and will carry over to Year 3. (See Exhibit 2-6 for a graphic presentation of the treatment of 70-604 and 277 carryovers.)

e. *The 70-604 carryovers to a subsequent year may be made indefinitely.*

While many tax practitioners believe that Revenue Ruling 70-604 permits an indefinite carryover of excess membership income, Revenue Ruling 70-604 should 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 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 advisable to make a disclosure of the change in the carryover amount must be made 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 20X3 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 20X4:	
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. No justification in tax law for permanently suspending carryovers of excess membership income because a Form 1120-H is filed in an intervening year can be located. 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."

Generally, there is 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 has the most 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 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, perhaps the association does not have a valid 70-604 carryover into the current year since no election was made. Instead, perhaps the successor accountant should notify the association that the prior-year income tax return was improperly prepared and suggest the return be amended.

Exhibit 2-6

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.

* * *

Excess Membership Deductions

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 believed that excess membership deductions should be shown 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) requires 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.) 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

Associations are entitled to the same tax credits as C corporations.

Alternative Minimum Tax. The Taxpayer Relief Act of 1997 repealed the Alternative Minimum Tax (AMT) for small corporations for tax years beginning after December 31, 1997. A small corporation is defined as one with three-year average annual gross receipts not exceeding $5 million for its first tax year beginning after 1996 that does not have three-year average annual gross receipts exceeding $7.5 million for any later year. However, in determining their tax liability, large CIRAs that file tax returns as corporations on Form 1120 must consider the AMT. Under the AMT rules, a corporation calculates two tax amounts: one based on the regular tax rules and a tentative minimum tax (TMT) based on the AMT rules. If TMT exceeds the regular tax, an additional tax equal to the excess, referred to as the alternative minimum tax, also must be paid. Thus, in reality, a corporation's tax liability is the greater of taxes calculated using either the regular tax system or the alternative minimum tax system.

Taxable income under the AMT system is referred to as AMT income or AMTI. It consists of taxable income under the regular tax system adjusted by the preference items and adjustments specified in IRC Sections 56, 57, and 58. Most of the preference items and adjustments do not affect the typical CIRA although the depreciation adjustment may affect CIRAs with respect to depreciable personal property placed in service after 1986 and before December 31, 1998. However, in addition to the preference items and adjustments, the AMT calculation is affected by an adjustment for adjusted current earnings (ACE adjustment). The calculation of adjusted current earnings starts with tentative AMTI. The adjustment is 75% of the difference between ACE and AMTI before the adjustment (generally taxable income for most associations). It may either increase or decrease AMTI.

Net Nonmembership Losses

Net Operating Loss. If associations have a net loss from nonmembership activities, the loss is a net operating loss as defined in IRC Section 172 and may be carried back or forward. Net nonmembership losses are rare for homeowners' associations. 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. It is virtually impossible to justify an allocation of expenses that is greater than the related interest income.

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 2-7 shows the effect on a condominium association's tax liability using the two forms under two different assumptions. The following describes other advantages and disadvantages of filing Form 1120:

Advantages of Filing Form 1120

1. Taxable income is taxed at the regular corporate rates (15% on the first $50,000 of taxable income) versus the 30% (or 32%) tax rate required when filing Form 1120-H.
2. Certain tax-planning opportunities may exist.

Disadvantages of Filing Form 1120

1. The risk of compliance is much higher for Form 1120 than for Form 1120-H.
2. Form 1120 is a longer, more complex tax form to complete, and the cost of preparing Form 1120 may offset the tax benefits received.
3. Large associations are subject to the alternative minimum tax on Form 1120 (see earlier discussion).
4. Associations that file Form 1120 may be subject to state income taxes.

Exhibit 2-7

Comparison of Forms 1120 and 1120-H

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.

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.

* * *

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 course, 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.

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.

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. Use a conservative approach in using the revenue ruling 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.

Risk Analysis with Association Income Tax Return Preparation

When viewed at the highest level, preparation of CIRA tax returns appears to be deceptively simple. Given the choice between Form 1120-H and its 30% flat tax rate, and Form 1120 with its 15% to 39% graduated tax rate, it would seem that any CIRA with less than $186,111 of taxable income (the breakeven point between the two tax forms) would benefit from filing Form 1120 and paying a lower income tax.

Many tax practitioners make the decision as to which tax form to file on behalf of their CIRA clients with no consideration of the other factors that should enter into the decision-making process, nor the consequences of that decision. When a tax practitioner makes the filing decision without proper consideration, he or she is at significant risk for a malpractice claim.

The decision-making process is actually quite complex and should take into consideration many factors. The tax practitioner's role is to advise his or her client and make a recommendation based upon their expertise. It is the client's responsibility to make the final decision as to which form to file. However, the client can appropriately make that decision only when properly educated and advised by his or her tax practitioner as to the factors involved.

There is generally no risk involved in filing Form 1120-H if the association qualifies to file that form. However, a risk exists that the association may overpay tax when filing Form 1120-H if the CIRA could have actually safely qualified to file Form 1120.

The filing of Form 1120 carries a high degree of inherent risk because it is so difficult for the CIRA to comply with all of the requirements upon which a proper filing of this form is based. Further, since the majority of those risk factors are under the sole control of the CIRA, there is little the tax practitioner can do to rehabilitate a bad set of circumstances.

Some tax practitioners informally take the position that because the tax audit rate for CIRAs is so low (approximately 1% according to IRS statistics), the risk factor is very low that the association will be "caught" even if it does not strictly comply with all the requirements of Form 1120. Unfortunately, some tax practitioners advise their clients based upon that fact. However, IRS Circular 230 and the AICPA's Statements on Standards for Tax Services (TS 100.03) both state that it is unethical for a tax practitioner to consider the audit selection process of a taxing authority in establishing a client's tax position.

Form 1120-H. If the tax practitioner ensures that the CIRA meets the criteria to qualify as a homeowners' association, there exists little other risk in filing Form 1120-H. However, should a Form 1120-H be filed in error, the association may find itself required to make a mandatory change to Form 1120, which exposes the association to greater risk. To qualify as a homeowners' association, and thus to utilize Form 1120-H, the association must meet the following requirements.

- *Lack of Private Benefit Test.* Most associations will automatically meet the lack of benefit test. Thus, that risk is considered to be low.
- *Substantially Residential Test.* It is generally clear for most associations whether they meet the substantially residential test which requires that 85% of the lots or square footage must be used for residential purposes. The greatest risk in meeting the substantially residential test is for resort-type associations where there is a high degree of short-term rental use of condominium units.
- *The 60% Income Test.* The 60% income test often presents qualification problems for associations that submeter utilities, provide valet or maid services, or provide extensive recreational amenities and services.
- *The 90% Expenditure Test.* This test is the most difficult qualification for associations to achieve. Generally, any association that fails the 60% income test will also fail the 90% expenditure test. For example, associations that provide even a simple laundry room facility to their members may discover that their costs related to support of the laundry room facility will exceed 10% of total expenditures, causing the association to fail the 90% expenditure test.

Form 1120. There are two significant and broad issues under the sole control of the CIRA that reduce the ability to safely file Form 1120. These issues are discussed in items a. and b. below. A third issue, discussed in item c., is under the control of the tax preparer. A final issue related to IRC Section 481 arises from the first three issues and is discussed in item d.

a. Revenue Ruling 70-604 issues.

   - The IRS has consistently held that it is the members of the association, not the association's board of directors, who must approve the annual election under Revenue Ruling 70-604 in order for it to be

effective. However, under most states' laws, the members do not have legal authority to make such a determination. That right is held solely by the elected board of directors. Since the IRS cares only about its own rulings, and is not interested in state law, best practice is to have the election consistently 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 (there is no indication that the Revenue Ruling allows multiple consecutive carryovers), and if such carryovers pass through any intervening Form 1120-H filings.

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 (IRC Section 277),
- a clear delineation between operating and capital transactions (IRC Sections 118 and 263), and
- a schedule of carryovers from the prior year to the succeeding year of excess member income (Revenue Ruling 70-604) or excess member deductions (IRC Section 277).

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 above *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. (Further discussion of subchapter T is beyond the scope of this course.)

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. Accountants will need 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

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.

29. 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. Which of the following statements about membership income is correct?

    a. Interest income paid by members if their initial membership fees are paid in installments is classified as nonmembership income.

    b. Membership income is the gross income received by a membership organization from its members in consideration for membership activities.

    c. Membership income excludes membership assessments and other amounts that are assessed ratably to members.

    d. Membership income excludes fees paid for services by members that also are considered nonexempt function income under IRC Section 528.

30. Revenue Ruling 70-604 allows associations to remove any excess membership assessments from taxable income by effectively refunding the excess assessments to the members. Which of the following statements about the revenue ruling is **incorrect**?

    a. Under the revenue ruling, associations may make an annual election to apply the excess of membership income over membership expenses to the following year's assessments.

    b. Under the revenue ruling, associations may elect to refund the excess of membership income over membership expenses to the association's members.

    c. Under the revenue ruling, only a two-year carryover of excess membership income is allowed.

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.)**

29. 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. Which of the following statements about membership income is correct? **(Page 211)**

    a. Interest income paid by members if their initial membership fees are paid in installments is classified as nonmembership income. [This answer is incorrect. Such interest income is classified as member income under IRC Section 277.]

    b. Membership income is the gross income received by a membership organization from its members in consideration for membership activities. [This answer is correct. Gross income received by a membership organization from its members in consideration for membership activities is considered membership income under IRC Section 277.]

    c. Membership income excludes membership assessments and other amounts that are assessed ratably to members. [This answer is incorrect. Membership assessments and other amounts assessed ratably to members are considered membership income under IRC Section 277.]

    d. Membership income excludes fees paid for services by members that also are considered nonexempt function income under IRC Section 528. [This answer is incorrect. 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.]

30. Revenue Ruling 70-604 allows associations to remove any excess membership assessments from taxable income by effectively refunding the excess assessments to the members. Which of the following statements about the revenue ruling is **incorrect**? **(Page 213)**

    a. Under the revenue ruling, associations may make an annual election to apply the excess of membership income over membership expenses to the following year's assessments. [This answer is incorrect. Associations may make an annual election to apply the excess of membership income over membership expenses to the following year's assessments under the revenue ruling.]

    b. Under the revenue ruling, associations may elect to refund the excess of membership income over membership expenses to the association's members. [This answer is incorrect. Associations may elect to refund the excess of membership income over membership expenses to the association's members under the revenue ruling.]

    c. Under the revenue ruling, only a two-year carryover of excess membership income is allowed. [This answer is correct. Only a one-year carryover is allowed under the revenue ruling.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (HOATG092)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

13. IRC Section 528 specifies a number of provisions under which homeowners' associations must qualify before they may file Form 1120-H. Which of the following statements best describes the effect of the qualification on how the associations are taxed?

    a. If a condominium or homeowners' association meets the "substantially residential test," it usually will not meet the 60% income test and fail the lack of benefit test.

    b. If a condominium association, homeowners' association, or timeshare association meets the applicable tests, it may elect to file Form 1120-H.

    c. A condominium or homeowners' association with significant commercial operations or recreational or nonmembership activities often meets the 90% expenditure test.

    d. If the association does not meet all of the tests listed in provisions in IRC Section 528, it will be taxed under IRC Section 277 and must file Form 1120-H.

14. A developer is building a resort condominium development in which the units will be held as vacation homes and rented out on a weekly basis. For purposes of applying the substantially residential test on transient occupied units, which of the following units would be considered residential?

    a. For more than half of the year, each person living in the unit occupies it for 7 days.

    b. For more than 85% of the year, each person living in the unit occupies it for 7 days.

    c. For more than half of the year, each person living in the unit occupies it for 30 days or more.

    d. For more than 85% of the year, each person living in the unit occupies it for 30 days or less.

15. An association has no commercial facilities or significant sources of nonexempt function income. Providing all **but which** of the following additional services may cause that association to fail to meet the 90% expenditure test?

    a. Maid or valet services.

    b. Laundry facilities.

    c. Recreational services.

    d. Building maintenance services.

16. In order for a CIRA's income to qualify as exempt function income, amounts received from members must be paid solely as a result of membership in the association. Which of the following statement about exempt function income is **incorrect**?

    a. As a general rule, income from amounts assessed ratably to all members would be considered exempt function income.

    b. Income from amounts assessed based on the value or size of the property would be considered exempt function income.

    c. Income from fees paid for services and per use admission fees would be considered exempt function income.

    d. IRS regulations allow special use fees to be considered as exempt function income if amounts are paid by members only once in any 12-month period.

17. 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 **all but which** of the following tests?

    a. Nature test.

    b. Gross income test.

    c. Expenditure test.

    d. Source test.

18. Under IRC Section 277, associations are taxed on both net membership and net nonmembership income. Which of the following types of income is considered membership income under IRC Section 277?

    a. Fees charged to nonmembers for use of laundry facilities.

    b. Taxable investment income on operating funds.

    c. Fees charged to members for dock and boat rentals.

    d. Imputed interest on litigation proceeds.

19. Under IRC Section 528, qualifying associations are not taxed on their exempt function activities. Which of the following would **not** qualify as income from exempt function activities?

    a. Fees, fines, and penalties charged to members.

    b. A litigation settlement with the developer for prior under-assessments.

    c. Investment income on operating funds.

    d. Member operating assessments.

20. Form 1120-H is specifically designed for qualifying homeowners' associations. However, there are also some disadvantages to filing that form. In which of the following circumstances should a qualifying association **not** consider filing a Form 1120-H?

    a. The difference between the tax calculated on Form 1120 and Form 1120-H does not warrant the additional risk assumed by filing Form 1120.

    b. The risk of filing Form 1120 is too great due to a lack of compliance with IRS regulations and rulings.

    c. The association's total tax liability is higher because it can avoid state income taxes.

    d. Cost-benefit considerations make filing the simpler return the better alternative.

21. For tax calculation purposes which of the following statements about Form 1120-H is correct?

    a. Nonexempt function income and expenses are shown on the return but are not actually a part of the tax calculation process.

    b. Only exempt function income and direct and allocable indirect expenses relating to exempt function income are shown on the return.

    c. Capital contributions also are included on the return.

    d. 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.

22. Once an association has elected IRC Section 528 treatment for a tax year by filing Form 1120-H, the election is considered binding. Which of the following statements about that election is **incorrect**?

    a. The election for a previously filed 1120-H may not be revoked without the consent of the IRS, except under the provisions of Treasury Regulation 301.9100-3.

    b. In Revenue Ruling 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.

    c. In Revenue Ruling 82-203, a homeowners' association was 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.

    d. 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 does not represent a valid revocation of election. Instead, CIRAs are urged to comply with the specific formal procedures described in Revenue Ruling 83-74.

23. According to the Tax Court in Concord Consumers Housing Cooperative v. Commissioner, which of the following services provided by a management company could be allocated against interest income without any written documentation on the invoice?

    a. Management fees.

    b. Reviewing investments.

    c. Tax preparation fees.

    d. Accounting and auditing services.

24. After a recent rain storm, Central Park Homeowners' Association had a retaining wall collapse in the common area. Prior to making repairs, the Statement of Revenue and Expenses for the Association included the following amounts:

Net Membership Income	$50,000
Net Nonmembership Income	$10,000

    The repairs to the retaining wall were extensive and required an engineering report along with certification from the city. Total amount of the repairs came to $55,000. Which of the following properly accounts for the membership deductions?

    a. The membership deductions in excess of membership income may be treated as an operating loss.

    b. The deductions in excess of the Net Membership Income may be offset with Net Nonmembership Income.

    c. The excess deductions may not be carried back, however, they may be carried forward indefinitely to offset future net membership income.

    d. The excess deductions may be carried back 5 years against Net Membership Income and carried forward 10 years as on offset to Net Membership Income.

25. Assume an association has interest income of $20,000; deductions against interest income of $5,000; and $10,000 excess membership income. The association files Form 1120, which indicates a tax rate of 15% on the first $50,000 of taxable income. How much tax will the association pay?

    a. $3,750

    b. $2,250

    c. $3,000

    d. $4,500

26. Assume the same facts in Question 25, except that the association files Form 1120-H (instead of Form 1120), which requires a tax rate of 30%. How much tax will the association pay?

    a. $3,500

    b. $4,470

    c. $7,500

    d. $4,500

27. Assume the same facts as in Question 25, except the association has $10,000 of excess membership deductions (instead of excess membership income). How much tax will the association pay?

    a. $3,750

    b. $2,250

    c. $3,000

    d. $4,500

28. Some accountants question why associations 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. Which of the following appropriately describes an advantage of filing Form 1120?

    a. The risk of compliance is much higher for Form 1120-H than for Form 1120.

    b. Taxable income is taxed at the regular corporate rates (15% on the first $50,000 of taxable income) versus the 30% (or 32%) tax rate required when filing Form 1120-H.

    c. Form 1120-H is a longer, more complex tax form to complete, and the cost of preparing Form 1120-H may offset the tax benefits received.

    d. Large associations are subject to the alternative minimum tax on Form 1120-H.

29. The risk of compliance is much higher with Form 1120 than with Form 1120-H. All of the following are risks of attempting to use Form 1120 **except**:

    a. Correct characterization of income and deductions.

    b. Ability to adequately document additions to the replacement fund as being contributions to capital rather than membership income.

    c. The risk of being taxed on excess membership income.

    d. The inability to use the alternative minimum tax.

30. A CIRA can take certain actions to increase its ability to safely file Form 1120. The tax preparer can assist the CIRA in this goal by ensuring that the preparation of tax Form 1120 contains sufficient documentation to provide for all of the following **except**:

    a. Clear delineation between member and nonmember transactions (IRC Section 277).

    b. Clear delineation between operating and capital transactions (IRC Sections 118 and 263).

    c. Clear delineation between exempt and nonexempt function income (IRC Section 528).

    d. Schedule of carryovers from the prior year to the succeeding year of excess member income (Revenue Ruling 70-604) or excess member deductions (IRC Section 277).

31. 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. Which of the following statements about a cooperative organization is **incorrect**?

    a. 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.

    b. By declaring patronage dividends, a cooperative organization can retain up to 80% of the dividend amount as working capital free from taxation.

    c. Patronage dividends are not deductible from the gross income of the cooperative organization.

    d. The governing documents of the corporation must indicate that it is operating on a cooperative basis and also must provide for making patronage dividends.

Lesson 3: Unique Tax Issues Relating to Other Types of CIRAs

INTRODUCTION

Certain types of CIRAs, such as tax-exempt CIRAs, master associations, timeshare developments, and commercial associations have their own unique tax issues. This lesson discusses those issues, as well as the complex tax rulings and regulations surrounding those issues. Finally, the lesson discusses how to file the requisite forms.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify the unique tax issues surrounding tax-exempt CIRAs, master associations, timeshare developments, and commercial associations.
- Describe how to file Form 990 and Form 990-T for such CIRAs.
- Cite the complex tax regulations affecting such CIRAs, including recent revenue rulings, tax court cases, and private letter rulings.

CIRAS THAT ARE TAX-EXEMPT

Homeowners' Associations under Section 501(c)(4)

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." 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. 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 requires a formal application process, and submission of Form 1024, "Application for Exemption," to the IRS. Applications are submitted to the IRS Exempt Section central processing facility in Covington, Kentucky, after which they may be distributed to other IRS offices for processing. While it generally takes 120 days for the IRS to begin processing the application, the time to complete the application process varies from weeks to as much as two years.

Many IRS agents involved in processing applications are relatively new, and have been trained under newly developed material introduced by the IRS in 2003. It appears that, having no other experience, these agents rely exclusively on the training material. The training material tends to be heavily biased against associations, not mentioning any rulings or court cases that support the qualification of associations for exemption. The training material is also deficient in that it discusses only one of three criteria upon which an association can qualify under IRC Section 501(c)(4). As a result, since 2003 the application process has become much more lengthy and difficult, and has often required filing appeals after an initial denial of the exemption application.

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.

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 the following rulings that provide guidelines for exemption under IRC Section 501(c)(4):

- 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.

- Private Letter Ruling 9815061 states that social welfare organizations are not precluded from engaging in business activities as a means of providing direct community benefit or financing their social welfare programs. However, a business activity conducted as the organization's primary business activity precludes exemption under IRC Section 501(c)(4).

- Private Letter Ruling 9539005 holds that the operation and maintenance of recreational facilities by a homeowners' association exempt under IRC Section 501(c)(4) will not cause the association to lose its exempt status if the amount is nominal and is not the core purpose of the organization.

Court cases and revenue rulings primarily refine the definition of "community" for purposes of applying IRC Section 501(c)(4). The most significant decisions are summarized in Exhibit 3-1.

Exhibit 3-1

Selected Citations for Tax-exempt CIRAs

Citation	Summary
Revenue Ruling 69-280	Revenue Ruling 69-280 provides an example of a nonprofit organization formed to provide maintenance of exterior walls and roofs that failed to meet the 501(c)(4) tests. The IRS held that the organization was operated "primarily for the private benefit of the members and any benefits to the community are not sufficient to meet the requirement of the regulation that the organization be operated primarily for the common good and general welfare of the people of the community."
Revenue Ruling 72-102	Revenue Ruling 72-102 held that an organization was exempt; that any "benefits to the developer and . . . owner-members are merely incidental . . . to the goal to which the organization's activities are directed, the common good of the community." The ruling further stated that "for the purposes of Section 501(c)(4) of the Code, a neighborhood, precinct, subdivision, or housing development may constitute a community."
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 street lights, 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.

Citation	Summary
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. 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.)

* * *

In 2008, the IRS issued Private Letter Ruling 200809035, which reached an adverse determination regarding a 501(c)(4) organization. The organization, previously exempt under IRC Section 501(c)(4), was determined to no longer qualify for exemption under this Section. The reason for the adverse determination was that the association provided services (primarily security) only to its members and, therefore, did not serve a community.

"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.

In 2007, the IRS issued Private Letter Ruling 200706014 that reached an adverse determination regarding a 501(c)(4) organization. The organization, previously exempt under IRC Section 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. Private Letter Ruling 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 non public 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-Ã-vis the public-at-large and the community which it serves."

In 2009, the IRS issued Private Letter Ruling 200910067 revoking the tax-exempt status of an organization previously exempt under IRC Section 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.

Homeowners' Associations under Section 501(c)(7)

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. One disadvantage to the IRC Section 501(c)(7) exemption, as compared to the IRC 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).]

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). Revenue Ruling 75-494 provides examples of activities that will disqualify an organization that would otherwise qualify under IRC Section 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.

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 as if 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 was 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. This is the first time that this position has been seen asserted with respect to a homeowners' association exempt under IRC Section 501(c)(7). This appears to represent a further refinement of the IRS position, that an organization must necessarily have some social activities in addition to the simple availability of the recreational amenities. 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).

Applying for Recognition of Tax-exempt Status

The association should apply for recognition of its tax-exempt status on Form 1024, "Application for Recognition of Exemption under Section 501(a)." That form is used for requesting exemption under IRC Sections 501(c)(4) and 501(c)(7). Accountants should request retroactive application of exempt status when filing Form 1024. Upon receipt of a favorable determination letter, it may be possible to amend prior year tax returns to obtain refunds of taxes previously paid.

Treasury Regulation 1.337(d)-4 assesses a tax on the gain on any assets transferred from a taxable to a tax-exempt organization. This applies to any association seeking exemption under IRC Section 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. Section 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.

SELF-STUDY QUIZ

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

31. A few CIRAs may qualify for tax exemption under IRC Section 501 under IRC Section 501(c)(4) as a "social welfare organization" or under IRC Section 501(c)(7) as a "recreational organization." Which of the following statements about such CIRAs is **incorrect**?

    a. CIRAs seek tax exempt status for two reasons: to eliminate the risks associated with filing Form 1120 and to reduce or eliminate federal taxes.

    b. IRC Section 501(c)(4) organizations pay no taxes on exempt function activities, including investment earnings. However, the net income of unrelated business activities is still subject to taxation.

    c. IRC Section 501(c)(7) organizations are treated similarly, except that investment earnings are taxable, as well as transactions with nonmembers.

    d. Like the election under IRC Section 528, qualification for exemption under IRC Section 501 requires only the annual filing of the appropriate form.

32. 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. Although Section 501(c)(4) requires that the exempt organization serve a "community," it does not define "community." **All but which** one of the following are criteria by which a CIRA can serve a community?

    a. Common areas of the CIRA must be for the use and enjoyment of the general public.

    b. The CIRA must serve a "community" that bears a reasonably recognizable relationship to an area normally identified as a governmental unit.

    c. The CIRA owns and maintains common areas or facilities for the use and enjoyment of its members.

    d. The CIRA must not conduct activities directed to the exterior maintenance of any private residence.

33. 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 non profitable purposes" to qualify under IRC Section 501(c)(7). **All but which** of the following activities would disqualify an organization that would otherwise qualify under IRC Section 501(c)(7)?

    a. Providing trash collection services.

    b. Maintaining private streets serving a residential area.

    c. Maintaining a swimming pool.

    d. Enforcing architectural covenants.

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.)**

31. A few CIRAs may qualify for tax exemption under IRC Section 501 under IRC Section 501(c)(4) as a "social welfare organization" or under IRC Section 501(c)(7) as a "recreational organization." Which of the following statements about such CIRAs is **incorrect**? **(Page 235)**

    a. CIRAs seek tax exempt status for two reasons: to eliminate the risks associated with filing Form 1120 and to reduce or eliminate federal taxes. [This answer is incorrect. These are the reasons a CIRA might seek tax exempt status.]

    b. IRC Section 501(c)(4) organizations pay no taxes on exempt function activities, including investment earnings. However, the net income of unrelated business activities is still subject to taxation. [This answer is incorrect. This statement correctly reflects the affect of such an exemption on the CIRA.]

    c. IRC Section 501(c)(7) organizations are treated similarly, except that investment earnings are taxable, as well as transactions with nonmembers. [This answer is incorrect. This statement correctly reflects the affect of such an exemption on the CIRA.]

    d. Like the election under IRC Section 528, qualification for exemption under IRC Section 501 requires only the annual filing of the appropriate form. [This answer is correct. Unlike the election under IRC Section 528, which is made annually by filing Form 1120-H, qualification for exemption under IRC Section 501 requires a formal application process, and submission of Form 1024, "Application for Exemption," to the IRS. 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.]

32. 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. Although Section 501(c)(4) requires that the exempt organization serve a "community," it does not define "community." **All but which** one of the following is criteria by which a CIRA can serve a community? **(Page 236**)

    a. Common areas of the CIRA must be for the use and enjoyment of the general public. [This answer is incorrect. One of the criteria is for the CIRA to offer unrestricted access to its facilities (its common areas) to the general public.]

    b. The CIRA must serve a "community" that bears a reasonably recognizable relationship to an area normally identified as a governmental unit. [This answer is incorrect. According to Revenue Rulings 74-99 and 80-63, an organization can serve a community by occupying a geographic area "which bears a reasonable recognizable relationship to an area ordinarily identified as governmental."]

    c. The CIRA owns and maintains common areas or facilities for the use and enjoyment of its members. [This answer is correct. A CIRA can serve a community by offering to the general public, i.e., "the community," unrestricted access to its facilities (its common areas). Therefore, this is not a criterion a CIRA would meet to serve its community.]

    d. The CIRA must not conduct activities directed to the exterior maintenance of any private residence. [This answer is incorrect. Conducting activities directed to the exterior maintenance of any private residence automatically excludes condominium associations from qualifying under IRC Section 501(c)(4). However, a homeowner's association would be able to qualify if it does not perform exterior maintenance on private residences.]

33. 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). **All but which** of the following activities would disqualify an organization that would otherwise qualify under IRC Section 501(c)(7)? **(Page 239)**

    a. Providing trash collection services. [This answer is incorrect. Providing trash collection services would disqualify an organization that would otherwise qualify under IRC Section 501 (c)(7).]

    b. Maintaining private streets serving a residential area. [This answer is incorrect. Maintaining private streets serving a residential area would disqualify an organization that would otherwise qualify under IRC Section 501 (c)(7).]

    c. Maintaining a swimming pool. [This answer is correct. Maintaining a swimming pool would not disqualify such an organization.]

    d. Enforcing architectural covenants. [This answer is incorrect. Enforcing architectural covenants would disqualify an organization that would otherwise qualify under IRC Section 501 (c)(7).]

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) 323-8724 or online at **ppc.thomson.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.

TAX 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.
- 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 is included at the beginning of Lesson 2.

Filing Form 1120-H

To qualify to file Form 1120-H, the master association as a whole should meet the provisions. 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. As noted, 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.

TAX RULES FOR 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.

TAX RULES FOR 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. (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 earlier topic for a discussion of associations conducting themselves as cooperative organizations subject to the provisions of subchapter T instead of IRC Section 277.)

The issue of whether Revenue Ruling 70-604 (allowing a carryforward of excess membership income to the next year) 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 may 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, perhaps the same tax rules apply, including IRC Section 118, Revenue Ruling 75-370, and Revenue Ruling 75-371. (See Exhibit 1-2.) 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.

SELF-STUDY QUIZ

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

34. 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. Which of the following statements about filing Form 990-T is **incorrect**?

    a. CIRAs must file Form 990-T even if gross unrelated business income is less than $1,000 and no tax is due.

    b. Unrelated business income is income that comes from an activity not related to the association's exempt purpose.

    c. Net taxable income from an unrelated trade or business is reported on Form 990-T.

    d. Tax on the unrelated business income is computed based on corporate rates and paid with Form 990-T.

35. An association exempt under either IRC Section 501(c)(4) or 501(c)(7) must report unrelated business income on Form 990-T, "Exempt Organization Business Income Tax Return." Which of the following is **not** one of the three key conditions which must be present for an association to be conducting an unrelated trade or business?

    a. The trade or business must not be substantially related to the association's exempt purpose.

    b. The activity must be a trade or business.

    c. The trade or business must be regularly carried on.

    d. The activity is performed substantially by volunteers.

36. A master association is an association made up of different types of associations, such as homeowners' associations plus commercial condominium associations. Which of the following statements related to master associations is correct?

    a. The tax rules that apply to condominium and homeowners' associations generally do not apply to master associations.

    b. Treasury Regulation 1.528-4 requires that 75% of the square footage of a condominium association be used for residential purposes or that 75% of the lots of a residential real estate management association be zoned for residential purposes.

    c. Treasury Regulation 1.528-4 states that timeshare associations are not affected by the substantially residential test.

    d. 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 each individual subsidiary association.

37. Commercial associations perform the same essential functions for their owners as typical residential CIRA management corporations perform for their owners, such as the management, maintenance, and care of common elements. Which of the following is **not** an example of a commercial association?

    a. Shopping center on the outskirts of a planned residential development.

    b. Office park located next to a planned residential development.

    c. Industrial parks located next to a planned residential development.

    d. Marina in a planned residential development.

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.)**

34. 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. Which of the following statements about filing Form 990-T is **incorrect**? **(Page 246)**

    a. CIRAs must file Form 990-T even if gross unrelated business income is less than $1,000 and no tax is due. [This answer is correct. The form need not be filed and no tax is due if gross unrelated business income is less than $1,000.]

    b. Unrelated business income is income that comes from an activity not related to the association's exempt purpose. [This answer is incorrect. 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."]

    c. Net taxable income from an unrelated trade or business is reported on Form 990-T. [This answer is incorrect. Form 990-T is used to report net taxable income.]

    d. Tax on the unrelated business income is computed based on corporate rates and paid with Form 990-T. [This answer is incorrect. Form 990-T is used to compute and pay taxes due.]

35. An association exempt under either IRC Section 501(c)(4) or 501(c)(7) must report unrelated business income on Form 990-T, "Exempt Organization Business Income Tax Return." Which of the following is **not** one of the three key conditions which must be present for an association to be conducting an unrelated trade or business? **(Page 246)**

    a. The trade or business must not be substantially related to the association's exempt purpose. [This answer is incorrect. 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. Thus, this is one of the key conditions that must be present for an association to be conducting an unrelated trade or business.]

    b. The activity must be a trade or business. [This answer is incorrect. This is one of the key conditions that must be present for an association to be conducting an unrelated trade or business.]

    c. The trade or business must be regularly carried on. [This answer is incorrect. This is one of the key conditions that must be present for an association to be conducting an unrelated trade or business.]

    d. The activity is performed substantially by volunteers. [This answer is correct. 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%).]

36. A master association is an association made up of different types of associations, such as homeowners' associations plus commercial condominium associations. Which of the following statements related to master associations is correct? **(Page 247)**

    a. The tax rules that apply to condominium and homeowners' associations generally do not apply to master associations. [This answer is incorrect. The same tax rules that apply to condominium and homeowners' associations generally also apply to master associations.]

    b. Treasury Regulation 1.528-4 requires that 75% of the square footage of a condominium association be used for residential purposes or that 75% of the lots of a residential real estate management association be zoned for residential purposes. [This answer is incorrect. 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.]

c. Treasury Regulation 1.528-4 states that timeshare associations are not affected by the substantially residential test. [This answer is correct. Timeshare associations are not affected by the substantially residential test.]

d. 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 each individual subsidiary association. [This answer is incorrect. In this case, the substantially residential determination is made by applying the criteria in the regulations *to all subsidiary association members as a whole*.]

37. Commercial associations perform the same essential functions for their owners as typical residential CIRA management corporations perform for their owners, such as the management, maintenance, and care of common elements. Which of the following is **not** an example of a commercial association? **(Page 248)**

a. Shopping center on the outskirts of a planned residential development. [This is an incorrect answer. A shopping center, regardless of its location, can be a commercial association.]

b. Office park located next to a planned residential development. [This answer is incorrect. An office park, regardless of its location, can be a commercial association.]

c. Industrial parks located next to a planned residential development. [This answer is incorrect. An industrial park can be a commercial association.]

d. Marina in a planned residential development. [This answer is correct. A marina in a planned residential development is part of that residential development, not a commercial association. If the association files under IRC Section 528, income from the marina is nonexempt function income; if it files under Section 277, it is membership income.]

SPECIALIZED TAX SITUATIONS RELATED TO CIRAS

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. For example, 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 assuming 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 previously, 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 is believed 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, 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 may 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. See further discussion of Revenue Ruling 81-152 in this lesson.

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.

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.

Perhaps the only logical conclusion that can be reached is 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 presented above.

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 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. More information has been provided regarding homeowners' associations that file under IRC Section 501(c)(7), in an earlier discussion.

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 has been provided already that offers more information homeowners' associations that file under IRC Section 501(c)(4).

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.

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, perhaps the acquisition should 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.

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.

Deduction of Property Taxes by Members of Homeowners' Associations

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 they meet certain other conditions as described in the discussion of environmental cleanup costs. 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). However, GAAP requires a liability to be recognized if the criteria under SFAS No. 5 (as discussed in SOP 96-1) are met.

SELF-STUDY QUIZ

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

38. A CIRA sells a long-term easement to which it has title for $50,000. If the CIRA has basis of $30,000 in the property, how should the sale be recorded?

    a. The sale should be treated as a gain to the individual CIRA members.

    b. The total sales proceeds should be reported as a gain when the easement is sold.

    c. The sales proceeds should reduce the basis of the property with any excess reported as a gain.

    d. The gain should be treated entirely as ordinary income (similar to rental income).

39. Revenue Ruling 81-152 discusses how capital assessments by an association affect a unit owners' tax bases. Which of the following statements best describes the affect of this ruling?

    a. If a capital assessment is made by the association, the unit owners' tax bases will be decreased.

    b. The association must have expended funds for the actual major repair or replacement of the common areas in order for there to be an affect on the unit owner's tax bases.

    c. 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.

40. The term *ancillary operations* describe any association activities other than the ordinary maintenance, security, governance, and administrative activities common to most associations. Which of the following statements about the tax treatment of ancillary operations is **incorrect**?

    a. The tax treatment of ancillary operations varies depending upon the tax form filed.

    b. Regardless of which tax form is filed, the association is required to allocate expenses to both member and nonmember revenues.

    c. If Form 1120-H is filed and user fees are charged, then ancillary operation revenues are classified as exempt function income.

    d. If Form 1120 is filed and user fees are charged, the association must determine nonmember revenues and expenses, as nonmember net income will be considered "taxable" income.

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.)**

38. A CIRA sells a long-term easement to which it has title for $50,000. If the CIRA has basis of $30,000 in the property, how should the sale be recorded? **(Page 252)**

    a. The sale should be treated as a gain to the individual CIRA members. [This answer is incorrect. If the members, rather than the association, have title, the sale should be treated by the individual members as described in c. and d. below.]

    b. The total sales proceeds should be reported as a gain when the easement is sold. [This answer is incorrect. This is how a sale of an easement should be treated if the association has title to the property but no basis in it.]

    c. The sales proceeds should reduce the basis of the property, with any excess reported as a gain. [This is the correct answer. 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.]

    d. The gain should be treated entirely as ordinary income (similar to rental income). [This answer is incorrect. If it were a short-term easement and the association has title (regardless of whether or not they have basis), this is how the gain should be treated.]

39. Revenue Ruling 81-152 discusses how capital assessments by an association affect a unit owners' tax bases. Which of the following statements best describes the affect of this ruling? **(Page 254)**

    a. If a capital assessment is made by the association, the unit owners' tax bases will be decreased. [This answer is incorrect. Generally, the unit owner's bases would be increased, not decreased, by the amount of capital assessments.]

    b. The association must have expended funds for the actual major repair or replacement of the common areas in order for there to be an affect on the unit owner's tax bases. [This answer is incorrect. Ruling 81-152 implies that the association does not have to have spent the funds for the assessment to increase an owner's tax bases.]

    c. 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. [This answer is correct. Revenue Ruling 81-152 supports this view. However, 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 this one.]

40. The term *ancillary operations* describe any association activities other than the ordinary maintenance, security, governance, and administrative activities common to most associations. Which of the following statements about the tax treatment of ancillary operations is **incorrect**? **(Page 255)**

    a. The tax treatment of ancillary operations varies depending upon the tax form filed. [This answer is incorrect. The tax treatment does depend upon which tax form is filed.]

    b. Regardless of which tax form is filed, the association is required to allocate expenses to both member and nonmember revenues. [This answer is incorrect. The association is required to allocate expenses in this manner, regardless of which form is filed.]

    c. If Form 1120-H is filed and user fees are charged, then ancillary operation revenues are classified as exempt function income. [This answer is correct. If Form 1120-H is filed and user fees are charged, then ancillary operation revenues are classified as *nonexempt* function income and must be considered in the 60% income test calculation.]

    d. If Form 1120 is filed and user fees are charged, the association must determine nonmember revenues and expenses, as nonmember net income will be considered "taxable" income. [This answer is incorrect. If Form 1120 is filed, the association must make this determination. Member income and expenses for the ancillary activities may be combined with all other member revenues and expenses.]

EXAMINATION FOR CPE CREDIT

Lesson 3 (HOATG092)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

32. The Waterford Park subdivision is a gated community. It currently has main common areas, a pool and clubhouse, equestrian center and walking trails, that are not located behind the gates. Since Waterford Park is a gated community, it is automatically disqualified for exempt status because it is no longer accessible to the public.

    a. True.

    b. False.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

33. Treasury Regulation 1.337(d)-4 assesses a tax on the gain on any assets transferred from a taxable to a tax-exempt organization. Which of the following statements about such tax is **incorrect**?

    a. The gain is measured as the excess of the fair market value of assets transferred over their tax basis.

    b. Section 501(c)(7) organization has seven years from the date of incorporation to apply for exemption without having the "transfer tax" rules apply.

    c. Section 501(c)(4) organizations have three years from the date of incorporation to apply for exemption without having the "transfer tax" rules apply.

    d. The tax on the gain on assets transferred from a taxable to a tax-exempt organization applies only to organizations exempt under IRC Section 501(c)(4). Those exempt under 501(c)(7) are not assessed such a tax.

34. An association club exempt under 501(c)(7)rents facilities to nonmembers at a profit. Which of the following statements about this activity is **incorrect**?

    a. This activity might be viewed as benefiting club members by reducing charges that members would otherwise need to pay to maintain the facilities.

    b. The activity would not jeopardize the club's tax-exempt status since IRS rules say that a club's earnings may not inure to the benefit of a shareholder/member.

    c. Although the tax rules lack specific guidance on the percentage limits that apply to nonmember receipts before a club's exempt status is in jeopardy, income from this activity is normally not a problem if it is less than 5% of gross receipts.

    d. This activity might result in unrelated business income. Because 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.

35. Proceeds from the sale of common area assets may be received from nonmembers or members of the association. Which of the following statements about the tax implications of such transactions is **incorrect**?

    a. Since proceeds received from nonmembers 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.

b. In the event that a sale of common area assets is made to a member of the association, proceeds from the sale will be classified as nonexempt function income if the association files Form 1120-H.

c. Sales proceeds received from a member will be classified as member income if the association files Form 1120.

d. Sales proceeds received from a member will be classified as nonmember income if the association files Form 1120.

36. Assume a condominium association has a rental pool in which a unit owner makes his or her unit available to the pool for rental use, but not on a shared basis. All **but which** of the following statements appropriately describe the implications of that arrangement?

a. The unit owner receives rental income only when the unit is rented, and the unit owner remains responsible for the unit's direct expenses.

b. Since the association is the rental agent, it pays any costs associated with the rental activity (such as maid and laundry service).

c. Expenses associated with the rental activity are generally allocated to a unit based upon a formula (such as $x per day or week rented) or as a flat percentage of rental income.

d. The association as rental agent is responsible for sending a Form 1099 to the unit owner, but has no other reporting obligation.

37. Assume a condominium associations has a rental pool composed of individually owned units or rooms that are operated by the association as a hotel. All **but which** of the following statements appropriately describe the implications of that arrangement?

a. 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.

b. Despite the shared income and expense features, this type of pooling arrangement is not considered an "active" trade or business.

c. The rental pool should be treated as a partnership, and a partnership return should be filed.

d. All owners who are part of the rental pool are partners.

38. A homeowner pays $500,000 for a condominium. Over the next two years, the homeowner spends $5,000 for interior improvements and capital assessments of $1000. What is the homeowner's tax basis in the condominium?

a. $500,000.

b. $505,000.

c. $506,000.

d. $504,000.

39. Assume a homeowner's association has to foreclose on a unit for delinquent assessments. All of the following statements describe how the unit should be accounted for **except**:

a. When a unit is received in that manner, its acquisition should be treated as an investment in real estate.

b. A gain or loss should be recognized on the unit when it is resold.

c. The CIRA's basis in a foreclosed unit for tax purposes may be different from the CIRA's basis for financial statement purposes.

d. The resale of the unit is a nontaxable transaction for tax purposes.

40. A CIRA owns recreational facilities that may be used by nonmembers. Because it has made reasonable accommodations to enable disabled employees to perform their jobs, several provisions of the Americans with Disabilities Act of 1990 might apply to the CIRA. Which of the following statements about these provisions is **incorrect**?

a. The CIRA is eligible for a tax credit for expenses incurred to provide access to disabled persons if, for the preceding year, it did not have more than $500,000 in gross receipts.

b. The CIRA is eligible for a tax credit for expenses incurred to provide access to disabled persons if, for the preceding year, it did not have more than 30 full-time employees.

c. The CIRA is eligible for a tax credit for expenses incurred to provide access to disabled persons if, for the preceding year, it did not have more than $1 million in gross receipts.

d. 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.

GLOSSARY

Additional Services: 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).

CIRA Funds: Funds comprised of member dues and contributions of capital.

Condominium Association: 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.

Contributions of Capital: Tax rules allow CIRAs to treat the following additional amounts as contributions of capital for tax purposes in certain circumstances: (1) Assessments for specific capital improvements or the replacement of personal property; (2) Litigation proceeds from developers for warranty claims; and (3) Assessments received from cooperative tenant-shareholders representing amortization of mortgage principal.

Exempt Function Income: Payments in lieu of dues (past, present, or future) and for under-assessments are generally considered to be membership income or exempt function income.

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.

Foreclose: Condominiums and homeowners' associations may receive abandoned units or foreclose on units for nonpayment of delinquent assessments.

Form 1120: Most CIRAs are taxed on nonexempt function, nonmember income, or nonpatronage income. They generally are taxed as corporations. Like other corporations, cooperatives file their federal income tax returns on Form 1120.

Form 1120-H: A special corporate tax return for homeowners' associations, condominium associations, and timeshare associations.

Form 990-T. 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.

Gross Income Test: The gross income test excludes from exempt function income any amounts that the tax rules exclude from gross income.

Homeowners' Association: Members of homeowners' associations own their own dwelling and the land on which the dwelling sits.

IRC Section 277: Residential condominium associations, homeowners' associations, and timeshare associations may elect to be taxed under IRC Section 277, which applies to certain membership organizations.

IRC Section 501(c)(4): 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".

IRC Section 501(c)(7): 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".

IRC Section 528: Residential condominium associations, homeowners' associations, and timeshare associations may elect to be taxed under IRC Section 528, which applies specifically to homeowners' associations as that term is defined for tax purposes.

Members: 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.

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.

Nonexempt Function: Gains and losses on sales of marketable securities are nonexempt function income,

Operating Reserve: Accumulating funds for contingencies (referred to as "general operating reserves" or "GOR") and for future major repairs and replacements.

Patronage Dividend: 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.

Pooling Arrangement: 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. 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.

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).

Structured Settlements: Are a relatively new 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.

Timeshare Association: The members hold rights to use or ownership interests in real property of the association.

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

COURSE 3

PERFORMING SUBSTANTIVE PROCEDURES AND CONCLUDING THE AUDIT (HOATG093)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course discusses substantive procedures and considerations specific to designing and performing substantive procedures for audits of common interest realty associations (CIRAs). It also discusses the general procedures necessary to conclude the audit.

Lesson 1 covers the substantive procedures the auditor of a CIRA needs to perform to detect material misstatement at the relevant assertion level. The lesson further explains for each assertion within an account balance, class of transactions, or disclosure how the auditor should determine the nature, timing, and extent of substantive procedures that are necessary to gain sufficient and appropriate audit evidence to express an opinion on the financial statements. Lesson 2 looks at the more general and concluding procedures that are necessary in a CIRA audit.

PUBLICATION/REVISION DATE: June 2009

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 QAS Hours, 8 Registry Hours

0 CTEC Federal Hours, 0 CTEC California Hours

Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours.

FIELD OF STUDY: Auditing

EXPIRATION DATE: Postmark by **September 30, 2010**

KNOWLEDGE LEVEL: Basic

Learning Objectives:

Lesson 1—Performing Substantive Procedures

Completion of this lesson will enable you to:

- Define *substantive procedures*, *tests of details*, and *substantive analytical procedures*, *summarize such procedures*, and identify the authoritative pronouncements that most directly affect the design of substantive procedures for CIRAs.
- Identify the general considerations in designing audit procedures to test the major accounts unique to CIRAs.
- Detect the special considerations that could apply to a CIRA audit and employ the appropriate procedures under several scenarios.

Lesson 2—Concluding the Audit

Completion of this lesson will enable you to:

- Explain audit procedures for a CIRA's commitments, contingencies, accounting estimates, and fair value.
- Describe proper auditing and reporting procedures regarding a CIRA's *subsequent events*, *related party transactions*, and *going concern* considerations.
- Summarize requirements related to a CIRA's *management representation letter* and gain a sense for evaluating whether the auditor's assessment of risks of material misstatements is still appropriate in the conclusion stage of the audit.
- Cite the purpose of analytical procedures in the final review stage of the audit and how to plan for the appropriate review of workpapers; and summarize how to evaluate and summarize the misstatements discovered in fieldwork.
- Explain the requirements for drafting financial statements and the auditor's report for a CIRA audit.
- Recognize aspects of the audit that the auditor must communicate to the client using required methods.

TO COMPLETE THIS LEARNING PROCESS:

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Lesson 1: Performing Substantive Procedures

INTRODUCTION

Obtaining a solid, in-depth understanding of the CIRA's business and how it operates is fundamental to audit effectiveness and efficiency.

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

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

Learning Objectives:

Completion of this lesson will enable you to:

- Define *substantive procedures*, *tests of details*, and *substantive analytical procedures*, *summarize such procedures*, and identify the authoritative pronouncements that most directly affect the design of substantive procedures for CIRAs.
- identify the general considerations in designing audit procedures to test the major accounts unique to CIRAs.
- Detect the special considerations that could apply to a CIRA audit and employ the appropriate procedures under several scenarios.

Authoritative Literature

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

a. SAS No. 56 (AU 329), *Analytical Procedures*, explains the use of analytical procedures as substantive tests to obtain sufficient appropriate audit evidence.

b. SAS No. 99 (AU 316), *Consideration of Fraud in a Financial Statement Audit*, requires the auditor to identify and assess risks of material misstatement due to fraud, and to design the audit to provide reasonable assurance of detecting fraud that results in the financial statements being materially misstated.

c. SAS No. 103 (AU 339), *Audit Documentation*, requires the auditor to document the work performed, the audit evidence obtained and its source, and the conclusions reached. In addition, it establishes other documentation requirements that need to be considered when designing audit programs and substantive procedures.

d. SAS No. 106 (AU 326), *Audit Evidence*, describes audit procedures used to obtain audit evidence.

e. SAS No. 110 (AU 318), *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, addresses audit procedures that are responsive to risks at the relevant assertion level.

Substantive Procedures Required in Every Audit

Because of the judgmental nature of the auditor's risk assessments and the inherent limitations of internal control, particularly the risk of management override, the auditing standards prescribe certain substantive procedures that should be performed in every audit.

SAS No. 110 (AU 318.52) requires the auditor to perform the following substantive procedures in every audit:

- Agree the financial statements, including the accompanying notes, to the underlying accounting records.
- Examine material journal entries and other adjustments made during the course of preparing the financial statements.

SAS No. 99 also requires certain substantive procedures in all audits to address the risk of management override of controls. These required procedures are as follows:

- Examining journal entries and other adjustments for evidence of possible material misstatement due to fraud (AU 316.58–.62).
- Reviewing accounting estimates for biases that could result in material misstatement due to fraud (AU 316.63–.65).
- Evaluating the business rationale for significant unusual transactions (AU 316.66).

Both SAS No. 110 and No. 99 require examining journal entries and other adjustments, but the requirement of SAS No. 99 is focused on identifying fraudulent journal entries. As discussed in Paragraph 6.69 of the AICPA Audit Guide, *Assessing and Responding to Audit Risk in a Financial Statement Audit*, the nature, timing, and extent of procedures required by SAS No. 99 are different from those required by SAS No. 110. SAS No. 110 focuses on journal entries made during the course of preparing the financial statements, and SAS No. 99 requires the auditor to consider reviewing journal entries made throughout the year. Auditors should ensure that their audit procedures satisfy both requirements.

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

- Confirmation of accounts receivable. (AU 331.34)
- Inventory observation, that is, being present at the time of the count and, by suitable observation, tests, and inquiries being satisfied about the effectiveness of the methods of inventory taking. (AU 331.01)

In addition, there are other specific requirements to perform procedures, typically called *general procedures*, that do not relate to particular account balances, such as sending a letter of audit inquiry to the client's lawyer.

Significant risks are risks that require special audit attention. When the audit approach to significant risks consists only of substantive procedures (that is, the auditor does not plan to rely on controls), the substantive procedures should be tests of details only or a combination of tests of details and substantive analytical procedures. The use of only substantive analytical procedures is not permitted (AU 318.54).

Considering the Sufficiency and Appropriateness of Audit Evidence. Even if the auditor concludes that the risk of material misstatement is low for a particular assertion related to a material account balance, transaction class, or disclosure based on performing risk assessment procedures and tests of controls, some substantive procedures are still required. The additional substantive procedures that are needed in particular circumstances depend on the auditor's judgment about the sufficiency and appropriateness of audit evidence in the circumstances. SAS No. 106 (AU 326.06) describes these characteristics of audit evidence as follows:

- *Sufficiency* is the measure of the *quantity* of audit evidence.
- *Appropriateness* is the measure of the *quality* of audit evidence, that is, its relevance and its reliability in providing support for, or detecting misstatements in, the classes of transactions, account balances, and disclosures and related assertions.

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

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

An important quality of audit evidence is its reliability, which is affected by both the nature and source of the evidence. SAS No. 106 (AU 326.08) provides the following generalization about the reliability of audit evidence:

a. Audit evidence is more reliable when it is obtained from knowledgeable independent sources outside the entity.

b. Audit evidence that is generated internally is more reliable when the related controls imposed by the entity are effective.

c. Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).

d. Audit evidence is more reliable when it exists in documentary form, whether paper, electronic, or other medium. For example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed.

e. Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or faxes.

Choosing between Analytical Procedures and Substantive Tests of Details

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

Generally, the higher the assessed risk of material misstatement, the more effective analytical procedures need to be to produce higher reliance than tests of details. Accordingly, auditors tend to use tests of details more extensively in high risk audit areas (such as areas containing fraud risks or other significant risks) and analytical procedures more often in low risk areas or as secondary rather than primary auditing procedures. However, if the auditor has highly effective analytical procedures, it may be possible to reduce the extent of detail testing needed, even in areas where significant risks exist. The effectiveness of substantive analytical procedures in reducing detection risk in comparison with the effectiveness of tests of details generally depends on the facts and circumstances. However, the following are some general observations:

a. Analytical procedures are generally not effective in testing assertions about rights or obligations or assertions related to presentation and disclosure because those assertions do not lend themselves to testing through comparisons with expectations. Therefore, analytical procedures would not be effective responses for risks related to matters such as parties to transactions lacking in economic substance or intentional ambiguity in financial statement disclosures.

b. Relationships involving transactions over a period of time (that is, revenue and expense accounts) tend to be more predictable than relationships at a point in time (that is, balance sheet accounts). Because of the difficulty in developing expectations about a balance at a point in time with sufficient precision, analytical procedures are often not as effective as tests of details for assertions about the existence of assets and

liabilities. Therefore, analytical procedures would not be as effective as tests of details when responding to risks such as recording false receivables or including items in inventory that are false or mislabeled.

c. Analytical procedures are often equally or more effective than tests of details for assertions about the completeness of assets, liabilities, revenues, and expenses. When testing for completeness, misstatements would often not be apparent from inspecting detailed evidence in the accounting records.

d. Analytical procedures are often equally or more effective than tests of details for assertions about the occurrence of revenues. For example, comparing recorded revenue with the amount expected, based on a reliable record of member units and average assessments, may be as likely to detect a material misstatement of assertions about the occurrence of revenues as inspecting supporting documentation for a sample of recorded revenue. Analytical procedures are more reliable if they are based on reliable data produced outside the accounting system (for example, approved assessment cost per unit or operating data used to manage the CIRA).

e. Analytical procedures are often equally or more effective than tests of details for assertions about the occurrence of certain expenses. For example, comparing recorded labor costs with the amount expected, based on the number of people employed and the average hours worked, may be as likely to detect a material misstatement resulting from errors as looking at supporting documentation for a sample of recorded compensation expense. However, if fraud is a concern, analytical procedures may not be effective. For example, if management is able to manipulate expense accounts so that ratios appear reasonable, ratio analysis would not be an effective analytical procedure for detecting material misstatements.

f. Analytical procedures may be as effective as tests of details for assertions about the valuation of some assets and liabilities but not for others. Generally, whether an analytical procedure is as effective as a test of details for a valuation assertion depends on whether an expectation can be developed. For example, an analytical procedure may be as effective as a test of details for assertions about the valuation of member receivables that are made up of a large number of relatively small balances. However, a test of details may be more effective when some account balances are disproportionately large. In that situation, failure to record an allowance for uncollectible amounts resulting from a deterioration in the financial condition of one of those members either before or after year-end would most likely not be detected by an analytical procedure.

g. Substantive tests of details may be more effective for valuation assertions in an unstable environment. The ability to develop an expectation that approximates the recorded amount is greater when the environment is stable. For example, when interest rates are fluctuating widely, it is difficult to develop a precise expectation about interest expense. Similarly, when transactions involve management discretion, such as the choice of repairing versus replacing equipment, there is also less predictability in relationships.

TESTS OF DETAILS

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

a. *Tests of Transactions.* These are tests of the processing of individual transactions by inspection of the documents and accounting records involved in processing, e.g., tracing a sample of invoices to the purchase journal or other accounting records to see whether invoices have been recorded as expenses.

b. *Tests of Balances.* These are tests applied directly to the details of balances in the accounting records, e.g., confirming investments held by others, such as a broker.

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

Confusion about Tests of Details

Inspection of documents and accounting records may be involved in both tests of controls directed toward operating effectiveness (if controls leave a documentary trail) and tests of details. For this reason, some auditors have equated tests of details and tests of controls. The difference is in the objective of the test. The mere fact that a transaction or balance is being tested does not make the test a test of controls. For example, the inspection of invoices in support of additions to equipment is a *substantive* test. The objective of the test is to substantiate the transaction, i.e., the addition. The same principle applies to other types of transactions or balances. For example, revenue transactions may be tested to substantiate total revenue without being concerned with the effectiveness of control policies and procedure for processing member assessment transactions. It is the objective of the test and not whether it is applied to a class of transactions or a balance that determines whether the test is a test of controls or a substantive procedure. Substantive procedures, including tests of details, are normally applied after the auditor has obtained an understanding of internal control, but substantive tests of details in the current period may contribute to the auditor's understanding in subsequent periods. Tests of details can be performed concurrently with tests of controls.

SUBSTANTIVE ANALYTICAL PROCEDURES

What Are Analytical Procedures?

Analytical procedures are evaluations of financial information made by a study and comparison of plausible relationships among both financial and nonfinancial data. SAS No. 56 identifies three categories of analytical procedures: preliminary (planning) analytical procedures, substantive analytical procedures, and overall review analytical procedures. Both preliminary and overall review analytical procedures are required in an audit. Preliminary analytical procedures are performed in the planning stage of the audit. Overall review analytical procedures are performed in the final review stage of the audit. Use of substantive analytical procedures is discretionary. The following paragraphs further discuss substantive analytical procedures in an audit engagement.

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

Exhibit 1-1

Common Financial Statement Trends

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

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

Assessment Revenue and
Assessments Receivable
Wages and Salaries Expense and
Payroll Taxes
Health Insurance
Interest Expense and
Long-term Debt
Assessments Receivable and
Bad Debt Expense
Legal Expense (for bad debt collection)
Cash and Investments and
Investment Income (such as interest and dividends)

* * *

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

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

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

Using analytical procedures generally involves:

a. Developing an expectation of what an account balance should be.
b. Comparing the expected amount with the recorded amount.
c. Determining whether any difference between the recorded and expected amount is significant.
d. Investigating the cause of any unexpected significant difference.
e. Evaluating the likelihood of material misstatement.
f. Documenting the analytical procedures.

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

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

Designing Analytical Procedures

According to SAS No. 110 (AU 318.57), when designing substantive analytical procedures, the auditor should consider whether:

- The use of substantive analytical procedures is appropriate considering the relevant assertions.

- The data from which the expectation of recorded amounts or ratios is developed is reliable.
- The expectation is sufficiently precise to identify the possibility of a material misstatement at the desired level of assurance.
- The amount of any difference in recorded amounts from expected values is acceptable.

Precision of Expectation. Precision is the term used to describe the degree of accuracy of the expectation developed by the auditor to the actual amount. Other things remaining equal, the larger the recorded amount, the more difficult it is to develop a precise expectation. This is because a small percentage of a very large recorded amount can be material to the financial statements taken as a whole. In some cases, to develop a precise expectation, the auditor might need to break the recorded amount down into more predictable components. Expectations developed at a more detailed level have a greater chance of detecting a misstatement of a given amount. For example, expectations developed concerning monthly amounts are generally more precise than annual amounts. Comparisons by location or department are generally more precise than entity-wide comparisons. Sometimes, an account balance can be separated into different categories of transactions. For example, assessment revenue might be separated by type of unit in a mixed-use association (for example, residential, timeshare, and commercial), or compensation expense might be separated by salaried and hourly employees. Deciding the level at which to develop expectations in a review engagement is also relevant to substantive analytical procedures in an audit.

Evaluating the Results of Analytical Procedures. Results of analytical procedures are usually evaluated against a CIRA's past operations, taking into account expected operations. Professional judgment must be applied in deciding when the results of analytical procedures indicate significant fluctuations from expected amounts that should be investigated further. Best practices indicate that auditors could determine the magnitude of changes that will be considered significant before applying analytical procedures so that those judgments will be as objective as possible. In making that decision, the following factors usually should be considered:

a. *Expected Size of the Fluctuation.* Some fluctuation from prior years (or expected results) often would be considered reasonable based on the CIRA and the circumstances. However, fluctuations in excess of expected amounts generally should be considered significant.

b. *Materiality.* Fluctuations should be considered in light of materiality for the financial statements, by financial statement line as well as in the aggregate.

c. *Percentage Change.* Usually the percentage change rather than the absolute amount of the change should be considered in deciding whether a change in an account balance is significant, especially in smaller accounts.

d. *Precision of the Analytical Procedure.* Relationships that are more direct and involve fewer variables can be expected to provide more accurate estimates of actual account balances.

When fluctuations from expected amounts are significant, the auditor should reconsider the methods used to develop the expectation and the plausibility of the relationships. Discussions with management may provide explanations for the variances. However, in most instances, auditors should combine additional inquiry or analytical procedures with preparing other accounting schedules or analyses to explain fluctuations. If the fluctuations cannot be explained, the auditor should perform other audit procedures to determine if the differences are likely misstatements.

Limitations of Analytical Procedures

Applying analytical procedures can be an effective method of identifying misstatements in financial statements. However, they do have certain limitations, including the following:

a. Inquiries may be more effective for certain assertions or accounts. For example, analytical procedures are ineffective when accounts are subject to significant management discretion, such as those involving estimates, because relationships are unpredictable.

b. Analytical procedures are ineffective when factors affecting accounts are not constant over time.

c. Analytical procedures are less precise and accurate as account relationships become more remote.

d. Reasonableness tests, to some extent, usually depend on operating data, which may not be available.

e. Ratios may not be comparable with industry averages, with ratios computed for similar CIRAs, or within the same CIRA over time, because of changes in accounting principles or because of differences in the way they are computed.

Required Documentation

When an analytical procedure is used as the principal substantive test of a significant financial statement assertion, SAS No. 56, *Analytical Procedures* (AU 329.22), requires the auditor to document:

- the expectation and the factors considered in its development (unless readily determinable from the work performed),
- the results of comparing recorded amounts to the expectation, and
- any additional procedures performed in response to significant unexpected 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 (for example, a percentage of tolerable misstatement). Also, many auditors document analytical procedures, particularly the results of ratio and trend analysis, in carryforward workpapers or in a permanent file to facilitate historical comparisons.

SELF-STUDY QUIZ

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

1. Performing substantive procedures is an important part of audits of CIRAs. Which of the following is the best definition of *substantive procedures*?

   a. The audit procedures taken to obtain an in-depth understanding of the CIRA's business and how it operates.

   b. The audit procedures performed to detect material misstatements at the relevant assertion levels of account balances, classes of transactions, and disclosures.

   c. The audit procedures required by SAS No. 56 (AU 329), *Analytical Procedures*.

2. There are several authoritative pronouncements that most directly affect the auditor's design of substantive procedures. Which piece of authoritative guidance specifically addresses the audit procedures related to risks at the relevant assertion level of material account balances, classes of transactions, and disclosures?

   a. SAS No. 56 (AU 329), *Analytical Procedures*.

   b. SAS No. 99 (AU 316), *Consideration of Fraud in a financial Statement Audit*.

   c. SAS No. 106 (AU 326), *Audit Evidence*.

   d. SAS No. 110 (AU 318), *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*.

3. John is planning his firm's audit of a CIRA. He should perform substantive procedures required by SAS No. 110, SAS 99, and other authoritative pronouncements. Which of the following is **not** correct based on such authority?

   a. The requirements in SAS No. 110 and SAS No. 99 that journal entries and other adjustments be examined is a redundancy in that the focus of each requirement is the same.

   b. SAS No. 99 and No. 110 require that specific substantive procedures be performed in every audit.

   c. AU 331.34 requires confirmation of accounts receivable and inventory observation.

   d. There are required *general procedures*, which are procedures that do not relate to a particular account balance.

4. Which one of the following is a good example of a situation where a test of details is most likely to be appropriate?

   a. The risk of recording false receivables.

   b. Testing for completeness of revenues.

   c. When comparing revenue and expense account balances that are predictable over a period of time.

   d. Testing for occurrence of labor cost where fraud is not a concern.

5. Which of the following is a correct match between the auditing procedure and the specific example of such a test?

   a. Test of balances: Determining what account balances have increased since the prior period.

   b. Test of balances: Test for unexpected increases or decreases in compensation expense between years.

   c. Analytical procedures: Tracing a sample of invoices to the purchase journal.

   d. Analytical procedures: Reasonableness of account balances.

6. Which of the following is **not** a consideration in designing analytical procedures?

   a. Whether the data from which the auditor develops expectations to compare to recorded amounts is reliable.

   b. How precise the auditor's expectations should be compared to the recorded amounts.

   c. Whether the budget amount is acceptable when compared to expected value.

   d. Whether substantive analytical procedures are appropriate to test the relevant assertions.

7. When an auditor is evaluating the results of analytical procedures performed, which one of the following is a factor that should be considered?

   a. The absolute amount of change in an account balance from the prior year because it is usually a better indicator of a significant fluctuation in account balances.

   b. Any fluctuations between the prior year-end and the year-end under audit should be considered with regard to materiality for the financial statements in the aggregate and not by financial statement lines.

   c. Typically, analytical procedures of an account balance are more precise when relationships being examined involve more variables (as opposed to fewer).

   d. If fluctuations between the prior period and the period under audit are significant, the auditor should seek to explain the fluctuation by discussing it with management and by performing other substantive procedures.

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. Performing substantive procedures is an important part of audits of CIRAs. Which of the following is the best definition of *substantive procedures*? **(Page 271)**

   a. The audit procedures taken to obtain an in-depth understanding of the CIRA's business and how it operates. [This answer is incorrect. Such procedures are important to gain a solid, in-depth understanding of the CIRA's business, but this is not the definition of *substantive procedures*.]

   b. The audit procedures performed to detect material misstatements at the relevant assertion levels of account balances, classes of transactions, and disclosures. [This answer is correct. Substantive procedures are those designed to detect the types of potential misstatements that could occur and not be prevented or detected by controls or the procedures used to obtain an understanding of the CIRA's business and legal environment.]

   c. The audit procedures required by SAS No. 56 (AU 329), *Analytical Procedures*. [This answer is incorrect. SAS No. 56 is only one piece of the body of authoritative literature that relates to substantive procedures. Analytical procedures are a type of substantive procedure, but not the only type. Tests of details are also substantive procedures.]

2. There are several authoritative pronouncements that most directly affect the auditor's design of substantive procedures. Which piece of authoritative guidance specifically addresses the audit procedures related to risks at the relevant assertion level of material account balances, classes of transactions, and disclosures? **(Page 271)**

   a. SAS No. 56 (AU 329), *Analytical Procedures*. [This answer is incorrect. SAS No. 56 explains the use of analytical procedures as substantive tests to obtain sufficient appropriate audit evidence.]

   b. SAS No. 99 (AU 316), *Consideration of Fraud in a financial Statement Audit*. [This answer is incorrect. SAS No. 99 is specifically targeted at identifying and assessing risks of material misstatement due to fraud.]

   c. SAS No. 106 (AU 326), *Audit Evidence*. [This answer is incorrect. SAS No. 106 describes audit procedures used to obtain audit evidence.]

   d. SAS No. 110 (AU 318), *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*. [This answer is correct. SAS No. 110 (AU 318) addresses audit procedures that are responsive to risks at the relevant assertion level. According to SAS No. 110, "regardless of the assessed risk of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure."]

3. John is planning his firm's audit of a CIRA. He should perform substantive procedures required by SAS No. 110, SAS 99, and other authoritative pronouncements. Which of the following is **not** correct based on such authority? **(Page 272)**

   a. The requirements in SAS No. 110 and SAS No. 99 that journal entries and other adjustments be examined is a redundancy in that the focus of each requirement is the same. [This answer is correct. It is not an accurate statement. The focus of SAS No. 99 is journal entries made throughout the year to detect fraud. SAS No. 110 focuses on journal entries made in the preparation of financial statements.]

   b. SAS No. 99 and No. 110 require that specific substantive procedures be performed in every audit. [This answer is incorrect. It is a true statement. Rationale for this requirement includes the fact that an auditor's risk assessments are judgment calls, and internal controls have inherent limitations, such as the risk of management override.]

   c. AU 331.34 requires confirmation of accounts receivable and inventory observation. [This answer is incorrect. It is a true statement. The requirement of inventory observation means that the auditor must be present at the time of the count and, by suitable observation, tests, and inquiries must be satisfied with the effectiveness of the methods of inventory taking.]

   d. There are required *general procedures*, which are procedures that do not relate to a particular account balance. [This answer is incorrect. It is a true statement. There are general procedures, such as sending a letter of audit inquiry to the client's lawyer, that are required.]

4. Which one of the following is a good example of a situation where a test of details is most likely to be appropriate? **(Page 273)**

   a. The risk of recording false receivables. [This answer is correct. Tests of details are more effective for assertions about the existence of assets and liabilities.]

   b. Testing for completeness of revenues. [This answer is incorrect. Misstatements in revenues would often not be apparent from inspecting detailed evidence in the accounting records.

   c. When comparing revenue and expense account balances that are predictable over a period of time. [This answer is incorrect. Analytical procedures are evaluations of financial information made by a study and comparison of plausible relationships among both financial and nonfinancial date. Comparing revenue and expense account balances that are predictable from year to year is an analytical procedure.]

   d. Testing for occurrence of labor cost where fraud is not a concern. [This answer is incorrect. Analytical procedures can be more effective by comparing recorded labor costs with the amount expected, based on the number of people employed and the average hours worked as opposed to examining supporting documentation for a sample of recorded compensation expense.]

5. Which of the following is a correct match between the auditing procedure and the specific example of such a test? **(Page 276)**

   a. Test of balances: Determining what account balances have increased since the prior period. [This answer is incorrect. The example is one of an *analytical procedure*, which is defined as a study or comparison of plausible relationships among financial and nonfinancial data.]

   b. Test of balances: Test for unexpected increases or decreases in compensation expense between years. [This answer is incorrect. The example is an *analytical procedure*. When the auditor questions fluctuations in accounts between years, the testing is one of *trend analysis*, which is a type of analytical procedure.]

   c. Analytical procedures: Tracing a sample of invoices to the purchase journal. [This answer is incorrect. The example is a test of details, and specifically, a test of transactions. Analytical procedures test for relationships, not individual transactions.]

   d. Analytical procedures: Reasonableness of account balances. [This answer is correct. Analytical procedures are evaluations of financial information, including tests for reasonableness.]

6. Which of the following is **not** a consideration in designing analytical procedures? **(Page 276)**

   a. Whether the data from which the auditor develops expectations to compare to recorded amounts is reliable. [This answer is incorrect. An important consideration when developing analytical procedures might be measuring the fluctuation which is critical to detecting a material misstatement. Some examples of data that is often thought of as reliable include data obtained from a knowledgeable outside party and industry comparables.]

   b. How precise the auditor's expectations should be compared to the recorded amounts. [This answer is incorrect. It is this comparison that helps the auditor to determine whether additional procedures or testing are necessary to detect material misstatements.]

   c. Whether the budget amount is acceptable when compared to expected value. [This answer is correct. The statement is false. The auditor should consider whether the amount of any difference in *recorded* amounts from expected value is acceptable.]

   d. Whether substantive analytical procedures are appropriate to test the relevant assertions. [This answer is incorrect. An auditor must consider appropriateness in deciding on and designing analytical procedures. Generally, the higher the assessed risk of material misstatement, the more effective analytical procedures need to be to produce higher reliance than tests of details.]

7. When an auditor is evaluating the results of analytical procedures performed, which one of the following is a factor that should be considered? **(Page 277)**

   a. The absolute amount of change in an account balance from the prior year because it is usually a better indicator of a significant fluctuation in account balances. [This answer is incorrect. The more effective indicator of significant fluctuation from one year-end to the next is the percentage change.]

   b. Any fluctuations between the prior year-end and the year-end under audit should be considered with regard to materiality for the financial statements in the aggregate and not by financial statement lines. [This answer is incorrect. When evaluating the results of analytical procedures, fluctuations should be considered in light of materiality with respect to the financial statements, by financial statement line as well as in the aggregate.]

   c. Typically, analytical procedures of an account balance are more precise when relationships being examined involve more variables (as opposed to fewer). [This answer is incorrect. An auditor can typically expect analytical procedures of an account to be more precise when there are fewer variables.]

   d. If fluctuations between the prior period and the period under audit are significant, the auditor should seek to explain the fluctuation by discussing it with management and by performing other substantive procedures. [This answer is correct. Discussions with management may explain the fluctuation; however, in most cases, analytical procedures should also be employed. There is also the possibility that the auditor should reconsider the methods used in developing the expectation.]

SUBSTANTIVE AUDIT PROCEDURES FOR CIRAS

SAS No. 108 (AU-311.19) requires preparing an audit plan, commonly referred to as a written audit program.

Cash and Cash Equivalents

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

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

For confirmation procedures, SAS No. 103, *Audit Documentation*, requires the auditor's documentation to include identification of the items selected for confirmation. If a CIRA holds funds in trust for members, such as in a social fund account, the cash is not an asset of the CIRA. However, if the amount is material, the auditors may want to treat the account the same as other accounts as a matter of client service. The volunteer board members of a CIRA are normally financially unsophisticated and will expect the auditors to apply procedures to material cash balances even if those balances are not included in the CIRA's financial statements.

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

Restrictions and Uninsured Balances. State laws or governing documents may restrict the types of accounts in which CIRAs may invest excess cash. Auditors ordinarily obtain an understanding of those matters during the risk assessment process and consider them in determining the nature, timing, and extent of further audit procedures. Restrictions on accounts holding replacement funds are common. Transfers between restricted and unrestricted accounts may be prohibited, and use of interest earned may be designated. Any restrictions or designations of cash balances should be disclosed. Also, consider whether the CIRA has material amounts of cash in certificates of deposit or money market accounts that are uninsured or that exceed insurance limits. SFAS No. 133 (FASB ASC 815) requires that such concentrations of credit risk be disclosed.

Commingled Cash. When the CIRA uses a managing agent, the auditors should consider whether the agent commingles the funds of the various CIRAs managed. (However, state laws may prohibit CIRAs from commingling funds.) A managing agent may deposit collections into one central account (sometimes called a sweep account)

and later disburse funds to separate accounts for each CIRA. Also, a managing agent may deposit cash from all CIRAs into a common account and account for the funds separately only in the accounting records. If funds are commingled, there is a greater risk of material misstatement, and the auditors may need to expand cash procedures to test more cash transactions during the period. Expanded testing of transactions is necessary when funds are commingled because the cash balance cannot be confirmed with an independent source. Control activities in the cash area are particularly important in those circumstances. The auditors have to be concerned that the managing agent may pay the bills of one CIRA with the funds of another. The auditors should be satisfied that the expenses charged to the CIRA client were authorized and incurred.

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

- The association deals with only one "institution"—the broker.
- Diversification of investments means the CIRA runs less risk of exceeding the FDIC's insured deposit limit (temporarily raised in late 2008 from $100,000 to $250,000 through 2013).
- With the help of a knowledgeable broker, the CIRA can maximize interest earned by matching long-term deposits with its replacement funding program.

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

Investments and Derivatives

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

If a CIRA has investments in debt or equity securities, SAS No. 92, *Auditing Derivative Investments, Hedging Activities, and Investments in Securities*, provides guidance with respect to auditing assertions related to those investments. Key considerations when auditing investment securities include evaluating whether securities are properly classified as trading, available-for-sale, or held-to-maturity; whether they are properly valued at fair value or amortized cost; and the proper treatment of unrealized gains or losses. In evaluating whether investments are properly classified, auditors may obtain evidence supporting management's intent and, if the securities are classified as held to maturity, the entity's ability to hold the securities to maturity. In evaluating management's intent, SFAS No. 115 (FASB ASC 320-10) requires an entity's historical experience to be considered. Auditors should also be alert for signs that investments are impaired. Additionally, the auditor ordinarily should determine if the CIRA's investments are insured or otherwise protected and whether an appropriate accrual of interest receivable has been made. The AICPA Audit Guide, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, provides practical guidance on implementing SAS No. 92. That Audit Guide is available online at **www.cpa2biz.com**.

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

- Fair value is significantly below cost and—
  - The decline in fair value can be attributed to adverse conditions specifically related to the security or to specific industry or geographic conditions.

  - The association does not have the ability or intent to hold the investment for a sufficient time period to allow for any anticipated recovery in fair value.
  - The decline in fair value has existed for an extended period of time.
- A rating agency has downgraded a debt security's rating.
- The financial condition of the security's issuer has deteriorated.
- Scheduled interest payments on debt securities have not been made or dividends have been reduced or eliminated on equity securities.
- Losses from the security have been recorded subsequent to year-end.

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

Most CIRAs do not hold derivative instruments. For those CIRAs that do have such investments accounted for under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FASB ASC 815), as amended, key audit considerations include identifying derivative instruments; evaluating whether derivative instruments are properly designated as hedging instruments and, if so, the type of hedge; evaluating whether derivative instruments are properly valued at fair value; and assessing the proper treatment of changes in fair value.

Evaluating Fair Value. When determining whether investments and derivatives are properly valued at fair value, the auditor should consider the requirements of SAS No. 101 (AU 328), *Auditing Fair Value Measurements and Disclosures*, which establishes standards and provides guidance for testing fair values. As fair values are essentially estimates, the SAS primarily expands the guidance in SAS No. 57 to apply to this specific topic.

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

When a valuation method is used, the auditor considers the appropriateness of the method, including management's rationale for selecting the method. Auditors may consider whether management has evaluated the range of values resulting from different methods and investigated the reasons for the differences. Changes in circumstances may require changes in the method used to determine fair value.

Use of a Custodian. Investment portfolios for CIRAs may sometimes be held by a custodian, such as a broker/dealer or bank trust department. In some cases (depending on the nature of transactions processed by the custodian), the auditors may need to consider obtaining a SAS No. 70 service auditor's report on the custodian's internal controls in order to gain an understanding of controls sufficient to plan the audit.

Prepaids, Deferred Charges, and Other Assets

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

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

Receivables

Member assessments represent the primary source of revenues for a CIRA. There may be both regular assessments and special assessments. Auditors need to consider whether member assessments have been recorded as revenue and receivables when assessed, whether the allowance for uncollectible assessments is reasonable, whether the CIRA's policies and procedures for late fees and liens and foreclosures are being followed, and whether any assessments have been prepaid by members and should be reclassified as a liability. Also, particularly during the initial operating period, auditors need to consider whether amounts due from the developer/sponsor related to unsold units have been properly recorded and are collectible.

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

SAS No. 67 (AU 330.34), *The Confirmation Process*, prohibits substituting effective alternative procedures, such as testing subsequent receivables collections, for confirmation of accounts receivable unless one of the following criteria exists:

- Accounts receivable are immaterial.
- The auditors' assessment of the risk of material misstatement is low (in other words, the combined assessment of inherent and control risk is low), and that assessment, together with evidence from other substantive procedures, will be able to meet the audit objectives.
- The use of confirmations would be ineffective.

According to SAS No. 67 (AU 330.34a), the requirement to confirm in certain circumstances will apply to accounts receivable that represent "the entity's claims against customers that have arisen from the sale of goods or services in the normal course of business." Some accountants believe that since the nature of a CIRA's operations is to maintain the development's common property and provide necessary services to unit owners, its receivables from members are analogous to accounts receivable of commercial businesses. Other accountants believe that since CIRAs operate solely for the benefit of members and do not provide goods or services at a profit, assessments receivable from members are different from accounts receivable of commercial businesses, and thus, the confirmation provisions of SAS No. 67 do not apply to CIRAs. Even if SAS No. 67 does not apply to assessments receivable, best practices indicate that in some cases, confirmation of assessments receivable from members may be a more effective auditing procedure than testing subsequent cash collections to substantiate recorded amounts (for example, if a managing agent commingles funds of the CIRAs to which it provides services). Auditors who omit confirmation procedures are required to document the reasons they were able to do so. It is ordinarily not sufficient to merely assert in the workpapers that the use of confirmations would be ineffective without providing some type of evidence or analysis to substantiate that assertion. When assessments are confirmed, the auditor should document the extent of confirmation work performed and summarize the results of those confirmation procedures. SAS No. 103 requires the auditor's documentation to include identification of the items selected for confirmation. Returned confirmations ordinarily should be retained in the workpapers, even when a schedule of confirmation results is prepared for the workpapers.

SAS No. 67 (AU 330.20) also provides guidance about the appropriate use of negative confirmations. That guidance applies to CIRAs and other entities if auditors decide to confirm receivables. According to SAS No.67, negative confirmations may be used only when all of the following criteria are met:

- The auditor's assessment of the risk of material misstatement is low (that is, the combined assessed level of inherent and control risk is low).
- A large number of small balances is involved.
- The auditors believe that the recipients will consider the requests.

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

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

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

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

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

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

Property and Equipment

Most CIRAs other than cooperatives do not capitalize common real property directly associated with the units (for example, exterior walls, roofs, public hallways, underlying land, sidewalks, driveways, roads, some parking areas, and greenbelts). However, those CIRAs typically capitalize common real property not directly associated with the units (for example, recreational facilities, managers' apartments, and properties that are primarily used for commercial operations) if specific conditions are met. Since a cooperative housing corporation owns the land and building, audit procedures for those CIRAs are similar to procedures for commercial businesses. (See Exhibit 2-4, which describes prevalent industry practice for capitalizing common property.) Furthermore, according to Paragraph 2.11 of the AICPA guide, all CIRAs should capitalize common personal property (for example, furnishings, recreational equipment, maintenance equipment, and work vehicles).

If common property is capitalized in response to the accounting practices described in the AICPA guide and the auditors have not previously applied auditing procedures to those amounts in the financial statements, their procedures will need to be directed to evidential matters concerning existence, title to the property, and the amount recorded in the financial statements. Generally, CIRAs' governing documents are not sufficient to determine title to real property, and auditors may examine properly filed deeds or similar evidence of title rather than rely on those internal documents. In addition, they should review the basis used to record the assets. If appraisals have been used, auditors should follow the guidance in SAS No. 73 at AU 336, *Using the Work of a Specialist*. In subsequent years, the auditors consider the need for auditing procedures aimed at determining whether capitalized common property continues to exist and be used by the CIRA.

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

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

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

Accounts Payable, Accrued Liabilities, and Other Liabilities

Confirmation of Accounts Payable. Most auditors believe it is not necessary to confirm accounts payable because the search for unrecorded liabilities is the primary procedure for testing completeness of accounts payable. Many CIRAs account for expenses on a cash basis during the year and convert to the accrual basis only at year end. There is no listing of accounts payable during the year and, in some cases, not even at year end. Often auditors propose the entry to record accounts payable as a by-product of the search for unrecorded liabilities. However, if there is a high risk that payables are incomplete or if the CIRA has extended payment terms with vendors or significant debit memos in accounts payable balances, auditors may decide to confirm accounts payable. When confirmation procedures are necessary, auditors should comply with the provisions of SAS No. 67, *The Confirmation Process*. For confirmation procedures, SAS No. 103, *Audit Documentation*, requires the auditor's documentation to include identification of the items selected for confirmation.

Search for Unrecorded Liabilities. The audit approach to the search for unrecorded liabilities is to (a) review disbursements after the balance sheet date and open purchase orders, (b) review vendor invoices and statements above a specified cutoff amount, and (c) inquire of responsible client personnel about their knowledge of additional sources of unprocessed invoices. To meet the requirements of SAS No. 103, the workpapers should identify the items inspected. For example, the auditor may identify the source and selection criteria, such as "all disbursements exceeding $2,000 from the cash disbursements journal for the period 1/1/X3 through the date of the auditor's report."

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

Refundable Security Deposits. Many associations maintain refundable security deposits on their books for deposits received from their members. Security deposits are commonly required for keys, clubhouse rentals, recreational activities, commercial leases, etc. Refundable security deposits represent a liability since the CIRA is generally obligated to eventually return these funds to their members. Auditors need to review their clients' activities with respect to accounting for deposits, as failure to adequately account for refundable security deposits or turn

over unclaimed deposits to the state may result in a material unrecorded liability. Auditors should be informed about the laws applicable to these deposits to help assess the proper accounting for them and to provide advice to their CIRA clients.

Debt and Related Liabilities

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

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

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

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

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

Cooperative Mortgages. A cooperative housing corporation normally has a mortgage on the real property of the corporation. In some cases, the sponsor/developer will guarantee the rate on a variable rate mortgage (for example, if the mortgage rate exceeds 12%, the sponsor/developer will reimburse the cooperative for amounts paid in excess of 12%). In that case, auditors may wish to confirm the terms of the guarantee and any payments under the guarantee during the period directly with the developer.

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

Small Business Administration (SBA) Loans. CIRAs may apply for low-interest, long-term loans from the SBA. The loan contract is between the association and the SBA. However, repayment is the unit owners' responsibility. Participating in the SBA loan program requires the association to keep subsidiary receivable records that clearly show the account history for each unit. For convenience, CIRAs generally record annual interest expense based on the most recent amortization schedule. Since not all CIRAs account for SBA loans the same, auditors should discuss the accounting method used by the CIRA during the risk assessment phase of the audit. The SBA sends monthly statements showing the application of payments between principal and interest. Auditors should consider whether the monthly statements provide adequate audit evidence or if confirmations with the SBA are necessary. These procedures may also be relevant to other types of debt.

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

Income Taxes

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

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

Equity

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

When a CIRA uses fund accounting, the auditors need to obtain or prepare an analysis of the transactions affecting fund balance and inspect appropriate support for any changes in the balance. Audit work on the replacement fund should be coordinated with procedures applied to major repairs and replacements.

Revenues, Operating Expenses, and Major Repair and Replacement Expenditures

Revenues. Member assessments represent the primary source of revenues for a CIRA. Because the legal documents creating most CIRAs require that assessments be based upon budgets, the budget becomes the financial defining structure of how the CIRA is expected to operate. Thus, auditor comparison of recorded revenue to the

CIRA's budget is a key analytical tool and is suggested by the AICPA guide at Paragraph 7.49. Any significant difference between recorded revenue and the budget should be investigated.

Auditors will generally also compare recorded assessment revenue with the prior year's actual amounts as part of audit planning. Additionally, SAS No. 99 requires performance of analytical procedures related to revenue, through the end of the reporting period. To perform a predictive test of assessment revenue, auditors can determine the number of units, the frequency of assessments, the assessment rate or amount in effect during the period, and whether, and if so when, the assessment rate or amount changed during the period. Also, auditors can determine whether special rates or amounts apply to any units. With that information, auditors should be able to determine the expected assessment revenue for the period. Any difference between recorded revenue and that amount should be explained. A fairly common reason for the difference when recorded revenue does not agree with analytical predictions stems from a unit or units that have inadvertently not been billed. This could occur when a new unit opens and the initial assessment billing has not been set up. Auditors who encounter this situation should consider if the association has inadequate procedures for initial assessment billings and whether the circumstance is a significant deficiency that should be communicated to management and those charged with governance. Another possible reason for a difference between recorded revenue and expected revenue could be late fees that are recorded as regular assessment revenue.

In certain special situations, a predictive analytical test will not be sufficient to test the reasonableness of recorded assessment revenue. An example of such a situation is an association that calculates member assessments as a factor of property tax assessments levied by the county. For example, there is a vacant lot with an assessed property tax valuation of $50,000 (although market value of the lot had increased to $1,000,000) was assessed association dues of $200, while the lot next door, which had recently sold and on which a house had been built, had an assessed property tax valuation of $4,250,000 and was assessed association dues of $17,000. Each member received identical services from the association. In that case, the only way for the auditors to satisfy themselves about the reasonableness of recorded assessment revenue is to perform detailed tests of assessment calculations, in addition to inquiring about the process of calculating and recording assessment revenue.

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

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

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

- *Revenues from Garage Operations or Other Commercial Tenants.* The amount of those revenues is usually specified in contracts or other agreements.
- *Fees Collected by the CIRA for Managing a Pool of Rental Units.* Those fees are common in resort locations. The monthly fee is usually either a flat monthly fee or a per unit fee based on either the total number of units in the rental pool or the number of units actually rented. The auditors verify the contractual arrangement, and, if the amounts are material, perform tests to satisfy themselves about the reasonableness of the recorded revenue.
- *Clubhouse Restaurants or Bars.* Restaurants and bars have audit considerations that may be much different than those related to member assessment revenue. Auditors should consider performing an analytical review of the monthly revenue from the restaurant or bar. For those CIRAs with significant restaurant or bar

operations, *PPC's Guide to Restaurants and Bars* provides guidance on the financial and operational issues related to those operations.

- *Laundry or Concession Vending Machines.* Generally, laundry and vending income is not material to the CIRA's financial statements. If it is significant, auditors should obtain an understanding of the internal controls over coin collections and perform further audit procedures such as an analytical review of the monthly revenue for any unusual items. If a third party is responsible for operating the laundry or vending machines, the auditor may be able to confirm with the service provider the revenue due to the CIRA.
- *"Unusual" Income, e.g., Oil and Gas Royalties.* One CIRA in Louisiana collects more in oil and gas royalties than it previously collected through member operating assessments. The auditors should inquire about, and examine documentation of, any type of "unusual" income, if significant. The tax consequences must also be determined. (For tax purposes, oil and gas royalty income appears to be nonexempt function income for Form 1120-H filers and nonmembership income for Form 1120 filers.)

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

SAS No. 99 requires auditors to perform preliminary analytical procedures related to revenue to identify unusual or unexpected relationships that may indicate fraudulent financial reporting. The results of preliminary analytical procedures, which may indicate the existence of unusual or unexpected relationships, should be considered in identifying the risks of material misstatement due to fraud. The analytical procedures related to revenue should be updated during the final review stage of the audit, that is, the procedures should be performed through the end of the reporting period. In addition, SAS No. 99 requires auditors to presume that improper revenue recognition is a risk that may result in material misstatement of the financial statements due to fraud. The auditor may be able to overcome that presumption, but, if so, should document how the presumption was overcome. If the auditor is unable to overcome the presumption, then a response to the risk of improper revenue recognition is required.

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

A nonauthoritative AICPA PITF Practice Alert 98-3, "Responding to the Risk of Improper Revenue Recognition," discusses conditions that may indicate an increased risk of improper revenue recognition, planning considerations for the auditor, and the auditor's communications with management and the board of directors or audit committee (if the CIRA has one). The Practice Alert is nonauthorative, but it may help auditors identify and deal with revenue recognition issues. The Practice Alert is available at **www.aicpa.org/download/auditstd/2004_0415_PracticeAlert98-3.pdf**. According to the Practice Alert, factors related to the control environment that may indicate an increased risk of improper revenue recognition include—

a. Aggressive accounting policies or practices.

b. Pressure from management to increase revenues and earnings.

c. Lack of involvement by those responsible for the accounting function in sales transactions.

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

Auditors may find it helpful to obtain representations from management concerning specific revenue recognition issues. Because of the potential for significant audit risk, auditors should approach this area with an appropriate degree of professional skepticism.

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

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

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

Special Considerations—Subsidy Agreements

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

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

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

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

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

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

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

Audit Procedures. Auditors should carefully read and understand any subsidy agreement in order to determine the accuracy of recorded receivable from, or payables to, the developer. Based on the risk assessment, the auditor may determine the need to confirm the receivable or payable balance. Legal counsel for both the association and the developer are often involved in rendering opinions regarding interpretation of the subsidy agreement. The auditor should consider obtaining written representations from both the developer and association management that the subsidy agreement has been properly interpreted, and that any revenues, receivables, or payables are accurately recorded.

Financial Statement Considerations. Associations subject to a subsidy agreement generally will have line items in the financial statements that report asset, liability, and/or revenue amounts related to the subsidy agreement. Associations with a separate replacement fund may show amounts in both the operating and replacement funds. Examples of financial statement line items may include:

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

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

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

Additionally, the developer generally is considered a related party and accordingly, the notes to the financial statements should include the required related party disclosures.

Special Considerations—Ancillary Operations

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

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

- Making inquiries to gain a general understanding of expenses and document how expenses are recorded.
- Designing and conducting analytical tests of expenditures, for example, determining the average cost per round of golf, and comparing that amount to budget and to other time periods, and comparing expense categories to budget and other time periods.
- Conducting substantive tests of balances, such as reviewing invoices for large purchases for specific expense accounts.

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

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

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

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

The association is responsible for designing and maintaining an adequate system of internal control to limit the risk of loss to the association. For an association with a limited number of appropriately skilled staff personnel and inherently high risk cash transactions exist, this can be a challenging situation. If the association is unable to maintain adequate segregation of duties over cash, it may be necessary for the association to design mitigating review and oversight procedures. It is not uncommon for associations to accept a risk of internal control system design deficiencies that cannot be reasonably overcome by the association, merely due to lack of appropriate personnel. In that situation, the auditor should evaluate the control deficiency against the requirements of SAS No. 115, *Communicating Internal Control Related Matters Identified in an Audit*.

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

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

As part of gaining an understanding of the CIRA and its environment, auditors obtain an understanding of the CIRA's policy on funding major repairs and replacements and whether there are any requirements of state statutes or governing documents to accumulate funds for that purpose. If noncompliance with those requirements could have a direct and material effect on the CIRA's financial statements, the auditors ordinarily should test compliance with applicable state statutes or rules specified in governing documents. Some CIRAs may be in violation of funding requirements because of economic developments and natural disasters. For example, reserve funds may be earning lower returns on investments, and some CIRAs may be forced to forego assessments for future repairs and replacements due to economic difficulties in the area or region. In addition, natural disasters (such as hurricanes and floods) may have depleted the reserve funds so that violations of funding requirements have occurred. Lastly, due to economic conditions, some CIRAs may be using reserve funds to finance current operations.

The AICPA guide, Paragraph 4.27 (FASB ASC 972-235-50-2), requires disclosure of two broad categories of information concerning major repairs and replacements. First, the notes to the financial statements should describe the CIRA's funding policy and disclose whether there are requirements in state statutes or the CIRA's governing documents (or mortgage on governmental bodies funding requirements, such as FHA) concerning funding, compliance with the policy and requirements, and certain related information. If the CIRA funds major repairs and replacements as the need occurs rather than accumulating funds, that policy also should be disclosed.

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

The AICPA guide states, 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

The AICPA guide states that 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 discussed in the AICPA guide: 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.

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 a valid audit consideration with respect to substantive procedures for a CIRA?

    a. Because CIRAs typically have only one bank account, substantive procedures applied to "Cash" are proportionately less extensive than for a typical commercial business.

    b. State laws and/or the CIRA's governing documents may limit the types of investments the CIRA may use to invest excess cash.

    c. CIRAs typically use the accrual basis of accounting.

    d. CIRAs that are not cooperatives typically capitalize common real property directly associated with the units.

9. If auditors are applying substantive procedures to a CIRA's security investments, which one of the following would **not** be one of the auditors' substantive procedures?

    a. When determining whether investments are valued properly at fair market value, auditors may observe market prices and rely on them if they are relevant quoted market prices

    b. Evaluating the classification of the investment as *trading*, *available for sale*, or *held to maturity*.

    c. Discover management's intent regarding the classification of investments.

    d. Determine whether a temporary decline in the value of the securities has occurred.

10. The following items match an auditing purpose with a proposed method. Some of these purposes are matched with invalid procedures. Others procedures are weak relative to the importance of the procedure. Select the match that is most likely to give the auditor the most assurance.

    a. Developer receivables: legal representation letter.

    b. Collectibility of assessments: Evaluate whether the CIRA files liens against a member's property when assessments become uncollectible.

    c. Title to real property: Examine the CIRA's governing documents

    d. Completeness of accounts payable: Confirm accounts payable.

11. The following items match an auditing purpose with an analytical procedure. Which one of the following is the best match, assuming that there is a risk of material misstatement and the procedure listed is the only one that is necessary?

    a. Adherence to loan restrictions: Review the CIRA's governing documents.

    b. The adequacy of income taxes payable as determined by an outside tax advisor: Obtain a copy of the prior year's tax return and the written assurance of the outside tax counsel that the payable is adequate.

    c. Accurate statement of equity: There are typically no procedures that need to be performed because there is often very little CIRA activity affecting equity accounts.

12. Karen, a junior auditor, has never worked on an audit of a CIRA that is party to a developer subsidy agreement. Which of the following would be an accurate explanation by the experienced auditor on the engagement?

    a. Subsidy agreements typically benefit the developer rather than the CIRA.

    b. Subsidy agreements are used when a developer incurs the expense of creating common area amenities for the entire community of homes, and the homeowner assessments are inadequate to compensate the developer because sufficient properties have not been sold.

    c. The form and content of developer subsidy agreements is dictated by state law.

13. A CIRA may have *ancillary operations* to provide services to their members. Select the item that is **not** accurate regarding ancillary operations of a CIRA?

    a. Tests of ancillary related expenses varies widely from tests of association expenses.

    b. A CIRA may have multiple ancillary operations that are material to the financial statements.

    c. Restaurants and bars owned by CIRAs are ancillary operations.

    d. Golf courses owned by a CIRA are ancillary operations.

14. Which of the following should an auditor of a CIRA consider when planning and performing audit procedures on a CIRA's ancillary operations?

    a. SAS No. 115, *Communicating Internal Control Related Matters Identified in an Audit* does not apply to CIRAs. Instead, AICPA *Audit and Accounting Guide*, *Common Interest Realty Associations* is relied on by for CIRA auditors for internal control issues.

    b. Auditors should verify that the ancillary operations have the required profit motive for federal income tax purposes.

    c. Compared with a CIRA that does not have ancillary operations, a CIRA with ancillary operations is more likely to have a significant issue with internal controls.

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 a valid audit consideration with respect to substantive procedures for a CIRA? **(Page 285)**

   a. Because CIRAs typically have only one bank account, substantive procedures applied to "Cash" are proportionately less extensive than for a typical commercial business. [This answer is incorrect. For example, a CIRA may have accounts maintained by the association, but its managing agent could also have the CIRA's money in various accounts. A CIRA often has discretionary accounts and separate accounts for specific purposes, e.g., members' key deposits and social activity funds.]

   b. State laws and/or the CIRA's governing documents may limit the types of investments the CIRA may use to invest excess cash. [This answer is correct. As with many issues, state laws vary on requirements. Examples include the investment of replacement funds, requiring federal guarantees for all deposited funds, or limits on investing in equities.]

   c. CIRAs typically use the accrual basis of accounting. [This answer is incorrect. Many CIRAs keep their accounting records on a cash basis. Thus the auditors' must be concerned about prepaid funds such as grounds maintenance and insurance expense.]

   d. CIRAs that are not cooperatives typically capitalize common real property directly associated with the units. [This answer is incorrect. Most CIRAs other than cooperatives do not capitalize common real property directly associated with the units, such as exterior walls, roofs, underlying land, and driveways. They should, however, capitalize common personal property such as furniture and fixtures, maintenance equipment, and work vehicles.]

9. If auditors are applying substantive procedures to a CIRA's security investments, which one of the following would **not** be one of the auditors' substantive procedures? **(Page 286)**

   a. When determining whether investments are valued properly at fair market value, auditors may observe market prices and rely on them if they are relevant quoted market prices. [This answer is incorrect. This is a valid substantive procedure. If there is no observable market price, a method such as discounted cash flows may provide the best estimate of value.]

   b. Evaluating the classification of the investment as *trading*, *available for sale*, or *held to maturity*. [This answer is incorrect. These are key considerations when auditing investment securities. If an investment is classified as *held to maturity*, auditors may obtain evidence of the entity's ability to hold the securities to maturity.]

   c. Discover management's intent regarding the classification of investments. [This answer is incorrect. This is a relevant substantive procedure. SFAS No. 115 provides guidance on performing this procedure and requires an entity's historical experience to be considered.]

   d. Determine whether a temporary decline in the value of the securities has occurred. [This answer is correct. Auditors need to determine other-than-temporary declines in value for investments in securities by evaluating whether management has considered relevant information to determine (among other things) that fair value is significantly below cost and the decline is due to adverse conditions specifically related to the security; that the CIRA can't hold the investment long enough for recovery in fair value, and the decline has existed over an extended period of time.]

10. The following items match an auditing purpose with a proposed method. Some of these purposes are matched with invalid procedures. Others procedures are weak relative to the importance of the procedure. Select the match that is most likely to give the auditor the most assurance. **(Page 288)**

    a. Developer receivables: legal representation letter [This answer is correct. This method might be necessary if the CIRA and the developer/sponsor dispute the amount owed the CIRA.]

    b. Collectibility of assessments: Evaluate whether the CIRA files liens against a member's property when assessments become uncollectible. [This answer is incorrect. A lien does not ensure collectibility such as bankruptcy cases.]

    c. Title to real property: Examine the CIRA's governing documents. [This answer is incorrect. Such internal documents generally are not sufficient evidence to verify title to assets. The auditor may examine properly filed deeds or similar evidence of title.]

    d. Completeness of accounts payable: Confirm accounts payable. [This answer is incorrect. The search for unrecorded liabilities is the primary procedure for testing completeness of accounts payable. Additionally, most CIRAs do not maintain a list of accounts payable during the year or, in some cases, not even at year end.]

11. The following items match an auditing purpose with an analytical procedure. Which one of the following is the best match, assuming that there is a risk of material misstatement and the procedure listed is the only one that is necessary? **(Page 290)**

    a. Adherence to loan restrictions: Review the CIRA's governing documents. [This answer is correct. If the CIRA has debt, the auditor must determine whether there are restrictions on the CIRA's borrowing that were not complied with. Auditor should look at the CIRA's articles of incorporation, bylaws, declarations, and covenants to determine the CIRA was allowed to incur the debt.]

    b. The adequacy of income taxes payable as determined by an outside tax advisor: Obtain a copy of the prior year's tax return and the written assurance of the outside tax counsel that the payable is adequate. [This answer is incorrect. The auditor must obtain and perform substantive procedures on documentation of the payable that is sufficient to form his or her own conclusion about the adequacy of the payable.]

    c. Accurate statement of equity: There are typically no procedures that need to be performed because there is often very little CIRA activity affecting equity accounts. [This answer is incorrect. CIRAs frequently do not record the adjusting journal entries prepared by the prior year's audit. Additionally, when a CIRA uses fund accounting, the auditors need to obtain or prepare an analysis of the transactions affecting fund balance and inspect the support for any changes in the balance.]

12. Karen, a junior auditor, has never worked on an audit of a CIRA that is party to a developer subsidy agreement. Which of the following would be an accurate explanation by the experienced auditor on the engagement? **(Page 294)**

    a. Subsidy agreements typically benefit the developer rather than the CIRA. [This answer is incorrect. Associations participate in developer subsidy agreements to obtain at least breakeven funding during the initial phase-in periods. Developers benefit by limiting cash outflows as it is generally less expensive to pay for what the subsidy agreement provides than the full cost of assessments on unsold lots.]

    b. Subsidy agreements are used when a developer incurs the expense of creating common area amenities for the entire community of homes, and the homeowner assessments are inadequate to compensate the developer because sufficient properties have not been sold. [This answer is correct. An example is a developer who paid for streets in a large development which will not be sold completely for years.]

    c. The form and content of developer subsidy agreements is dictated by state law. [This answer is incorrect. The only restriction on form is the parties' ingenuity. However, there are basic issues that are generally considered when creating the agreement.]

13. A CIRA may have *ancillary operations* to provide services to their members. Select the item that is **not** accurate regarding ancillary operations of a CIRA? **(Page 296)**

    a. Tests of ancillary related expenses vary widely from tests of association expenses. [This answer is correct. Generally, tests of expenses related to ancillary operations are no different than tests of expense for the association as a whole. One inquiry the auditor should consider making is how expenses are allocated and recorded.]

    b. A CIRA may have multiple ancillary operations that are material to the financial statements. [This answer is incorrect. A CIRA can have any number of ancillary operations. The larger the CIRA, the more likely the auditor will need to be concerned with control issues as well as performing analytical procedures.]

    c. Restaurants and bars owned by CIRAs are ancillary operations [This answer is incorrect. Restaurants are operations that exist to provide services to the CIRA members. Labor and food costs are examples of expenses that could be considered by the auditor.]

    d. Golf courses owned by a CIRA are ancillary operations. [This answer is incorrect. A golf course is an ancillary service of a CIRA. It exists for the benefit of the CIRA members. Auditors may need to rely on tests other than comparing the CIRA-owned golf course with a commercial golf course.]

14. Which of the following should an auditor of a CIRA consider when planning and performing audit procedures on a CIRA's ancillary operations? **(Page 296)**

    a. SAS No. 115, *Communicating Internal Control Related Matters Identified in an Audit* does not apply to CIRAs. Instead, AICPA *Audit and Accounting Guide*, *Common Interest Realty Associations* is relied on by for CIRA auditors for internal control issues. [This answer is incorrect. SAS No. 115 does apply to CIRAs, and the auditor should use it to evaluate control deficiencies.]

    b. Auditors should verify that the ancillary operations have the required profit motive for federal income tax purposes. [This answer is incorrect. A CIRA's ancillary operations are not required to have a profit motive. Often, the primary purpose of having ancillary operations is to draw and retain homeowners and maintain property values.]

    c. Compared with a CIRA that does not have ancillary operations, a CIRA with ancillary operations is more likely to have a significant issue with internal controls. [This answer is correct. Most professionally managed CIRAs that do not have ancillary operations do not have internal control issues. However, because most ancillary operations involve cash and multiple individuals, there is a greater chance that the CIRA will have significant internal control issues, especially as the operations grow.]

TRANSFER OF CIRA CONTROL TO PROPERTY OWNERS

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

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

Assessment Income

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

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

Developer Receivables

In many cases, a developer receivable at year end exists because the developer/sponsor is having cash flow problems, or there may be a dispute between the CIRA and the developer/sponsor over the correct amount owed.

Common Areas

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

Expenses

Auditors ordinarily should perform procedures to determine whether the CIRA has paid any expenses that are actually obligations of the developer/sponsor under the terms of the offering document. During the transition period, it is critical to properly segregate those expenses that apply to the CIRA from those of the developer/spon-

sor. For example, a landscape company may submit one invoice that includes charges for installation services that were incurred by the developer/sponsor and for maintenance services performed for the CIRA. It is not uncommon for developers to be delinquent in getting vendor billings switched over at time of transition due to neglect or error in the developer's accounting department. Generally, the developer will later come back and collect these amounts from the association. Accordingly, auditors need to question when there are no expenses in a particular category after developer transition has occurred.

Contracts

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

INITIAL AUDITS WITH A PREDECESSOR AUDITOR

Audits of CIRA financial statements are normally required by state statutes, CIRA bylaws, or, in the case of a cooperative, a financial institution holding the mortgage on the property. It is rare for a first audit to occur in other than the initial year of operations. That means that an incoming auditor usually will be auditing financial statements of the initial operating period or will be following a predecessor auditor. When there is a predecessor, the considerations are essentially the same as in other audits.

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

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

MANAGEMENT COMPANY TRANSITION AUDIT

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

Management company "transition audits" may actually be agreed-upon procedures engagements performed under the attestation standards rather than audits because of the nature of the procedures performed. The attestation standards are included in SSAE No. 10, *Attestation Standards: Revision and Recodification*, as amended. *PPC's Guide to Nontraditional Engagements* includes guidance on performing agreed-upon procedures engagements. Many of the procedures discussed in the following paragraphs would be applicable in both an agreed-upon procedures engagement and in a financial statement audit of a period in which the CIRA changed managing agents.

Assessment Income

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

Cash

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

Expenses

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

General Ledger

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

OTHER SPECIAL AUDITS OR ATTEST ENGAGEMENTS

CPAs are often engaged to perform procedures in other specialized circumstances relating to activities such as litigation or insurance settlements. These engagements may take the form of a special stand-alone audit, be performed in conjunction with the normal year-end audit, or be the application of agreed-upon procedures to specified elements of financial statements. It is not uncommon for the activities that underlie such special audits to span multiple years. Reporting often encompasses both current year and inception-to-date time periods. The procedures discussed below may be applicable in such an audit or an agreed-upon procedures engagement. When performing an agreed-upon procedures engagement, the practitioner should also follow the attestation guidance in AT 201, *Agreed-Upon Procedures Engagements*. Additionally, *PPC's Guide to Nontraditional Engagements* provides detailed information on performing agreed-upon procedures engagements.

General Understanding

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

Income and Expense

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

General Ledger

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

SELF-STUDY QUIZ

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

15. Which of the following is accurate regarding considerations that apply specifically or particularly to CIRAs?

    a. If an auditor is auditing a CIRA that has been in existence for years, treatment of property and equipment and potential income tax exposure are important considerations.

    b. Most audits of CIRAs that are not cooperatives are required by the CIRAs' lending institutions rather than a regulator.

    c. If a CIRA was unsatisfied with the prior year's auditor and hired a new auditor, the new auditor's considerations would be less extensive than they would be for other audits.

    d. When a CIRA changes management companies, the primary reason for having a t*ransition audit* is that it would be required by laws in most states to do so.

16. Select the item that typically would **not** be as important to the auditor who is to perform a management company transition audit as the other three would be.

    a. Analytical testing to determine whether homeowners have made assessment payments to the appropriate management company.

    b. The extent to which a developer has completed common areas within the development.

    c. Authorized signers are reflected on banking signature cards.

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 is accurate regarding considerations that apply specifically or particularly to CIRAs? **(Page 305)**

    a. If an auditor is auditing a CIRA that has been in existence for years, treatment of property and equipment and potential income tax exposure are important considerations. [This answer is correct. CIRAs often fail to record common property in accordance with the AICPA guide. Additionally, tax issues regarding misclassification of revenue, membership loss carryovers, and the characterization of transactions as capital versus operating are areas of potential risk of material misstatement.]

    b. Most audits of CIRAs that are not cooperatives are required by the CIRAs' lending institutions rather than a regulator. [This answer is incorrect. Most audits of CIRAs that are not cooperatives are conducted pursuant to state law or the CIRA's bylaws.]

    c. If a CIRA was unsatisfied with the prior year's auditor and hired a new auditor, the new auditor's considerations would be less extensive than they would be for other audits. [This answer is incorrect. A successor auditor would have essentially the same considerations as he or she would with have other audits.]

    d. When a CIRA changes management companies, the primary reason for having a t*ransition audit* is that it would be required by laws in most states to do so. [This answer is incorrect. A transition audit is discretionary, but may be prudent if the CIRA's relationship with the past auditor had deteriorated.]

16. Select the item that typically would **not** be as important to the auditor who is to perform a management company transition audit as the other three would be. **(Page 305)**

    a. Analytical testing to determine whether homeowners have made assessment payments to the appropriate management company. [This answer is incorrect. Determining that assessment income was properly recorded between the two management companies is very important. Members of the CIRA frequently send their payments to the previous company during a period of transition.]

    b. The extent to which a developer has completed common areas within the development. [This answer is correct. The most important audit procedures in this case would be those directed to the CIRA's assessment income, assessment receivables, cash, and expenses because these would be most likely impacted by the previous management company. Fraud could also be an issue, especially if there was dissention between the CIRA and the previous managing company.]

    c. Authorized signers are reflected on banking signature cards. [This answer is incorrect. Verifying that signature cards were updated at all banks is one very important way to pay special attention to the transfer of cash accounts from one management company to the other.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (HOATG093)

Determine the best answer for each question below. Then mark your answer choice on the **Examination for CPE Credit Answer Sheet** located in the back of this workbook or by logging onto the Online Grading System.

1. Which of the following is the best description of *substantive procedures* performed in an audit?

    a. The optional procedures performed to detect material misstatements in accounts, classes of transactions, and disclosures.

    b. The audit procedures to detect and evaluate risks of material misstatement due to fraud.

    c. The audit procedures consisting of tests of details and substantive analytical procedures to detect material misstatements at the relevant assertion levels.

    d. Audit procedures that are required during the concluding phase of the audit.

2. Which of the following is correct regarding the sufficiency and appropriateness of audit evidence?

    a. If an auditor uses risk assessment procedures and tests of controls to conclude that there is low risk of material misstatement for a particular assertion related to a material account, substantive procedures are not required to be performed with respect to that account.

    b. The auditor can objectively quantify the level of risk of material misstatement for a particular assertion by using a formula in SAS No. 106 (AU 326) that is based on the sufficiency and appropriateness of audit evidence.

    c. Interviews with multiple board members who attended a relevant meeting are generally more reliable than an electronic copy of the minutes of the meeting.

    d. The level of risk of material misstatement correlates directly with the necessary quality and quantity of audit evidence from substantive procedures.

3. John is planning whether to use analytical procedures and/or tests of details when performing substantive procedures on a material account balance. Which of the following is a valid conclusion with respect to the method(s) John should apply?

    a. If John believes there is a significant risk of material misstatement and does not choose to rely on controls, he can use substantive analytical procedures alone to test.

    b. If John is testing for a risk regarding the completeness of revenues that is not a significant risk, tests of details are typically at least or more effective than analytical procedures.

    c. If John is testing for a risk other than a significant risk, he can use the efficiency of a substantive procedure as a factor in deciding between analytical procedures and substantive tests of details.

    d. If John is conducting the audit for a period when interest rates were volatile, substantive analytical procedures would be more likely to detect material misstatements than substantive tests of details.

4. The audit manager's new staff is asking about the distinction, if any, between tests of controls and tests of details. Which of the following is the best explanation?

   a. The test's objective is the distinguishing factor.

   b. Tests of details are typically used before tests of controls are performed.

   c. The distinguishing factor is whether the test is applied to a balance as opposed to a class of transactions.

   d. If a test of controls on processing revenue reveals no risk of material misstatement, a test of details is not required.

5. Which of the following terms most closely applies to the following definition: evaluations of financial information made by comparisons of plausible relationships between both financial and nonfinancial data?

   a. Tests of balances

   b. Analytical procedures

   c. Tests of details

   d. Do not select this answer choice.

6. Select the item that SAS No. 56, *Analytical Procedures*, requires auditors to document when an analytical procedure is the principal substantive test of a significant financial statement assertion.

   a. Information about the approach to evaluating the significance of the difference between the amount in the financials accounts and the auditor's expectation.

   b. Any additional procedures the auditor performed in response to a significant unexpected difference and the results of those procedures.

   c. Results of ratio and trend analysis for historical comparison during the following year's audit.

   d. Do not select this answer choice.

7. Select the item that accurately describes a CIRA characteristic that should be considered in planning and performing substantive audit procedures.

   a. CIRAs generally cannot invest in derivative instruments.

   b. CIRAs may use a management agent who manages multiple CIRAs, but such managers are not authorized to commingle funds.

   c. Due to materiality, cash may require proportionately more audit time than a typical commercial business.

   d. If a CIRA has unsold units, the auditor should expect related payables to the developer.

8. Which of the following is a valid consideration with respect to substantive procedures for a CIRA?

   a. In planning the auditor's precision of expectation, consider that a small percentage of a large amount in the financial statements is always immaterial to the financial statements taken as a whole.

   b. If a CIRA uses a managing agent who commingles funds of several CIRAs, confirmation by an independent source is typically sufficient to obtain assurance that there is no material misstatement.

   c. Tests of transactions are generally more effective than tests of balances.

   d. If a CIRA uses a single brokerage account for securities, there is the possibility of losing the protection of dual authority over cash.

9. Which of the following is correct concerning of investment-related substantive procedures for a CIRA audit?

    a. Auditors may not need a separate audit program for a CIRA's investments because CIRAs often limit their investments to certificates of deposit.

    b. In evaluating management's intent, SFAS No. 115 requires that an entity's historical experience not be considered.

    c. Fair values of investments cannot be estimates for financial statement purposes.

    d. Do not select this answer choice.

10. When auditors apply substantive procedures to determine whether securities have experienced an other-than-temporary decline in value, they may need to consider **all but one** of the following. Identify that exception.

    a. If there is a decline in fair value, the CIRA's intent to hold an investment long enough to recover fair value.

    b. Whether management has determined whether a security's issuer has experienced deterioration in its financial condition.

    c. Whether gains from the security have been recorded after year-end.

    d. Obtain evidence as to whether a rating agency has downgraded a debt security's rating.

11. What is the most normal approach for an auditor to use on assessments that are deemed material?

    a. Confirmations sent to members.

    b. Test subsequent cash collections.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

12. The following items match a testing purpose with a proposed testing method. Some of the purposes could be matched with invalid procedures. Other procedures are weak relative to the importance of the procedure. Select the match that is most likely to give the auditor the appropriate level of assurance.

    a. Misstatement of revenue: Create a test to reasonably predict member assessment revenue by starting with the prior year's revenue and then adjusting that amount by management's representation of reasons the current year differs from the prior year.

    b. Reasonableness of recorded assessment revenue: Predictive analytical tests based on the number of units and *frequency* of assessments.

    c. Reasonableness of expenses: Review a list of approved vendors with management.

    d. Misstatement of a receivable or payable under a subsidy agreement: Read and examine a copy of the subsidy agreement.

13. Assume the CIRA and the developer have a subsidy agreement in place. Select the correct statement concerning this type of contract.

    a. Subsidy agreements typically relate primarily to the developer's responsibilities to build individual housing units.

    b. The subsidy agreement should help the auditor determine the accuracy of recorded receivables from the developer and payables to the developer.

    c. Subsidy agreements are fixed rather than variable with respect to the agreement's duration.

    d. Any amenities under a subsidy agreement must be completed and turned over to the CIRA before the termination of the contractual subsidy period.

14. The Cumberland Homeowner's Association has *ancillary operations*. Which item is a valid consideration when performing substantive procedures of the association's financials?

    a. The tests on the expenses of a CIRA's ancillary services are substantially different than tests that would be performed on the CIRA's primary financial activities.

    b. Comparisons with identical activities of for-profit businesses could be expected to be effective.

    c. The reasonableness of the association's allocation of expenses between the primary and ancillary operations is typically an important issue to test.

    d. Auditors are not required to apply procedures to the association's disclosure of unaudited supplementary information about future major repairs and replacements.

15. Assume a CIRA fired its management company. Which of the following is the **least** likely area of concern to the CIRA and the new auditor?

    a. Revenues from laundry machines.

    b. Member assessments.

    c. Cash receipts from a golf course with substantial revenue.

    d. Expenses.

16. Select the item that most correctly states a special consideration in performing accounting and auditing services for a CIRA?

    a. Subsidy agreements between developers and CIRAs may be in force requiring the developer to pay the full cost of member assessments for the unsold lots until all lots are sold.

    b. If a CIRA is involved in litigation and needs auditing services, the auditor who is engaged is required to treat the engagement as a special stand-alone audit.

    c. A management company transition audit may be an agreed-upon procedure engagement.

    d. It is probable that a CIRA will have a profit if there is an operating subsidy agreement between the developer and the CIRA.

Lesson 2: Concluding the Audit

INTRODUCTION

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

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

Learning Objectives:

Completion of this lesson will enable you to:

- Explain audit procedures for a CIRA's commitments, contingencies, accounting estimates, and fair value.
- Describe proper auditing and reporting procedures regarding a CIRA's *subsequent events*, *related party transactions*, and *going concern* considerations.
- Summarize requirements related to a CIRA's *management representation letter* and gain a sense for evaluating whether the auditor's assessment of risks of material misstatements is still appropriate in the conclusion stage of the audit.
- Cite the purpose of analytical procedures in the final review stage of the audit and how to plan for the appropriate review of workpapers; and summarize how to evaluate and summarize the misstatements discovered in fieldwork.
- Explain the requirements for drafting financial statements and the auditor's report for a CIRA audit.
- Recognize aspects of the audit that the auditor must communicate to the client using required methods.

COMMITMENTS AND CONTINGENCIES

The primary audit objectives for commitments and contingencies are discovering their existence, assessing their financial statement effect, and evaluating the adequacy of their disclosure. Examples of commitments and contingencies of concern to a CIRA auditor are as follows:

- Pending or threatened litigation or unasserted claims, including developer lawsuits.
- Communications from regulatory agencies regarding violations or possible violations of laws or regulations.
- Commitment related to expansion or rehabilitation of facilities.
- Possible losses on long-term contracts.
- Long-term leases with required fixed payments for several years.
- Financial transactions or arrangements with financial institutions, for example, oral or written guarantees, endorsements, open letters of credit, etc.
- Other oral or written guarantees.
- IRS examinations in progress related to tax elections or taxes on nonmembership/non-exempt functions.
- Environmental remediation liabilities, including designation as a potentially responsible party by the Environmental Protection Agency.
- Fraud involving CIRA management or personnel that could affect the financial statements.

Audit Procedures

The auditor may be aware of possible commitments or contingencies from knowledge of the CIRA's activities gained during audit planning and from reading minutes, contracts, agreements, or other documents. Some commitments or contingencies may be discovered as a result of audit procedures applied to specific account balances or transaction classes. For example, lease commitments may be discovered during the audit of rent and other lease payments, and compensating balance or debt guarantee arrangements may be disclosed on confirmation responses received from lenders.

The auditor may decide to send confirmation letters to financial institutions to confirm or discover details of financing arrangements, such as guarantees or other contingent liabilities. The auditor should specifically question management about the possibility of unrecorded contingencies or commitments, such as those listed above. The management and legal representation letters also provide evidence about commitments and contingencies.

Legal Representation Letter

SAS No. 12 (AU 337), *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, requires the auditor to send a letter of inquiry to the client's legal counsel and evaluate the response. The auditor identifies lawyers who were consulted about litigation, claims, and assessments and should be inquired of. These lawyers are identified by reviewing client legal files, analyzing legal and professional fees and invoices, and inquiring of management. (These procedures are also performed to identify commitments and contingencies.)

Some CIRAs may use more than one lawyer, and since many lawyers charge for responding to the inquiries, management often does not want to send requests to lawyers unless they are helpful to the audit. Communicating with some lawyers may not be necessary. For example, communication is not required with lawyers involved only with collections, lawyers representing the CIRA at exchanges of ownership interests, lawyers involved with litigation *by* the CIRA, unless counterclaims are involved, or lawyers contacted last year who performed no services this year. (However, auditors should consider whether, because of the general lack of sophistication of many CIRA officers, the CIRA's attorney may be the only reliable source of information for discovering litigation in which the CIRA is involved.)

If a lawyer on the board of directors serves as the CIRA's counsel, either a letter should be obtained from that individual or the individual should sign the management representation letter. Signing the representation letter normally is appropriate only when there are no pending or threatened litigation, claims, or assessments and no unasserted claims that are probable of assertion and have a reasonable possibility of an unfavorable outcome. In that situation, the authors believe the letter should include those specific assertions.

If a lawyer was not consulted during the period, the auditor may not send a legal letter, but, according to an auditing interpretation at AU 9337.15–.17 the written representation obtained from management could state that management is not aware of any pending or threatened litigation, claims, or assessments or unasserted claims or assessments and that a lawyer has not been consulted about such matters.

Content of the Letter. The legal letter asks the lawyer to provide or corroborate information about pending or threatened litigation, including, for each individual case, its nature and progress to date, how the CIRA is responding or intends to respond, the likelihood of an unfavorable outcome, and an estimate, if one can be made, of the amount or range of potential loss. With respect to unasserted claims, the lawyer is asked to comment on any possible unasserted claims specifically identified by management and to confirm that he or she will notify management of any unasserted claims that come to his or her attention that, in his or her judgment, must be disclosed in accordance with the requirements of SFAS No. 5, *Accounting for Contingencies* (FASB ASC 450).

The letter should specify a materiality limit so that the lawyer knows what items are to be considered material, individually or in the aggregate, for purposes of the response. The materiality amount should be some fraction of tolerable misstatement computed in audit planning. The specific amount used is a matter of auditor judgment based on knowledge of the client and other factors. The letter should request the lawyer to respond as of a date reasonably close to the date of the auditor's report, for example, within two weeks of the anticipated report date. If particularly volatile litigation proceedings exist, the auditor may decide to confirm the continued appropriateness of the lawyer's response as of a date nearer to the report date. This follow-up may be oral or written.

A "long form" request for legal representation can be used in which the lawyer is asked to comment on the completeness of client-prepared information about the details of each matter listed as pending or threatened litigation. This approach may be more efficient if the CIRA has both inside and outside legal counsel. The inside legal counsel may be able to prepare the information and thus reduce the cost of obtaining outside counsel's representations. A "short form" request for legal representation can be used in which the lawyer is asked to prepare information rather than comment on management's list. This letter may be used only when the client represents that there are no unasserted claims or assessments that are probable of assertions and must be disclosed in accordance with SFAS No. 5 (FASB ASC 450). This form is usually best suited for a small CIRA, especially if the CIRA does not have inside counsel.

Evaluating Lawyers' Responses. In reviewing the lawyer's response, the auditor should make sure it reflects the materiality limit specified, is as of the specified response date, and contains all items of information requested (if a short form request was sent). If the date of the response significantly differs from the date requested, the auditor should obtain an updated letter. Also, the auditor should carefully evaluate how the lawyer words the assessment of the probability of an unfavorable outcome. The auditor should decide whether the response is clear regarding a probable or remote outcome. Wording such as "the CIRA believes there is absolutely no merit to the litigation," "the CIRA has a substantial chance of prevailing," or "the CIRA will be able to assert meritorious defenses," are not clear as to likelihood of outcome. In addition, lawyers' responses that are unclear or amount to talking around the point without taking a solid position should be carefully evaluated by the auditor. For example, terms like *substantial chance* and *reasonable opportunity* indicate more uncertainty than an opinion that the CIRA will prevail. The term *meritorious defenses* means only that the defenses will not be summarily dismissed by the court.

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

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

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

According to an interpretation at AU 9337.28–.29, such comments in lawyers' letters are not limitations on the scope of their responses. Thus, those comments should not affect the auditors' evaluations.

Some attorneys also include language such as the following in their responses to emphasize the preservation of attorney-client privilege:

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

According to an interpretation of SAS No. 12 (AU 9337.31–.32), such language is not a limitation on the scope of the audit as long as the lawyer's response includes a confirmation of the understanding that the lawyer, under certain circumstances, will advise and consult with the client concerning the client's obligation to make financial statement disclosure with respect to unasserted claims or assessments.

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

Another important consideration is the effective date of the lawyer's response. If the lawyer's effective response is dated too long before the date of the auditor's report, the auditor should consider getting an updated response, either oral or written. If the update is obtained orally, it should be documented in the workpapers. If significant matters (such as new litigation or significant developments relating to old litigation) are discovered in the oral update, the authors recommend obtaining a written update from the attorney.

Environmental Remediation Liabilities

SOP 96-1, *Environmental Remediation Liabilities* (FASB ASC 410), provides accounting and auditing guidance related to environmental remediation liabilities. In general, SOP 96-1 requires the CIRA to accrue environmental remediation liabilities when the criteria of SFAS No. 5 (FASB ASC 450) are met.

Audit Procedures. The extent of procedures performed for environmental liabilities depends on the CIRA's potential to incur such liabilities. Questions auditors may ask to evaluate a CIRA's potential for environmental remediation liabilities are included in Exhibit 2-1. If there is an increased risk that the CIRA has environmental remediation liabilities, auditing procedures generally are the same procedures applied for other contingent liabilities (that is, reading the minutes of board or administrative committee meetings, making inquiries of the CIRA's attorney, and making inquiries of the client). Some of the inquiries auditors should make of management include whether they have:

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

Exhibit 2-1

Questions for Identifying an Increased Risk of Environmental Liabilities

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

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

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

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

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

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

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

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

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

* * *

Auditors frequently obtain information about potential environmental liabilities through the lawyer's response. If the client has been notified by a federal regulator that a potential liability exists for a site with which it is or has been associated, the auditor would normally question an assertion by the CIRA's attorney that the risk of loss is other than probable.

Auditing the Estimated Liability. If a CIRA has been designated a PRP or has an increased risk of exposure, the auditor should obtain an understanding of the method used to estimate the liability. If the client uses an attorney, engineer, or other specialist to make the estimate, the guidance in SAS No. 73 (AU 336), *Using the Work of a Specialist*, should be considered.

According to SAS No. 57 (AU 342), *Auditing Accounting Estimates*, auditors should gain an understanding of how management developed its estimate and should use one or a combination of methods included in the statement to evaluate the reasonableness of the estimate. The following briefly summarizes the application of SAS No. 57 and SOP 96-1 to environmental liabilities:

- Review and test the process used by management to develop the estimate. (Often, this is the most appropriate method when the client engages an environmental specialist and the estimate is recommended by the specialist.)

- Develop an independent estimate to corroborate the reasonableness of management's estimate. (Auditors can develop their own estimate or engage a specialist to aid in developing an estimate.)

- Review subsequent events or transactions occurring prior to the date of the auditor's report. (Generally, this method has limited value for environmental liabilities because remediation costs are incurred over a long period of time extending well beyond the date of the auditor's report.)

Auditors should also consider information such as the following when assessing the adequacy of the client's estimate:

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

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

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

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

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

Risks and Uncertainties

SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties* (FASB ASC 275), requires disclosures about risks and uncertainties that could significantly affect the amounts or situations reported in the financial statements. The disclosures are grouped into the following four areas:

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

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

Nature of Operations. The AICPA guide requires CIRA financial statements to disclose the entity for which the CIRA provides services, the areas it controls, and the number of units in the CIRA. In most cases, those disclosures will satisfy the requirements of SOP 94-6 (FASB ASC 275) to disclose the nature of operations. If a CIRA has significant revenue from nonmembers, however, SOP 94-6 (FASB ASC 275) also requires disclosure of the relative importance of that segment of the CIRA's operations.

Use of Estimates. SOP 94-6 (FASB ASC 275) requires financial statements to disclose that the preparation of financial statements requires the use of management estimates. That boilerplate disclosure generally is included in the summary of significant accounting policies.

Certain Significant Estimates. Initially, an auditor's objective is to determine whether all significant estimates have been identified. One way of determining the existence of a significant estimate that requires disclosure is to answer the following questions:

- Was an estimate used in preparing the financial statements?
- Is there more than a remote possibility that the estimate will change by a material amount within one year from the date of the financial statements due to a condition that existed at the date of the financial statements?

SAS No. 57 (AU 342), *Auditing Accounting Estimates*, also provides guidance that is useful. The SAS requires auditors to determine whether all estimates that could be material to the financial statements have been identified. It recommends that auditors consider performing the following procedures to identify circumstances that require accounting estimates:

- Consider assertions embodied in the financial statements to determine the need for estimates. An appendix to the SAS (AU 342.16) gives numerous examples of accounting estimates included in financial statements.
- Evaluate information obtained by reading minutes or performing other procedures about the following:
  - The client's industry and regulatory environment.
  - Changes made or planned in the CIRA's activities or operating strategy.
  - Changes in methods of accumulating data.
  - Litigation, claims, and assessments or other contingencies.
- Inquire of management about whether there are circumstances that indicate the need to make an accounting estimate.

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

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

A good practice is to document conclusions about estimates that could change, particularly if the decisions are difficult or contentious. Such documentation can be informal and can be done, for example, on the relevant

workpaper or in a separate memo. Note that even if it is determined that the chances of an estimate changing are more than remote, the remaining criteria—"material amount," "near term," and "existing conditions"—may still eliminate the need for disclosure.

Current Vulnerability Resulting from Certain Concentrations. SOP 94-6 (FASB ASC 275) requires disclosure of current vulnerability from concentrations that exist at the balance sheet date (a) in the volume of business with a particular customer, supplier, or lender, (b) in revenue from particular products or services, (c) in the available sources of supply of materials, labor, or services, or of licenses or other rights used in the entity's operations, and (d) in the market or geographic area in which an entity conducts its operations if the concentrations meet the following criteria:

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

Vulnerability from concentrations occurs when an entity is exposed to a greater risk of loss than would have existed if the entity had mitigated its risk through diversification. A concentration is of concern when it involves something that cannot be easily replaced, for example, if a cooperative purchases most of its heating fuel from a single supplier that cannot easily be replaced. Concentrations may involve another entity or individual, or they may involve a group of counterparties or items that have similar economic characteristics, such as a group of homeowners that collectively expose the CIRA to a particular kind of risk.

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

Wording the Disclosure. Applying the requirements of SOP 94-6 (FASB ASC 275) requires significant judgment on the part of both the auditor and the client. However, the SOP contains only disclosure requirements. It does not require amounts to be recorded in the financial statements. For that reason, an approach of "when in doubt, disclose" is recommended. In a sense, by making the disclosure, both the client and the auditor transfer some of the risk due to uncertainties in the financial statements to the users of the financial statements themselves. By not making the disclosures, however, the client and the auditor forego an opportunity to reduce the risk that a user may successfully assert in litigation that the disclosures should have been made.

CIRAs may have concerns that the disclosures required by SOP 94-6 (FASB ASC 275) will include information considered by management to be confidential. That is particularly true for disclosure of certain concentrations. Other concerns may include that the disclosures are too negative. Some client resistance may be overcome by carefully wording the proposed disclosures. For example, when disclosing a concentration, phrases such as "a significant portion" or "a substantial percentage" are appropriate. The SOP does not require disclosure of names or percentages.

Reporting Issues. SOP 94-6 (FASB ASC 275) only leads to modifying the auditors' report if either—

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

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

ACCOUNTING ESTIMATES AND FAIR VALUE

Accounting Estimates

Preparation of financial statements normally requires making accounting estimates. SAS No. 57, *Auditing Accounting Estimates*, (AU 342.01) defines an accounting estimate as "an approximation of a financial statement element, item, or account" in the absence of exact measurement. The following are examples of accounting estimates may be relevant to CIRAs:

a. Net realizable values of assessments receivable.

b. Valuation of common property contributed by the developer/sponsor.

c. Valuation of securities.

Accounting estimates may involve fair value measurements.

SAS No. 57 (AU 342.08) highlights the importance of evaluating whether management has identified all material accounting estimates.

SAS No. 57 does not prescribe specific audit procedures to substantiate specific accounting estimates; for example, specific audit procedures for substantiating the estimated allowance for uncollectible assessments. Instead, the SAS suggests a framework for designing audit procedures to evaluate the reasonableness of specific accounting estimates. An auditor must first understand how management developed the estimate. Three approaches may then be used to determine the reasonableness of the estimate: (a) make an independent estimate for comparison with the client's, (b) review and evaluate the client's estimation process for reasonableness, or (c) review subsequent events or transactions in identifying and evaluating estimates. In small CIRA engagements, estimates can often be calculated by the auditor based on discussion with the client about factors that usually affect the client's experience.

Whatever approach is used to audit an accounting estimate, the usual result is an acceptable range in the auditor's mind for the estimate, e.g., the member assessments that will become uncollectible will be somewhere between $12,000 and $15,000. If the client's accounting estimate falls within this range, it is acceptable. SAS No. 107, *Audit Risk and Materiality in Conducting an Audit*, states that an accounting estimate may be evaluated by comparing it with a range or a point estimate, if the point is a better estimate than any other amount. However, accounting estimates are usually evaluated based on a range of reasonableness because it is rarely possible to be precise in estimating future events.

If the CIRA's estimate falls outside the auditor's range of reasonableness, then the difference between the CIRA's estimate and the closest end of the auditor's range should be considered a misstatement. For example, if the auditor's range of reasonableness is $12,000 to $15,000 for uncollectible assessments, but the CIRA has chosen to estimate $10,000 for uncollectibles, then there is a $2,000 misstatement that should be included with other audit differences. SAS No. 107 on materiality and audit risk supports this position.

SAS No. 107 also states that the auditor should consider the possibility of management bias in the development of accounting estimates. In other words, an auditor should consider whether differences between estimates best supported by the audit evidence, and the estimates included in the financial statements that are individually reasonable, indicate (in the aggregate) a possible bias on the part of management. If management, for example, always chooses estimated amounts for the valuation of assets that are at the low end of the range the auditor considers reasonable, the combined effect could result in a material misstatement of income. In that case, the auditor should consider whether other recorded estimates reflect a similar bias and perform additional procedures to address those estimates. The auditor should also consider whether management's estimates were at one end of the auditor's reasonable range in the prior year and at the other end in the current year. That could indicate the possibility that management is using accounting estimates to manage earnings. If the auditor believes that is the case, he or she should consider communicating the matter to those charged with governance.

SAS No. 99 (AU 316), *Consideration of Fraud in a Financial Statement Audit*, requires the auditor to review accounting estimates for biases that could result in material misstatement due to fraud. In addition, it requires auditors to perform a retrospective review of significant prior-year accounting estimates to determine whether the underlying judgments and assumptions indicate possible bias. The review may provide additional information about whether the current year's estimates could be biased. If the auditor identifies possible bias, SAS No. 99 requires the auditor to evaluate whether the circumstances represent a risk of material misstatement due to fraud.

Fair Value Measurements and Disclosures

GAAP requires some assets, liabilities, and components of equity to be measured or disclosed at fair value. Examples of a CIRA's use of fair value measurements include (a) abandoned or foreclosed units received by the CIRA for nonpayment of delinquent assessments, (b) units received by the CIRA from the developer in settlement of litigation, (c) securities classified as available for sale, and (d) common property transferred to the CIRA by the developer. SAS No. 101 (AU 328), *Auditing Fair Value Measurements and Disclosures*, establishes standards and provides guidance for testing fair values. Because fair values are essentially estimates, the SAS primarily expands the guidance in SAS No. 57 to apply to this specific topic.

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

When a valuation method is used, the auditor considers the appropriateness of the method, including management's rationale for selecting the method. Auditors may consider whether management has evaluated the range of values resulting from different methods and investigated the reasons for the differences. Changes in circumstances may require changes in the method used to determine fair value.

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

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

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

- The general economic environment, the economic environment of the specific industry, and the entity's economic circumstances.
- Existing market information.
- The plans of the entity, including what management expects will be the outcome of specific objectives and strategies.

- Assumptions made in prior periods, if appropriate.
- Past experience of, or previous conditions experienced by, the entity to the extent currently applicable.
- Other matters relating to the financial statements, for example, assumptions used by management in accounting estimates for financial statement accounts other than those relating to fair value measurements and disclosures.
- The risk associated with cash flows, if applicable, including the potential variability in the amount and timing of the cash flows and the related effect on the discount rate.

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

The auditor who independently develops assumptions for use in evaluating the client's estimate should still understand management's assumptions so he or she can assess whether any significant matters have been omitted and can evaluate any significant differences between management's and the auditor's estimates. This evaluation also should be performed if the fair value estimate is developed by a valuation specialist.

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

During summarization and evaluation procedures, the auditor should evaluate the sufficiency of the evidence obtained and its consistency with other evidence obtained during the audit. Regardless of the audit approach used, the auditor should ordinarily obtain management representations about the reasonableness of significant assumptions and consider certain communications with those charged with governance.

Identifying Financial Instruments of Nonpublic Entities

Financial instruments consist of the following:

a. Cash.

b. Evidence of an ownership interest in an entity.

c. Contracts that require one entity to deliver cash or another financial instrument to another entity.

d. Contracts that require two entities to exchange financial instruments on potentially unfavorable terms.

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

Disclosure Requirements

SFAS No. 107, *Disclosures about Fair Value of Financial Instruments*, primarily requires certain entities to disclose (a) the fair values of financial instruments for which it is practical to estimate fair values and (b) concentrations of credit risk. Disclosures about market risk of financial instruments are encouraged, but not required.

Auditing Fair Value Disclosures

SAS No. 101, *Auditing Fair Value Measurements and Disclosures*, provides guidance on auditing such measurements and disclosures contained in financial statements. SAS No. 101 supplements, rather than amends, SAS No.

57, *Auditing Accounting Estimates*. It is applicable to disclosure of the fair value of financial instruments required by SFAS No. 107 (FASB ASC 825). According to SAS No. 101:

- Evaluation of whether fair value disclosures are in conformity with GAAP ordinarily involves the same audit procedures used to audit fair value measurements recognized in the financial statements.

- If fair value disclosure is omitted because it is not practical to determine fair value with sufficient reliability, the adequacy of disclosures required in such circumstances is evaluated.

SELF-STUDY QUIZ

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

17. Identify the item that does **not** accurately match a valid audit procedure with related, relevant audit evidence concerning commitments and contingencies.

    a. Confirmations from lenders: The CIRA's loan commitments, including guarantees.

    b. Sending letter of inquiry to non-attorney on CIRA's board that the CIRA has no commitments or contingencies: Legal representation letter.

    c. Interviews of management: The existence of any commitments and contingencies.

    d. Audit of rent: The existence of lease commitments.

18. John, the auditor, is preparing a legal letter to the CIRA's legal counsel. Which one of the following is guidance John should follow in writing the letter or evaluating the response when it is received?

    a. The letter should ask for information on any commitment or contingency known to him or her regardless of materiality.

    b. Such letters should be sent to all of the CIRA's attorneys, including those who represent the CIRA in litigation instigated by the CIRA.

    c. An unclear response from a lawyer should be carefully evaluated.

19. Select the item that is accurate with respect to the auditor performing procedures to detect environmental remediation liabilities.

    a. Procedures are not necessary as long as the client was in compliance with environmental laws when they disposed of a toxic substance.

    b. The auditor needs to ask management whether the business has been notified by a governmental agency that it is considered a PRP (potentially responsible party).

    c. Once a client has sold a business facility (the site), there is little likelihood of environmental remediation liability.

    d. A potential liability does not exist if the client used a landfill on public property to dispose of hazardous substances.

20. Which of the following statements is valid concerning disclosure of the use of estimates and certain significant estimates when auditing a CIRA for risks and uncertainties?

    a. Disclosure of estimates based on the client's industry is not intended by SAS 57 (AU 342), *Auditing Accounting Estimates*.

    b. Materiality for disclosure depends on the amount reported in the financial statements.

    c. Recognitions of a small financial statement amounts cannot cause disclosure of estimates to be required

    d. The financial statements must disclose if there is a less than likely, but more than remote chance that an estimate will change by a material amount within a year of the audit of the financial statements.

21. As a procedure within the concluding stage of the audit, Arthur is determining the reasonableness of material fair value estimates prepared by CIRA's management. Which of the following is appropriate guidance for Arthur as he performs this procedure?

    a. Arthur does not need to obtain management's representations about the reasonableness of the fair values and the method and assumptions used to determine fair value.

    b. Even if circumstances change from year to year or from the date of management's calculation of value to the date of the financial statements, the method the client used needs to stay consistent

    c. Management's strategic plans for the CIRA's future are relevant in determining the reasonableness of managements' assumptions and representations of 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.)**

17. Identify the item that does **not** accurately match a valid audit procedure with related, relevant audit evidence concerning commitments and contingencies. **(Page 315)**

    a. Confirmations from lenders: The CIRA's loan commitments, including guarantees. [This answer is incorrect. The auditor may send confirmation letters to financial institutions to confirm or discover details of financing arrangements.]

    b. Sending letter of inquiry to non-attorney on CIRA's board that the CIRA has no commitments or contingencies: Legal representation letter. [This answer is correct. The procedure is not valid. Auditors send legal representation letters to legal counsel (attorneys) for their assertions. If a lawyer on the board of directors serves as the CIRA's counsel, either a representation letter should be obtained from that individual or the individual should sign the management representation letter.]

    c. Interviews of management: The existence of any commitments and contingencies. [This answer is incorrect. This is a valid procedure because the auditor should specifically question management about the possibility of unrecorded contingencies or commitments.]

    d. Audit of rent: The existence of lease commitments. [This answer is incorrect. One of the primary audit objectives for commitments and contingencies is to discover their existence. Lease commitments may be discovered during the audit of rent and other lease payments.]

18. John, the auditor, is preparing a legal letter to the CIRA's legal counsel. Which one of the following is guidance John should follow in writing the letter or evaluating the response when it is received? **(Page 315)**

    a. The letter should ask for information on any commitment or contingency known to him or her regardless of materiality. [This answer is incorrect. The letter should specify a materiality limit so the lawyer knows what items are to be considered material, individually or in the aggregate.]

    b. Such letters should be sent to all of the CIRA's attorneys, including those who represent the CIRA in litigation instigated by the CIRA. [This answer is incorrect. A legal letter need not be sent to these attorneys unless the attorney representing the CIRA in litigation it initiated expects counterclaims.]

    c. An unclear response from a lawyer should be carefully evaluated. [This answer is correct. The auditor should carefully evaluate how the lawyer words the assessment of the probability of an unfavorable outcome. Terms like substantial chance and reasonable opportunity indicate more uncertainty than an opinion that the CIRA will prevail.]

19. Select the item that is accurate with respect to the auditor performing procedures to detect environmental remediation liabilities. **(Page 316)**

    a. Procedures are not necessary as long as the client was in compliance with environmental laws when they disposed of a toxic substance. [This answer is incorrect. The law itself and regulatory agencies normally have jurisdiction over environmental hazards that exist. The test is not what the law was at the time of the disposal of the substance. The client is not free from its liability for cleaning up the site.]

    b. The auditor needs to ask management whether the business has been notified by a governmental agency that it is considered a PRP (potentially responsible party). [This answer is correct. If the client has been designated a PRP [by the Environmental Protection Agency (EPA)], there is a potential liability for environmental cleanup.]

    c. Once a client has sold a business facility (the site), there is little likelihood of environmental remediation liability. [This answer is incorrect. A former owner or operator can be a PRP if it disposed of hazardous substances at the site.]

    d. A potential liability does not exist if the client used a landfill on public property to dispose of hazardous substances. [This answer is incorrect. There is a potential liability if the CIRA ever used a landfill to dispose of hazardous substances. Thus, the CIRA could be a PRP for this disposal site.]

20. Which of the following statements is valid concerning disclosure of the use of estimates and certain significant estimates when auditing a CIRA for risks and uncertainties? **(Page 319)**

    a. Disclosure of estimates based on the client's industry is not intended by SAS 57 (AU 342), *Auditing Accounting Estimates*. [This answer is incorrect. SAS No. 57 (AU 342) recommends that auditors consider performing procedures to identify circumstances that require accounting estimates, including those that exist because of the industry the client is part of. However, for a CIRA, industry comparisons are not necessarily valid.]

    b. Materiality for disclosure depends on the amount reported in the financial statements. [This answer is incorrect. Materiality is measured against the effect that using a different estimate would have on the financial statements.]

    c. Recognitions of a small financial statement amounts cannot cause disclosure of estimates to be required. [This answer is incorrect. Disclosure may be required even if an estimate resulted in the recognition of a small financial statement amount or no amount.]

    d. The financial statements must disclose if there is a less than likely, but more than remote chance that an estimate will change by a material amount within a year of the audit of the financial statements. [This answer is correct. The auditor must determine if there is a reasonable possibility that an estimate will change by a material amount in the near term. This would be a possibility that is more than remote but less than likely. Even if the change can be reasonably expected to change, the tests of materiality and whether the change will be in the "near term" may still eliminate the need for disclosure.]

21. As a procedure within the concluding stage of the audit, Arthur is determining the reasonableness of material fair value estimates prepared by CIRA's management. Which of the following is appropriate guidance for Arthur as he performs this procedure? **(Page 322)**

    a. Arthur does not need to obtain management's representations about the reasonableness of the fair values and the method and assumptions used to determine fair value. [This answer is incorrect. It is appropriate for Arthur during the summarization and evaluation procedures, regardless of the audit approach Arthur used, to obtain management representations about the reasonableness of significant assumptions and consider communications with those who govern the CIRA.]

    b. Even if circumstances change from year to year or from the date of management's calculation of value to the date of the financial statements, the method the client used needs to stay consistent. [This answer is incorrect. Valuation assumptions and methods must be reasonable, and if circumstances change, the original assumptions and methods may no longer be appropriate.]

    c. Management's strategic plans for the CIRA's future are relevant in determining the reasonableness of managements' assumptions and representations of fair value. [This answer is correct. It is appropriate guidance for Arthur. He must determine the reasonableness of management's assumptions in determining fair value. This is one of many relevant factors to consider. Others include assumptions made in other periods, if appropriate; the general economic environment; the industry's economic environment; and the CIRA's past experience.]

SUBSEQUENT EVENTS

SAS No. 103, which amends SAS No. 1, *Codification of Auditing Standards and Procedures*, AU 530, "Dating of the Independent Auditor's Report," requires that the date of the auditor's report should be no earlier than the date sufficient appropriate audit evidence has been obtained to support the opinion on the financial statements. Among other items, *sufficient appropriate audit evidence* includes evidence that:

a. The audit work has been reviewed.

b. The financial statements, including disclosures, have been prepared.

c. Management has taken responsibility for the financial statements.

The period between the financial statement date and the date the financial statements are issued or available to be issued is called the subsequent period, and the audit procedures performed specifically to search for material events in this period are referred to as the subsequent events review. The objective of the subsequent events review is to identify transactions or events that occur after the financial statement date that should be recorded or disclosed in the financial statements.

Auditors should be mindful that subsequent events procedures need to be performed up through the date when the auditor has obtained sufficient evidence to support the opinion on the financial statements. In other words, if the auditor wraps up fieldwork, but cannot date his or her report because additional procedures must be performed, such as preparing financial statements or finalizing the review of the audit documentation, then subsequent events procedures should continue to be applied until the date the financial statements are available to be issued. However, if there are delays in releasing the financial statements, auditors should consider the need to apply additional subsequent events review procedures.

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

Some subsequent events may be discovered as a result of audit procedures applied for specific account balances or transaction classes. Other procedures are performed specifically to search for material subsequent events. They include reading minutes of meetings held through the date of the auditor's report; scanning cash receipts and disbursements for the subsequent period; reading any interim financial statements or financial reports prepared in the subsequent period and investigating any unusual fluctuations; and inquiring of management about the existence of significant subsequent events. The lawyer's response and the management representation letter may also provide evidence of, or representations about, the existence of significant subsequent events. The auditor would apply any additional audit procedures necessary to follow up on material subsequent events identified.

Timing

The subsequent events review procedures should cover a period as close as possible to the date the financial statements are available for issuance. Also, the lawyer's letter should have an effective date within about two weeks of the report date. The management representation letter should be dated as of the audit report date.

Subsequent Events Occurring After the Date of the Report. Subsequent to the date of the auditor's report, the auditor may become aware of facts that existed on that date that might have caused him to believe information supplied by the association was incorrect, incomplete, or otherwise unsatisfactory had he then been aware of them. In such circumstances, the auditor should consider the guidance in SAS No. 1 (AU 561), *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*, in determining an appropriate course of action.

The guidance in SAS No. 1 (AU 561) can be summarized as follows:

a. If the information that the auditor becomes aware of is of such a nature and from such a source that he would have investigated it had it come to his attention during the engagement, he should investigate it as soon after it comes to his attention as is practical.

b. If, after investigation, the auditor determines that (1) his report or the financial statements would have been affected if the information had been known to him at the date of his report and (2) he believes there are persons currently relying on, or likely to rely on, the financial statements who would attach importance to the information, he should advise his client to make appropriate disclosure of the newly discovered facts and their impact on the financial statements to persons who are relying on the financial statements and the related auditor's report.

AU 561 provides information concerning suggested methods of disclosure by the client (depending upon the circumstances) and procedures the auditors should take if the client refuses to make the requested disclosures.

RELATED PARTIES

Most business transactions result from bargained dealing. When the parties to a transaction are related, the objectivity expected in unrelated bargaining may be lost. Because of the loss of objectivity, knowledge of the nature and volume of transactions with related parties may be necessary for financial statement users to properly evaluate the company's financial condition and results of operations. Consequently, SFAS No. 57, *Related Party Disclosures* (FASB ASC 850), requires that material related party transactions be disclosed. In this area, an auditor's primary objective is to determine that all significant transactions with related parties have been identified (*completeness*). Once those transactions have been identified, attention focuses primarily on the adequacy of presentation and disclosure.

Under SFAS No. 57 (FASB ASC 850), related parties include affiliates; equity investees; pension, profit-sharing, and similar trusts managed by or under the trusteeship of management; principal owners, management, and members of their immediate families; other parties if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the parties might be prevented from pursuing its own separate interest; another party that can significantly influence the management or operating policies of the transacting parties or that has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from pursuing its own separate interests.

Audit Procedures

Audit procedures for related parties are applied at all audit stages. At the start of the audit, procedures include identifying obvious or known related parties and transactions (or updating information obtained in previous audits) and communicating that information to the audit staff to consider as other procedures are applied during the audit. Inquiry of predecessor auditors and management; review of prior audit workpapers, minutes, contracts, and agreements; etc., are sources of information about related parties and transactions with such parties.

Known related parties can be documented. Best practices indicate updating the list of related parties throughout the engagement and communicating changes to all engagement team members. If other auditors are involved in the engagement, auditors can use a "Letter from Principal Auditor to Other Auditors Regarding Related Parties" to help facilitate timely communication with other auditors regarding known related parties and related party transactions.

When examining transactions in the audit of specific accounts or in the subsequent events review, the auditor should consider whether the transactions involve related parties. Generally, the same audit procedures are applied to substantive material related-party transactions that are applied to other material transactions. Procedures include vouching, examining authorizations, confirmation, recomputation, etc., to obtain an understanding of the transaction's nature, extent, and business purpose, and to obtain reasonable assurance that the transactions do not contain misstatements that could be material to the financial statements. The auditor should also be sure to understand that proper authorization of related-party transactions, such as by the board of directors or audit committee (if the CIRA has one), is more important than for similar transactions with unrelated parties.

Generally, the purpose of final review procedures is to evaluate whether there are major transactions with undisclosed related parties and to evaluate the adequacy of disclosure of identified transactions. Some audit procedures of an overall review or analytical nature that are performed near the end of the audit may disclose related party transactions. Generally, those procedures include scanning accounting records for large, unusual, or nonrecurring

transactions or balances, particularly those around the end of the period; considering the nature and extent of business with the CIRA's officers, the developer/sponsor, and major suppliers, borrowers, or lenders for undisclosed relationships; and considering whether transactions are occurring, but not being given accounting recognition, e.g., the transfer of a unit in development from the developer to the CIRA in settlement of litigation.

To obtain an understanding of a transaction's nature or purpose, it may be necessary to apply additional procedures. Examples of such procedures include inspecting evidence possessed by the other party to the transaction; discussing relevant information with intermediaries, such as banks, agents, or attorneys; referring to financial publications, credit agencies, and other sources for information about unfamiliar parties to the transaction; etc. The authors believe the auditor should consider whether any related-party transactions are occurring that are not being recognized in the accounting records.

Also, an auditing interpretation at AU 9334.16–.21 discusses other procedures that may be necessary to understand the transaction or obtain evidence about it, such as consultation with persons knowledgeable about a particular specialized type of transaction, application of audit procedures at the related party, or even audit of the related party's financial statements. The interpretation also suggests obtaining representations from senior management and directors about whether they, or any other related parties, engaged in any transactions with the company during the period.

Auditors do not have a duty to substantiate the arm's length equivalence of related party transactions unless representations of equivalence are made in the financial statements. SFAS No. 57 indicates that representations about related-party transactions should not imply that the transactions were consummated on an arm's length basis unless those representations can be substantiated. An auditing interpretation at AU 9334.22–.23 addresses the situation where management discloses in the financial statements that a related-party transaction was consummated on an arm's length basis, but prefaces that representation with a phrase such as "Management believes that . . ." or "It is the Association's belief that . . ." The interpretation indicates that prefacing a disclosure about related-party transactions with such a phrase does not change management's responsibility to substantiate the representation.

Related-Party Transactions and Fraud. SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AU 316), requires the auditor to consider the existence of fraud risk factors when identifying and assessing risks of material misstatement due to fraud. A common thread in many frauds is the use of related parties unknown to the auditor to facilitate management intentionally misstating the financial statements (for example, selling real estate or other assets to a related party for artificial gain).

Disclosures

SFAS No. 57 (FASB ASC 850) requires certain note disclosures about related parties.

GOING CONCERN CONSIDERATIONS

Conditions and Events

SAS No. 59, (AU 341), *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, as amended, requires the auditor to evaluate whether conditions and events identified during the audit, when considered in the aggregate, indicate that there could be a substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, that is, for a period not to exceed one year beyond the financial statement date.

Audit Procedures

SAS No. 59 does not mandate any procedures specifically and solely to search for conditions or events that might indicate inability to continue as a going concern, but it does require a specific assessment of whether audit procedures that were applied for other purposes identified such conditions and events. Examples of such other auditing procedures include applying analytical procedures, reviewing subsequent events, reading minutes, inquiring of the CIRA's legal counsel about litigation, claims, and assessments, etc.

If necessary, the auditor should apply procedures to obtain additional information about any conditions and events identified. If, after considering the identified conditions and events, the auditor believes there is a substantial doubt about the CIRA's ability to continue as a going concern for a reasonable period of time, he or she should obtain information about management's plans that are intended to mitigate the effect of the conditions and events and assess the likelihood that those plans can be effectively implemented.

If the preceding procedures cause the auditor to conclude that there is substantial doubt about the entity's ability to continue as a going concern, the auditor should consider the possible effects on the financial statements, adequacy of disclosures, and auditor's report. Certain disclosures may be necessary, even if the auditor's initial substantial doubt is alleviated based on his consideration of management's plans. If substantial doubt does not exist but the financial statements might lead a reader to conclude there is substantial doubt, the authors recommend disclosing the mitigating factors. The auditor also has an obligation to communicate certain matters to those charged with governance.

Documentation Requirements

When conditions or events cause the auditor to believe there is substantial doubt about the CIRA's ability to continue as a going concern for a reasonable period of time, SAS No. 59, as amended (AU 341.17), requires documentation of the following:

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

SELF-STUDY QUIZ

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

22. Carol is planning for the conclusion of an audit. Which one of the following is the most accurate or relevant concerning the auditor's role with respect to subsequent events?

    a. An auditing firm could have a policy stating how long of a delay in releasing the report after the initial report date should cause a subsequent events review to the new release date. The report should be re-dated to that subsequent date.

    b. If a subsequent events review must be conducted, SAS No. 103 provides the required steps for any review of subsequent events.

    c. The purpose of a subsequent events review is to identify events or transactions occurring after the original financial statement date. The results of the subsequent events review are not recorded in the accounts.

    d. The relevant guidance for the auditor whose client refuses to make the requested disclosures about subsequent events is SAS No. 103, *Audit Documentation*.

23. Charles, the audit manager needs to help the audit staff learn the definition of related parties, the reason for audit focus on related-party transactions, and the auditors' responsibility in this regard. Which of the following should Charles **not** share with the staff because it is incorrect?

    a. A basic audit issue surrounding related party transactions is the concern that transactions between related parties could lack the bargained dealing and objectivity elements of business transactions that those who rely on the financial statements would expect.

    b. One area of focus for the auditor is to detect related party transactions that management has not disclosed in the financial statements and then to properly disclose the transactions and their effect on the financials.

    c. The audit procedures for discovering related-party transactions should be performed throughout the audit.

    d. Related parties include only those parties that are related by ownership or family.

24. According to SFAS No. 57, which transaction in the following list is **least** likely to be a related party transaction that should be disclosed in the financial statements?

    a. The developer of the CIRA owes a material amount to the CIRA for assessments on properties that have not sold.

    b. A board member is the CIRA's insurance agent, and the CIRA has purchased all liability, property and casualty, and employee life insurance from the board member.

    c. A board member's neighbor, who is not an employee of the CIRA, performs occasional maintenance on CIRA common areas. He is not the only party the CIRA relies on for these services

    d. A board member makes a long term and substantial loan to the CIRA.

25. In which situation in the following list would an auditor determine under SAS No. 59 that the CIRA is **not** a going concern?

    a. Conditions identified during the annual audit led the auditors to believe that the business will not be able to continue in business for more than one year from the date of the auditor's report.

    b. The auditing firm has substantial doubt about the entity's ability to continue as a viable business for one year following the fiscal year-end of the year being reported.

    c. The auditors identified conditions that in the aggregate indicate that the business will experience net operating losses for the next three fiscal years.

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. Carol is planning for the conclusion of an audit. Which one of the following is the most accurate or relevant concerning the auditor's role with respect to subsequent events? **(Page 329)**

    a. An auditing firm could have a policy stating how long of a delay in releasing the report after the initial report date should cause a subsequent events review to the new release date. The report should be re-dated to that subsequent date. [This answer is correct. Many firms adopt policies concerning decisions to redate the report. It would be prudent for the firm to state such a policy in its quality control policies and procedures.]

    b. If a subsequent events review must be conducted, SAS No. 103 provides the required steps for any review of subsequent events. [This answer is incorrect. Reviews of subsequent events are structured to apply to information that is relevant to the particular audit and the significant client's known and unknown subsequent events and transactions. For example, a subsequent events review can focus on specific account balances or transaction classes.]

    c. The purpose of a subsequent events review is to identify events or transactions occurring after the original financial statement date. The results of the subsequent events review are not recorded in the accounts. [This answer is incorrect. The objective of the subsequent events review is to identify transactions or events that occur after the financial statement date that *should be recorded* or *disclosed* in the financials.]

    d. The relevant guidance for the auditor whose client refuses to make the requested disclosures about subsequent events is SAS No. 103, *Audit Documentation*. [This answer is incorrect. SAS No. 1 (AU 561), *Subsequent Discovery of Facts Existing at the Date of the Auditors Report*, is the most relevant guidance in this situation.]

23. Charles, the audit manager needs to help the audit staff learn the definition of related parties, the reason for audit focus on related-party transactions, and the auditors' responsibility in this regard. Which of the following should Charles **not** share with the staff because it is incorrect? **(Page 330)**

    a. A basic audit issue surrounding related party transactions is the concern that transactions between related parties could lack the bargained dealing and objectivity elements of business transactions that those who rely on the financial statements would expect. [This answer is incorrect. This is an important point to share with the new audit staff. These parties depend on transactions resulting from bargained dealing, and if this is not the case, that the transactions and their effect be disclosed.]

    b. One area of focus for the auditor is to detect related party transactions that management has not disclosed in the financial statements and then to properly disclose the transactions and their effect on the financials. [This answer is incorrect. Charles should share this information with the audit team because the auditor's procedures are designed to detect significant unrecorded related party transactions for evaluation and possible disclosure.]

    c. The audit procedures for discovering related-party transactions should be performed throughout the audit. [This answer is incorrect. Audit procedures for related parties are applied at all audit stages. For example, procedures in the early stages of the audit include identifying obvious or known related parties and transactions, updating information obtained in previous audits, and communicating the information to all audit staff. Additionally, the auditors can use a "Letter from Principal Auditor to Other Auditors Regarding Related Parties" to make sure other auditors are aware of related-party transactions so all auditors can apply this knowledge to other procedures.]

    d. Related parties include only those parties that are related by ownership or family. [This answer is correct. Related parties are defined in SFAS No. 57 (FASB ASC 850), *Related Party Disclosures*, and include (among other things) non-family parties that can significantly influence the management or operating policies of the transacting parties.]

24. According to SFAS No. 57, which transaction in the following list is **least** likely to be a related party transaction that should be disclosed in the financial statements? **(Page 330)**

    a. The developer of the CIRA owes a material amount to the CIRA for assessments on properties that have not sold. [This answer is incorrect. It would likely be considered a related party transaction that should be disclosed because the relationship meets the relationship and materiality tests.]

    b. A board member is the CIRA's insurance agent, and the CIRA has purchased all liability, property and casualty, and employee life insurance from the board member. [This answer is incorrect. This example shows a related party transaction that should be considered for disclosure. The materiality test would likely be met because the CIRA buys all of its insurance from the board member. The board member and the CIRA are related parties because the board member could significantly influence the CIRA's management to buy insurance from his agency.]

    c. A board member's neighbor, who is not an employee of the CIRA, performs occasional maintenance on CIRA common areas. He is not the only party the CIRA relies on for these services. [This answer is correct. It is unlikely that CIRA management would contract with the neighbor in an amount that would be material to the CIRA. Additionally, it is highly unlikely that the board member's influence over the CIRA and his relationship with his neighbor is such that the CIRA or the neighbor could not pursue their own interests; i.e., it is not a related party transaction.]

    d. A board member makes a long term and substantial loan to the CIRA. [This answer is incorrect. This is a related party transaction that the auditors should consider for disclosure in the financial statements because it is a related party transaction and the amount is substantial and potentially material to the financial statements as a whole.]

25. In which situation in the following list would an auditor determine under SAS No. 59 that the CIRA is **not** a going concern? **(Page 331)**

    a. Conditions identified during the annual audit led the auditors to believe that the business will not be able to continue in business for more than one year from the date of the auditor's report. [This answer is correct. SAS 59's threshold for not being a going concern is a reasonable period of time. Thus, a business that is not expected to be able to continue for more than one year is considered to not be a going concern.]

    b. The auditing firm has substantial doubt about the entity's ability to continue as a viable business for one year following the fiscal year-end of the year being reported. [This answer is incorrect. The time period that is within the definition of going concern is not measured by the end of the year under audit.]

    c. The auditors identified conditions that in the aggregate indicate that the business will experience net operating losses for the next three fiscal years. [This answer is incorrect. The test for whether a business is considered a going concern by the auditor is not whether the business will be experience losses for a specific period of time. This test is whether it is viable for a reasonable period of time.]

MANAGEMENT REPRESENTATION LETTER

SAS No. 85 (AU 333.01), *Management Representations*, requires the auditor to obtain written representations from client officials. A management representation letter, among other things, confirms oral representations about specific matters given to the auditor during the audit. The letter is part of the evidential matter the auditor obtains; however, it is not a substitute for other necessary audit procedures to corroborate information about matters for which written representations are obtained. For example, the auditor should not simply accept management's representations as the only necessary audit evidence for significant matters. If the auditor cannot verify a representation using another form of evidence, such as management's intent to hold investment securities to maturity, the auditor should evaluate whether the representation is feasible considering past history with the client and the current economic conditions. In addition, if other audit evidence contradicts a representation made by management, the auditor should investigate the circumstances and consider the reliability of the representation. Depending on the circumstances, the auditor may need to consider whether reliance on management's representations relating to other aspects of the financial statements is appropriate. SAS No. 85 is clear that management's refusal to furnish written representations is a limitation on the audit scope sufficient to preclude an unqualified opinion.

Content of the Letter

In the representation letter, CIRA officials acknowledge their primary responsibility for the financial statements and provide other representations that are "ordinarily" obtained, according to SAS No. 85, for example, representations that all financial records were made available to the auditor. In addition to items specified in SAS No. 85, the letter should include any other matters relevant to CIRAs or to the specific engagement.

For example, CIRAs frequently use managing agents, and there is often a lack of auditor interaction with the CIRA's board of directors and officers. In those circumstances, it is particularly important to remind the CIRA's officers and, if applicable, the managing agent of their responsibility for the financial statements as well as their responsibility to provide the auditors with complete and accurate information.

In addition, the AICPA guide at Paragraph 7.104 states that auditors should consider obtaining representations from management and the board of directors about the following matters in addition to those made in audits of the financial statements of other kinds of reporting entities:

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

Not all of those additional representations would be appropriate for every CIRA engagement. In addition, the representation letter should state that management is responsible for the presentation of supplementary information about future major repairs and replacements required by the AICPA.

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

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

   - Whether the CIRA has complied with its policy for funding future major repairs and replacements including requirements, if any, for outside studies to estimate future costs.
   - If the CIRA is accumulating funds for future major repairs and replacements, whether the board of directors believes they will be adequate.

b. *Allocation of Expenses against Membership and Nonmembership Income (or against Exempt and Nonexempt Function Income).* Best practices indicate that auditors could obtain the CIRA's representation

that the CIRA's allocations conform with IRS rules, which state that such allocations be made "on a reasonable and consistently applied basis."

c. *Excess Revenues over Expenses.* CIRAs have some options that will allow them to exempt the excess of assessments over operating expenses from federal taxation. The CIRAs may elect to—

- apply the excess against the next year's assessments, or
- refund the excess to members.

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

d. *Required Supplementary Information about Future Major Repairs and Replacements.* If the auditors assisted the CIRA's board of directors in assembling the required supplementary information, the authors recommend they obtain the CIRA's acceptance of responsibility for it.

e. *Adequacy of Insurance.* Although not required, some auditors review management's evaluation of the adequacy of insurance. In that case, the auditors should consider obtaining representations about whether management has reviewed the adequacy of insurance and whether they believe it is adequate.

f. *Interfund Transactions.* The authors recommend that auditors obtain the CIRA's representation that there are no unauthorized transfers or designations of fund balance or interfund borrowings, or uncollectible interfund loans.

g. *Responsibility for Tax Election.* The authors recommend that auditors obtain the CIRA's representation that management is responsible for the choice of filing either Form 1120 or 1120-H, as appropriate.

If required communications are orally reported (as permitted in certain circumstances under SAS No. 114), it is desirable for management to acknowledge in the representation letter that the matters have been reported. Also, the letter may include management's promise to let the auditor review any subsequently published document that includes the auditor's report.

Audit Adjustments

SAS No. 85 (AU 333) requires an acknowledgment in the representation letter that management has considered the financial statement misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented, and has concluded that any uncorrected misstatements are not material, both individually and in the aggregate, to the financial statements taken as a whole. The SAS also requires that a summary of the uncorrected misstatements should be included in, or attached to, the representation letter. SAS No. 85 does not provide specific guidance for the auditor when there are no uncorrected misstatements. In that situation (that is, when either no misstatements are noted in the audit or all noted misstatements are corrected), best practices indicate that no representation about uncorrected misstatements is required in the management representation letter.

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

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

Materiality

SAS No. 85 permits, but does not require, limiting representations to matters that are either individually or collectively material to the financial statements. That limitation is acceptable, however, only for representations that directly relate to amounts included in the financial statements and only if the auditor and management reach an agreement about what is material for this purpose. It would not be acceptable, for example, to limit representations about the completeness of available financial records or about management's responsibility for fair presentation. SAS No. 85 notes that materiality may be different for different representations, and it permits but does not require including an explicit discussion of materiality in the representation letter, in either qualitative or quantitative terms. A discussion that includes both qualitative and quantitative terms is also acceptable.

Signatures and Date on the Letter

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

Periods Covered by the Letter

SAS No. 85 (AU 333.10) also requires auditors to obtain written representations from current management on all periods covered in the auditor's report. For example, if the auditor's report covers the financial statements for the years ended 20X1 and 20X2, management's representation letter should also cover both years. If management or the managing agent changed during or after the period under audit, the current management may be hesitant to provide this assurance. That is especially true of managing agents. Auditors may point out that the letter limits the confirmants' responses to the best of their knowledge and belief. While, in some cases, it may be possible to obtain representations from the previous management, it is unlikely, and under SAS No. 85 the auditor should obtain representations for all periods covered by the auditor's report from current management. In some cases, the managing agent may sign the representation letter, but new CIRA officials not present during the period under audit may decline because they are new to the situation. The authors believe this is acceptable and would not result in a scope limitation. However, the auditor should make inquiries to determine that the reason for not signing the letter is because the official was not responsible for the financial statements and not due to other reasons (such as a disagreement about accounting matters or knowledge of an actual or suspected material misstatement). The authors also recommend that the official be asked to sign a separate representation stating that he or she has no knowledge of a material matter that was not properly treated in the financial statements.

Updating Letters. There are circumstances that require auditors to obtain updating representation letters from management. SAS No. 85 amended SAS No. 58, *Reports on Audited Financial Statements*, to require a predecessor auditor to obtain a representation letter from management, in addition to the previous requirement for a representation letter from the successor auditor, before reissuing a report on financial statements of a prior period. This requirement applies when the prior period financial statements are presented on a comparative basis with audited financial statements of a subsequent period. The updating management representation letter should address (a) whether management is aware of any new information that would cause them to believe that any of the previous representations should be modified, and (b) whether any events occurring subsequent to the latest balance sheet date of the financial statements reported on by the predecessor require disclosure in or adjustment to such financial statements.

THE ACCUMULATED RESULTS OF AUDIT PROCEDURES

Reevaluating Risk Assessments

The auditor's assessment of the risks of material misstatement at the relevant assertion level made during planning is based on available audit evidence and naturally may change as additional evidence is obtained. For example, in performing substantive procedures, the auditor may identify misstatements that are larger or more frequent than had been anticipated. In this situation, SAS No. 110 (AU 318), *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, requires the auditor to reevaluate whether the assessment of risks of material misstatement at the relevant assertion level remains appropriate. The audit evi-

dence may either confirm the auditor's risk assessments or result in the auditor performing additional audit procedures. Exhibit 2-2 illustrates this concept.

Exhibit 2-2

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

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

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

* * *

As indicated in Exhibit 2-2, an auditor should not assume that an identified error or instance of fraud is an isolated occurrence. Instead, the auditor should consider how the misstatement affects the assessed risks of material misstatement. In doing so, the auditor should consider all relevant audit evidence, even if it appears to contradict relevant assertions in the financial statements.

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

SAS No. 110 (AU 318) requires the auditor to evaluate whether audit risk has been reduced to an appropriately low level and whether the nature, timing, and extent of audit procedures may need to be reconsidered. At the end of the audit, the auditor concludes whether sufficient appropriate audit evidence was obtained to reduce to an appropriately low level the risk of material misstatement in the financial statements and to support the opinion on the financial statements. This requires the auditor to evaluate whether the audit was performed at a level that provides the auditor with a high level of assurance that the financial statements, taken as a whole, are free of material misstatement. The sufficiency and appropriateness of audit evidence is a matter of the auditor's professional judgment.

SAS No. 110 (AU 318) states that if the auditor has not obtained sufficient appropriate audit evidence with respect to a material financial statement assertion, the auditor should try to obtain additional evidence. If the auditor cannot obtain sufficient appropriate audit evidence, the auditor should either express a qualified opinion or disclaim an opinion.

Evaluating the Existence of Fraud

Fraud Risk Assessment Is a Cumulative Process. Assessing the risks of material misstatement due to fraud is a cumulative process that should occur throughout the audit. Fraud risks may be identified during the engagement acceptance/continuance process, during engagement planning, while obtaining an understanding of internal control, assessing the risks of material misstatement of the financial statements due to error or fraud, performing further audit procedures to respond to assessed risks, or communicating with management or others. Examples of

conditions the auditor may note that may change or support the assessment of risks made during planning are included in Exhibit 2-3.

Required Procedures. SAS No. 99 (AU 316), *Consideration of Fraud in a Financial Statement Audit*, requires auditors to evaluate whether the results of analytical procedures performed as substantive tests, or in the overall review stage of the audit, indicate a previously unidentified risk of material misstatement due to fraud. In addition, the SAS requires performance of analytical procedures relating to revenue, through the end of the reporting period. If the full year's information is available during audit planning, the procedures can be performed during preliminary analytical procedures. Otherwise, the procedures performed during planning should be updated during the final analytical review stage of the audit. Auditors also should consider, throughout the audit, whether responses to their inquiries about the results of analytical procedures have been vague, implausible, or inconsistent with other evidence.

Exhibit 2-3

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

- Unrecorded transactions or transactions recorded improperly as to account, amount, period, or CIRA policy.
- Balances or transactions that are unsupported or unauthorized.
- Adjustments made by the CIRA at the last minute that substantially affect financial results.
- Evidence of employees' unauthorized or unnecessary access to systems or records.
- Missing documents.
- Indications of altered documents.[a]
- Only photocopies or electronic versions of documents being provided to auditors when originals are expected to exist.
- Significant unexplained reconciling items.
- Vague, implausible, or inconsistent responses by the client to the auditor's inquiries.
- Significant physical assets are missing.
- Denial by client personnel of auditor's access to records, facilities, certain employees, members, vendors, or others.[b]
- Unusual discrepancies between confirmation replies and the CIRA's records.
- Failure to retain documents or electronic files consistent with the CIRA's record retention policies or practices.
- Unusual delays by CIRA personnel in providing requested information.
- Unusual delays in the entity's closing process.
- Unreasonable time pressures to resolve complex or contentious accounting issues.
- Attempts by the management or the managing agent to intimidate audit team members or control the conduct of the audit.
- Complaints or tips received by the auditor about fraud or potential fraud.
- Unwillingness to make financial statement disclosures more clear or complete.

Notes:

[a] If the auditor suspects that documents have been altered, it may be necessary to engage a specialist to determine their authenticity.

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

* * *

At or near the completion of fieldwork, SAS No. 99 (AU 316) requires the auditor to evaluate the accumulated results of audit procedures and other conditions noted during the audit to determine their effect on the auditor's assessment of risks made previously. Based on the evaluation, the auditor determines whether additional or different audit procedures are necessary. In addition, the auditor should perform a qualitative evaluation of misstatements identified in the financial statements and determine whether the misstatements may indicate possible fraud. In addition, the auditor with final responsibility for the audit should ascertain there has been adequate communication with the engagement team throughout the audit about information or conditions that indicate potential risks of material misstatement due to fraud. One way of doing this might be to hold another engagement team meeting.

Evaluating Significant Unusual Transactions

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

SAS No. 99 requires the auditor to evaluate the business rationale for significant unusual transactions to address the risk of management override of controls (AU 316.66). The auditor should consider whether the business rationale (or lack thereof) suggests that transactions may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets. In evaluating the business rationale for significant unusual transactions, the auditor should consider whether:

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

Considering the Application of Significant Accounting Principles for Bias

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

Documentation Requirements

SAS No. 103 requires auditors to document significant audit findings or issues, actions taken and evidence obtained in addressing them, and the basis for the auditor's conclusions. On some audits, the auditor may be faced with difficult issues that require significant professional judgment to resolve.

SELF-STUDY QUIZ

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

26. Which of the following statements is consistent with SAS No. 85 (AU 333.01), *Management Representations*?

    a. A management representation letter is a component of the audit evidence the auditor uses to form the basis of the audit report rather than serving only as documentation that an oral representation was made.

    b. If the CIRA uses a managing agent to conduct daily operations, the requirement that management acknowledge responsibility for the financial statements is transferred to the managing agent.

    c. Typically, an auditor could depend on management's oral representation that there were, for example, three material related party transactions and the details of each. It is not necessary to include this representation in the management representation letter.

    d. Management must represent at least orally that it has considered the financial statement misstatements identified by the auditor related to the latest period and that the uncorrected ones are immaterial to the financial statements when considered individually rather than in the aggregate.

27. Each of the following examples of management representations is written as if it were applicable to a CIRA but not necessarily required of a CIRA. However, one is unique to a CIRA. Select the one that is unique to a CIRA.

    a. Representations that all of the CIRA's financial records were made available to the auditor.

    b. Management's acknowledgment of its responsibility for the fair presentation of its financial statements.

    c. Management's representation that the CIRA is complying with IRS rules regarding allocations being made on a reasonable and consistently applied basis to income sourced to members as opposed to nonmembers.

28. Which one of the following correctly states the required treatment of audit adjustments according to SAS No. 85?

    a. The management representation letter must include the current year effect of unadjusted audit differences from prior years.

    b. The uncorrected misstatements can be summarized in an attachment to the management representation letter.

    c. SAS No. 85 provides explicit guidance for documentation of the fact that there are no material misstatements that have not been corrected.

    d. The management representation letter should include only the material uncorrected misstatements identified by management.

29. An auditor is required to determine the risks of material misstatement at the relevant assertion level. Which of the following is appropriate guidance for the auditor who is performing the audit?

    a. If an auditor detects inconsistent application of internal controls, the auditor must recommend to management in his or her report that the control be changed to achieve consistent, effective application.

    b. If the auditor detects a fraudulent transaction, he or she may limit additional testing to transactions and balances that would have been directly impacted by the fraudulent instance.

    c. If the auditor does not believe there is sufficient appropriate audit evidence to assert that there is no material misstatement of the financial statements, he can still issue an unqualified opinion if relevant requirements of SAS 110 are met.

d. If during tests of balances, the auditor finds misstatements that are larger than anticipated, the auditor must evaluate whether the original risk assessment of material misstatement at the relevant assertion level is still correct. If not, the auditor must adjust the audit procedures to obtain sufficient evidence to reach a higher level of assurance that all material misstatements have been identified.

30. Which of the following procedures is a CIRA's auditor **least** likely to perform when evaluating the business rationale for significant unusual transactions and the existence of fraud?

a. Consider a significant business transaction between the CIRA and known, legitimate businesses that is a common transaction of CIRAs.

b. Interview members of management, and possibly members of the CIRA's board of directors, regarding a transaction that is unusual for a CIRA.

c. Perform procedures to determine why the CIRA did not keep documentation of a significant transaction even though it was required to do so by the CIRA's standard operating procedures.

d. Follow up on tips the auditor received about a related-party transaction that is questionable in terms of its size and legitimacy.

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.)**

26. Which of the following statements is consistent with SAS No. 85 (AU 333.01), *Management Representations*? **(Page 336)**

    a. A management representation letter is a component of the audit evidence the auditor uses to form the basis of the audit report rather than serving only as documentation that an oral representation was made. [This answer is correct. Although the management representation letter is audit evidence of managements representations made during the audit, those representations must be tested during the audit. The importance of this requirement is emphasized by the fact that the inability to obtain appropriate written representations prevents an auditor from expressing an unqualified opinion and may cause an auditor to disclaim an opinion or even withdraw from the engagement.]

    b. If the CIRA uses a managing agent to conduct daily operations, the requirement that management acknowledge responsibility for the financial statements is transferred to the managing agent. [This answer is incorrect. In circumstances where a CIRA uses a managing agent, it is particularly important to remind the CIRA's officers and the managing agent of their responsibility for the financial statements and to provide the auditors with complete and accurate information. The managing agent should acknowledge its responsibility in this regard.]

    c. Typically, an auditor could depend on management's oral representation that there were, for example, three material related party transactions and the details of each. It is not necessary to include this representation in the management representation letter. [This answer is incorrect. A management representation letter, among other things, confirms oral representations about specific, material matters made to the auditor during the audit. SAS No. 85 (AU 333.01) requires the auditor to obtain written representations from client officials.]

    d. Management must represent at least orally that it has considered the financial statement misstatements identified by the auditor related to the latest period and that the uncorrected ones are immaterial to the financial statements when considered individually rather than in the aggregate. [This answer is incorrect. The representation that uncorrected misstatements are not material, both individually and in the aggregate, to the financial statements as a whole must be included in the management representation letter so that the representation serves as written audit evidence.]

27. Each of the following examples of management representations is written as if it were applicable to a CIRA but not necessarily required of a CIRA. However, one is unique to a CIRA. Select the one that is unique to a CIRA. **(Page 336)**

    a. Representations that all of the CIRA's financial records were made available to the auditor. [This answer is incorrect. SAS No. 85, *Management Representations*, considers this a representation that is "ordinarily" obtained, regardless of the entity being audited. This requirement applies to CIRA management but also to its managing agent, if they use one.]

    b. Management's acknowledgment of its responsibility for the fair presentation of its financial statements. [This answer is incorrect. SAS No. 85 includes this acknowledgement as one that is "ordinarily" obtained from management of the entity under audit, so this would include a CIRA.]

    c. Management's representation that the CIRA is complying with IRS rules regarding allocations being made on a reasonable and consistently applied basis to income sourced to members as opposed to nonmembers. [This answer is correct. The IRS requires that CIRAs allocate expenses against membership and nonmembership income if the CIRA files a federal Form 1120 or income that relates to the CIRA's exempt and nonexempt function income for CIRAs that file a federal Form 1120-H for the year.]

28. Which one of the following correctly states the required treatment of audit adjustments according to SAS No. 85? **(Page 337)**

    a. The management representation letter must include the current year effect of unadjusted audit differences from prior years. [This answer is incorrect. The management representation letter may include the current year effect of unadjusted audit differences from prior years, but SAS No. 85 does not require this.]

    b. The uncorrected misstatements can be summarized in an attachment to the management representation letter. [This answer is correct. SAS No. 85 allows the summary of uncorrected misstatements to be summarized in an attachment to the management representation letter.]

    c. SAS No. 85 provides explicit guidance for documentation of the fact that there are no material misstatements that have not been corrected. [This answer is incorrect. SAS No. 85 does not provide specific guidance for the auditor when there are no uncorrected misstatements or all noted misstatements are corrected.].

    d. The management representation letter should include only the material uncorrected misstatements identified by management. [This answer is incorrect. The summary must include material uncorrected misstatements identified by management and the auditors.]

29. An auditor is required to determine the risks of material misstatement at the relevant assertion level. Which of the following is appropriate guidance for the auditor who is performing the audit? **(Page 338)**

    a. If an auditor detects inconsistent application of internal controls, the auditor must recommend to management in his or her report that the control be changed to achieve consistent, effective application. [This answer is incorrect. It is to be expected that controls are not perfectly or consistently applied because different people may apply the same control, the circumstances could be different, and errors occur. It is the auditor's responsibility when deviations in the application of controls are detected to determine whether the tests provide an appropriate basis for reliance on the controls, whether additional tests of controls are needed, or whether the potential risks of misstatement need to be addressed by substantive procedures.]

    b. If the auditor detects a fraudulent transaction, he or she may limit additional testing to transactions and balances that would have been directly impacted by the fraudulent instance. [This answer is incorrect. In the auditor detects an error or instance of fraud, SAS 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, requires that the auditor consider all relevant audit evidence, even if it appears to contradict relevant assertions in the financial statements.]

    c. If the auditor does not believe there is sufficient appropriate audit evidence to assert that there is no material misstatement of the financial statements, he can still issue an unqualified opinion if relevant requirements of SAS 110 are met. [This answer is incorrect. SAS 110 states that if the auditor has not obtained sufficient appropriate audit evidence with respect to a material financial statement assertion and cannot obtain additional sufficient evidence, the auditor should either express a qualified opinion or disclaim an opinion.]

    d. If during tests of balances, the auditor finds misstatements that are larger than anticipated, the auditor must evaluate whether the original risk assessment of material misstatement at the relevant assertion level is still correct. If not, the auditor must adjust the audit procedures to obtain sufficient evidence to reach a higher level of assurance that all material misstatements have been identified. [This answer is correct. The degree of the risks of material misstatement that the auditor expects may differ from results of audit procedures. SAS No. 110 requires that the auditor perform additional audit procedures in this case.]

30. Which of the following procedures is a CIRA's auditor **least** likely to perform when evaluating the business rationale for significant unusual transactions and the existence of fraud? **(Page 341)**

    a. Consider a significant business transaction between the CIRA and known, legitimate businesses that is a common transaction of CIRAs. [This answer is correct. It is the least likely of these answers to be necessary to detect fraud. If the parties to the transaction lack substance, however, the transaction could suggest a fraudulent transaction.]

    b. Interview members of management, and possibly members of the CIRA's board of directors, regarding a transaction that is unusual for a CIRA. [This answer is incorrect. It is a likely step the auditor would take if he or she detected an unusual transaction. SAS No. 99 requires the auditor to evaluate the business rationale for significant unusual transactions to address the risk of management override of controls. Interviewing multiple members of management and governance is a reasonable procedure in this case.]

    c. Perform procedures to determine why the CIRA did not keep documentation of a significant transaction even though it was required to do so by the CIRA's standard operating procedures. [This answer is incorrect. Failure to retain documents or electronic files consistent with the CIRA's record retention policies or practices is a condition that may change or support the auditor's assessment of fraud risks. Performing such procedures is reasonable in this situation.]

    d. Follow up on tips the auditor received about a related-party transaction that is questionable in terms of its size and legitimacy. [This answer is incorrect. It is reasonable that an auditor would perform procedures to determine whether a related party transaction was fraudulent as alleged by the party that communicated the information and material to the financial statements. SAS 110 requires the auditor to reevaluate whether the assessment of risks of material misstatement at the relevant assertion level remains appropriate. SAS 99 requires the auditor to evaluate possibilities of fraud throughout the audit.]

ANALYTICAL PROCEDURES

Purpose of Analytical Procedures

SAS No. 56 (AU 329), *Analytical Procedures*, as amended, requires the use of analytical procedures in the final review stage of the audit. The purpose of analytical procedures at this stage is to identify any unusual or unexpected financial statement relationships not previously identified and to assess whether the information gathered during the audit provides a sufficient understanding of such relationships identified during the planning or final review stages. The auditor assesses whether the financial statements make sense in light of the knowledge and understanding obtained during the audit. When the auditor does not have a sufficient understanding of the cause of an unusual or unexpected relationship, additional procedures may have to be applied.

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

One common form of documentation is referred to as a *flux analysis*. A flux analysis is a narrative explanation by financial statement caption (line item) of the change in the amount from the prior period and of any unusual or unexpected relationships to other financial statement line items in the current period. Although a flux analysis does not appear to be required by SAS No. 56, it may be a convenient means of documenting the thought process that is required by the SAS.

SAS No. 99 (AU 316), *Consideration of Fraud in a Financial Statement Audit*, requires the auditor to perform preliminary analytical procedures related to revenue to identify unusual or unexpected relationships that may indicate fraudulent financial reporting. Those procedures should be performed through the end of the reporting period. If the full year's information is available during audit planning, the required procedures can be performed during preliminary analytical procedures. Otherwise, the analytical procedures related to revenue performed during planning should be updated during the final analytical review stage of the audit.

WORKPAPER REVIEW

The review of workpapers near the conclusion of the engagement generally consists of a detailed review of the audit work of staff assistants and a higher level supervisory review. The supervisory review is usually conducted after financial statements and the auditor's report have been drafted and is the final check on whether the audit work supports the overall conclusions on the financial statements. SQCS No. 7, *A Firm's System of Quality Control*, indicates that a firm should establish policies and procedures that address supervision and review responsibilities. SAS No. 103, *Audit Documentation*, requires that the workpapers indicate who reviewed the workpapers and the date of the review (AU 339.18).

Tax Department Review

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

Timing of Review of Workpapers

SAS No. 103 (AU 339), requires that the date of the auditor's report should be no earlier than the date that sufficient appropriate evidence has been obtained to support the opinion on the financial statements. Among other items, *sufficient appropriate audit evidence* includes evidence that:

a. The audit documentation has been reviewed.

b. The financial statements, including disclosures, have been prepared.

c. Management has taken responsibility for the financial statements

Best practices indicate that both the detailed and supervisory review should be performed and evidenced prior to the date of the auditor's report.

Review Checklists

Most firms use some form of checklist to serve as a reminder of important engagement completion matters and to document completion of a review of the workpapers. Using such a checklist on a CIRA audit indicates best practices.

SUMMARIZATION AND EVALUATION

One of the final steps near completion of the engagement is evaluation of the misstatements discovered in fieldwork. SAS No. 99, (AU 316.75), *Consideration of Fraud in a Financial Statement Audit* requires that audit differences be evaluated as to whether they are indicative of possible fraud. SAS No. 107 (AU 312), *Audit Risk and Materiality in Conducting an Audit*, requires that the individual and combined effects of all uncorrected misstatements (both known and likely) be considered to determine whether they are material to the financial statements taken as a whole. To evaluate the combined effect of various uncorrected misstatements, it is necessary to summarize them in one place in the workpapers.

Categories for Evaluation

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

a. *Normal Closing Entries.* These are routine entries, such as adjustments of accruals, that are made to help the client close out the books for the year. If normal closing entries are booked, they *are not misstatements* and should not be included in the summary of audit differences. Generally normal closing entries ordinarily are not significant findings or issues that would be subject to the documentation requirements of SAS No. 103 (AU 339), *Audit Documentation*. However, it is often useful to group all those entries in one place. Normally, the entries are prepared in each audit area as the fieldwork for a financial statement component is completed. Grouping closing entries in one schedule is more convenient for supervisory review and discussion with the client. The client must agree with booking these entries and accept responsibility for them because the financial statements are the client's responsibility.

b. *Audit Differences.* These are any differences noted between the accounting records and the evidence obtained during the audit, other than closing entries. An audit difference could be any of the following:

   (1) Passed adjustment for a specifically identified misstatement.

   (2) Projected misstatement from a substantive audit sampling application.

   (3) Significant unexplained difference from an analytical procedure that is treated like a misstatement.

   (4) Difference between the client's accounting estimate and the relevant end of the auditor's acceptable range for that estimate.

Audit Differences

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

Known and Likely Misstatements. In analyzing audit differences, a distinction is drawn between known and likely misstatements. These terms are defined in SAS No. 107 (AU 312.08) as follows:

a. *Known Misstatement.* A specific misstatement that the auditor identifies by performing audit procedures. A known misstatement arises from the incorrect selection or misapplication of accounting principles or misstatements of facts identified.

b. *Likely Misstatement.* Misstatements that (1) arise from differences between judgments made by management and the auditor about accounting estimates that the auditor believes are unreasonable or inappropriate, and (2) the auditor deems likely to exist resulting from an extrapolation from audit evidence obtained.

Communication of Misstatements to Management. SAS No. 107 (AU 312.42) requires the auditor to communicate to management on a timely basis all known and likely misstatements identified during the audit, other than trivial ones. SAS No. 107 (AU 312.44) requires the communication to distinguish between known and likely misstatements. SAS No. 107 also requires the auditor to ask management to do the following with respect to misstatements the auditor has identified:

- Correct all known misstatements, other than trivial ones.

- Examine the account balance, transaction class, or disclosure in which the auditor identified a material likely misstatement from a sample to identify and correct misstatements in the account balance, transaction class, or disclosure.

- When the auditor has identified a likely misstatement involving a difference in an estimate, SAS No. 107 states that the auditor should ask management to review the assumptions and methods used in developing its (management's) estimate. After management has reviewed and challenged the assumptions and methods, the auditor should reevaluate the amount of likely misstatement and, if necessary, perform further audit procedures.

If management decides not to correct some or all of the known or likely misstatements, the auditor should obtain an understanding of management's reasons for not correcting the misstatements and take that into account when making the qualitative considerations. The auditor should also consider the implications for the audit report. In addition, uncorrected misstatements are significant audit findings under SAS No. 114 and should be communicated to those charged with governance.

Evaluating Audit Differences

SAS No. 107 (AU 312.62) states that the auditor must evaluate whether the financial statements taken as a whole are free of material misstatement. The auditor must consider both the individual and aggregate effects of all uncorrected misstatements (known and likely) to evaluate whether the financial statements are fairly stated. In making that evaluation, the auditor should consider both quantitative and qualitative factors. The summarization and evaluation of audit differences can be complex. It should include consideration of the following factors:

- *Nature.* For example, services provided but not billed, accounts payable not recorded, and assets expensed instead of capitalized.

- *Cause.* For example, arithmetic or mechanical mistake, or inappropriate application of an accounting principle because of misunderstanding, intentional use of an accounting principle that is not generally accepted, and whether misstatements are isolated or related to a common cause.

- *Amount.* The dollar amount of the difference and whether the difference is an overstatement or understatement.

- *Effect.* The financial statement components affected by the difference, (for example, the excess of revenue over expenses or total liabilities). (Also, consider the effect on compliance with loan covenants, such as maintaining certain operating ratios, or similar issues.)

According to SAS No. 107 (AU 312.51), misstatements should be combined in a way that enables the auditor to consider whether, in relation to individual amounts, subtotals, or totals in the financial statements, the misstatements materially misstate the financial statements taken as a whole. That simply means the auditor needs to consider not only the materiality of individual misstatements, but also their combined effect on important financial statement totals or subtotals.

Trivial Misstatements. Some auditors set an amount below which detected misstatements need not be accumulated on the summary of audit differences (often referred to as adjustments passed at the workpaper level). SAS No. 107 (AU 312.42) requires the auditor to accumulate all known and likely misstatements identified during the audit, except for those the auditor believes are trivial. Footnote 17 to AU 312.42 states that "trivial" matters "are amounts designated by the auditor below which misstatements need not be accumulated. This amount is set so that any such misstatements either individually or when aggregated with other such misstatements, would not be material to the financial statements, after the possibility of further undetected misstatements is considered."

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

Evaluating Estimates. This course had an earlier discussion of accounting estimates and examples of common accounting estimates. The usual result of auditing an accounting estimate is a range for the estimate that the auditor considers reasonable. If the client's estimate falls within this range, it is acceptable. If it falls outside the range, then the difference between the client's estimate and the closest end of the auditor's range should be considered a likely misstatement and summarized with other audit differences. SAS No. 107 states that an accounting estimate may be evaluated by comparing it with a range or a point estimate, if the point is a better estimate than any other amount. However, accounting estimates are usually evaluated based on a range of reasonableness because it is rarely possible to be precise in estimating future events.

SAS No. 107 also states that an auditor should consider whether differences between estimates best supported by the audit evidence, and the estimates included in the financial statements that are individually reasonable, indicate (in the aggregate) a possible bias on the part of management. If management, for example, always chooses estimated amounts for the valuation of assets that are at the low end of the range the auditor considers reasonable, the combined effect could result in a material misstatement of income. In that case, the auditor should consider whether other recorded estimates reflect a similar bias and perform additional procedures to address those estimates. The auditor should also consider whether management's estimates were at one end of the auditor's reasonable range in the prior year and at the other end in the current year. That could indicate the possibility that management is using accounting estimates to manage the excess of revenues over expenses. If the auditor believes that is the case, he or she should consider communicating the matter to those charged with governance.

SAS No. 99 requires the auditor to review accounting estimates for biases that could result in material misstatement due to fraud. In addition, it requires auditors to perform a retrospective review of significant prior-year accounting estimates to determine whether the underlying judgments and assumptions indicate possible bias. The review may provide additional information about whether the current year's estimates could be biased. If the auditor identifies possible bias, SAS No. 99 requires the auditor to evaluate whether the circumstances represent a risk of material misstatement due to fraud.

Different Levels for Different Amounts, Subtotals, or Totals. For planning purposes, a judgment is made about a single materiality amount for the financial statements taken as a whole. (However, the auditor may determine

more than one level of planning materiality for particular items in the financial statements if there are items for which a lesser amount is more appropriate.) However, in evaluation, an auditor is considering the effect of misstatements on specific amounts, subtotals, or totals in financial statements. In this case, it is possible to use a larger amount in evaluating the effect on certain amounts, subtotals, or totals than on others. Some auditors use a form to accumulate audit differences by various financial statement subtotals to accommodate the auditor's consideration of the effect of misstatements noted. However, exclusive reliance on a quantitative amount or percentage relationship for determining materiality is not appropriate. Qualitative factors also should be considered. If, as the audit progresses or when evaluating audit findings, the auditor concludes that a lower materiality level than the amount determined during audit planning is appropriate, the auditor should reconsider the related levels of tolerable misstatement and the sufficiency of the further audit procedures that were performed. If the auditor believes a misstatement is, or may be, the result of fraud, the auditor should consider the implications of the misstatement in relation to other aspects of the audit, as described in SAS No. 99, even if the effect of the misstatement is not material to the financial statements.

Overall Evaluation. If the auditor believes the financial statements are materially misstated, the auditor should request that management make the necessary corrections. If management refuses, the auditor must determine the implication for the auditor's report.

Even if the auditor believes that the effects of uncorrected misstatements do not cause the financial statements to be materially misstated, the auditor should consider the risk of further misstatement before reaching a final conclusion. According to SAS No. 107 (AU 312.65), even if the auditor concludes that the effects of uncorrected misstatements, individually or in the aggregate, do not cause the financial statements to be materially misstated, the auditor recognizes that there is a risk that the financial statements may be materially misstated due to further misstatement remaining undetected. If combined uncorrected misstatement is very close to the amount an auditor considers material to the financial statements taken as a whole, the risk of further misstatement may be considered unacceptable. For example, if an auditor considers $20,000 material and uncorrected misstatement is $5,000, the risk of further misstatement of $15,000 may be considered acceptably low. If combined uncorrected misstatement is very close to $20,000, the risk may be considered unacceptably high.

Evaluating the Existence of Fraud

If the auditor believes fraud may have occurred, even if the effect is immaterial to the financial statements, the auditor should evaluate its implications for the audit. Those implications may be more significant if management is involved. If management is involved, questions about management's integrity may raise doubts about the auditor's ability to rely on representations made during the audit. In that case, the auditor should reevaluate his or her assessment of fraud risks and reconsider the adequacy of audit procedures and the control risk assessment.

If the auditor believes fraud may have occurred that is material to the financial statements, or if he or she is unable to evaluate its materiality, the auditor should:

a. attempt to determine whether material fraud has occurred and its effects on the financial statements and auditor's report;

b. discuss the matter and the approach for any further investigation with an appropriate level of management (at least one level above those involved), the audit committee (if the entity has one) and others charged with governance;

c. suggest that the client consult with legal counsel, if appropriate; and

d. consider the implications for other aspects of the audit.

In some cases, the risk of material misstatement of the financial statements due to fraud is so significant that auditors should consider withdrawing from the engagement and communicating the reasons for their withdrawal to those charged with governance. The decision to withdraw may depend on whether the identified risks call into question the integrity of management and whether management or others with oversight are diligent and cooperative in investigating the situation and taking appropriate action. Auditors considering withdrawal might want to consult with legal counsel.

Documentation Requirements

To evaluate the combined effect of various uncorrected misstatements, it is necessary to summarize them in one place in the workpapers. SAS No. 107 (AU 312.69) states that the auditor should prepare documentation of the following:

- A summary of uncorrected misstatements, other than trivial ones, related to known and likely misstatements.
- The auditor's conclusion as to whether uncorrected misstatements, individually or in the aggregate, do or do not cause the financial statements to be materially misstated, and the basis for that conclusion.
- All known and likely misstatements identified by the auditor during the audit, other than trivial ones, that have been corrected by management.

Summary of Audit Differences. An auditor has to combine, or aggregate, the effect on the financial statements of all likely misstatements (including known misstatements) to evaluate whether the financial statements taken as a whole are materially misstated. According to SAS No. 107, misstatements should be combined in a way that enables the auditor to consider whether the misstatements in individual amounts, subtotals, or totals in the financial statements materially misstate the financial statements taken as a whole. That simply means the auditor needs to consider not only the materiality of individual misstatements, but also their combined effect on important financial statement totals or subtotals.

There is diversity in practice regarding the methodologies used to aggregate audit differences. Some firms use the *rollover* method. Others use the *iron curtain* method. The main difference between the two methods is how the effects of prior-period misstatements are considered. The rollover method considers all misstatements (current-period misstatements as well as the impact of prior-period waived adjustments on current-period income). The iron curtain method focuses on the impact of misstatements on the audited *balance sheet* and considers the effect on current-period income of amounts needed to correct the balance sheet.

Evaluation of Overall Materiality

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

SELF-STUDY QUIZ

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

31. Which is an accurate statement concerning SAS No. 56 (AU 329), *Analytical Procedures*, as amended, and its requirements?

    a. A flux analysis is clearly required under SAS No. 56.

    b. SAS No. 56 requires performance of preliminary analytical procedures to revenue to identify unusual relationships that may indicate fraudulent financial reporting.

    c. Analytical procedures are required during the final stage of the audit.

32. Which of the following procedures define preliminary analytical procedures?

    i. Applied to unaudited amounts.

    ii Applied to amounts after audit adjustment.

    iii Used to determine what further audit procedures should be performed as a result of risk assessments.

    iv. Used to understand the entity and its environment to assess the risks of material misstatement

    v. Used to consider the adequacy of the procedures performed.

    vi. Flux analysis

    a. ii and v

    b. i and vi

    c. iii and iv

33. Identify the accurate statement regarding the reviews of workpapers that take place near the completion of the audit.

    a. The supervisory review of workpapers is typically conducted before the financial statements and the auditor's report are in draft form.

    b. Most CIRAs do not need a review of tax aspects of the audit workpapers and financial statements.

    c. The auditor's report should not be dated before auditors have reviewed all documents to support the auditor's opinion.

    d. According to SAS No. 103, *Audit Documentation*, each reviewer must personally initial each workpaper.

34. A final step near completion of the audit is the summarization and evaluation of misstatements discovered in fieldwork. Which one of the following is accurate regarding this process?

    a. The auditor must evaluate the effect of known and likely corrected and uncorrected misstatements to form an opinion as to whether they are individually or collectively material to the financial statements taken as a whole.

    b. In the evaluation process, the auditor uses a single materiality amount rather than considering the effect of misstatements in specific amounts, subtotals, or totals in the financial statements.

    c. The term *audit differences* refers to misstatements of amounts rather than classification.

    d. If the auditor concludes that there is a material misstatement in the financial statements, management must make the necessary corrections or risk not receiving an unqualified opinion on the financial statements.

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.)**

31. Which is an accurate statement concerning SAS No. 56 (AU 329), *Analytical Procedures*, as amended, and its requirements? **(Page 348)**

    a. A flux analysis is clearly required under SAS No. 56. [This answer is incorrect. A flux analysis is not clearly required by SAS No. 56, but it might be a convenient means of documenting the thought process that is required by the SAS.]

    b. SAS No. 56 requires performance of preliminary analytical procedures to revenue to identify unusual relationships that may indicate fraudulent financial reporting. [This answer is incorrect. This requirement comes from SAS No. 99 not SAS No. 56. These procedures should be performed through the end of the reporting period.]

    c. Analytical procedures are required during the final stage of the audit. [This answer is correct. The SAS requires the auditors to use analytical procedures in the final stage of the audit. The purpose of such procedures is to identify any unusual or unexpected financial statement relationships not previously identified and to assess whether the information gathered during the audit provides a sufficient understanding of such relationships identified during the planning or final review stages.]

32. Which of the following procedures define preliminary analytical procedures? **(Page 348)**

    i. Applied to unaudited amounts.

    ii Applied to amounts after audit adjustment.

    iii Used to determine what further audit procedures should be performed as a result of risk assessments.

    iv. Used to understand the entity and its environment to assess the risks of material misstatement

    v. Used to consider the adequacy of the procedures performed.

    vi. Flux analysis

    a. ii and v [This answer is incorrect. Items ii and v define final analytical procedures.]

    b. i and vi [This answer is incorrect. Item i defines planning analytical procedures and item vi is a form of documentation.]

    c. iii and iv [This answer is correct. Items iii and iv describe preliminary analytical procedures well. They are risk assessment procedures performed to obtain an understanding of the entity and its environment for the purpose of assessing the risks of material misstatement and determining what further audit procedures should be performed in response to the risk assessment.]

33. Identify the accurate statement regarding the reviews of workpapers that take place near the completion of the audit. **(Page 349)**

    a. The supervisory review of workpapers is typically conducted before the financial statements and the auditor's report are in draft form. [This answer is incorrect. The supervisory review is usually conducted after financial statements and the auditor's report have been drafted. It is the final check on whether the audit work supports the overall conclusions on the financial statements.]

    b. Most CIRAs do not need a review of tax aspects of the audit workpapers and financial statements. [This answer is incorrect. Tax considerations often are significant to CIRAs. Auditors review tax considerations and CPA firms with separate tax departments may have tax personnel review them as well.]

    c. The auditor's report should not be dated before auditors have reviewed all documents to support the auditor's opinion. [This answer is correct. SAS No. 103, *Audit Documentation*, requires that the date of the auditor's report should be no earlier than the date that the audit documentation has been sufficiently reviewed by the auditors (among other criteria). This is critical because of the need for the auditors to have sufficient appropriate evidence to support the auditor's opinion.]

    d. According to SAS No. 103, *Audit Documentation*, each reviewer must personally initial each workpaper. [This answer is incorrect. SAS 103 requires only that the workpapers indicate who reviewed the workpapers and the date of the review. According to SAS 103, the requirement to document who reviewed the audit work performed does not imply a need for each specific working paper to include evidence of review. It should be clear from the audit documentation who reviewed specified elements of the audit work performed and when.]

34. A final step near completion of the audit is the summarization and evaluation of misstatements discovered in fieldwork. Which one of the following is accurate regarding this process? **(Page 352)**

    a. The auditor must evaluate the effect of known and likely corrected and uncorrected misstatements to form an opinion as to whether they are individually or collectively material to the financial statements taken as a whole. [This answer is incorrect. The only misstatements that are relevant to this procedure are those that are uncorrected.]

    b. In the evaluation process, the auditor uses a single materiality amount rather than considering the effect of misstatements in specific amounts, subtotals, or totals in the financial statements. [This answer is incorrect. In the evaluation and summarization stage of the audit, the focus is on the effect of misstatements in specific amounts, subtotals, or totals in the financial statements. The auditors use a single materiality amount for the financial statements taken as a whole for planning purposes.]

    c. The term *audit differences* refers to misstatements of amounts rather than classification. [This answer is incorrect. In discussing summarization and evaluation, the term *audit differences* is used to refer to misstatements of amounts and classification.]

    d. If the auditor concludes that there is a material misstatement in the financial statements, management must make the necessary corrections or risk not receiving an unqualified opinion on the financial statements. [This answer is correct. SAS No. 107 (AU 312.64) states that auditors must consider the implications of material misstatements on the financial statements. Therefore, if the CIRA's management refuses to correct items that result in a material misstatement, the auditor must consider this in reporting on the financial statements.]

DRAFTING FINANCIAL STATEMENTS AND THE AUDITOR'S REPORT

Financial Statements

In many small CIRA audit engagements, the auditor drafts or assists with drafting the financial statements. Management must understand that the auditor's involvement in financial statement preparation does not change the fact that management is responsible for the financial statements. Management is expected to acknowledge its responsibility in the management representation letter. Furthermore, for the auditor to remain independent, management must agree to accept this responsibility, and the auditor should be satisfied that management has the ability to do so. The auditor's understanding with the client regarding preparation of the financial statements should be documented. The auditor should discuss the representation letter with management personnel so they understand the meaning and significance of acknowledging responsibility for the financial statements.

Management must also understand that the auditor's involvement in financial statement preparation may represent a significant deficiency or material weakness in internal control that must be communicated, in writing, to management and those charged with governance. Under SAS No. 115, *Communicating Internal Control Related Matters Identified in an Audit*, if the auditor prepares the financial statements because the client lacks sufficient expertise to do so and lacks the skills and competencies necessary to prevent, detect, and correct a material misstatement, this represents a control deficiency that is most likely a significant deficiency or material weakness. SAS No. 115, including issues related to the auditor's involvement in financial statement preparation, is discussed in detail later in this lesson.

Notes to the Financial Statements

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

It can be a problem determining that all of the disclosures required by GAAP are made. The use of a disclosure checklist can be helpful.

Auditor's Reports

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

- Note disclosure on funding future repairs and replacements.
- Reporting on comparative financial statements.
- Reporting on additional information accompanying the basic financial statements.
- Reporting on comparisons of budgeted and actual information.
- Difference between auditor-submitted and client-prepared financial statements.
- Required supplementary information presented in a note to the financial statements.
- Reporting on information required by HUD.
- Auditor's responsibility for other information in electronic sites containing audited financial statements.

Note Disclosure on Funding Future Major Repairs and Replacements

To keep the financial statements from being misleading, the AICPA guide, Paragraph 4.27, (FASB ASC 972-235-50-2) requires CIRAs to disclose the following information concerning their funding for future major repairs and replacements:

- Requirements, if any, in statutes or association documents (or mortgage on governmental bodies funding requirements, such as the FHA), to accumulate funds for future major repairs and replacements and the CIRA's compliance or lack of compliance with them

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

The AICPA guide, Paragraphs 4.31–4.32, include additional disclosures concerning funding plan goals and reserve studies that a CIRA may choose to disclose.

Comparative Financial Statements

If CIRAs present their financial statements using fund accounting, prior-period financial statements usually are presented in a single column and show only total-all-funds information. If auditors are to express an unqualified opinion on the prior-period financial statements, the prior-year statements should include all of the detail required by GAAP. Thus, generally auditors will need to consider whether the statements include all of the disclosures required by GAAP, especially information about funds that have been designated for future major repairs and replacements and any assessments that were used for purposes other than those for which they were designated. Often any necessary disclosures may be easily made in the notes to the financial statements. (This approach might provide the most meaningful information to the users of CIRA financial statements.) If the prior-period financial statements include all of the disclosures required by GAAP, the auditors should report on the comparative financial statements in conformity with SAS No. 58 at AU 508.08.

If prior-period financial statements lack the sufficient detail required by GAAP, SAS No. 58, at AU 508.65, footnote 24, describes the auditors' reporting responsibility as follows:

> A continuing auditor need not report on the prior-period financial statements if only summarized comparative information of the prior period(s) is presented. For example, entities such as state and local governmental units frequently present total-all-funds information for the prior period(s) rather than information by individual funds because of space limitations or to avoid cumbersome or confusing formats. Also, not-for-profit organizations frequently present certain information for the prior period(s) in total rather than by net asset class. In some circumstances, the client may request the auditor to express an opinion on the prior period(s) as well as the current period. In those circumstances, the auditor should consider whether the information included for the prior period(s) contains sufficient detail to constitute a fair presentation in conformity with generally accepted accounting principles. In most cases, this will necessitate including additional columns or separate detail by fund or net asset class, or the auditor would need to modify his or her report.

Thus, auditors need not report on summarized comparative information. In that case, the auditors' report is the same as their report on the financial statements of a single period even though the prior-period financial statements were previously audited and reported on. To indicate that fact, some auditors add a sentence at the end of the introductory paragraph or a paragraph at the end of their report such as the following:

> We have previously audited and reported on the financial statements presented by fund for the preceding year.

or

> Information for the year ended December 31, 20X1, is presented for comparative purposes only and was extracted from the financial statements presented by fund for that year, on which we expressed an unqualified opinion in our report dated March 8, 20X2.

If the auditors do not report on the summarized prior-year information, the authors also recommend that column headings be labeled so as not to imply that the auditors' report covers that information. For example, the following headings may be used when the auditors' report only extends to the financial statements of the current year:

20X2			20X1
Operating Fund	Replacement Fund	Total	Total (For Comparative Purposes Only)

Additional Information Accompanying the Financial Statements

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

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

SAS No. 29 (AU 551), *Reporting on Information Accompanying the Basic Financial Statements in Auditor-submitted Documents*, gives three options auditors have for reporting on supplementary information. They can:

- Express assurance that all of the information is fairly stated in all material respects in relation to the financial statements taken as a whole.
- Disclaim an opinion on all of the supplementary information.
- Express assurance on some of the information and disclaim an opinion on the remainder.

In most cases, assurance can be expressed on all of the information because it has been subjected to the procedures applied in the audit of the financial statements. That may also apply even when nonfinancial information is presented because it often has been used in analytical procedures.

The report on supplementary information can either be presented as a separate report preceding the supplementary information or in an additional paragraph of the report on the financial statements.

Proposed SAS on Additional Information Accompanying the Basic Financial Statements. In January 2009, the Auditing Standards Board issued an exposure draft of a proposed SAS titled *Other Information in Relation to the Financial Statements Taken as a Whole*, which would supersede SAS No. 29. The proposed SAS would apply whenever the auditor is engaged to express an opinion on whether other information presented with audited financial statements is fairly stated, in all material respects, in relation to the financial statements taken as a whole. *Other information* is defined as "financial and nonfinancial information (other than the financial statements and the auditor's report) that is included in a document containing the audited financial statements and the auditor's report but is not required supplementary information (that is, information that an accounting standards setter requires to accompany an entity's basic financial statements.)

Unlike SAS No 29, which only addresses reporting on other information accompanying the basic financial statements, the proposed SAS would require auditors to apply the certain procedures, including obtaining representations from management, to determine whether the other information is fairly stated in relation to the financial statements taken as a whole.

When the other information is presented with the financial statements, the exposure draft would require auditors to report on it by including an explanatory paragraph in their report on the entity's financial statements. (Unlike SAS No. 29, the exposure draft would provide for the auditor to issue a separate report on the other information only when the entity does not present the other information with the financial statements.) The auditor's report, while similar to the report required by SAS No. 29, would be more detailed in that it refers to the procedures the auditor

is required to apply with respect to the supplementary information. An example of an explanatory paragraph on other information that would be included in the auditor's report on the financial statements is as follows:

> Our audit was conducted for the purpose of forming an opinion on the financial statements as a whole. The [Identify Accompanying Information] is presented for purposes of additional analysis and is not a required part of the financial statements. Such information was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements and other additional procedures as prescribed by auditing standards generally accepted in the United States of America. The purpose of the additional procedures is to provide us with a basis for expressing an opinion on whether the [Identify Accompanying Information] is not misstated by an amount that would be material to the financial statements. In our opinion, the information is fairly stated in all material respects in relation to the financial statements as a whole.

When the auditor is not engaged to express an opinion on whether other information presented with audited financial statements is fairly stated, in all material respects, in relation to the financial statements, or the other information is not derived from accounting records underlying the financial statements, such as certain nonfinancial information, the auditor should disclaim an opinion on the other information in an explanatory paragraph of the report on the financial statements. The language of the auditor's disclaimer, in those circumstances, does not differ from current auditing standards. (However, those circumstances are addressed in the ASB's exposure draft, *Information in Documents Containing Audited Financial Statements*, rather than the exposure draft, *Other Information in Relation to the Financial Statements Taken as a Whole*.

The comment period on the exposure draft ended in May 2009, and the ASB expects to finalize the standard in the fourth quarter of 2009 to be effective for periods beginning on or after December 15, 2009. Auditors should be alert for the issuance of a final standard.

Comparisons of Budgeted and Actual Information

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

- *Expired Periods.* The current year actual compared with the budget for the current year (that is, the budget covers the same period as the historical financial statements).

- *Prospective Periods.* The current year actual compared with the budget for next year (for example, the financial statements for the year ended December 31, 20X2, include the CIRA's 20X3 budget).

The reporting responsibility for budgets differs depending on which of those two periods the budget covers.

Budgets for Expired Periods. If the expired budget is included in an *auditor-submitted* document, reporting on it as additional information accompanying the financial statements in accordance with the provisions of SAS No. 29 is indicated by best practices.

When expired budget information accompanies audited financial statements in a *client-prepared* document, auditors should comply with SAS No. 8 (AU 550), *Other Information in Documents Containing Audited Financial Statements*. However, in most cases, CIRA financial statements and additional information will be included in *auditor-submitted* documents, and SAS No. 8 will not apply.

Budgets for Prospective Periods. If the financial statements include budget information for a period that has not expired, the unexpired budget meets the definition of prospective financial information. Thus, the auditors' respon-

sibility for the budget is governed by the authoritative literature on prospective financial information. Two aspects of budgets for prospective periods affect the reporting requirements:

- Whether the information is forecasted or projected:
  - Forecasted information presents the results management expects. Often budgets used by the CIRA are forecasted.
  - Projected information presents the results management expects given certain hypothetical assumptions.
- Whether the information is a complete or partial presentation:
  - A complete presentation presents the key revenue and expense items and significant changes in financial position.
  - A partial presentation is any other presentation. Most CIRA budgets are partial presentations because they do not address significant changes in financial position.

Reporting on such presentations usually requires the following:

- After the audit report on the financial statements, a compilation report on the prospective information should be presented.
- The financial statement headings should be modified to clearly indicate which information is historical and which is prospective.
- Significant forecast or projection assumptions should be presented in a separate note to the financial statements.

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

Difference between Auditor-submitted Documents and Client-prepared Documents

Auditor-submitted documents generally are bound in the auditors' report cover and sometimes are printed on paper bearing the auditors' logo or watermark. The appearance of those documents often leads readers of the financial statements to assume that auditors are taking some degree of responsibility for all of the information in the document. As a result, SAS No. 29 (AU 551) requires auditors to disclaim an opinion on any additional information not covered by their audit and indicate the responsibility they have taken for any information that has been subjected to auditing procedures.

On the other hand, client-prepared documents appear to be the responsibility of the client. They may be used as an annual report or for a loan proposal and include a variety of information, such as a president's message and client-prepared prospective information. In such documents, the reader of the financial statements generally would expect the auditors' report to cover only the financial statements. It usually is clear that other information in the document is provided by the client. Thus, SAS No. 8 (AU 550), *Other Information in Documents Containing Audited Financial Statements*, only requires auditors to read the other information for consistency with the financial statements. In addition, if accountants' reports on financial statements are included in client-prepared documents that also include presentations of prospective financial information on which the accountants are not reporting, either the CIRA or the auditors should indicate that the auditors take no responsibility for the client-prepared prospective information.

Auditors are required to report on additional information in a client-prepared document only if they determine the information is inconsistent with information in the financial statements or contains a material misstatement of fact and the client refuses to revise it. SAS No. 58 (AU 550.07) allows the auditor to issue a report providing an opinion

on client-prepared information that has been subjected to the same auditing procedures as those used to audit the basic financial statements.

Auditor-submitted and client-prepared documents usually can be distinguished by their appearance—more specifically, by the auditors' report cover or letterhead. SAS No. 29 at AU 551.04, footnote 2, states that client-prepared documents also include financial reports prepared by the client but merely reproduced by the auditors on the client's behalf. In the authors' opinion, however, documents bearing the auditors' logo or watermark or included in their report covers are auditor-submitted documents.

Proposed SAS on Other Information in Documents Containing Audited Financial Statements. In January 2009, the Auditing Standards Board issued an exposure draft of a proposed SAS titled *Other Information in Documents Containing Audited Financial Statements*, which would supersede SAS Nos. 8 and 29. The proposed SAS would apply when the auditor is not engaged to express an opinion on whether information presented with audited financial statements is fairly stated in relation to the financial statements or when the other information presented with audited financial statements is not derived from accounting records underlying the financial statements, such as certain nonfinancial information. The proposed SAS also would apply to other information in "documents containing audited financial statements," such as annual reports or similar documents that are issued to owners (which are referred to as *client-prepared documents* under current auditing standards).

The proposed SAS maintains the primary requirements of the existing auditing standards in SAS No. 8 that the auditor read the information for consistency with the audited financial statements and report only when the auditor determines that the other information is inconsistent with information in the financial statements or contains a material misstatement of fact and the client refuses to revise it. The proposed SAS also allows, but does not require, the auditor to issue a disclaimer of opinion on the other information when the auditor believes that users may infer a level of auditor assurance that is not intended (for example, when the other information is included in auditor-submitted documents). The proposed SAS also requires the auditors to make certain communications to those charged with governance.

The comment period on the exposure draft ended in May 2009, and the ASB expects to finalize the standard in the fourth quarter of 2009 to be effective for periods beginning on or after December 15, 2009. Auditors should be alert for the issuance of a final standard.

Required Supplementary Information on Future Major Repairs and Replacements

The AICPA guide, Paragraph 4.33 (FASB ASC 972-235-50-3), requires CIRAs to disclose the following supplementary information about future major repairs and replacements of its common property as supplementary information outside of the basic financial statements:

- Estimates of current or future costs of future major repairs and replacements of all existing components, such as roofs, including the following:
  - Estimated amounts required
  - Methods used to determine the costs
  - The basis for the calculations, including assumptions, if any, about interest and inflation rates
  - Sources used
  - Dates of studies made for that purpose, if any
- A presentation of components to be repaired and replaced that includes the following:
  - Estimates of the remaining useful lives of the components
  - Estimates of current or future replacement costs

- Amount of funds accumulated for each component to the extent designated by the CIRA's board of directors

Exhibit 2-2 illustrates presentations of required supplementary information.

When required supplementary information is presented with *audited* financial statements in auditor-submitted documents, SAS No. 29 (AU 551) and SAS No. 52 (AU 558.06), apply. The auditor has the following alternatives when reporting on required supplementary information:

- Express an opinion on the information if they have been engaged to do so;
- Report on the information in relation to the basic financial statements taken as a whole, provided the information has been subjected to the auditing procedures applied in the audit of the basic financial statements; or
- Disclaim an opinion on the information.

Applying Limited Procedures. Required supplementary information differs from voluntary presentations of information outside of the basic financial statements because standard-setting bodies such as the AICPA's Accounting Standards Executive Committee (AcSEC) or the FASB consider the information an essential part of the financial reporting of certain entities and because authoritative guidelines for presentation of the information have been established. Thus, AU 558 requires auditors to apply certain limited procedures to the required supplementary information whenever it is included in the same document with audited financial statements.

The limited procedures are described in AU 558.07. In general, they require auditors to—

- Make inquiries of management about (a) how the required supplementary information was prepared, (b) whether the required supplementary information conforms to guidelines prescribed in the AICPA guide, (c) significant assumptions underlying the information, and (d) whether the information has been prepared on a consistent basis.
- Compare the required supplementary information for consistency with management's responses to the preceding inquiries, the financial statements, and any other information of which the auditors are aware.
- Consider whether to include representations about the required supplementary information in the management representation letter.
- Apply additional procedures specified in the AICPA guide.
- Apply additional procedures if the auditors believe that the required supplementary information may not conform to the guidelines in the AICPA guide.

Exhibit 2-4 lists the required procedures contained in AU 558.07. The exhibit also compares those general procedures to procedures tailored to required supplementary information on future repairs and replacements in Paragraph 7.101 of the AICPA guide. The guide states that auditors should consider its specific procedures in carrying out the required procedures in AU 558.07. In general, the procedures in the AICPA guide are not onerous, and the authors believe auditors should apply them whenever the required supplementary information is included with audited financial statements. Auditors should tailor their inquiries to the approach followed by the CIRA in developing the required supplementary information. For example, if the required supplementary information has been prepared by the CIRA's board of directors, auditors should address their inquiries to the particular members responsible for developing the information.

Exhibit 2-4

Limited Procedures for Information about Required Supplementary Information

Description of Procedure	Required by AU 558.07	Additional Procedure in AICPA Guide
1. Inquire of the managing agent or the board of directors about the means used by the board to develop the required supplementary information (e.g., internal study made by the board of directors, estimates obtained from licensed contractors, or a study conducted by a professional engineer).		X
2. Inquire of the managing agent or the board of directors about each of the following items:		
a. Whether the required supplementary information is measured and presented in conformity with guidelines in the AICPA guide.	X	
b. Whether the methods and bases used for estimating the amounts are reasonable.		X
c. Any significant assumptions or interpretations underlying the measurement or presentation of the information.	X	
d. Whether the methods and bases for estimating the amounts are documented.		X
e. Whether the CIRA's historical property maintenance costs were considered in determining the information to be disclosed.		X
f. Whether the age and condition of the common property components were considered in determining the information and amounts to be disclosed.		X
g. Whether the methods of measurement or presentation have been changed from those used in the prior period and the reasons for any such changes.	X	
h. Whether or not the reserve study preparer has the Reserve Specialist designation as a way of confirming that the study was completed in conformance with the National Reserve Study Standards.		X
i. When the study was performed (that is, what is the age of the study).		X

Description of Procedure	Required by AU 558.07	Additional Procedure in AICPA Guide
3. If the study was conducted by the board of directors, consider whether the sources of the information used to estimate useful lives (technical manuals) and current or future repair and replacement costs (bids from contractors) are reasonable.		X
4. Determine by physical inspection of the common property or review of legal documents whether the required information is disclosed for all major components.		X
5. Compare the information for consistency with the following:		
a. Management's responses to the preceding inquiries.	X	
b. Audited financial statements.	X	
c. Other knowledge obtained during the audit of the financial statements.	X	
6. Compare estimates of repair and replacement costs with current period expenditures and with the annual budget, if any.		X
7. Check the mathematical accuracy of amounts disclosed.		X
8. Consider whether to include representations on required supplementary information in specific representations obtained from management in the client representation letter.	X	
9. Make additional inquiries if the results of the preceding procedures cause the auditors to believe that the information may not be measured or presented in conformity with the guidelines in the AICPA guide.	X	

* * *

Because there are widely divergent practices by reserve preparers, auditors should be alert to (a) the lack of adequate reporting on reserves and (b) whether the procedures underlying the reserve study itself are sufficient to ensure accuracy and completeness. Auditors should question their CIRA clients as to whether *they* believe the CIRA has an adequate reserve study. Many CIRA clients may respond that they believe their reserve study is not adequate for any number of reasons, such as that the study lacks all required components, it has incorrect pricing or measurements, or the replacement dates used in the study do not match the CIRA's maintenance program. Some boards do not devote any time to reviewing the CIRA's reserve study, only having one prepared because it is required by State law. At the other end of the spectrum, inquiry of some reserve preparers may reveal that the CIRA board manipulated the reserve study to ensure that the funding amount was *acceptable* by the board. Auditors should be aware that inaccurate reserve studies may have a direct financial impact on the association, since relying on such faulty information can result in significant special assessments. CIRA managers often know

the physical complex better than anyone else and can be an valuable source of information about the reliability of the reserve study.

Although auditing standards require auditors to apply limited procedures to presentations of required supplementary information, the objective of the procedures differs significantly from the objective of procedures applied during an audit of financial statements. Since the limited procedures do not include examining evidence or testing to corroborate management's responses to auditors' inquiries, auditors do not have a basis for expressing an opinion on the required supplementary information itself. Rather, the auditors' reporting alternatives would be to either report on the information in relation to the basic financial statements taken as a whole if the procedures are sufficient to allow the auditor to express such an opinion or to disclaim an opinion on the supplementary information.

Smaller CIRAs or those that do not employ a managing agent may request auditors to assist their board of directors in preparing the required supplementary information. In those cases, the auditors could obtain the CIRA's acceptance of responsibility for the required supplementary information, preferably in writing. If the auditor provides much more than assembly-type assistance with an audit client's reserve study, he or she might consider whether they could be providing a nonattest service, as defined by Ethics Interpretation 101-3, by performing such work.

Auditors' Reports. In most cases, the CIRA's financial statements and required supplementary information will be presented in an auditor-submitted document and SAS No. 29 would apply. In rare circumstances when the financial statements and the required supplementary information appear in a client-prepared document, SAS No. 8 would apply. While the auditor does not ordinarily express an opinion on the required supplementary information, the AICPA guide at Paragraph 7.124 states that he or she may subject the supplementary information to certain auditing procedures in conjunction with the audit of the financial statements. If the procedures are sufficient to enable the auditor to express an opinion on whether the information is fairly stated in all material respects in relation to the financial statements taken as a whole, the auditor may expand the audit report in accordance with SAS No. 8 (AU 550.07).

Generally, however, the required supplementary information on future major repairs and replacements is not ordinarily susceptible to the auditing procedures applied in the audit of the basic financial statements, and the limited procedures required by AU 558.07 and the AICPA guide would not be sufficient to enable the auditor to express an opinion on the required supplementary information in relation to the basic financial statements.

Regardless of whether the required supplementary information appears in a client-prepared or auditor-submitted document, AU 558.08 requires auditors to add an explanatory paragraph to their report on the basic financial statements in the following circumstances:

- The supplementary information that GAAP requires to be presented is omitted. However, auditors need not present the required supplementary information if the CIRA omits it.
- The auditors have concluded that the required supplementary information departs materially from prescribed guidelines.
- The auditors are unable to complete the prescribed procedures. Although auditors are unable to complete the procedures, if they conclude that the information has not been measured or presented in conformity with the guidelines in the AICPA guide, the auditor should suggest appropriate revision; if the CIRA refuses to revise it, the auditors should describe the nature of any material departures in their report.
- The auditors are unable to remove substantial doubts about whether the required supplementary information conforms to prescribed guidelines.

The explanatory paragraph may either precede or follow the opinion paragraph of the auditors' standard report. However, since required supplementary information is not part of the basic financial statements and is not necessary for the financial statements to be presented in conformity with generally accepted accounting principles, none of the preceding circumstances preclude auditors from expressing an unqualified opinion on the basic financial statements.

Proposed SAS on Required Supplementary Information. In January 2009, the Auditing Standards Board issued an exposure draft of a proposed SAS titled *Required Supplementary Information*, which would supersede the requirements of SAS Nos. 29 and 52. The proposed SAS carries forward the requirement of the existing auditing standards that the auditor apply specified limited procedures with respect to the required supplementary information, however, it requires the auditor to obtain written representations from management regarding the information. (SAS No. 52 currently states that the auditor should consider obtaining written representations, but they are not required.) The reporting requirements in the proposed standard are similar to those in the existing standards; however, the language of the auditor's explanatory paragraph in the proposed standard more clearly communicates the auditor's responsibility for the information. An example of an explanatory paragraph on required supplementary information that would be included in the auditor's report on the financial statements when required supplementary information is presented is as follows:

> Accounting principles generally accepted in the United States of America require that the supplementary information about [Identify the Supplementary Information] on page XX be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by [Identify the Accounting Standard setter who requires the information to be presented] who considers it to be an essential part of financial reporting and for placing the basic financial statements and related notes in an appropriate operational, economic, or historical context. We have applied certain limited procedures, which consisted of inquiries of management and other limited procedures as prescribed by auditing standards generally accepted in the United States of America, regarding the methods of measurement and presentation of the required supplementary. These limited procedures do not provide us with evidence sufficient to express an opinion or any other form of assurance on the information.

The comment period on the exposure draft ended in May 2009, and the ASB expects to finalize the standard in the fourth quarter of 2009 to be effective for periods beginning on or after December 15, 2009. Auditors should be alert for the issuance of a final standard.

Required Supplementary Information Presented in a Note to the Financial Statements

According to the AICPA guide, CIRAs should disclose the required supplementary information about future major repairs and replacements outside of the basic financial statements. Nevertheless, some state statutes currently require some of that information to be presented in the notes to the financial statements. SAS No. 52 does not prohibit placing the required supplementary information in the notes to the financial statements and states, in that situation, that the note should be marked "Unaudited." For example, certain state statutes require changes in replacement fund balances allocated to each common property component to be disclosed in the notes to the financial statements. Thus, some CIRAs may present the preceding information in the notes to the financial statements and the estimated remaining useful lives and estimated replacement cost of each common property component in a supplementary schedule outside of the basic financial statements.

CIRAs Involved with HUD Reporting

If the CIRA is involved in a not-for-profit or a for-profit multifamily housing program and is receiving financial assistance from HUD, the HUD reporting and audit requirements for such programs mandate that a hardcopy of the financial data schedule (this is a template used to submit financial information electronically to HUD's financial assessment subsystem) be included with the basic financial statements and reported on by the auditor in accordance with SAS No. 29. Since the financial data schedule is outside the basic financial statements, auditors should report on this information as it relates to the financial statements taken as a whole.

Other Information in Electronic Sites Containing Audited Financial Statements

When a CIRA makes its audited financial statements (including the auditors' report) available on its Internet site, electronic bulletin boards, or similar venues, auditors may question their responsibility with respect to other information in those electronic sites. An auditing interpretation at AU 9550.16, "Other Information in Electronic Sites Containing Audited Financial Statements," clarifies the issue, noting that electronic sites are not "documents" as

the term is used in SAS No. 8 (AU 550). Thus, auditors are not required to read information contained in the sites or consider the consistency of the other information in the sites with the original documents.

Auditors may be requested by their clients to provide other services with respect to information in electronic sites. The interpretation indicates that, in that situation, the auditors should refer to guidance for applying agreed-upon procedures.

SELF-STUDY QUIZ

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

35. Identify the answer that is correct concerning the drafting of financial statements and the auditor's report.

    a. It is common for auditors to assist in the drafting of the financial statements, but doing so transfers the responsibility for the financial statements to the auditor.

    b. Auditors can draft the financial statements, but doing so may cause a material weakness or significant deficiency in internal control.

    c. The notes to the financial statements are ancillary to the financial statements, rather than being a fundamental part of the financial statements.

    d. If a CIRA's financial statements have been based on fund accounting, prior-year statements are not required to include the detail that GAAP requires.

36. Select the item that is accurate concerning a CIRA's financial statements, supplementary information, and the auditor's report.

    a. A CIRA may present information that supplements the financial statements, but auditors are prohibited from expressing assurance on some of the information and disclaiming an opinion on the remainder.

    b. A CIRA's financial statements may include a comparison of budget information with actual results for the period but only if the current year actual financials are compared with the budget for the same period.

    c. The AICPA guide requires CIRAs to disclose specific supplementary information about future major repairs and replacements of common property, but the information is not a component of the basic financial statements.

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.)**

35. Identify the answer that is correct concerning the drafting of financial statements and the auditor's report. **(Page 359)**

    a. It is common for auditors to assist in the drafting of the financial statements, but doing so transfers the responsibility for the financial statements to the auditor. [This answer is incorrect. Regardless of who prepares the financial statements, management must accept responsibility for the financials in the management representation letter.]

    b. Auditors can draft the financial statements, but doing so may cause a material weakness or significant deficiency in internal control. [This answer is correct. According to SAS 115, *Communicating Internal Control Related Matters Identified in an Audit*, if the auditors are involved in preparing the CIRA's financial statements, this could be a significant deficiency or material weakness in internal control. The auditors must inform management and the governing parties (e.g., board of directors) in writing that this is the case. Management must include their understanding of this point in its management representation letter.]

    c. The notes to the financial statements are ancillary to the financial statements, rather than being a fundamental part of the financial statements. [This answer is incorrect. The notes to the financial statements are integral to the financial statements. Financial statement disclosures are typically tested when the related information is tested.]

    d. If a CIRA's financial statements have been based on fund accounting, prior-year statements are not required to include the detail that GAAP requires. [This answer is incorrect. If auditors are to express an unqualified opinion on the CIRA's prior-period financial statements, the prior-year statements should include all of the details required by GAAP.]

36. Select the item that is accurate concerning a CIRA's financial statements, supplementary information, and the auditor's report. **(Page 364)**

    a. A CIRA may present information that supplements the financial statements, but auditors are prohibited from expressing assurance on some of the information and disclaiming an opinion on the remainder. [This answer is incorrect. Auditors are permitted under SAS 29 (AU 551) to report on supplementary information if the reporting complies with one of three options the SAS articulates.]

    b. A CIRA's financial statements may include a comparison of budget information with actual results for the period but only if the current year actual financials are compared with the budget for the same period. [This answer is incorrect. It is true that a budget comparison is permitted if the budget covers the same period as the historical financial statements. However, there is another permissible presentation. The current year actual results can be compared with the budget for the next year. For example the financial statements for the year ended December 31, 20X2 includes the CIRA's 20X3 budget.]

    c. The AICPA guide requires CIRAs to disclose specific supplementary information about future major repairs and replacements of common property, but the information is not a component of the basic financial statements. [This answer is correct. Paragraph 4.33 of the AICPA guide specifically requires that the supplementary information on future major repairs and replacements of its common property be supplementary information outside the basic financial statements. The supplementary information must include (1) certain specific information on estimates of current or future costs of future major repairs and replacements of all existing components and (2) a presentation of other specifically required information on the components to be repaired and replaced, such as estimates of the remaining useful lives of the components.]

CLIENT COMMUNICATIONS

Communicating Internal Control Related Matters Under SAS No. 115

SAS No. 115 (AU 325), *Communicating Internal Control Related Matters Identified in an Audit*, (which supersedes SAS No. 112 effective for audits of financial statements for periods ending on or after December 15, 2009, with early implementation permitted) establishes requirements for auditors to communicate certain control deficiencies including control deficiencies in a management agent's internal control, that they have identified during the audit. Control deficiencies which, in the auditor's judgment, are *significant deficiencies* or *material weaknesses* must be communicated in a written report.

SAS No. 115 establishes two unconditional requirements:

- The auditor must evaluate identified control deficiencies and determine whether, individually or in combination, they are significant deficiencies or material weaknesses.

- The auditor must communicate, in writing, to management and those charged with governance all significant deficiencies or material weaknesses identified during the audit, including those communicated in prior audits if they have not been corrected.

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

Identifying Control Deficiencies. SAS No. 115 indicates "a control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis." A control deficiency may be either a deficiency in design or a deficiency in operation.

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

Evaluating Control Deficiencies. Although there is no requirement to search for control deficiencies to report, the auditor is required to evaluate identified control deficiencies to determine if they are significant deficiencies or material weaknesses. SAS No. 115 requires auditors to evaluate control deficiencies individually and in the aggregate by significant account balance, disclosure, relevant assertion, and component of internal control. This is because multiple control deficiencies that affect the same financial statement account balance or disclosure increase the likelihood of misstatement and may, in combination, constitute a significant deficiency or material weakness even though they are individually insignificant.

Significant Deficiency. According to SAS No. 115 (AU 325.05), a *significant deficiency* is "a deficiency, or combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance." Identified control deficiencies should be evaluated to determine whether they are significant deficiencies or material weaknesses.

Material Weakness. A *material weakness* is defined by SAS No. 115 (AU 325.06) as a "deficiency, or combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected in a timely basis." SAS No. 115 (AU 325) requires auditors to separately identify significant deficiencies and material weaknesses. The difference between a significant deficiency and a material weakness is the severity of the control deficiency when evaluated individually or in combination with other deficiencies. The severity of an identified control deficiency depends on (a) the magnitude of the potential misstatement resulting from the deficiency or deficiencies and (b) whether there is a

reasonable possibility that the entity's controls will fail to prevent, or detect and correct, a misstatement of an account balance or disclosure.

When evaluating the severity of an identified control deficiency under SAS No. 115, most auditors might begin by considering whether an identified control deficiency should be considered a material weakness. If not, they will consider its severity to determine whether it should be communicated to management as a significant deficiency. Unlike judgments about materiality, which can affect whether a client's financial statements are fairly presented (and, thus, the auditor's report), the auditor's judgment about the severity of an identified control deficiency affects only whether the auditor communicates the significant deficiency or material weakness to the client. Therefore, when in doubt, best practices indicate communicating it to the client.

Examples of Deficiencies. A control deficiency may be either a deficiency in design or a deficiency in operation. A *deficiency in design* exists when a control necessary to meet the control objectives is missing or an existing control is not properly designed so that, even if it operates as designed, the control objective would not be met. A *deficiency in operation* exists when a properly designed control does not operate as designed or when the person performing the control lacks the necessary authority or qualifications to perform the control effectively. Exhibit 2-5 lists examples from SAS No. 115 for both deficiencies in design and deficiencies in operation. While SAS No. 115 distinguishes between the two types of control deficiencies, there is no requirement to indicate in the communication to management and those charged with governance which are deficiencies in design and which are deficiencies in operation. The examples in the exhibit may be control deficiencies, significant deficiencies, or material weaknesses.

Exhibit 2-5

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

Deficiencies in the Design of Controls

- Inadequate design of internal control over financial statements.
- Inadequate design of internal control over a significant account or process.
- Inadequate documentation of the internal control components.
- Insufficient control consciousness within the association, e.g., the tone at the top and the control environment.
- Absent or inadequate segregation of duties within a significant account or process.
- Absent or inadequate controls over the safeguarding of assets (this applies to controls that the auditor determines would be necessary for effective internal control over financial reporting).
- Inadequate design of information technology (IT) general and application controls that prevent the information system from providing complete and accurate information consistent with financial reporting objectives and current needs.
- Employees or management lack the qualifications and training to fulfill their assigned functions. For example, the person responsible for the accounting and reporting function lacks the skills and knowledge to apply GAAP in recording transactions or preparing the financial statements.
- Inadequate design of monitoring controls used to assess the design and operating effectiveness of internal control over time.
- The absence of an internal process to report deficiencies in internal control to management on a timely basis.

Failures in the Operation of Internal Control

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

* * *

Factors to Consider When Evaluating Control Deficiencies. The auditor considers both the likelihood and magnitude of potential misstatement when evaluating control deficiencies. If, in the auditor's professional judgment, the likelihood that a misstatement could have occurred because of a control deficiency is remote, the auditor can conclude that the control deficiency does not rise to the level of a significant deficiency or material weakness. Accordingly, the magnitude of the misstatement does not matter. If, however, the auditor believes that it is at least reasonably possible that a misstatement could occur because of a control deficiency, the auditor should also evaluate the magnitude of the deficiency to determine whether it results in a significant deficiency or material weakness. In evaluating the likelihood of a misstatement, the auditor might consider risk factors such as:

- The nature of the accounts, disclosures, and assertions involved, e.g., suspense accounts may present more risk.
- Susceptibility of the related assets or liabilities to loss or fraud.
- The complexity, subjectivity, and extent of judgment needed to determine the amount involved.
- The frequency and cause of exceptions related to a control's operating effectiveness.
- The relationship and interaction of the control with other controls.
- Interaction of the control deficiency with other control deficiencies.
- Possible future consequences of the deficiency.

Indicators of Material Weaknesses. According to SAS No.115, the following conditions are indicators of material weaknesses:

- Identification of fraud, whether or not material, on the part of senior management.

- Restatement of previously issued financial statements to reflect the correction of a material misstatement due to error or fraud.

- Identification by the auditor of a material misstatement of the financial statements under audit in circumstances indicating that the misstatement would not have been detected by the entity's internal control.

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

Can the Auditor Prepare the Financial Statements? A question that frequently arises is whether auditors can prepare the client's financial statements without having to report a significant deficiency or material weakness. Asking the auditor to draft financial statements does not cause a control deficiency. However, it may be the result of a control deficiency. The intent of SAS No. 115 is not to prevent auditors from preparing the client's financial statements. Instead, the issue to be considered when determining if a significant deficiency or material weakness exists is whether the client is capable of preparing the financial statements and has the skills and competencies necessary to prevent, detect, and correct a material misstatement. A system of internal control over financial reporting includes controls over financial statement preparation, including note disclosures. A control deficiency exists when the client does not have controls over preparation of the financial statements that would prevent or detect a misstatement in the financial statements.

If the client is not capable of preparing the financial statements and lacks the skills and competencies to prevent, detect, and correct a misstatement, the client has a control deficiency that is probably a material weakness. The auditor can still prepare the financial statements but the material weakness must be communicated to those charged with governance. The fact that the auditor prepares the financial statements may mean they are correct, but it doesn't eliminate the control deficiency because an auditor cannot be considered part of the client's internal control. Thus, controls over the financial statement preparation function that exist in the auditor's firm cannot be considered. Only the controls the client has in place can be considered in determining whether there is a control deficiency and its severity. (However, a CPA firm other than the auditor's firm can be part of the client's internal control, and those controls could be considered.)

It is important for the client to know that even if the auditor prepares the financial statements and the related notes, the client remains responsible for them. The authors recommend that the auditor clearly communicate to management and those charged with governance that the financial statements are the responsibility of management. Further, management and those charged with governance need to be made aware of the possible consequences of not correcting control deficiencies.

Another way of looking at the issue is to consider whether the client has sufficient knowledge to identify a material misstatement in the auditor-prepared financial statements. If the auditor gave financial statements to a CIRA client knowing that they contained material errors, would the client have controls in place that would detect those misstatements? For example, would the client recognize a misstatement in the income tax accrual, identify an error in the recording of transfers to the repair and replacement fund, or notice that an important disclosure had been omitted from the notes to the financial statements? If the answer to questions such as these is "no," the authors believe the client lacks the skills and competencies to prevent, detect, and correct a misstatement and, therefore, has a control deficiency that is probably a material weaknesses.

It is important to distinguish between the auditor's responsibilities under the AICPA Ethics Rules and SAS No. 112. Ethics Rule 101 requires independence in performance of an audit. According to Ethics Interpretation 101-3, *Performance of Nonattest Services*, before auditors perform nonattest services, they should determine that the requirements of 101-3 have been met. The determination of auditor independence is totally separate from the evaluation of whether there is a control deficiency. Even though the auditor can prepare financial statements and maintain independence under the ethics rules, there could be a control deficiency. It is important to note that there are two levels of understanding of accounting and financial reporting required by SAS No. 115 and Interpretation 101-3. Under SAS No. 115, the issue to be considered is whether the client is capable of performing accounting functions and preparing the financial statements and has the skills and competencies necessary to prevent, detect, and correct a misstatement. Under Interpretation 101-3, the auditor may assist management in performing man-

agement functions or making management decisions if they meet certain criteria. Among those criteria, Interpretation 101-3 allows clients to designate an individual who possesses suitable skill, knowledge, or experience, preferably within senior management, to oversee nonattest services. Possessing suitable skill, knowledge, or experience to oversee a service requires a lower level of technical knowledge than the competence criteria in SAS No. 115.

Under Ethics Interpretation 101-3, establishing and maintaining (or functioning as) the client's internal controls would impair the auditor's independence. However, proposing journal entries or preparing the client's financial statements would not automatically impair independence. As a practical matter, small and midsize entities typically view proposing journal entries and preparing financial statements as part of the audit.

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

Auditor Identifies Misstatements in the Financial Statements. During the course of an audit, an auditor might identify (and propose adjustments to correct) any number of errors, some of which may be material to the CIRA's financial statements. SAS No. 115 states that the auditor's identification of a material misstatement of the financial statements in circumstances that indicate that it would not have been identified by the entity's internal control is an indicator of a material weakness. Therefore, whenever the auditor identifies a material misstatement in the financial statements, he or she should evaluate whether the control deficiency that allowed the misstatement to occur represents a material weakness or a significant deficiency.

If an auditor identifies a misstatement that is less than material, best practices indicate that the auditor also should evaluate whether the control deficiency that allowed the misstatement to occur represents a control deficiency, a significant deficiency, or a material weakness. If the auditor determines the control deficiency is, individually or when aggregated with other deficiencies, a significant deficiency or a material weakness, SAS No. 115 requires the auditor to communicate the deficiencies to the appropriate parties.

Aggregation of Deficiencies. SAS No. 115 requires auditors to evaluate control deficiencies both individually and in the aggregate by significant account balance, disclosure, and component of internal control to determine whether they represent a significant deficiency or material weakness on an aggregate basis. For example, an auditor may consider several control deficiencies in and of themselves insignificant and, thus, only a control deficiency. However, if those control deficiencies are all related (for example, they all relate to investments), the requirement in SAS No. 115 to aggregate control deficiencies by significant account might cause the auditor to consider them a significant deficiency or a material weakness when aggregated.

Mitigating Effects of Compensating Controls. The auditor's focus is generally on controls that work. When the auditor identifies deficiencies in controls, there may be redundant controls that achieve the same objectives or mitigating controls that limit the severity of the control deficiencies. When a control deficiency has been identified, the auditor should evaluate the possible mitigating effects of any compensating controls. Compensating controls should be evaluated to determine if they mitigate the severity of a control deficiency such that it does not rise to the level of a significant deficiency or material weakness. Compensating controls that the auditor tests and evaluates as part of the audit may be considered for possible mitigating effects. However, even though a deficiency does not rise to the level of a significant deficiency, the control deficiency still exists. Compensating controls can only mitigate—not eliminate—a control deficiency.

Redundant Controls. *Redundant controls* are controls that duplicate other controls and achieve the same objectives. Unlike compensating controls, redundant controls can eliminate a control deficiency. Therefore, if a CIRA client has a control that is not properly designed and operating, but a redundant control achieves the same objectives as the deficient control, the auditor can test the design and operating effectiveness of the redundant control. If the redundant control is found to be effective, the auditor can conclude that there is no control deficiency.

Prudent Official Assessment. SAS No. 115 requires auditors to consider whether prudent officials, having knowledge of the same facts and circumstances, would agree with the auditor's conclusion that an identified deficiency is not a material weakness. In other words, would a prudent official, knowing what the auditor knows

about the facts and circumstances, other controls tested, and the likelihood and magnitude of potential misstatement, agree with the auditor's conclusion that a deficiency is not a material weakness? The SAS does not define the term *prudent official*. Instead, the intent is for the auditor to take a final, objective look at the severity of the deficiency similar to what a regulator or someone in an agency oversight role would do. This objective consideration is used only to gauge whether the judged severity of a control deficiency should be increased—not to justify a decrease in the severity.

Communication Requirements. The auditor must communicate significant deficiencies and material weaknesses identified during the audit, including significant deficiencies and material weaknesses in a managing agent's internal control, in writing to management and those charged with governance. The communication is best made by the report release date but, in any case, should be made within 60 days of that date. The report release date is defined in SAS No. 103, (AU 339) *Audit Documentation*, as the date that the auditor grants the entity permission to use the auditor's report in connection with the financial statements.

SAS No. 103 defines *those charged with governance* as the persons responsible for overseeing the strategic direction of the entity and obligations related to the accountability of the entity, including oversight of the financial reporting and disclosure process. In a CIRA, those charged with governance may include the CIRA's board of directors, audit committee (if any), and the management company.

SAS No. 115 requires significant deficiencies and material weaknesses reported in prior years that still exist to be reported again. The authors believe there should be an indication that the same comments were made in prior communications. For convenience, such comments may be presented separately from new comments under a heading such as "Significant Deficiencies Communicated in Prior Years." Prior-year comments typically are presented after new comments. The communication may merely refer to the previously-issued communication and its date.

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

Reporting When There Are No Significant Deficiencies. To prevent potential misunderstandings, SAS No. 115 prohibits the auditor from issuing a written communication stating that no significant deficiencies were noted during the audit. Therefore, if no significant deficiencies or material weaknesses were identified in an audit engagement, no SAS No. 115 communication would be provided to the client. Even though there may be no significant deficiencies, less serious control deficiencies may still exist, and SAS No. 115 does not preclude auditors from communicating those to management. The form of communication is not subject to the requirements of SAS No. 115. Accordingly, auditors may want to include the deficiencies in a separate communication such as a management letter.

Reporting When There Are No Material Weaknesses. The auditors' communication of significant deficiencies may indicate that no material weaknesses were noted. Thus, auditors may discuss the absence of *material weaknesses* but not the absence of *significant deficiencies*.

Management Letters. During the audit, the auditors may identify control deficiencies they do not consider to be significant deficiencies or material weaknesses. In addition, other suggestions on how to improve administrative or other functions (for example, legal requirements, operational efficiencies, and tax strategies) may be identified. There is no requirement to communicate these other control deficiencies. However, if the auditor decides to communicate such matters, SAS No. 115 (AU 325) indicates that the communication can be made orally; however, any oral communications should be documented in the audit workpapers. All such matters are sometimes called management points, and as a matter of client service, most auditors take time to educate and inform the client by preparing a formal "management letter."

Communication with Those Charged with Governance

SAS No. 114, *The Auditor's Communication With Those Charged With Governance*, establishes the following unconditional communication responsibility:

> The auditor must communicate with those charged with governance matters related to the financial statement audit that are, in the auditor's professional judgment, significant and relevant to the responsibilities of those charged with governance in overseeing the financial reporting process. (SAS No. 114, Paragraph 5)

The communication requirements of SAS No. 114 apply to all entities, regardless of their governance structure or size. However, the standard does provide specific considerations for situations where all of those charged with governance are also involved in managing the entity. SAS No. 114 does not establish requirements for communication with management or owners unless they are also charged with a governance role.

The term "those charged with governance" replaces references in prior SASs to the board of directors or audit committee, but is much broader in scope. It includes all "person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process." (SAS No. 114, Paragraph 3)

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

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

a. The auditor's responsibilities under generally accepted auditing standards.

b. An overview of the planned scope and timing of the audit.

c. Significant findings from the audit.

Responsibilities Under GAAS. The auditor should communicate the following matters:

a. The auditor is responsible for forming and expressing an opinion about whether the financial statements are presented fairly, in all material respects, in conformity with GAAP.

b. The audit of the financial statements does not relieve management or those charged with governance of their responsibilities.

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

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

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

a. *Qualitative Aspects of the Entity's Significant Accounting Practices.* The appropriateness of the accounting policies to the particular circumstances of the CIRA, management's process for identifying and making significant estimates, and the neutrality, consistency, and clarity of disclosures. If the auditor considers a significant accounting practice to be inappropriate, the auditor should explain why and request changes.

b. *Significant Difficulties Encountered During the Audit.* Explicit and implicit restrictions imposed by management, including significant delays in providing required information, unavailability of expected

information, an unnecessarily brief time to complete the audit, or unexpected effort to obtain sufficient, appropriate audit evidence.

c. *Uncorrected Misstatements.* The effect that individual uncorrected misstatements from the current and prior period may have on the opinion, and the implications of failing to correct, considering qualitative as well as quantitative factors.

d. *Disagreements with Management.* Whether or not satisfactorily resolved, differences with management about application of accounting principles, audit scope, or reporting disclosures, and similar matters that individually or in the aggregate could be significant to the CIRA's financial statements or the auditor's report.

e. *Independence.* Circumstances or relationships that in the auditor's professional judgment may reasonably be thought to bear on independence. (SAS No. 114 does not mandate this communication, but states the auditor "may determine" it is appropriate.)

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

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

a. *Material Corrected Misstatements.* Misstatements brought to the attention of management as a result of auditing procedures.

b. *Representations Requested from Management.* This may be done by providing a copy of the written representations obtained from management.

c. *Management's Consultations with Other Accountants.* The auditor's views about significant accounting or auditing matters that were the subject of consultation.

d. *Significant Issues Discussed, or Subject to Correspondence with, Management.* Issues such as application of accounting principles and auditing standards; and business conditions, plans or strategies that may affect the risks of material misstatement.

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

SAS No. 114 does not change the following communication requirements of other SASs:

a. SAS No. 54 (AU 317.17), *Illegal Acts by Clients*, to communicate with the audit committee, or others with equivalent authority and responsibility, illegal acts.

b. SAS No. 99 (AU 316.22), *Consideration of Fraud in a Financial Statement Audit*, to inquire directly of the audit committee (or at least its chairman) regarding its views on risks of fraud and knowledge of fraud or suspected fraud.

c. SAS No. 99 (AU 316.79), to communicate with those charged with governance all fraud involving senior management and any other fraud that causes a material misstatement on the financial statements.

d. SAS No. 112 (AU 325.20), *Communicating Internal Control Related Matters Identified in an Audit*, to communicate in writing to management and those charged with governance control deficiencies that are considered significant deficiencies or material weakness.

e. SAS No. 59 (AU 341.17), *An Entity's Ability to Continue as a Going Concern*, the effects on the audit report and financial statement disclosures, as well as the nature of conditions and events identified, when the auditor concludes there is a substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.

Documentation of Communications. SAS No. 114 requires the auditor to document matters that have been communicated orally. This documentation may include a copy of minutes prepared by the entity. When matters have been communicated in writing, the auditor should retain a copy of the communication.

Fraud and Illegal Acts

SAS No. 54 (AU 317), *Illegal Acts by Clients*, imposes detection and communication responsibilities for illegal acts, that is, for violations of laws and regulations that have a *direct and material* effect on the determination of financial statement amounts. (Federal income tax status governing CIRAs, for example, contain laws and regulators that could have a direct and possibly material effect on the financial statements.) SAS No. 54 imposes lesser responsibilities for *detection* of illegal acts having *material but indirect* effects on the determination of financial statement amounts (the auditor only need be aware of the possibility that they may have occurred) and establishes communication responsibilities for those acts.

When the auditor is confronted with a discrepancy between the accounting records and other evidential matter (for example, no supporting documentation or no apparent authorization for a transaction, or discovery of documents for transactions that are not recorded), the auditor needs to consider how and why they might have occurred and investigate further. If the investigation leads the auditor to believe there may have been fraud or an illegal act, he or she should:

a. Obtain an understanding of the matter and other sufficient information to evaluate the possible effects on the financial statements and the auditor's report, including the need for adjustments and for disclosure of illegal acts and any related contingencies, or the need for a report modification if necessary financial statement adjustments or disclosures are not made or because of a scope limitation).

b. Consider the implications for other aspects of the audit, for example, reliance on management's representations.

c. Discuss the matter and the need for any further investigation with an appropriate level of management at least one level above those involved.

d. Consult with the CIRA's legal counsel (or suggest that the CIRA consult with legal counsel as appropriate) on any questions of law and on the course of action the client should take.

In the rare event that management is not willing to follow sound legal advice about fraud or illegal acts, the auditor should seek the recommendation of a lawyer on his or her own legal responsibilities, including possible withdrawal from the engagement. The auditor should of course carefully document all communications related to the matter and its disposition.

Fair Housing Amendments Act of 1988 (Public Law 100-430). The Act prohibits discrimination in housing on the basis of handicap or familial status. (There are certain exemptions for housing of older persons.) Under the law, unlawful discrimination is subject to fines. Because the Fair Housing Act does not directly affect the determination of financial statement amounts, however, a CIRA's noncompliance with the Act usually is regarded as having a material but indirect effect on its financial statements. Accordingly, auditors should be aware of the possibility that such illegal acts may have occurred but would not be required to test for noncompliance with the Act. If specific information comes to the auditors' attention that provides evidence concerning the existence of possible illegal acts that could have a material indirect effect on the financial statements, they should apply procedures specifically directed to ascertaining whether the illegal act has occurred. However, because of the characteristics of such illegal acts, an audit provides no assurance that they will be detected or that any contingent liabilities that may result will be disclosed.

Notwithstanding auditors' lesser responsibility for detection of noncompliance with laws and regulations that have an indirect effect on financial statements, some accountants choose to determine (through inquiry or inspection of

the governing documents) whether the CIRA qualifies for exemption from the Act. A CIRA is exempt from the Act if it meets one of the following criteria:

- The housing is under a federal or state program specifically designed to house elderly persons.
- The housing is intended for *and* occupied exclusively by persons age 62 and older. (The CIRA's Declaration of Covenants, Conditions, and Restrictions must make that restriction explicit.)
- The housing is intended for and operated for residents age 55 or older and meets *both* of the following criteria:
  - 80% of the units are occupied by at least one person age 55 or older.
  - There must be a published policy or covenant demonstrating an adherence to a policy that assures the development is intended as housing for persons age 55 and older.

H.R. 660, eliminated the "significant facilities and services" requirement from the Act. It also protects violators of the Fair Housing Act from monetary damages if they followed, in good faith, the Act's housing for older persons exemption.

Communication about Fraud. SAS No. 54 requires the auditor to be sure that the audit committee (or others with equivalent authority and responsibility such as the board of directors or management company) is adequately informed about any illegal acts, unless clearly inconsequential, that come to the auditor's attention. If the auditor determines there is evidence that fraud may exist (even if the matter is inconsequential), SAS No. 99 (AU 316.79) requires the auditor to report it to the appropriate level of management. If the fraud or potential fraud involves senior management or causes the financial statements to be materially misstated, it should be reported directly to those charged with governance. Auditors are also required to reach an understanding with those charged with governance about the nature and extent of communication about misappropriations committed by lower level employees.

Both SAS No. 54 and SAS No. 99 state that the auditor ordinarily is not responsible for disclosing fraud or other illegal acts to parties other than senior management and its audit committee. However, state laws may require communication of certain illegal acts.

Communication about the CIRA's Ability to Continue as a Going Concern

SAS No. 114 amends SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, to require the auditor to communicate with those charged with governance events or conditions that, when considered in the aggregate, indicate a substantial doubt about the CIRA's ability to continue as a going concern for a reasonable period of time. The auditor should communicate the following to those charged with governance (AU 341.17):

- The nature of the events or conditions identified.
- The possible effect on the financial statements and the adequacy of related disclosures in the financial statements.
- The effects on the auditor's report.

ENGAGEMENT SUMMARY MEMORANDUM

Some CPA firms, especially those that are larger, have found that preparing a memorandum summarizing the significant accounting and auditing issues that arose and how they were resolved is helpful. Those who favor the memorandum believe it forces auditors to reconsider whether they performed enough procedures and it facilitates the internal review of the working papers. However, for smaller audits, the time required to prepare the memorandum often is not justified, especially since the information included in an engagement summary memorandum can be found elsewhere in the workpapers.

ENGAGEMENT QUALITY CONTROL REVIEW

SQCS No. 7, *A Firm's System of Quality Control*, requires firms to establish criteria to determine which (if any) engagements are subject to an engagement quality control review (EQCR). If an engagement meets the criteria established by the firm, an EQCR should be performed and completed before the report is released. (Smaller firms may be challenged to perform engagement quality control reviews due to limited personnel resources. SQCS No. 7 states that sole practitioners or small firms may contract with qualified external individuals or firms to perform the EQCR function.)

Establishing Criteria for Engagement Quality Control Reviews

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

- Third-party use of the report, such as to the client's lender for financing purposes.
- High profile clients.
- Entities subject to governmental regulations.
- New types of service for the firm.
- New or complex specialized industries.
- Client entities without competent or experienced accounting personnel.
- Client entities with substantial fraud risk factors.
- Client entities with significant related party transactions.
- Clients that have experienced material misstatements during the current or previous engagements.
- First time clients.
- New firm partners.

Any circumstance that creates an unusual or a higher level of engagement risk should be considered in establishing EQCR criteria. Since EQCR criteria is based upon each firm's unique circumstances, firms should consider whether their established EQCR criteria need to change when firm circumstances change. The firm's quality control system should be a dynamic system that changes as the firm changes.

Firms define engagement quality control review criteria based upon the firm's unique circumstances (that is, structure and nature). In addition, for each type of service provided, the firm may consider a different set of EQCR criteria. In other words, the criteria established for audit engagements may differ significantly than for other types of attest engagements. Accordingly, some firms may establish criteria that result in more EQCRs being performed than other firms. Furthermore, firms may treat the same engagement differently for purposes of establishing engagement quality control review criteria. The key point is that EQCR criteria are as unique as the firm.

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

SELF-STUDY QUIZ

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

37. Denise, the auditor, is conducting a final review of the CIRA's financial statements and is confirming that issues that require client communication have been addressed. Which one of the following is **not** accurate regarding control deficiencies?

    a. Control deficiencies that the auditor considers to be *material weaknesses* must be communicated to the client in writing.

    b. Control deficiencies must be considered individually or in combinations to determine whether, in the auditor's judgment, the deficiencies are significant or material.

    c. An ineffectively designed control can result in a control deficiency.

    d. A *control deficiency exists* even if the employees performing their assigned functions can detect and prevent a misstatement on a timely basis.

38. Select the guidance that is accurate regarding control deficiencies and the requirements for communication under SAS 112.

    a. Assume the auditors believe a control is designed effectively but the CIRA's employees who perform the related function continue to make mistakes. There could still be a *control deficiency* if the employees are unable to prevent or detect mistakes that could cause a material misstatement.

    b. Auditors are required to search for control deficiencies throughout the audit.

    c. Auditors are required to distinguish between significant deficiencies in design and those that are deficiencies in operation in a written communication to the CIRA's management and board of directors.

39. What is a control deficiency that causes the entity to be unable to perform essential financial functions, including reporting financial data reliably in accord with GAAP, and there is greater than a remote likelihood that the entity's internal control will not detect or prevent a misstatement of the financial statements?

    a. Material weakness.

    b. Significant deficiency.

    c. Deficiency in operation

    d. Deficiency in design.

40. Select the item that is accurate concerning the auditors' communications about the audit.

    a. The auditor's written communication on significant deficiencies and material weaknesses must be provided to the CIRA's management and those charged with governance.

    b. The written communication from the auditor to the relevant CIRA officials should be made within 30 days of the report release date.

    c. An auditor can develop *management points* as a client service, but they cannot be communicated orally to the CIRA's in-house manager or managing agent.

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.)**

37. Denise, the auditor, is conducting a final review of the CIRA's financial statements and is confirming that issues that require client communication have been addressed. Which one of the following is **not** accurate regarding control deficiencies? **(Page 373)**

    a. Control deficiencies that the auditor considers to be *material weaknesses* must be communicated to the client in writing. [This answer is incorrect. It is a correct statement. SAS No. 115 (AU 325), *Communicating Internal Control Related Matters identified in an Audit*, requires that the auditor report in writing to the CIRA that in the auditor's judgment, there is a *material weakness*.]

    b. Control deficiencies must be considered individually or in combinations to determine whether, in the auditor's judgment, the deficiencies are significant or material. [This answer is incorrect. It is an accurate statement. This is an unconditional requirement of SAS 115.]

    c. An ineffectively designed control can result in a control deficiency. [This answer is incorrect. It is an accurate statement. A control deficiency is either a failure in design or the operation of a control.]

    d. A *control deficiency* exists even if the employees performing their assigned functions can detect and prevent a misstatement on a timely basis. [This answer is correct. It is an inaccurate statement. An essential portion of the definition of *control deficiency* is that a misstatement cannot be detected or prevented *on a timely basis.*]

38. Select the guidance that is accurate regarding control deficiencies and the requirements for communication under SAS 115. **(Page 373)**

    a. Assume the auditors believe a control is designed effectively but the CIRA's employees who perform the related function continue to make mistakes. There could still be a *control deficiency* if the employees are unable to prevent or detect mistakes that could cause a material misstatement. [This answer is correct. This is an example of a *control deficiency* that results from an operational failure to prevent or detect mistakes that could cause a material misstatement.]

    b. Auditors are required to search for control deficiencies throughout the audit. [This answer is incorrect. SAS does not require auditors to search for control deficiencies. However, if one is identified, it must be evaluated to determine if it is a significant deficiency or a material weakness.]

    c. Auditors are required to distinguish between significant deficiencies in design and those that are deficiencies in operation in a written communication to the CIRA's management and board of directors. [This answer is incorrect. SAS No. 115 distinguishes between the two types of control deficiencies, but there is no requirement to indicate in the communication to management and those charged with governance which are deficiencies in design and which are deficiencies in operations.]

39. What is a deficiency in internal control where there is not a reasonable possibility that financial statements will be misstated materially, yet important enough to merit attention by those charged with governance? **(Page 373)**

    a. Material weakness. [This answer is incorrect. A material weakness is defined by SAS No. 115 as a deficiency, or combination of deficiencies in internal control, such that there is a reasonable possibility that a material misstatement of the financial statements will not be prevented, or detected and corrected in a timely basis."]

    b. Significant deficiency. [This answer is correct. This is the correct definition as communicated in SAS No. 115. When a control deficiency is identified, it should be evaluated to determine whether it is a significant deficiency or material weakness.]

    c. Deficiency in operation. [This answer is incorrect. This exists when a properly designed control does not operate as designed or when the person performing the control lacks the necessary authority or qualifications to perform the control effectively.]

    d. Deficiency in design. [This answer is incorrect. This exists when a control necessary to meet the control objectives is missing or an existing control is not properly designed so that even if it operates as designed, the control objective is not always met.]

40. Select the item that is accurate concerning the auditors' communications about the audit. **(Page 378)**

    a. The auditor's written communication on significant deficiencies and material weaknesses must be provided to the CIRA's management and those charged with governance. [This answer is correct. In a CIRA, those charged with governance may include the CIRA's board of directors, audit committee, and the management company.]

    b. The written communication from the auditor to the relevant CIRA officials should be made within 30 days of the report release date. [This answer is incorrect. The written communication on significant deficiencies and material weaknesses should be made no later than 60 days of the report release date.]

    c. An auditor can develop *management points* as a client service, but they cannot be communicated orally to the CIRA's in-house manager or managing agent. [This answer is incorrect. *Management points* are a customer service and communicating them to the CIRA management is not required. If communicated, the auditor can do it orally but should document the audit workpapers accordingly.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (HOATG093)

Determine the best answer for each question below. Then mark your answer choice on the **Examination for CPE Credit Answer Sheet** located in the back of this workbook or by logging onto the Online Grading System.

17. Which of the following is correct concerning an auditor's focus when auditing a CIRA's commitments or contingencies for financial statement effect?

    a. The auditor is not expected to consider threatened litigation.

    b. The auditor is not required to inquire about unasserted claims, even if they are related to the developer.

    c. The auditor is concerned about open lines of credit.

    d. The auditor is concerned about short-term lease obligations.

18. Ann is auditing a CIRA and is planning the legal representation inquiries she will make and is researching how to evaluate attorney responses. Which of the following is accurate concerning such inquiries and responses?

    a. Ann does not need to send a letter to an attorney who signed one the previous year if he performed no services for the year being audited.

    b. If the attorney's response is later than the date requested, the auditor should request an updated letter if the response date is at all after the date requested.

    c. Attorney responses that include language that emphasizes retention of the attorney-client work product privilege are considered a limit of audit scope according to AU 9337.28–9337.29.

    d. Oral responses to written legal representation inquiries are not acceptable as audit evidence.

19. Select the item that is accurate regarding an auditor's procedures regarding a CIRA's potential environmental remediation liabilities?

    a. The auditor does not need to ask questions of the client regarding the potential for environmental liabilities if the previous owner was responsible for the hazardous disposal.

    b. The auditor needs to evaluate the potential for liability that could materially impact the financial statements if there is an *indication* that the CIRA may have violated environmental laws.

    c. Insurance companies have rewritten policies to provide policyholders with greater protection. This is relevant to the audit if mold claims are material to the financial statements.

    d. The auditor should not consider the environmental cleanup experiences of other CIRAs because hazardous disposal considerations are unique to each business.

20. SOP 94-6 requires disclosure of the following four categories of significant risks and uncertainties. Select the statement within choices a through d that is accurate regarding these four.

    i. Nature of operations

    ii Use of estimates in the preparation of financial statements

    iii Certain significant estimates

    iv. Current vulnerability resulting from certain concentrations

    a. i and iv are required of all CIRA financial statements.

    b. i and ii are required of all CIRA financial statements

    c. The thresholds for disclosures of iii and iv are the same, i.e., the threshold is *materiality*.

    d. iii requires little additional audit work because the information is readily available.

21. In most cases, a CIRA's disclosures of three of the following meet the disclosure requirements concerning the nature of its operations. Select the item that is the exception because it is only required under specific circumstances.

    a. Relative importance of significant revenue from nonmembers.

    b. The entity for which the CIRA provides services.

    c. The number of units in the CIRA.

    d. The areas the CIRA controls.

22. GAAP requires that some elements of the balance sheet be measured or disclosed at fair value. Select the item that is accurate regarding fair values and their use in the audit of a CIRA.

    a. The auditor is required by SAS 101 (AU 328), *Auditing Fair Value Measurements and Disclosures*, to develop an independent estimate of the fair value of material balance sheet accounts to compare to management's fair value conclusions.

    b. If management used a certified specialist to develop a valuation, the auditor's responsibility to test the assumptions is less than if management itself developed the valuation.

    c. In addition to preparing an independent estimate, the auditor may obtain evidence that supports a fair value estimate by reviewing subsequent events and transactions.

    d. The general economic environment is not used to determine whether a valuation is reasonable because it is not relevant enough to the CIRAs operations.

23. Items in the first column are significant to the conclusion of the audit of a CIRA. Select the best matching of the item in the first column (audit evidence or procedures) with the one in the second column (dates relevant to the terms in the first column).

Audit Evidence or Procedures	Relevant Dates
i. Subsequent events review	v. Should be dated as of the audit report date
ii Date of auditor's report	vi Should be as close as possible to the report date.
iii Lawyer's letter	vii Should have an effective date that is within two weeks of the report date
iv Management representation letter	viii Should be the date that sufficient audit evidence has been obtained to support the opinion on the financial statements

a. i and v

b. ii and vi

c. iii and vii

d. iv and viii

24. According to SFAS No. 57, which transaction in the following list is most likely to be a *related party transaction* that should be disclosed?

a. A CIRA's ten-year lease of office space from the chairman of the CIRA's board.

b. A short-term loan between two affiliated CIRAs that does not meet the materiality threshold the auditor established for the CIRA.

c. One-time lawn-mowing of the CIRA's common areas by a board member's son.

d. A sale of the fully depreciated furniture of moderate value that is used in the common clubhouse's library to a member of CIRA's management.

25. Which one of the following is **not** one of the elements of documentation that SAS No. 59 requires when conditions or events cause the auditor to have substantial doubt that the CIRA can continue as a *going concern* for a reasonable time?

a. The conditions that exist that led the auditor to this conclusion.

b. Steps management has taken in the last year to improve its chances of being a going concern for a reasonable period of time.

c. The possible effects of the auditor's report.

d. The auditing procedures and audit evidence obtained to evaluate whether management can overcome its adverse conditions that led to the auditor's substantial doubt about the business being a going concern.

26. The auditors are in the concluding phase of a CIRA's audit and are reviewing management's representation letter. All but one of the following situations violates the requirements of SAS No. 85 (AU 333.01), *Management Representations.* Which one is consistent with the SAS No. 85 requirements?

    a. The CIRA's management representation letter, signed by the chairman of the board, communicates that there were no related-party transactions during the year being audited. Because the CIRA is a small association, the auditors do not plan to perform procedures to determine whether there are undisclosed related-party transactions.

    b. If management's representations cannot be verified by current-year audit evidence, the auditor should not rely on the CIRA's history to form an opinion as to whether management's representations are valid.

    c. The management representations letter does not include the CIRA officials' acknowledgement that they are responsible for the financial statements.

    d. If management refuses to document its representations in writing, the auditors are required to take the position that there is a limitation on the audit scope sufficient to preclude the auditors from issuing an unqualified opinion.

27. The auditors are reviewing the management representation letter to determine whether all of SAS No. 85's requirements regarding the summary of uncorrected misstatements have been met. Select the item below that must be included in the summary.

    a. Management brings to the auditors' attention an uncorrected misstatement in the Abandoned or Foreclosed Units account of $15,000. This amount is less than the $20,000 Stephanie set as the amount below which amounts do not need to be included in the summary. The account is one that is typically of interest to those who depend on the statements.

    b. The CIRA's managing agent prepared the summary and aggregated an uncorrected mistake with other uncorrected misstatements. The CIRA's other management that signs the letter knows the amount but does not know the effect it has on the financial statements.

    c. The *turnaround effect* of the material uncorrected misstatements in the member assessment account the previous year.

    d. An uncorrected misstatement that exceeds the floor Stephanie has established and is material to the overall financial statements when netted with other uncorrected misstatements.

28. Select the item that is accurate about the requirements of SAS No. 85, *Management Representations* as they pertain to CIRAs.

    a. SAS 85 allows limitations on representations about the completeness of the financial records the client made available to the auditors.

    b. The management representations letter must explain the definition of materiality used for the content of the letter.

    c. For purposes of management's representations letter, the term *materiality* can have multiple definitions, depending on the representation being made.

    d. According to SAS No. 85, the auditors may not limit management's representations to those that are material to the financial statements.

29. When planning the CIRA's audit, the auditor determined that there was a low risk that assessments receivable would be materially misstated. The auditor determined the substantive procedures that should be performed based on the low risk assessment. In performing substantive procedures, the auditor detected more mistakes and of a higher amount than expected. Which one of the following is **least** likely to be an action the auditor would take in this situation?

    a. Evaluate whether the assessment of risks of material misstatement at the relevant assertion level is still appropriate.

    b. Obtain additional audit evidence to determine whether the original risk assessment was appropriate.

    c. Assume these identified errors are an isolated occurrence.

    d. If the original assessment of risk of material misstatement at the relevant assertion level is not valid, increase the extent of substantive procedures for the period under audit.

30. SAS No. 99 (AU 316), *Consideration of Fraud in a Financial Statement Audit*. Identify the item that accurately depicts requirements of this SAS or is otherwise a correct statement concerning identifying fraud in an audit.

    a. Throughout the audit, the auditor should evaluate the CIRA's responses to questions to determine whether they are vague, implausible, or inconsistent with other audit evidence and possibly indicative of fraud.

    b. Even if the CIRA's full year's information relating to revenue is available during audit planning, the substantive tests for material misstatement must be performed during planning and then updated during the final review stage of the audit.

    c. Adjustments the CIRA makes to accounts throughout the year that substantially affect financial results are relatively more indicative of fraud than adjustments made at the last minute.

    d. The auditor should expect to detect highest risks of material misstatement due to fraud when learning to understand internal controls and in performing procedures to assess the risks of material misstatement of the financial statements due to fraud.

31. Which one of the following conditions is **not** as likely as the others to be a situation that would cause the auditor to evaluate the business rationale to detect the possibility of fraud?

    a. A complex transaction between related parties that management brought to the auditor's attention during the planning stage of the audit.

    b. The CIRA's management is unusually concerned about a particular accounting treatment.

    c. Selling real estate or other assets to a related party that has not been identified as such previously.

    d. The approval of a particular manner of accounting for a particular transaction at a level higher than would be expected.

32. Select the best match between the first column (name of the analytical procedure) and the second column (the purpose or description of the analytical procedure).

Analytical Procedure	**Purpose**
i Final review analytical procedures	ii Applied to amounts before final adjustment
	iii To consider the adequacy of procedures already performed
	iv Comparison of prior period amounts at the final statement level.
	v Update of analytical procedures performed during the planning stage of the audit

a. i, iii and v

b. i, ii and iii

c. i, iv and v

d. i, iii, iv and v

33. Carol is to plan for the review of the workpapers near the conclusion of the audit. Select the item that is an **optional** step in the review process near the end of the audit engagement.

a. Detailed review of workpapers

b. Tax department review of workpapers

c. Supervisory review.

d. Checking for compliance with SAS 103 regarding documentation in the audit.

34. Which of the following is an accurate audit requirement for evaluating and summarizing relevant misstatements and their impact on the financial statements as a whole.

a. The auditor's focus should be on quantitative rather than qualitative factors.

b. If fraud is detected, the auditor should evaluate the implications, even if the effect on the financial statements is determined to be immaterial.

c. The process involves considering the following factors: the account category that was misstated (e.g., asset, liability, or equity); the cause of the misstatement; the amount of the audit difference, and the effect on the financial statements.

d. SAS No. 107 (AU 312.69) allows documentation of the effect of various misstatements to be summarized in the appropriate sections of the workpapers (i.e., assets, liabilities, and equity).

35. Select the item that is accurate concerning the CIRA's financial statements, supplementary information, and the auditor's report.

    a. The AICPA guide requires that a CIRA that is accumulating funds for future major repairs and replacements disclose in the financial statements that the accumulation is based on an estimate derived by averaging the current year's costs with the prior year's costs.

    b. A CIRA must have a funding policy that it describes in the notes to the financial statements.

    c. If a CIRA presents nonfinancial information supplementing the financial statements, the auditor cannot express assurance on the information because it will not have been tested by the auditors during the audit.

    d. The auditor's independence is compromised if the auditor is involved in the preparation of the financial statements, and the CIRA management does not acknowledge its responsibility for the financial statements.

36. Armando, the auditor, researched several issues on the topic of drafting the financial statements and the auditor's report. Which one of the following would be a correct answer found in the authoritative literature?

    a. If a CIRA that uses fund accounting, asks the auditor to express an opinion on the current year's information compared to the prior year's, the auditor needs to report on the comparative information even if it is summarized.

    b. The authoritative literature on prospective financial information applies when a budget for an unexpired period is included in the financial statements.

    c. SAS No. 52 (AU 558) does not require auditors to apply procedures to *required* supplementary information included in the CIRA's annual report to members if the report also includes the audited financial statements.

    d. If a CIRA posts its audited financial statements and the auditor's report on the internet, the auditors are required to read the other information the CIRA includes on its site and consider whether it is consistent with the original documents.

37. SAS 115, *Communicating Internal Control Related Matters Identified in an Audit*, identifies situations requiring important communications the auditor needs to have with the appropriate parties affiliated with the CIRA. Internal controls are at the heart of this issue. Which one of the following is consistent with SAS No. 115?

    a. If there is a control deficiency, the cause must be in the design or documentation of the control.

    b. *Significant deficiencies* and *material weaknesses* are distinct categories of control deficiencies, and once properly categorized, they do not move from one category to the other.

    c. Auditors are required to evaluate control deficiencies by account balance, relevant assertion, disclosure, and component of internal control.

    d. SAS 115 does not require the auditor to report in writing significant deficiencies and material weaknesses found in the current audit if they were properly reported with respect to a prior period.

38. Select the accurate item that correctly states a requirement or characteristic of SAS No. 115 or SAS No. 114.

    a. SAS No. 115 states that when the auditor communicates the significant deficiencies found during the audit, he or she may not indicate that no material weaknesses were noted.

    b. Based on SAS No. 115, the auditor must be careful not to orally communicate significant deficiencies and material weaknesses before the conclusion of the audit.

    c. SAS No. 114's (*The Auditor's Communication with Those Charged with Governance*), defines *those charged with governance* as the members of the CIRA's audit committee and board of directors.

    d. SAS No. 114 applies to all CIRAs, regardless of their governance structure or size.

39. Which one of the following is most likely **not** a control deficiency?

    a. The CIRA's internal accountant who prepares financial statements was an auditor herself years ago, but is not current on GAAP requirements.

    b. Adequate design of internal control over a significant account, and adequate documentation of the control.

    c. The CIRA's chairman of the board overrides the managing agent's application of internal controls.

    d. Communication regarding breakdowns in internal control are timely but are often incomplete with respect to the information the CIRA management needs to prevent a material misstatement of the financial statements.

40. Eric, the auditor, is conducting a final review of the CIRA's financial statements and is confirming that issues requiring client communication have been addressed correctly. Which one of the following is correct regarding auditor communications?

    a. Suggestions on how to improve administrative and other functions are to be reported in writing according to SAS No. 115.

    b. The auditor's responsibility under SAS 114 to communicate with *those charged with governance* is limited to the auditor's responsibilities under generally accepted auditing standards and the significant findings of the audit.

    c. Significant audit findings cannot be communicated orally to those charged with governance if the auditor believes this method would be adequate.

    d. SAS No. 115 does not allow the auditor to communicate in writing that no significant deficiencies were noted during the audit.

GLOSSARY

Accounting Estimate: An approximation of a financial statement element, item, or account in the absence of exact measurement.

Analytical Procedures: Evaluations of financial information made by a study and comparison of plausible relationships among both financial and nonfinancial data.

Ancillary Operations: Activities that associations do not enter into to generate profit, but to provide services to their members such as an association owned restaurant or golf course.

Appropriateness: The measure of the quality of audit evidence, that is, its relevance and its reliability in providing support for, or detecting misstatements in, the classes of transactions, account balances, and related assertions.

Audit Differences: Any differences noted between the accounting records and the evidence obtained during the audit, other than the closing entries.

Control Deficiency: Exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. It may be either a deficiency in design or a deficiency in operation.

Deficiency in Design: This exists when a control necessary to meet the control objectives is missing or an existing control is not properly designed so that even if it operates as designed, the control objective is not always met.

Deficiency in Operation: This exists when a properly designed control does not operate as designed or when the person performing the control lacks the necessary authority or qualifications to perform the control effectively.

Fair Housing Amendments Act of 1988: The Act prohibits discrimination in housing on the basis of handicap or familial status. Unlawful discrimination is subject to fines.

Final Review Analytical Procedures: Used to consider the adequacy of the procedures performed.

Flux Analysis: A narrative explanation by financial statement caption (line item) of the change in the amount from the prior period and of any unusual or unexpected relationships to other financial statement line items in the current period.

General Procedures: Other specific requirements to perform procedures that do not relate to particular account balances, such as sending a letter of audit inquiry to the client's lawyer.

Iron curtain Method: A methodology used to aggregate audit differences. This method focuses on the impact of misstatements on the audited balance sheet and considers the effect on current-period income of amounts needed to correct the balance sheet.

Magnitude of the Misstatement: The basic difference between a significant deficiency and a material weakness is the magnitude of the misstatement that could occur because of the failure of a control to prevent or detect a misstatement.

Management Bias: Whether differences between estimates best supported by the audit evidence, and the estimates included in the financial statements that are individually reasonable, indicate (in the aggregate) a possible bias on the part of management.

Management Points: Communication from auditor to management about identified control deficiencies that are not considered to be significant deficiencies or material weaknesses; could also include other suggestions on how to improve administrative or other functions.

Management Representation Letter: Among other things, confirms oral representations about specific matters given to the auditor during the audit. The letter is part of the evidential matter the auditor obtains; however it is not a substitute for other necessary audit procedures to corroborate information about matters for which written representations are obtained.

Material Weakness: A significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected.

Normal Closing Entries: These are routine entries, such as adjustments of accruals, that are made to help the client close out the books for the year. They are not misstatements and should not be included in the summary of audit differences.

Precision: The degree of accuracy of the expectation developed by the auditor to the actual amount.

Preliminary Analytical Procedures: Risk assessment procedures performed to obtain an understanding of the entity and its environment for the purpose of assessing the risks of material misstatement and determining what further audit procedures should be performed in response to the risk assessment.

Prudent Official Assessment: Auditors are required to conclude "whether prudent officials, having knowledge of the same facts and circumstances, would agree with the auditor's classification of the deficiency."

Reasonably Possible: Encompasses the entire range from "more than remote" to "less than likely."

Related Parties: Include affiliates; equity investees; pension, profit-sharing, and similar trusts managed by or under the trusteeship of management; principal owners, management, and members of their immediate families; other parties if one party controls or can significantly influence the management of operating policies of the other to an extent that one of the parties might be prevented from pursuing its own separate interest; another party that can significantly influence the management or operating policies of the transacting parties or that has an ownership interest in one of the transacting parties might be prevented from pursuing its own separate interest.

Report Release Date: The date that the auditor grants the entity permission to use the auditor's report in connection with the financial statements.

Rollover Method: A methodology used to aggregate audit differences. This method considers all misstatements (current-period misstatements as well as the impact of prior-period waived adjustments on current-period income).

Severe Impact: A significant financially disruptive effect on the normal functioning of the association. It is more than material, but less than catastrophic.

Significant Deficiency: A control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with GAAP such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

Significant Risks: Risks that are identified by risk assessment procedures as risks that require special audit consideration.

Subsequent Events Review: The audit procedures performed specifically to search for material events in the subsequent period. The objective is to identify transactions or events that occur after the financial statement date that should be recorded or disclosed in the financial statements.

Subsequent Period: The period between the financial statement date and the date of the auditor's report.

Subsidy Agreements: Agreements between the developers and the association they are developing that are necessary because developers often create significant common area amenities that can only be supported adequately by the full membership of the association (at build-out). The subsidy agreement is used to obtain at least breakeven funding during the initial phase-in periods.

Substantive Procedures: Procedures that should be applied to all relevant assertions related to each material class of transaction, account balance, and disclosure to detect material misstatements at the assertion level, regardless of the assessed risk of material misstatement.

Sufficiency: The measure of the quantity of audit evidence.

Sufficient Appropriate Audit Evidence: Audit evidence that the audit work has been reviewed; the financial statements (including disclosures) have been prepared; and management has taken responsibility for the financial statements.

Tests of Balances: Tests applied directly to the details of balances in the accounting records.

Tests of Details: These tests may be applied to transaction or to balances.

Tests of Transactions: Tests of the processing of individual transactions by inspection of the documents and accounting records involved in processing.

Those Charged with Governance: The persons responsible for overseeing the strategic direction of the entity and obligations related to the accountability of the entity, including oversight of the financial reporting and disclosure process.

Trivial Matters: Amounts designated by the auditor below which misstatements need not be accumulated. This amount is set so that any such misstatements either individually or when aggregated with other such misstatements, would not be material to the financial statements, after the possibility of further undetected misstatements is considered.

Vulnerability from Concentrations: This occurs when an entity is exposed to a greater risk of loss than would have existed if the entity had mitigated its risk through diversification.

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

COURSE 4

PRE-ENGAGEMENT ACTIVITIES AND AUDIT PLANNING FOR AUDITS OF CIRAS (HOATG094)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course discusses pre-engagement activities and audit planning with a focus on auditing common interest reality associations (CIRAs). Lesson 1 covers the authoritative literature related to pre-engagement activities and preliminary planning. It also discusses the client acceptance and continuance process, the necessary documentation, and establishing the terms of the engagement with the client. Lesson 2 looks at audit planning in depth and discusses related items, including understanding the entity, its environment, and its internal control and the decisions and judgments an auditor makes during audit planning. Lesson 3 covers special circumstances, such as using a specialist, audit sampling, the organization and structure of workpapers, and initial engagements, and how audit planning will be affected.

PUBLICATION/REVISION DATE: July 2009

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** QAS Hours, **8** Registry Hours

Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours.

FIELD OF STUDY: Auditing

EXPIRATION DATE: Postmark by **September 30, 2010**

KNOWLEDGE LEVEL: Basic

Learning Objectives:

Lesson 1—Pre-engagement Activities

Completion of this lesson will enable you to:

- Identify the authoritative literature related to pre-engagement activities and preliminary planning and the standard setting bodies.
- Outline processes for making the client acceptance and continuance decision and establishing an understanding with the client.

Lesson 2—Audit Planning

Completion of this lesson will enable you to:

- Summarize the basics of audit planning.
- Describe how an auditor gains an understanding of an entity and its environment.
- Summarize how an auditor gains an understanding of internal control, and compare and contrast the five elements of internal control.
- Assess issues related to making decisions and judgments during audit planning.

Lesson 3—Specialists, Sampling, Workpapers, and Initial Engagements

Completion of this lesson will enable you to:

- Plan for issues related to using the work of a specialist and audit sampling.
- Develop procedures for organizing and structuring audit plans and workpapers.
- Identify planning considerations unique to initial engagements.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

Thomson Reuters
Tax & Accounting—R&G
HOATG094 Self-study CPE
36786 Treasury Center
Chicago, IL 60694-6700

See the test instructions included with the course materials for more information.

ADMINISTRATIVE POLICIES:

For information regarding refunds and complaint resolutions, dial (800) 323-8724 for Customer Service and your questions or concerns will be promptly addressed.

Lesson 1: Pre-engagement Activities

INTRODUCTION

This course discusses the activities that should take place when deciding whether to propose for or accept a common interest realty association (CIRA) client or to retain an existing client. It also discusses the necessary activities in the early planning stages of a new or continuing audit engagement.

Pre-engagement activities involve consideration of the auditor's ability and desire to propose for, accept, or retain a particular CIRA engagement, including the auditor's independence and technical expertise; management's integrity; and the scope of the audit. Pre-engagement activities also include communicating with the predecessor auditor, if there is one, and establishing the terms of the engagement.

Planning activities include obtaining an understanding of the CIRA and its environment, including the particular CIRA's activities, internal control, and factors, including fraud, that affect the risk of material misstatements in its financial statements. These activities allow the auditor to make a decision about the acceptance or continuance of a client relationship, but certain 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.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify the authoritative literature related to pre-engagement activities and preliminary planning and the standard setting bodies.
- Outline processes for engagement acceptance and continuance decision and establishing an understanding with the client.

AUTHORITATIVE LITERATURE

Pre-engagement Activities. The authoritative pronouncements that establish requirements or provide guidance that most directly affects pre-engagement activities are as follows:

a. SAS No. 84 (AU 315), *Communications Between Predecessor and Successor Auditors*, establishes the required communications that should occur prior to client acceptance when a change of auditors has taken place.

b. SAS No. 108 (AU 311), *Planning and Supervision*, provides requirements relating to client acceptance and continuance and establishing an understanding with the client, including the issuance of a written engagement letter.

c. Statement on Quality Control Standards (SQCS) No. 7 (QC 10), *A Firm's System of Quality Control*, 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. SQCS No. 7 supersedes all existing Statements on Quality Control Standards and is applicable to a CPA firm's system of quality control for its accounting and auditing practice as of January 1, 2009.

d. Interpretation 101-3 (ET 101-3), *Performance of Nonattest Services*, of the AICPA's *Code of Professional Conduct*, provides guidance regarding an auditor's independence in relationship to an attest client when performing nonattest services.

In addition to the items listed, 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.

Preliminary Planning. The authoritative pronouncements that establish requirements and provide guidance that affect preliminary audit planning are as follows:

a. SAS No. 107 (AU 312), *Audit Risk and Materiality in Conducting an Audit*, requires auditors to consider audit risk and determine and document materiality for the financial statements as a whole, as well as tolerable misstatement, when planning the audit.

b. SAS No. 108 (AU 311), *Planning and Supervision*, addresses planning the audit, including topics such as establishing an overall audit strategy, developing the audit plan, determining the extent of the audit plan, involvement of professionals with specialized skills, supervision of assistants, communication with management and those charged with governance, and considerations in initial audits.

c. SAS No. 109 (AU 314), *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, establishes the level of understanding of the entity and its environment, including its internal control, the auditor should obtain for preliminary planning purposes. That standard also addresses risk assessment procedures and assessing the risks of material misstatement.

d. SAS No. 110 (AU 318), *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, explains the factors that affect a decision to apply substantive procedures before the financial statement date.

In addition, aspects of the following standards also affect audit planning:

a. SAS No. 54 (AU 317), *Illegal Acts by Clients*, indicates that the auditor's responsibility for detecting misstatements resulting from illegal acts having a direct and material effect on the determination of financial statement amounts is the same as that for other errors and fraud. For other illegal acts, the auditor, in conducting the audit, remains aware of their possibility but does not design the audit specifically to detect them.

b. SAS No. 56 (AU 329), *Analytical Procedures*, requires the auditor to apply analytical procedures during the planning stage (and the overall review stage) of the audit.

c. SAS No. 99 (AU 316), *Consideration of Fraud in a Financial Statement Audit*, requires the auditor to identify and assess risks of material misstatement due to fraud and to design the audit to provide reasonable assurance of detecting fraud that results in the financial statements being materially misstated.

These authoritative pronouncements are also explained further at the relevant points in the following discussion.

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 Statements on Auditing Standards (SASs) affects an auditor's pre-engagement activities?

   a. SAS No. 84, *Communications Between Predecessor and Successor Auditors*.

   b. SAS No. 54, *Illegal Acts by Client*.

   c. SAS No. 107, *Audit Risk and Materiality in Conducting an Audit*.

   d. SAS No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*.

2. An auditor has numerous authoritative pronouncements available to offer direction in the planning of an audit. Which SAS helps the auditor not only with planning but also with the supervision of the audit?

   a. SAS No. 56.

   b. SAS No. 99.

   c. SAS No. 108.

   d. SAS No. 109.

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 Statements on Auditing Standards (SASs) affects an auditor's pre-engagement activities? **(Page 407)**

   a. SAS No. 84, *Communications Between Predecessor and Successor Auditors*. [This answer is correct. SAS No. 84 establishes the required communications that should occur prior to client acceptance when a change of auditors has taken place. Client acceptance and continuance is a pre-engagement activity.]

   b. SAS No. 54, *Illegal Acts by Client*. [This answer is incorrect. This piece of guidance includes aspects that affect audit planning, not pre-engagement activities. SAS No. 54 includes the auditor's responsibility for detecting misstatements resulting from illegal acts and their affect on the financial statements.]

   c. SAS No. 107, *Audit Risk and Materiality in Conducting an Audit*. [This answer is incorrect. SAS No. 107 affects preliminary audit planning, not pre-engagement activities. This SAS requires auditors to consider audit risk and determine and document materiality for the financial statements as a whole, as well as tolerable misstatement, during audit planning.]

   d. SAS No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*. [This answer is incorrect. SAS No. 110 explains factors that affect a decision to apply substantive procedures before the financial statement date. This is part of audit planning, not pre-engagement activities.]

2. An auditor has numerous authoritative pronouncements available to offer direction in the planning of an audit. Which SAS helps the auditor not only with planning but also with the supervision of the audit? **(Page 408)**

   a. SAS No. 56 [This answer is incorrect. SAS No. 56 requires the auditor to apply analytical procedures during the planning stage and the overall review stage of an audit.]

   b. SAS No. 99 [This answer is incorrect. SAS No. 99 gives the auditor guidance to identify and assess risks of material misstatement due to fraud and to design of the audit to provide reasonable assurance that fraud that can result in the financial statements being materially misstated, will be discovered.]

   c. SAS No. 108 [This answer is correct. SAS No. 108 helps with the planning of the audit, for example, establishing an overall audit strategy, developing the audit plan and determining the extent of the audit plan. It also provides direction on the supervision of assistants and communicating with management and those charged with governance.]

   d. SAS No. 109 [This answer is incorrect. SAS no. 109 establishes the level of understanding of the entity and its environment, including its internal control, that the auditor should obtain for preliminary planning purposes. The standard also addresses risk assessment procedures and assessing the risks of material misstatement.]

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.* SQCS No. 7 requires CPA firms to establish policies and procedures for the acceptance and continuance of client relationships and specific engagements. The requirement to establish such policies and procedures is not intended to suggest that a firm must guarantee the integrity or reliability of a client. Instead, according to paragraph 27 of SQCS No. 7, the policies and procedures should be "designed to provide the firm with reasonable assurance that it will undertake or continue relationships and engagements only where the firm:

    a. Has considered the integrity of the client, including the identity and business reputation of the client's principal owners, key management, related parties and those charged with governance, and the risks associated with providing professional services in the particular circumstances;

    b. Is competent to perform the engagement and has the capabilities and resources to do so; and

    c. Can comply with legal and ethical requirements."

- *Timing of Procedures.* SAS No. 108 (AU 311) indicates 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. Before accepting an engagement, auditors should also determine whether circumstances will allow an adequate audit and an unqualified opinion. If it appears that a qualified or disclaimer of opinion may be necessary, that should be discussed with the client.

- *Communicating with Previous Auditors.* SAS No. 84 (AU 315) and SAS No. 108 require a successor auditor to make certain inquiries of the predecessor auditor before accepting an engagement.

Client acceptance/continuance policies and procedures should 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. SAS No. 106 (AU 326.2) 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, SQCS No. 7 requires the firm to document how the issues were resolved.

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 should be declined and when the relationship with a continuing client should be 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 SAS No. 99 (AU 316.34) and SAS No. 109 (AU 314.13) explicitly note that the auditor should consider 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? Do the pressures, opportunities, or indications of potential lack of management integrity create an increased risk that management will engage in fraudulent financial reporting? 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. 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.

Before deciding to propose for or accept a new CIRA audit engagement, the auditor should consider his or her ability to accept the engagement, management's integrity, and the scope of the proposed audit. These considerations should also be made annually in deciding whether to retain an existing client.

Ability to Accept the Engagement

An auditor should not propose for, or accept, an audit unless he or she will be able to meet the responsibilities and requirements related to the engagement. Factors the auditor should consider include the following:

- Auditor independence.
- Expertise in the CIRA area or ability to obtain sufficient knowledge to meet professional standards.

These matters are discussed in the following paragraphs.

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). 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 are those who are members of an attest engagement team or able to influence the engagement or attest engagement team. Under the AICPA rules, auditors may be able to structure the engagement team so that independence is not impaired.

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 these 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 these circumstances.

Competency in the CIRA Industry. Rule 201 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. 7, *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 required competencies may vary depending on the client, industry, or type of service being provided. Although the CIRA industry 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 should consider whether he or she 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 SQCS No. 7, a CPA firm's quality control policies and procedures should also require that the engagement partner have the appropriate 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 to have sufficient time to adequately perform their responsibilities.

Management Integrity

An auditor should consider the reputation and integrity of a prospective or continuing client and its management. The auditor should evaluate any adverse information about management and consider whether the CPA firm would not 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 SAS No. 84 (AU 315), *Communications Between Predecessor and Successor Auditors*, as amended, to communicate with a predecessor auditor. SAS No. 84, as amended, requires that a successor auditor communicate with any former auditors who have provided services to the prospective client. (The guidance in SAS No. 84 (AU 315) is not applicable to the audit of an entity by a successor auditor if the latest audited financial statements are more than two years before the beginning of the earliest period being audited.) The SAS requires written or oral communication with the predecessor auditor when determining whether to accept an engagement. The communication should include the following matters:

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

b. Disagreements with management on accounting principles, auditing procedures, or similarly significant 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 or other illegal acts performed by the client or its employees, and internal control related matters.

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

In addition to communication 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—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 requirement for confidentiality in Rule 301 of the AICPA *Code of Professional Conduct*. If the potential client refuses to give authorization, the auditor should determine why. He should also consider whether such refusal is 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.

Outsourcing

Revised Ethics Ruling No. 112 (ET 191.224–.225) under Rule 102, *Integrity and Objectivity*, 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 must 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. The ethics ruling 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 ruling is not believed to 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 administrative support services, such as record storage or software application hosting. Ethics Rule 301, *Confidential Client Information*, 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. The client can be informed of this in an engagement letter.

Level of Service

Information about the entity and the level of service being requested is vital in deciding whether to propose for the engagement, in preparing a proposal and reasonable fee estimate once a decision is made to do so, and in planning the engagement once it is obtained. There are procedures auditors should follow when a CIRA requests a level of service lower than one required by the CIRA's governing documents or state statutes. If, based on those procedures, auditors believe the lower level of service is acceptable, it is recommended that the auditors document the results of those procedures in their working papers and address the issue in their engagement letter.

DOCUMENTATION OF THE DECISION TO ACCEPT OR CONTINUE AN ENGAGEMENT WITH A CLIENT

It is recommended that the auditor document the considerations discussed in the preceding section as they are made during the proposal, pre-engagement, or early planning stages. 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. When performing client acceptance (and continuance) procedures, the auditor should 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.

Information that could be documented includes information about the services requested and the considerations of independence, management integrity, and other matters that influence the decision to accept or retain an engagement, in addition to the acceptance or retention decision, including how identified issues were resolved if the firm decides to accept or retain the client.

Information about the CIRA's operations, organization, audit risk factors, and internal control can be documented, as well. Much of this information will be obtained during later planning stages, but the auditor should document any of the information identified during the pre-engagement and early planning stages.

Annual Evaluation for Continuing Engagement

An annual evaluation of clients and engagements should be performed as part of the planning process for those engagements. SQCS No. 7 and SAS No. 108 require the firm to assess its continuing association with a client and the engagement. The continuing auditor should consider the topics discussed in this lesson and reassess 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 should also consider 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, SQCS No. 7 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. For those engagements that will be continued, auditors should 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 should be 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. SAS No. 108 indicates the auditor should perform this review 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 should be made before work commences on the engagement.

The continuance decision should be documented during the planning stage of the current year engagement.

ESTABLISHING AN UNDERSTANDING ABOUT THE TERMS OF THE ENGAGEMENT WITH THE CLIENT

After a new or continuing engagement has been accepted, SAS No. 108 (AU 311), *Planning and Supervision*, requires the auditor to establish an understanding with the client about the services to be performed for each engagement and to document that understanding through a written engagement letter. Although engagement letters have been a common, but optional, practice for many years, SAS No. 108 eliminated the previous alternative of documenting the understanding with the client in the workpapers only. 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.

SAS No. 108 indicates that the understanding with the client should include (a) the objectives of the engagement, (b) management's responsibilities, (c) the auditor's responsibilities, and (d) limitations of the engagement. If possible, the understanding should 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 SAS 70 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 should also include any other services to be rendered, for example, preparation of the tax return.

SAS No. 108 states that the auditor generally establishes an understanding of the services to be performed with the entity's management or, in some cases, with those charged with governance, which encompasses the board of directors. It is recommended that the engagement letter be signed by the appropriate CIRA officer (for example, the president) and, if applicable, the managing agent. 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.

The AICPA audit and accounting guide, *Audits of Common Interest Realty Associations* (the AICPA guide), requires CIRAs to disclose certain information about future major repairs and replacements as supplementary information outside of the basic financial statements. In addition, SOP 93-5, Paragraph 3, requires the auditor to "establish an understanding with the entity regarding the services the accountant will perform with respect to the required supplementary information." An engagement letter can be used to describe the auditor's responsibilities for that information (for example, they will compile the information and not audit or review it). The engagement letter can also illustrate how the auditors will report on the required supplementary information.

SQCS No. 7, *A Firm's System of Quality Control*, indicates that an audit firm should establish policies and procedures requiring the identity and role of the engagement partner to be communicated to management and those charged with governance. This can be done in an engagement letter.

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 should be communicated early in the engagement. If those matters are included in the engagement letter and the engagement letter is sent to those charged with governance, the letter need not be sent.

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 statements best describes the consideration of risk during client acceptance and continuance procedures?

   a. Risk consideration happens on a low level and focuses on individual elements of the financial statements.

   b. If a potential engagement has a high level of risk, the auditor must decline the engagement immediately.

   c. An appropriate audit response must be included in the audit plan if an engagement with a greater-than-normal amount of risk is accepted.

4. Larry, an auditor, is evaluating a potential CIRA audit client. Part of his client acceptance process includes considering his ability to accept the engagement. Which of the following factors is part of Larry's consideration of this ability?

   a. Risks associated with the engagement.

   b. His independence from the CIRA client.

   c. Preliminary scheduling of audit work.

   d. Integrity of the CIRA's management.

5. Which of the following might compromise an auditor's independence with regard to a small CIRA client?

   a. Contact with the CIRA's predecessor auditor.

   b. Lack of experience in the CIRA industry.

   c. Adverse information about the CIRA's management.

   d. Performance of nonattest services.

6. SAS No. 84 requires an auditor to communicate with a predecessor auditor before accepting an engagement. Which of the following statements best describes that communication?

   a. The communication must take place in writing.

   b. If the last audit was performed two years previous, the communication is not necessary.

   c. Information related to management's integrity should be discussed.

   d. The communication can be made without the client's approval.

7. If documented during the client acceptance and continuance procedures for a potential CIRA client, which of the following pieces of information will provide the basis for the auditor's acceptance or continuance decision?

   a. Information about independence, management's integrity, and the auditor's ability to provide requested services.

   b. Information on the CIRA's managing agent, the type of CIRA, and common properties managed.

   c. Information on the CIRA's internal control, operations, organization, and audit risk factors.

8. List all of the items that should be covered in the engagement letter under SAS No. 108.

   i. Fee estimate.

   ii. Engagement objectives.

   iii. Engagement limitations.

   iv. Expected timing of fieldwork.

   v. Expected client clerical assistance.

   vi. Responsibilities of management.

   vii. Responsibilities of the auditor.

   viii. Arrangements with the predecessor auditor.

   a. i., ii., and iii.

   b. ii., iii., vi., and vii.

   c. iv., v., vi., and vii.

   d. vi., vii., and viii.

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 statements best describes the consideration of risk during client acceptance and continuance procedures? **(Page 411)**

    a. Risk consideration happens on a low level and focuses on individual elements of the financial statements. [This answer is incorrect. 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.]

    b. If a potential engagement has a high level of risk, the auditor must decline the engagement immediately. [This answer is incorrect. Auditors are not required to decline an engagement simply because it has high associated risks. However, the auditor may wish to consider declining a high risk engagement, as the auditor's business risk will increase by taking on the engagement, and the engagement will also have a greater risk of material misstatement of the financial statements.]

    c. An appropriate audit response must be included in the audit plan if an engagement with a greater-than-normal amount of risk is accepted. [This answer is correct. If the firm's acceptance and continuance procedures allow the firm to accept the engagement despite the additional risk, an appropriate audit response to the risk level must be included in the audit plan.]

4. Larry, an auditor, is evaluating a potential CIRA audit client. Part of his client acceptance process includes considering his ability to accept the engagement. Which of the following factors is part of Larry's consideration of this ability? **(Page 412)**

    a. Risks associated with the engagement. [This answer is incorrect. The consideration of risk should be part of Larry's acceptance procedures, but it is not related to his ability to accept the engagement.]

    b. His independence from the CIRA client. [This answer is correct. There are two factors that Larry must consider related to his ability to accept the CIRA audit engagement, (1) his independence as the auditor and (2) the expertise he has in the CIRA area or his ability to obtain sufficient knowledge to meet the professional standards.]

    c. Preliminary scheduling of audit work. [This answer is incorrect. If Larry does any preliminary scheduling of audit work for the engagement, that scheduling will be affected by the information he gathers during the acceptance procedures; however, whether he does preliminary scheduling is not one of the factors he needs to consider related to his ability to accept the engagement.]

    d. Integrity of the CIRA's management. [This answer is incorrect. Larry should consider management's integrity when evaluated the risks associated with the engagement, but this consideration is not directly related to Larry's ability to accept the engagement.]

5. Which of the following might compromise an auditor's independence with regard to a small CIRA client? **(Page 412)**

    a. Contact with the CIRA's predecessor auditor. [This answer is incorrect. Contacting a predecessor auditor should be part of an auditor's acceptance and continuance procedures. Such contact would not cause an auditor's independence to be impaired with respect to the client.]

    b. Lack of experience in the CIRA industry. [This answer is incorrect. Lack of experience in the CIRA industry would be a red flag in an auditor's client acceptance and continuance procedures for a potential CIRA client; however, the lack of this experience would not cause the auditor to lose independence with regard to the CIRA.]

c. Adverse information about the CIRA's management. [This answer is incorrect. If the auditor discovers such information, it should be considered whether the auditor wants to be associated with the CIRA. However, the reputation of the CIRA's management would not impair the auditor's independence with respect to the CIRA.]

d. Performance of nonattest services. [This answer is correct. In a small CIRA engagement, performance of nonattest services by the auditor would cause concern about whether the auditor can meet the independence requirements necessary to accept the engagement. Nonattest services such as bookkeeping may raise a red flag during the auditors acceptance and continuance procedures.]

6. SAS No. 84 requires an auditor to communicate with a predecessor auditor before accepting an engagement. Which of the following statements best describes that communication? **(Page 413)**

a. The communication must take place in writing. [This answer is incorrect. The SAS requires written or oral communication with the predecessor auditor when determining whether to accept an engagement.]

b. If the last audit was performed two years previous, the communication is not necessary. [This answer is incorrect. If the last audited financial statements are more than two years before the beginning of the earliest period being audited, SAS No. 84 is not applicable.]

c. Information related to management's integrity should be discussed. [This answer is correct. This is one of the four matters that should be covered in the auditor's conversation with the predecessor. Another matter that must be covered is the predecessor's understanding of the reasons for the change in auditors.]

d. The communication can be made without the client's approval. [This answer is incorrect. Under Rule 102 of the AICPA *Code of Professional Conduct*, the predecessor cannot ethically respond without the client's authorization.]

7. If documented during the client acceptance and continuance procedures for a potential CIRA client, which of the following pieces of information will provide the basis for the auditor's acceptance or continuance decision? **(Page 415)**

a. Information about independence, management's integrity, and the auditor's ability to provide requested services. [This answer is correct. This information provides a basis for the auditor's decision about whether to accept or retain a client. It is recommended that it be documented during the proposal, pre-engagement, or early planning stages.]

b. Information on the CIRA's managing agent, the type of CIRA, and common properties managed. [This answer is incorrect. Information such as this, if documented, would be useful in later stages of the audit. It can also serve as a basis for review and update in future years.]

c. Information on the CIRA's internal control, operations, organization, and audit risk factors. [This answer is incorrect. Much of this type of information would be obtained during later stages of the audit, and, therefore, would not provide the basis for the acceptance or continuance decision. However, any such information documented during the pre-engagement and early planning stages can be documented at that time.]

8. List all of the items that should be covered in the engagement letter under SAS No. 108. **(Page 416)**

   i. Fee estimate.

   ii. Engagement objectives.

   iii. Engagement limitations.

   iv. Expected timing of fieldwork.

   v. Expected client clerical assistance.

   vi. Responsibilities of management.

   vii. Responsibilities of the auditor.

   viii. Arrangements with the predecessor auditor.

   a. i., ii., and iii. [This answer is incorrect. Though it might be a good idea to include a fee estimate in an engagement letter to avoid any misunderstandings with the client, this is not required by SAS No. 108.]

   b. ii., iii., vi., and vii. [This answer is correct. These four items must be included in an engagement letter to meet the requirements of SAS No. 108. If possible, the auditor should also include whether a specialist or another auditor's report on the information system and other controls will be used, but the auditor's decision on that may have to wait until the audit planning stage.]

   c. iv., v., vi., and vii. [This answer is incorrect. The expected timing of fieldwork and client clerical assistance are not a required part of an engagement letter under SAS No. 108; however, including this information would be a good way to avoid misunderstandings with the client.]

   d. vi., vii., and viii. [This answer is incorrect. If applicable, it would be a good idea for an auditor to include arrangements with a predecessor auditor in an engagement letter; however, this is not required by SAS No. 108.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (HOATG094)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. Which of the following is a pre-engagement activity?

   a. Documenting the CIRA's internal controls.

   b. Considering the auditor's ability and desire to the do the audit of the CIRA.

   c. Gaining an understanding of the CIRA and its environment.

   d. Auditing the CIRA's financial statements for material misstatement.

2. List all of the following pieces of authoritative guidance that affect pre-engagement activities, and those that affect audit planning. (**Hint**: It is possible for a piece of authoritative literature to affect both audit areas.)

      i. SAS No. 56, *Analytical Procedures*.
      ii. SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*.
      iii. SAS No. 108, *Planning and Supervision*.
      iv. SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.
      v. Statement on Quality Control Standards (SQCS) No. 7, *A Firm's System of Quality Control*.
      vi. Interpretation 101-3, *Performance of Nonattest Services*.

   a. Pre-engagement activities—i., ii., and vi.; audit planning—ii., iii., iv., and v.

   b. Pre-engagement activities—i., iii., iv., and v.; audit planning—ii., iii., and vi.

   c. Pre-engagement activities—ii., iii., v., and vi.; audit planning—i., iv., and v.

   d. Pre-engagement activities—iii., v., and vi.; audit planning—i., ii., iii., and iv.

3. Which of the following assurances should be provided by a firm's client acceptance and continuance procedures?

   a. The expectation that the engagement can be completed with professional competence is reasonable.

   b. All risks associated with providing professional services under these circumstances are fully accounted for.

   c. The client will be able to pay its bill in a timely manner, as expected by the firm.

   d. All information gathered during the acceptance and continuance process will be disregarded during the actual engagement.

4. Which of the following considerations is unique to a continuance decision for an existing audit CIRA client?

   a. Management's integrity and its reputation.

   b. The CIRA's financial condition and its operations.

   c. Any changes in the CIRA in the past year.

   d. Who the financial statements are distributed to.

5. An auditor's ability to accept an engagement is affected by his independence from the potential client. Which organization's independence approach is generally the most applicable to a CIRA audit?

   a. PCAOB.

   b. AICPA.

   c. SEC.

   d. Do not select this answer choice.

6. Julia is considering accepting an engagement to audit a CIRA, but she does not have previous experience in the CIRA industry. Can Julia accept the CIRA client?

   a. Yes, nothing restricts Julia from accepting the engagement.

   b. Yes, if she is willing to obtain CIRA knowledge through CPE or other methods.

   c. No, Julia cannot accept this engagement under any circumstances.

   d. Do not select this answer choice.

7. List all of the considerations below that are important to an auditor's annual evaluation for a continuing engagement.

      i. Turnover in management positions.
      ii. Significant changes in financial position.
      iii. Litigation status.
      iv. The scope of the engagement.
      v. Reasons why the auditor accepted the engagement originally.
      vi. Conflict of interest issues.
      vii. Compliance with independence rules.

   a. i., iv., and vi.

   b. ii., iii., iv., and vi.

   c. ii., iii. iv., v., and vii.

   d. i., ii., iii., iv., v., vi., and vii.

8. Which of the following statements best describes an engagement letter?

   a. Engagement letters are required by SAS No. 108 for establishing an understanding with a client.

   b. Engagement letters are a common, but optional, way to establish an understanding with a client.

   c. Engagement letters are less preferable than establishing an oral understanding with the client.

   d. Do not select this answer choice.

Lesson 2: Audit Planning

INTRODUCTION

This lesson will discuss audit planning, understanding the entity and its environment, understanding internal control, and the decisions and judgments that are a part of audit planning.

Learning Objectives:

Completion of this lesson will enable you to:

- Summarize the basics of audit planning.
- Describe how an auditor gains an understanding of an entity and its environment.
- Summarize how an auditor gains an understanding of internal control, and compare and contrast the five elements of internal control.
- Assess issues related to making decisions and judgments during audit planning.

OBJECTIVES OF AUDIT PLANNING

The first standard of fieldwork states that "the auditor must adequately plan the work and must properly supervise any assistants" (AU 150.02). According to SAS No. 108 (AU 311.02), *Planning and Supervision*, audit planning involves "developing an overall audit strategy for the expected conduct, organization, and staffing of the audit." 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. 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 of risks that should be considered and an assessment of whether the risks could result in material misstatement of the financial statements. According to SAS No. 108, obtaining an understanding of the CIRA and its environment, including its internal control, is an essential part of planning the audit. Auditors must plan the audit so that it 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 the 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 should 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.

Requesting Information from the CIRA

Before fieldwork begins, the auditor should consider 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 is required to perform all of these procedures when planning the audit. Further, the auditor's consideration of fraud required by SAS No. 99, *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 SAS No. 99 are addressed at relevant points throughout this course.

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 2-1 summarizes the various elements in the risk assessment process in the categories of procedures performed, understanding obtained, and decisions and judgments made.

Exhibit 2-1

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: • Tolerable misstatement. • 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).

* * *

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. An example approach is presented in Exhibit 2-2.

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 taken as a whole, and the twelfth step, determine tolerable misstatement, are often performed concurrently. For the eighth step, the discussion among the engagement team, the precise timing of this meeting can vary with the circumstances, but should occur relatively early in planning, and it is not required to occur in any particular sequence.

Exhibit 2-2

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 taken 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 tolerable misstatement.
13. Assess audit risk in relation to relevant assertions for transactions classes, account balances, and disclosures.
14. Develop a detailed audit plan for the nature, timing, and extent of further audit procedures.

* * *

As stated previously, an overriding objective throughout the planning process is the consideration of risks that should be assessed and whether they could result in material misstatement of the financial statements. SAS No. 106 (AU 326.21) clearly indicates the role of the risk assessment procedures within this process as follows:

> The auditor must perform risk assessment procedures to provide a satisfactory basis for the assessment of risks at the financial statement and relevant assertion levels.

Obtaining an understanding of the entity and its environment, including its internal control, is an essential aspect of the consideration of risk. Thus auditing standards refer to the audit procedures performed to obtain that understanding as *risk assessment procedures* because some of the information obtained by performing those procedures may be used by the auditor to support the assessments of the risks of material misstatement. Auditors normally consider the effectiveness of various types of risk assessment procedures in identifying risks during the planning process. The risk assessment standards encourage this by requiring the use of a variety of risk assessment procedures when obtaining an understanding of the entity and its environment. For example, an auditor cannot limit his or her risk assessment procedures to only inquiry.

In addition to obtaining 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.

Types of Risk Assessment Procedures

The risk assessment and other planning procedures required by SAS Nos. 108 and 109 to obtain information about the entity and its environment, including its internal control, and to assess the risks of material misstatement include the following:

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

b. Inquiries of management and others.

c. Preliminary analytical procedures.

d. Observation and inspection, such as visits to the HOA development and tracing transactions through the information system (that is, walkthroughs).

e. Discussion among the engagement team.

Each of the procedures listed are explicitly required by the risk assessment standards and, except for item d., are also explicitly enumerated in SAS No. 99, *Consideration of Fraud in a Financial Statement Audit,* as sources of information that should be considered when identifying risks of material misstatement due to fraud. SAS No. 109 requires the auditor to perform the procedures specified in items b.–d. when obtaining an understanding of the entity and its environment. However, 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.

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. In addition, 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? The answer 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.

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, the auditor should determine whether changes have occurred that may affect its relevance in 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 covenants; 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 should perform some 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.

As a result, although the nature of the auditor's procedures always includes inquiries, observation, and inspection, the extent of risk assessment procedures is believed to often be considerably less in continuing engagements than in initial engagements, consisting primarily of sufficient procedures to identify and evaluate changes that have occurred that may affect the relevance of such information in the current year. 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 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. In many cases, it 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. Professional standards require the use 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) about the following matters:

a. The aspects of the entity and its environment as enumerated in SAS No. 109 (AU 314.21).

b. The information about fraud, suspected fraud, fraud-related programs and controls, and risks of fraud as enumerated in SAS No. 99 (AU 316.20–.21).

The auditor might decide that inquiries of others within and outside the CIRA, in addition to management and those responsible for financial reporting, would be useful. Examples of other inquiries that might be made include the following:

a. *Those Charged with Governance.* Their involvement in the financial reporting process. (SAS No. 99, AU 316.22, requires the auditor to inquire directly of the audit committee, or at least its chairman, about the risks of fraud and knowledge of fraud or suspected 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. (SAS No. 99, AU 316.23, requires inquiry of internal audit personnel about risks of fraud, knowledge of fraud or suspected fraud, and activities concerning fraud detection.)

c. *Other Employees.* Their role in the financial reporting process and additional or corroborating information to support management's responses. (SAS No. 99, AU 316.24, requires inquiry of others within the CIRA, determined through the auditor's judgment, 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. As part of gathering the information needed to identify fraud risks, SAS No. 99 requires auditors to inquire of management personnel and others about:

- Their knowledge of any actual fraud or suspicions of fraud affecting the CIRA.
- Their awareness of any allegations of fraud or suspected fraud affecting the CIRA.
- Their understanding of the risks of fraud within the CIRA, including any specific fraud risks the CIRA has identified or account balances or transaction classes that may be susceptible to fraud.
- How they communicate to employees the importance of ethical behavior and appropriate business practices.
- Programs and controls the CIRA has implemented to address identified fraud risks or otherwise help prevent, deter, and detect fraud and how those programs and controls are monitored.
- If applicable, the nature and extent of monitoring multiple locations or operating segments (for example, developer operations) and whether any of them have a higher level of fraud risk.
- If applicable, whether they have reported to the audit committee (or its equivalent) about how the CIRA's internal control serves to prevent, deter, and detect material misstatements due to fraud.

The objective of the inquiry includes obtaining different perspectives on financial statement areas and organizational areas and locations with a risk of fraud and identifying whether anyone has suspicions or actual knowledge of fraud.

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 2-3 presents a list of questions the auditor might consider asking management of a CIRA or managing agent, if applicable.

Exhibit 2-3

Inquiries about Fraud Risks for Management of a CIRA

Required Inquiry	Possible Questions
Their 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?
Their 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?
Their understanding of the risks of fraud within the CIRA, including any specific fraud risks the CIRA has identified or account balances or transaction classes that may be susceptible to fraud.	• 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? • 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 an OCBOA) are most common for CIRAs? What departures from GAAP (or an OCBOA) 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?
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 Inquiry	Possible Questions
Programs and controls the CIRA has implemented to address identified fraud risks or otherwise help prevent, deter, and detect fraud and how those programs and controls are monitored.	• 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? • 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?
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? • How do you monitor the affiliated association's locations to reduce the likelihood of fraud occurring and going undetected?
Whether they have reported to the audit committee (or its equivalent) about how the CIRA's internal control serves to prevent, deter, and detect material misstatements due to fraud.	• Have you reported to the audit committee (or its equivalent) 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 the audit committee, 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 those parties identified previously, 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 2-4 for illustrative inquiries that might be appropriate for employees of different levels and departments.

Documentation. SAS No. 109 (AU 314.22) requires documentation of risk assessment procedures performed in obtaining an understanding of the entity and its environment. When documenting inquiry procedures, SAS No. 103 (AU 339.21), *Audit Documentation*, requires audit documentation to include the identifying characteristics of the specific items tested. In conjunction with this requirement, the standard provides an example for documenting inquiries of specific personnel indicating that auditors may document the date of the inquiry, name and job description of the individual queried, and the nature of the inquiry. Documenting these identifying characteristics when performing risk assessment inquiry procedures is recommended.

Exhibit 2-4

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? • Is there anything else you would like to add, or anyone else we should talk to? • I must ask you 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?	Human resources (or CIRA employee responsible for compensation)
• 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?	Purchasing

* * *

Preliminary Analytical Procedures

SAS No. 56 (AU 329.04) states that analytical procedures should be applied to some extent in all audits of financial statements to assist the auditor in planning the nature, timing, and extent of other auditing procedures. To accomplish this, SAS No. 56 (AU 329.06) indicates that analytical procedures used in planning the audit should focus on—

a. Enhancing the auditor's understanding of the client's business and the transactions and events that have occurred since the last audit date.

b. Identifying areas that may represent specific risks relevant to the audit.

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.

SAS No. 56 (AU 329) does not require the use of any particular analytical procedures. It recognizes that 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 inquires 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?

SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AU 316), specifically requires auditors to 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 should be used. Other 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 clash 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.

When the results of preliminary analytical procedures indicate the existence of unusual or unexpected relationships, the auditor should consider those results in identifying risks of material misstatement of the financial statements due to fraud.

Observation and Inspection

Observation and inspection procedures are required when obtaining an understanding of the entity and its environment, including its internal control. 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, 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 inquires 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. Ordinarily, observation and inspection procedures are believed 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 required 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. SAS No. 109 requires documentation of risk assessment procedures performed in obtaining an understanding of the entity and its environment. SAS No. 103, *Audit Documentation*, requires documentation of the identifying characteristics of specific items tested and provides examples for documenting the identifying characteristics of observation and inspection procedures. Based on that guidance, the following documentation is recommended:

- 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, consider 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

SAS No. 109 (AU 314.14) requires the members of the audit team to discuss the susceptibility of the CIRA's financial statements to material misstatements. SAS No. 99 (AU 316.14) 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 should be 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 more experienced members of the audit team can share their insights based on their cumulative knowledge of the CIRA, its industry, and the environment.

Matters to be Discussed. This discussion is aimed at the susceptibility of the financial statements to material misstatement, 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 should not be a narrow one focused on risks already identified, but one that opens 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, should be communicated to the team members. Among other matters, SAS No. 109 indicates that the discussion should include the following:

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. Application of GAAP to the CIRA's facts and circumstances in light of its accounting policies.

e. Important control systems.

f. Materiality at the financial statement level (planning materiality) and at the account level (tolerable misstatement).

g. How materiality will be used to determine the extent of testing.

h. 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 discussion can also 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.

- 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.

In addition, SAS No. 99 indicates that the discussion should also include the following fraud-related matters:

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

The fraud aspect of the discussion should 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.

The discussion should 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*). Participants should maintain an attitude of professional skepticism throughout the discussion. Both SAS No. 99 and SAS No. 109 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, SAS No. 109 notes that the auditor can 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) should encourage interaction and an appropriate exchange of ideas. Although SAS Nos. 99 and 109 both require the engagement team to have a specific discussion, communication about the risks of material misstatement is not limited to that discussion, but should occur throughout the audit.

The discussion should not be influenced by past favorable experience with the integrity of management. In fact, SAS No. 99 states that the engagement team should abandon neutrality and any preconceptions about management's and employees' honesty, but instead presume the possibility of dishonesty at various levels of management. Thus, 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. Engagement team members should not rely on less than persuasive audit evidence because of a belief that management or employees are honest.

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 engagement team can discuss each significant audit area. The team should discuss the real risks affecting each area and determine the most effective and efficient audit procedures that address those risks. Members of the audit team should 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 should be reviewed to make sure there are not any issues that were overlooked.

Who Should Attend the Discussion? Both SAS No. 99 and SAS No. 109 require auditors to exercise judgment in determining who should attend the discussion among the engagement team, but they indicate that the discussion should include the auditor with final responsibility for the audit (generally the audit partner) and ordinarily should comprise key members of the engagement team. For audits involving affiliated locations, there may be several discussions involving team members in those locations. Also, 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. It is recommended that all members of the engagement team, including specialists with an ongoing role in the engagement, participate in the discussion.

When Should the Discussion Occur? Before holding the discussion with the engagement team, it is recommended that the in-charge auditor and/or 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 should discuss the CIRA's 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 should 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 should be reviewed before the engagement team discussion to identify risk areas identified in the prior audit.

The timing of the engagement team discussion and other logistics depend on the circumstances and are not addressed in SAS No. 109, other than to note that for audits involving multiple locations, there may be discussions involving engagement team members in those locations. SAS No. 99 states only that the engagement team discussion may occur before or while obtaining an understanding of the CIRA and gathering the information needed to identify fraud risks. Holding the discussion prior to performing the information-gathering procedures discussed in the next section is recommended. 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 the auditor with final responsibility for the audit, and firms should exercise professional judgment to determine what works best in their particular audit process. In any case, engagement team members should 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 in-charge auditor or partner to remind the audit team members of the audit documentation requirements of SAS No. 103, *Audit Documentation*, that they should observe while performing audit procedures, including 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 used as the principal substantive test of significant financial statement assertions.

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.

Documentation of the Discussion. SAS No. 109 requires specific items be documented regarding the discussion among the audit team. These requirements are similar to the documentation requirements of SAS No. 99 regarding the fraud-related discussion among the audit team.

SELF-STUDY QUIZ

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

9. What term best fits the following definition?

   An operational approach that allows an auditor to achieve the objectives of an audit.

   a. Audit program.

   b. Audit evidence.

   c. Audit plan.

   d. Audit strategy.

10. Which of the following statements best describes the risk assessment process?

    a. The risk assessment process is cut and dried, so the auditor will not have to use professional judgment.

    b. An auditor performs risk assessment procedures so he will understand the entity, its environment, and its internal control.

    c. The auditor's consideration of fraud under SAS No. 99 is separate from the auditor's consideration of audit risk.

11. Can audit evidence obtained during previous audits be used during the current audit?

    a. Yes.

    b. No.

12. Blake accepts an engagement to audit a CIRA. During the planning phase of the audit, Blake makes inquiries of management about fraud risk. Which of the following questions will alert Blake to any knowledge management might have of actual fraud or suspicions of fraud that might affect the CIRA?

    a. How do you make it clear to employees that fraudulent or unethical behavior will not be tolerated?

    b. Have you seen any changes in employee behavior?

    c. Have you identified any specific risks of fraud within the association?

    d. What measures have you taken to address specific risks of fraud within the organization?

13. What is the purpose of performing observation and inspection procedures during an audit engagement?

    a. To help the auditor plan the nature, timing and extent of other auditing procedures.

    b. To analyze relationships between financial and nonfinancial amounts in the financial statements.

    c. To obtain an understanding of the entity and its environment, including internal control.

    d. To document any risk assessment procedures used during the audit.

14. As part of audit planning, the engagement team must have a discussion about ways the CIRA's financial statements could be susceptible to material misstatement due to error or fraud. Under SAS No. 109, what is one topic that must be included in the discussion?

    a. The firm's past experience with the CIRA.

    b. Ways the CIRA's assets could be stolen.

    c. The nature and complexity of the CIRA's transactions.

    d. Any unusual accounting practices the CIRA uses.

SELF-STUDY ANSWERS

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

9. What term best fits the following definition? **(Page 425)**

> An operational approach that allows an auditor to achieve the objectives of an audit.

   a. Audit program. [This answer is incorrect. An audit program is more detailed than the operational approach described in the above definition.]

   b. Audit evidence. [This answer is incorrect. Sufficient appropriate audit evidence must be found for an auditor to complete an audit and give his or her opinion.]

   c. Audit plan. [This answer is incorrect. This is a more detailed plan than the one described above. It documents the nature, timing, and extent of procedures to be performed.]

   d. Audit strategy. [This answer is correct. The audit strategy is a high-level description of the audit scope, and, according to SAS No. 108, includes such matters as the expected conduct, organization, and staffing for an audit.]

10. Which of the following statements best describes the risk assessment process? **(Page 426)**

   a. The risk assessment process is cut and dried, so the auditor will not have to use professional judgment. [This answer is incorrect. Decisions and judgments an auditor must make during the risk assessment process include determining materiality levels and assessing risks of material misstatement at the financial statement and relevant assertion levels.]

   b. An auditor performs risk assessment procedures so he will understand the entity, its environment, and its internal control. [This answer is correct. The auditor can obtain this understanding by finding the industry, regulatory, and other external factors; the nature of the entity (organizational structure and personnel, operating characteristics, etc.); objectives and strategies and related business risks; measurement and review of financial performance; internal control; and fraud risk factors.]

   c. The auditor's consideration of fraud under SAS No. 99 is separate from the auditor's consideration of audit risk. [This answer is incorrect. This fraud risk consideration should be integrated in to the overall risk assessment process; therefore, assessment of risks due to error occurs simultaneously with the assessment of risks due to fraud.]

11. Can audit evidence obtained during previous audits be used during the current audit? **(Page 429)**

   a. Yes. [This answer is correct. However, this is a qualified "yes." The auditor must determine if changes have occurred that will affect the relevance of audit evidence collected in pervious audits, and, if so, the current period audit activities may need to be increased.]

   b. No. [This answer is incorrect. Previous experience contributes to an auditor's understanding of an entity and its environment.]

12. Blake accepts an engagement to audit a CIRA. During the planning phase of the audit, Blake makes inquiries of management about fraud risk. Which of the following questions will alert Blake to any knowledge management might have of actual fraud or suspicions of fraud that might affect the CIRA? **(Page 432)**

   a. How do you make it clear to employees that fraudulent or unethical behavior will not be tolerated? [This answer is incorrect. This question would help Blake determine how management communicates the importance of ethical behavior and appropriate business practices to employees.]

b. Have you seen any changes in employee behavior? [This answer is correct. Other questions Blake could ask along this line of inquiry include "Are you aware of any actual instances of fraud within the association?" and "Do you have any suspicions that fraud may be occurring within the association?"]

c. Have you identified any specific risks of fraud within the association? [This answer is incorrect. This question would help Blake understand management's understanding of the risks of fraud within the CIRA, including any specific fraud risks the CIRA has identified or account balances or transaction classes that may be susceptible to fraud.]

d. What measures have you taken to address specific risks of fraud within the organization? [This answer is incorrect. This question will help Blake understand the programs and controls the CIRA has implemented to address identified fraud risks or otherwise help prevent, deter, and detect fraud and how those programs and controls are monitored.]

13. What is the purpose of performing observation and inspection procedures during an audit engagement? **(Page 437)**

a. To help the auditor plan the nature, timing and extent of other auditing procedures. [This answer is incorrect. According to SAS No. 56, this is the purpose of performing preliminary analytical procedures, not observation and inspection procedures.]

b. To analyze relationships between financial and nonfinancial amounts in the financial statements. [This answer is incorrect. This type of procedure will help an auditor identify unusual or unexpected relationships related to revenue, but this is not an observation and inspection procedure.]

c. To obtain an understanding of the entity and its environment, including internal control. [This answer is correct. Observation and inspection procedures are required for this purpose. For example, inspection and observation can be used to corroborate or follow-up on the results of inquires made of management and others.]

d. To document any risk assessment procedures used during the audit. [This answer is incorrect. Documentation of risk assessment procedures is required by SAS Nos. 103 and 109, but this is not done with inspection and observation.]

14. As part of audit planning, the engagement team must have a discussion about ways the CIRA's financial statements could be susceptible to material misstatement due to error or fraud. Under SAS No. 109, what is one topic that must be included in the discussion? **(Page 438)**

a. The firm's past experience with the CIRA. [This answer is incorrect. This topic could be included in the engagement team's discussion, but it is not required by SAS No. 109.]

b. Ways the CIRA's assets could be stolen. [This answer is incorrect. While a discussion topic that could be useful to include in the engagement team discussion, this topic is not required by SAS No. 109.]

c. The nature and complexity of the CIRA's transactions. [This answer is incorrect. This is a fraud-related matter that is required by SAS No. 99 (not SAS No. 109) for inclusion in the engagement team discussion.]

d. Any unusual accounting practices the CIRA uses. [This answer is correct. SAS No. 109 requires the engagement team to discuss the susceptibility of the CIRA's financial statements to material misstatement (i.e., misstatement due to error). This portion of the discussion should include unusual accounting practices, as well as other issues (e.g., areas of significant audit risk, important control systems, and the need to exercise professional skepticism during the engagement).]

OBTAINING AN UNDERSTANDING OF THE ENTITY AND ITS ENVIRONMENT

The second standard of field work requires an understanding of the "entity and its environment, including its internal control" (AU 150.02). Requiring an understanding of the entity and its environment focuses the auditor's attention on the fact that the understanding establishes a frame of reference within which the auditor assesses the risks of material misstatement and plans the audit in response to those risks. The auditor's focus in obtaining the required level of understanding should be 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. However, 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 should be focused on those matters that could cause material misstatements in the financial statements, including potential fraud risk factors, undisclosed related-party transactions, illegal acts, 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 must 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 should 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, something changes each year. There are always important new developments with the client and within the industry. For this reason, it is advisable for each member of the audit team to 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 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.

Components of the Understanding

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. Internal control.

As part of understanding the entity and its environment, the auditor obtains an understanding of the CIRA's selection and application of accounting policies. The selection and application of accounting policies is considered an aspect of internal control, but is presented separately in this discussion because of its significance to the auditor's assessment of the risks of material misstatement. The selection and application of accounting policies is an integral part of the control environment component of internal control, but merits separate and focused attention. Similarly, 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. Items a.–d. above are discussed in this section. Items a. and b. are considered together in the following discussion because of their close interrelationship. Item e., internal control, is discussed later in this course.

Documentation. SAS No. 109 (AU 314.122) indicates that auditors should document:

- Key elements of the understanding obtained for each of the aspects of the entity and its environment to assess the risks of material misstatement in the financial statements.
- Sources of the information from which the understanding was obtained.
- Risk assessment procedures that were performed.

SAS No. 99 (AU 316) requires auditors to document their consideration of fraud risk factors.

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

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.

Matters the auditor might consider when obtaining an understanding of industry, regulatory, or other external factors include the following:

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

b. Regulatory environment, including relevant legislation and regulation, 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, societal attitudes, unemployment, interest rates, availability of credit, energy and insurance risks, and inflation.

AICPA Audit Risk Alert. The current financial and economics crisis may affect the CIRA's operations, risks, and financial reporting. This in turn may affect the auditor's responsibilities in providing auditing services. The AICPA issued an Audit Risk Alert, *Current Economic Crises—Accounting and Auditing Considerations*, to help identify and respond to accounting and auditing issues related to the current economic environment. The Alert notes, audit risks that may have been identified previously might become more significant, or new risks may exist due to current events such as events affecting the economy, credit, and liquidity.

A characteristic of the current environment is the high volatility and rapidity of changing conditions. The AICPA Alert notes that the rapidity changing economic environment complicates the auditor's responsibility to obtain a sufficient understanding of the CIRA and its environment (including the industry, regulatory, and other external factors) in order to assess the risks of material misstatement of the financial statements and design responsive audit procedures. Changed conditions may require the auditor to update his or her understanding of how the current economic environment affects the CIRA, reassess audit risks, and modify planned audit procedures as the audit progresses.

The AICPA Alert provides an extensive review of the economic and financial events that led to the financial crises and resulting legislative and regulatory actions and also covers issues arising from the economic crises including—

- Fair value accounting.
- Other than temporary impairment issues.
- Auditing accounting estimates.
- Liquidity considerations.
- Going-concern considerations.
- Fraud considerations.

Possible Risk Assessment Procedures and Factors to Consider. In most situations, auditors will initially gather information and identify risks related to the entity and its environment 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 his or her 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.

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*, 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 revenue agent's 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 the "Observation and Inspection" discussion in the previous section.

Nature of the Entity

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 organizational structure, ownership, personnel and governance; the types of its investments; and its 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.

Matters that the auditor might consider about the entity's operations and its structure, ownership, and governance include the following:

a. Revenue sources.

b. Number of residential and commercial units in the CIRA development.

c. Involvement in e-commerce.

d. Conduct of operations.

e. Important suppliers.

f. Major assets, including types of common property, and liabilities.

g. Major operating expenses and expenditures from replacement and capital improvement funds.

h. Policy, statutory requirements, and methods for funding major repairs and replacements.

i. Policy and methods for funding capital improvements.

j. Employment and human resource matters, including compensation methods and employee benefits.

k. Tax status.

l. Related parties and transactions with them.

m. Location of facilities.

n. Types of investments.

o. 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 should 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 should be retained in the permanent file. Auditors should 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 should 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 the auditors should obtain an understanding of the nature and size of the work force and the compensation methods.

Operating Characteristics. Auditors should 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 should 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 should review the governing documents as well as relevant state statutes or local ordinances. They should have an understanding of the effects of noncompliance on the financial statements. Auditors should 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 should 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 should 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. 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, Paragraph 4.25 of the AICPA guide (FASB 972-605-50-2) requires that fact and the amounts of revenue from each source to be disclosed.] In addition, the auditors should 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 and should be disclosed in the financial statements.

Auditors should review documents in the permanent file, inquire of management, and review board minutes to identify transactions with related parties. Also, auditors should 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 as deemed necessary to fully understand the entity, its operations, structure, ownership, governance, 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

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. 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.

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:

- Products and services for members.

- Regular and special assessments.
- Business expansion or restructuring.
- Major repairs and replacements and capital improvements.
- Employment or compensation.

Measurement and Review of the Entity's Financial Performance

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 in service or parts sales, 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 these 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

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. This understanding 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 pronouncements 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 an OCBOA).

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

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 should use 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. 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 industry.
- The auditor's 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 both selecting 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 where 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 in the discussion of "Risk Assessment Procedures and Factors to Consider." 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 to the client's transactions.

Fraud Risk Factors

When obtaining information about the entity and its environment, the auditor should consider whether the information indicates that fraud risk factors are present. That is, the auditor considers the existence of fraud risk factors while performing other audit planning procedures. Auditors are not specifically required to look for fraud risk factors during planning, but are required to consider, based on their knowledge of the entity and its environment, whether fraud risk factors exist. Fraud risk factors are conditions or events that indicate incentives/pressure to perpetuate fraud, opportunities to carry out the fraud, or attitudes/rationalizations to justify a fraudulent action.

The identification of fraud risk factors is a natural by-product of performing risk assessment procedures. Along with the other information obtained about the entity 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 should 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 should 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. SAS No. 99 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 presented in SAS No. 99 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, SAS No. 99 (AU 316.33) 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 of the risk factors related to fraudulent financial reporting is that CIRA management may be dominated by a single individual or a small group without compensating controls. Is that circumstance always a fraud risk factor? This course maintains 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 later in this lesson.

If the CIRA has a managing agent, fraud risk factors related to a CIRA's management should also be considered from the perspective of the CIRA's managing agent. For example, a fraud risk factor related to fraudulent financial reporting is if the CIRA has ineffective oversight over financial reporting and internal control by the board of directors or audit committee. 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 should consider the importance of the modifying language 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 should be 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, there should always be some consideration of fraud risk factors related to misappropriation. 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, he or she should consider them when identifying the risks of material misstatement due to fraud.

If fraud risk factors are present, SAS No. 109 (AU 314.12) requires that "the auditor should consider 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 transaction, or disclosure 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.

15. Which of the following statements best describes obtaining an understanding of the entity and its environment?

    a. It is a general knowledge level, not a purpose-driven audit focus.

    b. It is helpful in an audit engagement, but not required of the auditor.

    c. The auditor should focus on areas that could cause material misstatement of the financial statements.

    d. Once the understanding is obtained, it is sufficient for the auditor's association with the client.

16. Minnie's CIRA client employs a property management company, so she performs procedures to obtain an understanding of the extent of the company's responsibilities and the degree of control over the company maintained by the CIRA's board of directors. This is an example of what element of an auditor's understanding of the entity and its environment?

    a. The nature of the CIRA.

    b. The CIRA's industry, regulatory, and other external factors.

    c. The CIRA's financial performance.

    d. The CIRA's objectives, strategies, and related business risks.

17. Which of the following statements most accurately describes an element of obtaining an understanding of an entity and its environment?

    a. Inquires about business objectives, strategies, and related risks should be made of employees at all levels of the organization.

    b. Performance measures will be more effective to assess if the audit client is a smaller business entity.

    c. Understanding selection and application of accounting policies is important for considering the risk of material misstatement.

    d. Fraud risk factors are separate from the auditor's consideration of the entity and its environment.

18. Which of the following scenarios should provide an auditor with a red flag for the risk of misappropriation of assets?

    a. CIRA A instituted a new 401(k) plan for all employees with at least one year of service.

    b. CIRA B announced a series of layoffs that will occur in the next year.

    c. CIRA C paid out an annual bonus to all employees on time in the current reporting period.

    d. CIRA D codified its policies and procedures in a handbook and distributed it to employees.

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 obtaining an understanding of the entity and its environment? **(Page 447)**

    a. It is a general knowledge level, not a purpose-driven audit focus. [This answer is incorrect. In fact, the opposite is true. 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.]

    b. It is helpful in an audit engagement, but not required of the auditor. [This answer is incorrect. The second standard of field work requires an understanding of the "entity and its environment, including its internal control."]

    c. The auditor should focus on areas that could cause material misstatement of the financial statements. [This answer is correct. Such areas include potential fraud risk factors, undisclosed related-party transactions, illegal acts, uncertainties, or going-concern problems.]

    d. Once the understanding is obtained, it is sufficient for the auditor's association with the client. [This answer is incorrect. Obtaining this understanding is a continual process. 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 will always be important new developments with the client and within the industry.]

16. Minnie's CIRA client employs a property management company, so she performs procedures to obtain an understanding of the extent of the company's responsibilities and the degree of control over the company maintained by the CIRA's board of directors. This is an example of what element of an auditor's understanding of the entity and its environment? **(Page 450)**

    a. The nature of the CIRA. [This answer is correct. While understanding her CIRA client's nature, Minnie must understand its structure and personnel, including the activities of a managing agent or property management company.]

    b. The CIRA's industry, regulatory, and other external factors. [This answer is incorrect. An example of something Minnie might investigate when obtaining this understanding is the CIRA's market and competition, economic or demographic changes, cyclical or seasonal activities, and the availability and cost of materials and supplies.]

    c. The CIRA's financial performance. [This answer is incorrect. Information used to measure and review a CIRA's financial performance might include key performance indicators, trends, key ratios, period-on-period financial performance, and employee performance measures.]

    d. The CIRA's objectives, strategies, and related business risks. [This answer is incorrect. The CIRA's management will determine its objectives. 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.]

17. Which of the following statements most accurately describes an element of obtaining an understanding of an entity and its environment? **(Page 454)**

    a. Inquires about business objectives, strategies, and related risks should be made of employees at all levels of the organization. [This answer is incorrect. Questioning in this area would generally be restricted to the entity's board of directors and officers, given the subject matter and the level of knowledge that is needed to sufficiently address it.]

    b. Performance measures will be more effective to assess if the audit client is a smaller business entity. [This answer is incorrect. A small entity may not have a formal process for measuring and reviewing financial performance; therefore, consideration of performance measures will be more effective for a larger entity. However, management may still be aware of key performance indicators that it uses and that can be helpful to the auditor.]

    c. Understanding selection and application of accounting policies is important for considering the risk of material misstatement. [This answer is correct. This understanding is important for considering the risks of material misstatement at both the financial statement and relevant assertion levels.]

    d. Fraud risk factors are separate from the auditor's consideration of the entity and its environment. [This answer is incorrect. Auditors are not specifically required to look for fraud risk factors during planning procedures, but they are required to consider, based on their knowledge of the of the entity and its environment, whether fraud risk factors exist.]

18. Which of the following scenarios should provide an auditor with a red flag for the risk of misappropriation of assets? **(Page 456)**

    a. CIRA A instituted a new 401(k) plan for all employees with at least one year of service. [This answer is incorrect. A risk factor for misappropriation of assets would be if the CIRA's level of compensation or its employee benefit plans were changed in an unfavorable way.]

    b. CIRA B announced a series of layoffs that will occur in the next year. [This answer is correct. This would cause potential financial stress or dissatisfaction on the part of the CIRA's employees, and, thus, could be an indicator of possible misappropriation of assets.]

    c. CIRA C paid out an annual bonus to all employees on time in the current reporting period. [This answer is incorrect. Failure to receive promotions or other expected awards would be a red flag for misappropriation of assets.]

    d. CIRA D codified its policies and procedures in a handbook and distributed it to employees. [This answer is incorrect. Employee behavior indicating disregard of the CIRA's policies and procedures would be a risk factor that might indicate possible misappropriation of assets.]

OBTAINING AN UNDERSTANDING OF INTERNAL CONTROL

SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, provides guidance to 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.

Components of Internal Control

SAS No. 109 (AU 314.40) requires auditors to 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. The *Enterprise Risk Management—Integrated Framework* (the Framework), issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), describes the essential components of enterprise risk management, and is designed to help organizations of all sizes identify, assess, and manage risk. The Framework is built on the foundation of COSO's *Internal Control—Integrated Framework*, and does not change the basic COSO requirements. An executive summary of the framework is available at **www.aicpa.org**, and copies can be ordered at **www.cpa2biz.com**.

SAS No. 109 requires 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 in the following paragraphs.

In assessing the risk of material misstatement of the financial statements to develop an overall audit strategy, auditors generally focus on obtaining an understanding of the control environment, risk assessment, information and communication, and monitoring components, typically obtaining an understanding of the control environment first. The understanding of control activities is not needed until planning the nature, timing, and extent of further audit procedures at the assertion level. As a practical matter, however, auditors often obtain an understanding of control activities while obtaining an understanding of the other control components. As a CIRA's operations and systems become more complex, auditors will most likely need to increase their understanding of the internal control components to obtain the understanding necessary to assess the risk of material misstatement of the financial statements and to plan the nature, timing, and extent of further audit procedures.

Nature of the Auditor's Understanding

SAS No. 109 requires auditors to obtain a sufficient understanding of the five components of internal control to assess risk and design the nature, timing, and extent of further audit procedures. To obtain that understanding, the SAS requires auditors to perform risk assessment procedures to (a) evaluate the design of controls that are relevant to the audit and (b) determine if they have been implemented. A key consideration is whether and how the CIRA'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, it may represent a control deficiency 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 should use risk assessment procedures to obtain audit evidence that the control has actually been implemented. 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 serve as testing 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 requires the auditor to develop a fairly thorough and robust knowledge of the components of internal control. That is primarily because the auditor is required to have, and document, the basis for his or her risk assessment. 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 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.

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 and tolerable misstatement.
- Size of the CIRA.
- Type of legal entity (corporation, association, etc.) and development (condominium, planned unit development, etc.).
- Number and nature of operating locations.
- Degree of diversity of systems within the CIRA, including the use of service organizations.
- Nature of the CIRA industry.
- Applicable legal and regulatory requirements.
- Level of business and financial sophistication of the client.

The auditor's understanding of the CIRA and its environment other than internal control as discussed previously (as well as preliminary engagement activities) will generally influence the extent of the understanding of internal control

components. Most of the factors noted above 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 should be aware that additional risks of material misstatement may be identified when obtaining an understanding of internal control and by performing further audit procedures.) It is recommended that the auditor perform risk assessment procedures related to the understanding of the CIRA and its environment prior to obtaining an understanding of internal control.

How Are the Results of the Understanding Used? The understanding of internal control should 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 misstatements.
- Consider factors that affect the risks of material misstatement.
- Design tests of controls, when applicable, and substantive procedures.

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

Effect of Information Technology (IT) on Internal Control

Many small associations have simple computer operations, typically desktop computers that may be linked in a local area network (LAN), and run purchased software packages for specific applications such as assessments receivable. However, some small associations depend heavily on information technology (IT). SAS No. 109 does not address IT as a separate component of internal control—it discusses how IT fits into internal control. While the SAS does not require that auditors take a different approach in considering internal control when a CIRA uses IT, it indicates that auditors should consider how IT affects the way transactions are initiated, authorized, recorded, processed, and reported. 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 computer 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 computer programs. In addition, the nature of the manual controls may be different. Manual controls in an automated system may be independent of the computer 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.

As noted in SAS No. 109 (AU 314.62), 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 where 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 control 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 where 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.

Benefits and Risks of IT. The use of computers 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 computers 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 a computerized system, security controls can help achieve segregation of duties. However, the use of computers 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.

SAS No. 109 (AU 314.96) notes that the auditor should consider whether the entity established effective controls that adequately respond to the risks that arise from IT. Such controls not only include properly designed and implemented application controls, but general controls upon which application controls depend. The AICPA risk assessment guide, *Assessing and Responding to Audit Risk in a Financial Statement Audit* (paragraph 4.63), notes that the auditor should evaluate the design of IT general controls and determine whether they have been implemented when assessing the risks of material misstatement. The auditor would consider testing general controls when they plan to rely on IT application controls to modify the nature, timing, and extent of substantive tests.

In addition to the risks of material misstatement due to error or fraud that IT may introduce, the auditor should 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 information is initiated, authorized, recorded, processed, or reported electronically, 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 should consider whether specialized IT skills are needed to determine the effect of IT on the audit, understand the IT controls, or to design and perform tests of IT controls or substantive procedures. The decision to use an IT specialist is a matter of auditor judgment. SAS No. 108 (AU 311.23) states that auditors should consider the

following factors in determining whether the audit team should include individuals who possess specialized IT skills:

- The complexity of the CIRA's systems and IT controls and the manner in which they are used in conducting the CIRA's business.
- The significance of changes made to existing systems or the implementation of new systems.
- The extent to which data is shared among systems.
- The CIRA's use of emerging technologies.
- The significance of audit evidence that is available only in electronic form.
- The 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.

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 SAS 70 report on the service organization's internal control.

c. The auditor believes he or she 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, 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 effects 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 auditor's responsibility when using a computer specialist is the same as for other members of the engagement team. To effectively supervise an IT specialist, auditors need a basic understanding of computer 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. If the firm uses an outside professional, the guidance in SAS No. 73 (AU 336) should be considered.

Documentation

SAS No. 109 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.

SAS No. 109 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.

The control environment includes the following elements:

- 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. 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 should obtain 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 responsibilities assumed by management and those charged with governance related to financial reporting are particularly important. For example, the auditor should 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 insure 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 elements of 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 Practice Aid, *Obtaining an Understanding of the Control Environment* (TIS 8200.08). TIS 8200.08 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.

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. 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. CIRA management that is dominated by a single individual or small group with out compensating controls, because of the ability to dominate activities or override 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 resulting from a poor or deteriorating financial condition 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.

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.

All CIRAs should 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 should 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 should 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 fraud risks and taking appropriate action to reduce or eliminate the risks.

e. 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).

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.

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, the 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 may arise due to the following:

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

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

The auditor should 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 should gain an understanding of management's assessment of the effect of expending the CIRA's operations on internal control and the steps taken to address that impact. For risks related to fraud, the auditor should 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 his or her 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. 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.

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 computerized, 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 financial reporting system and communication process are discussed 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 should 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, and monitoring, it may not be necessary to devote additional attention to obtaining an understanding of control activities.

Financial Reporting System. 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, 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 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.

A financial reporting system includes methods and records that:

- Identify and record all valid 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 should consider the qualifications of accounting personnel and the time pressure they face. Inexperienced or harried accounting personnel make more errors.

Essentially, 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. In a simple financial reporting system, where the auditor assists with the preparation of financial statements and disclosures, this generally will involve:

- Identifying the CIRA's significant transaction classes.
- Understanding the flow of information through the financial reporting system for significant transaction classes.
- Understanding the financial close and reporting process, including how information about other events and conditions (that is, other than items included in the CIRA's significant transaction classes) is captured for inclusion in the general ledger and financial statements.
- Understanding the extent to which IT is used in the financial reporting system.

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 Significant Transaction Classes. The auditor should identify significant classes of transactions and obtain 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 2-5 provides examples of transaction classes for specified audit areas and identifies the transaction classes that will be considered significant for many CIRAs.

Exhibit 2-5

Examples of Transaction Classes for Specified Audit Areas

Cash

Processing cash receipts[a]
Processing disbursements[a]
Other (specify)

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
Recording deferred revenue for special assessments
Maintaining member master file
Other (specify)

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
Other (specify)

Investments and Derivatives

Managing investments[a]
Managing derivatives
Assessing assets for impairment
Other (specify)

Other Assets

Recording purchases of other assets
Assessing assets for impairment
Amortizing assets
Other (specify)

Accounts Payable and Other Liabilities

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

Notes Payable and Long-term Debt

Managing borrowings
Other (specify)

Income Taxes

Calculating and reporting income taxes
Other (specify)

Equity

Recording equity transactions
Other (specify)

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
Other (specify)

Financial Close and Reporting

Defining the financial closing and reporting process[a]
Performing the accounting period close[a]
Capturing and processing other nonroutine information requiring significant estimates and judgments from management[a]
Preparing and reviewing financial statement disclosures[a]
Reviewing and approving the financial statements[a]
Other (specify)

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 nature and extent of the auditor's risk assessment procedures. Typically, such documentation exists for larger and more complex entities 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 this documentation, corroborated by inquires of various personnel to determine if the information is current. 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 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 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. The AICPA Audit and Accounting Guide, Audit Sampling, notes in Paragraph 3.25 that a walkthrough may be designed to include procedures that are also tests of the operating effectiveness of controls.

Walkthroughs of transactions often involve both 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 and related controls 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(s) or control(s).

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 should follow 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.

Communication. The auditor should 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 should 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 must be open channels of communication and a willingness on the part of management to deal with problems. For control activities to be effective, individuals should 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 should 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 regarding problems, controls, potential fraud, or other issues is welcomed and expected.
- That alternative channels of communication are available should an employee or participant feel 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 internal evaluation and (b) 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 his or her 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 that monitoring is accomplished, identified deficiencies should be reported to the individuals responsible for taking corrective action and to management and those charged with governance as appropriate.

The auditor should obtain an understanding of the major types of activities that management uses to monitor internal control over financial reporting. 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 should 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 his or her experience with the client, general observations of company operations, and discussions with management or the dealer/owner-manager.

Consideration of Internal Audit Function. One method some entities use to monitor internal control is through separate evaluations by internal auditors. Most small and midsize CIRAs do not have internal auditors. However, if there is a designated internal audit function, the auditor should obtain an understanding of that function during audit planning. SAS No. 65 (AU 322.05) states that the auditor should make inquiries about the following matters relating to the internal audit function (if one exists) as part of audit planning:

a. Organizational status within the entity (i.e., to whom does the internal audit function report?).

b. Application of professional internal auditing standards (e.g., standards of the Institute of Internal Auditors).

c. Internal audit plan (i.e., the nature, timing, and extent of audit work).

d. Limitations on access to records or on the scope of internal audit procedures.

In addition, SAS No. 99 (AU 316) requires auditors to inquire of appropriate internal audit personnel about their understanding of the risks of fraud, whether they have 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 or suspected fraud. The auditor should explain that fraud includes both misappropriation of assets and fraudulent financial reporting. The results of those inquiries should be documented and then considered when identifying risks of material misstatement due to fraud.

The auditor's understanding of the CIRA's monitoring process should be documented.

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 should be done and (b) the procedure that implements the policy. The auditor's understanding of the other components of internal control, such as the control environment, is used in assessing the risks of material misstatement at both the financial statement and relevant assertion levels. Certain components, such as the control environment, are more important for developing the overall audit strategy. In contrast, control activities are important at the relevant assertion level for detailed planning of the nature, timing, and extent of further audit procedures.

Control activities, which can be either automated or manual, are performed at various levels within the CIRA. The auditor should 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 should concentrate 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. Also, as required by SAS No. 109 (AU 314.92), the auditor should understand how it affects control activities that are relevant to planning the audit.

Control activities that are relevant to the audit are policies and procedures that pertain to the following:

- *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 such as those that limit access to assets, authorization safeguard for access to computer programs 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.
- *Asset 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.

Control policies may be communicated either orally or in writing. This will depend to a great extent on the size of the CIRA and the channels of communication within it. Also critical to control activities are the follow-up actions taken in response to identified discrepancies.

An audit of financial statements does not require an understanding of all control activities related to each class of transactions, account balance, and disclosure or to every relevant assertion. The auditor first considers the knowledge about control activities obtained from the understanding of the other components of internal control before devoting additional attention to obtaining an understanding of control activities. Generally, the auditor accumulates a significant amount of knowledge about control activities through the process of obtaining an understanding of the other components of internal control. Professional standards specifically require the auditor to obtain an understanding of the process of reconciling detail to the general ledger for material accounts.

The auditor may also learn of control activities while performing risk assessment procedures to obtain the understanding of the CIRA and its environment discussed previously. Most frequently, however, the auditor learns of control activities while obtaining an understanding of the financial reporting process as discussed beginning in the "Financial Reporting System" paragraph. A natural by-product of the understanding of how transactions are initiated, authorized, processed, 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.

Professional 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 under professional standards 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 should evaluate whether a sufficient understanding of control activities has been obtained for those areas where the auditor considers that material misstatements are more likely to occur. 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 material misstatements in specific assertions related to fraud risks or other significant risks.

- The auditor plans 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 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

The auditor's understanding of internal control should include the CIRA's programs and controls that address identified risks of material misstatement that are considered significant risks. Fraud risks are always considered to be significant risks. Programs and controls addressing significant or fraud risks may relate to any of the five components of internal control; thus, the auditor should use care not to isolate the understanding to only the control activities component. The auditor should be alert to the fact that significant or fraud risks may not be subject to routine controls given the nature of the risk. 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 should evaluate whether the programs and controls that relate to significant risks are suitably designed and implemented and assess 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 should be sure 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 or theft in the accounting records.

Documentation

Control activities should be documented. Auditors can describe the sources of information used and the procedures performed, as well as conclude whether the controls over the significant transaction classes in the audit area are properly designed and implemented. One method for this documentation is to use the forms provided in *PPC's Guide to Homeowners' Associations*.

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. One method for documenting tests of controls is to use the forms provided by *PPC's Guide to Homeowners' Associations*.

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), SAS No. 70, *Service Organizations*, (AU 324.06), makes it clear that auditors should obtain an understanding of the client's financial reporting system and internal control policies and procedures for information produced by the service organization. The understanding should include how the CIRA develops information to submit to the service organization and how it ensures the information returned from the service organization is free of material errors. Generally, the understanding can be obtained in one of three ways:

- SAS No. 70 recognizes the CIRA may have sufficient controls over the information produced by the service organization. An example would be a CIRA that authorizes and verifies all transactions (all cash disbursements and collections, etc.) and related information produced by the managing agent. In that case, the requirements are met by obtaining an understanding of the CIRA's controls over the information produced by the managing agent.

- If the CIRA does not have sufficient controls over the information produced by the service organization, auditors should obtain a copy of the *service auditor's report* (a type of special purpose report described in SAS No. 70) from the service organization.

- If neither of the two preceding alternatives is possible, auditors will need to personally apply procedures at the service organization to obtain an understanding of internal control and substantiate financial statement amounts. Auditors can obtain that understanding by (a) reviewing documentation about the service organization that is available from the client or (b) visiting the service organization to make inquiries and observations and review documentation.

Many CIRAs do not have sufficient controls over the information produced by the managing agent. If the CIRA does not have sufficient controls, the auditor may obtain information about the managing agent's controls needed to plan the audit 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 planning the audit. (The lack of controls by the CIRA probably is a significant deficiency that should be communicated to the client.)

If the CIRA uses service organizations other than managing agents, information similar to that described in the previous paragraph may be obtained to plan the audit.

SELF-STUDY QUIZ

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

19. Which of the following is **not** one of the factors that affects the extent of an auditor's understanding of internal control?

    a. The auditor's previous experience with the client.

    b. The nature and number of operating locations.

    c. The client's business level and financial sophistication.

    d. The client's related party transactions.

20. What risk does a CIRA's use of a computer system pose to its internal control?

    a. Unauthorized access to data.

    b. Lack of consistency.

    c. Lack of segregation of duties.

21. Define *control environment*.

    a. The foundation for all other components of internal control.

    b. The identification, analysis, and management of risks relevant to financial statement preparation.

    c. The financial reporting system and accountability over its liabilities, assets, and equity.

    d. A process for assessing the quality of internal control over time.

22. Which of the following statements most accurately describes obtaining an understanding of the information and communication element of internal control?

    a. The auditor should focus almost exclusively on the information aspect as is provides key information used in the rest of the audit.

    b. It may be efficient for an auditor to gain an understanding of the financial reporting system, internal control monitoring, and control activities simultaneously.

    c. If a CIRA has a managing agent, the only important aspect of communication is how the agent communicates with employees.

    d. Communication must take place orally with each employee and be documented by the CIRA in the employee's file.

23. Which of the following is an example of a monitoring activity?

    a. Reconciliations of common property with general ledger control accounts.

    b. Distribution of training manuals to employees.

    c. Performing a walkthrough.

    d. Review of any member complaints about the assessment process.

24. What control activities are related to *performance reviews*?

    a. Comparisons of current financial reports to other information.

    b. Application controls and general controls.

    c. Controls related to an asset's physical security.

    d. Assignment of different people to authorize and record transactions.

25. When auditing a CIRA that uses service organization, when would an auditor need a copy of the *service auditor's report*?

    a. The CIRA has sufficient controls over information the services organization produces.

    b. The CIRA does not have sufficient controls over information the services organization produces.

SELF-STUDY ANSWERS

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

19. Which of the following is **not** one of the factors that affects the extent of an auditor's understanding of internal control? **(Page 461)**

    a. The auditor's previous experience with the client. [This answer is incorrect. This does factor into the auditor's understanding of internal control. Another factor that will affect the auditor's understanding is the size of the audit client.]

    b. The nature and number of operating locations. [This answer is incorrect. The auditor's understanding of internal control will be affected by this factor. To obtain an understanding that will allow the auditor to assess the risks of material misstatement, the auditor's knowledge of the components of internal control must be thorough and robust.]

    c. The client's business level and financial sophistication. [This answer is incorrect. This factor will affect an auditor's understanding of internal control. Another example of such a factor is the degree of diversity of systems within the client.]

    d. The client's related party transactions. [This answer is correct. Understanding the client's related party transactions will help an auditor obtain an understanding of the entity and its environment; however, this is not one of the factors that specifically affects the auditor's understanding of internal control.]

20. What risk does a CIRA's use of a computer system pose to its internal control? **(Page 463)**

    a. Unauthorized access to data. [This answer is correct. If this risk is realized, it could lead to destruction of data or improper changes to the data. Other risks that are associated with the use of a computer system are unauthorized changes to systems or programs and the loss or destruction of data.]

    b. Lack of consistency. [This answer is incorrect. Use of a computer system can actually enhance the effectiveness and efficiency of a CIRA's internal control because of the consistency, timeliness, and accuracy inherent in automated systems.]

    c. Lack of segregation of duties. [This answer is incorrect. In a computer system, security controls can help achieve segregation of duties; however, the auditor should be alert for other risks, such as inappropriate manual intervention and failure to change systems or programs when necessary.]

21. Define *control environment*. **(Page 465)**

    a. The foundation for all other components of internal control. [This answer is correct. The control environment sets the tone of the CIRA, influences its people's control consciousness, and provides structure and discipline.]

    b. The identification, analysis, and management of risks relevant to financial statement preparation. [This answer is incorrect. This describes a CIRA's *risk assessment*. Risk assessment can also be described as identifying types of potential misstatements and designing control activities to prevent or promptly detect those misstatements.]

    c. The financial reporting system and accountability over its liabilities, assets, and equity. [This answer is incorrect. This describes the information portion of *information and communication*. The financial reporting system includes the accounting system and related procedures and records. Communication is the process of providing an understanding of roles and responsibilities to individuals within the CIRA regarding internal control over financial reporting.]

d. A process for assessing the quality of internal control over time. [This answer is incorrect. This is a description of *monitoring*. Monitoring involves assessing the design and operation of controls on a timely basis, capturing and reporting identified control deficiencies, and taking actions as necessary.]

22. Which of the following statements most accurately describes obtaining an understanding of the information and communication element of internal control? **(Page 468)**

a. The auditor should focus almost exclusively on the information aspect as is provides key information used in the rest of the audit. [This answer is incorrect. The auditor must not lose sight of the importance of the communication of accounting and financial reporting roles within a 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.]

b. It may be efficient for an auditor to gain an understanding of the financial reporting system, internal control monitoring, and control activities simultaneously. [This answer is correct. The elements of internal control overlap in this way. While 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.]

c. If a CIRA has a managing agent, the only important aspect of communication is how the agent communicates with employees. [This answer is incorrect. How communications occur between the CIRA and the managing agent is also important.]

d. Communication must take place orally with each employee and be documented by the CIRA in the employee's file. [This answer is incorrect. Communication may be written, electronic, oral, or through the direct actions and involvement of management.]

23. Which of the following is an example of a monitoring activity? **(Page 474)**

a. Reconciliations of common property with general ledger control accounts. [This answer is incorrect. This is an example of a control activity.]

b. Distribution of training manuals to employees. [This answer is incorrect. Existence of this type of documentation describing classes of transactions and the transaction flow of the accounting system will influence the nature and extent of the auditor's risk assessment procedures for the information and control element of internal control.]

c. Performing a walkthrough. [This answer is incorrect. Walkthroughs are a common method of obtaining an understanding of the design and implementation of the financial reporting system for a significant transaction class.]

d. Review of any member complaints about the assessment process. [This answer is correct. Another example of a monitoring activity is review of whether bank reconciliations are prepared on a timely basis.]

24. What control activities are related to *performance reviews*? **(Page 475)**

a. Comparisons of current financial reports to other information. [This answer is correct. This type of procedure is a performance review. Control activities related to performance reviews, information processing, physical controls, and segregation of duties are relevant to the audit.]

b. Application controls and general controls. [This answer is incorrect. This type of control activity is related to *information processing*. Information processing controls are performed to check accuracy, completeness, and authorization of transactions.]

c. Controls related to an asset's physical security. [This answer is incorrect. This type of control activity is related to *physical controls*. Such controls can limit access to assets and authorization to access computer programs and files.]

d. Assignment of different people to authorize and record transactions. [This answer is incorrect. This type of control activity is related to *segregation of duties*. In addition to having different people authorize and record transactions, different people would also be needed to maintain custody of assets.]

25. When auditing a CIRA that uses service organization, when would an auditor need a copy of the *service auditor's report*? **(Page 477)**

a. The CIRA has sufficient controls over information the services organization produces. [This answer is incorrect. In this case, the auditor can obtain an understanding of the CIRA's controls over the information, and a service auditor's report would not be needed.]

b. The CIRA does not have sufficient controls over information the services organization produces. [This answer is correct. The service auditor's report is a special purpose report described in SAS 70, and it is applicable in this type of situation.]

MAKING 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. Tolerable misstatement 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.

Because 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 SAS No. 107 (AU 312.27), *Audit Risk and Materiality*, the auditor should determine a materiality level for the financial statements taken 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*. SAS No. 107 (AU 312.69) states that the auditor should document the levels of materiality, including any changes thereto, used in the audit and the basis on which those levels were determined. 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 quantitatively material to the financial statements. According to SAS No. 107 (AU 312.36), the auditor should be alert for misstatements that could be qualitatively material, but it ordinarily is not practical to design audit procedures to detect them.

Quantifying Planning Materiality. Materiality is determined based on the auditor's understanding of the needs and expectations of users of financial statements, but this is a conceptual view. In other words, the auditor considers the needs and expectations of hypothetical general users and does not survey the actual users. 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.

These rules of thumb generally apply a percentage to a benchmark amount from the financial statements. SAS No. 107 (AU 312.28) acknowledges the appropriateness of this approach and suggests the following factors to consider in selecting a benchmark:

- Elements of financial statements (for example, assets, liabilities, income, and expenses) and GAAP financial statement measures (for example, financial position, financial performance, and cash flows).

- Nature of the entity and the industry in which it operates.

- Size of the entity, nature of its ownership, and the way it is financed.

- Focus of users' attention for the particular entity on particular financial statement items.

The appropriate benchmark and the related percentage applied to it can vary with the circumstances. For CIRAs, .5–1% of total revenue might be an appropriate rule of thumb. Many auditing firms prefer to use an approach to planning materiality that allows the firm to establish planning materiality as a matter of firm-wide policy to achieve consistency in application and year-to-year stability and predictability in audit approach. To achieve these objectives, the firm may preselect the benchmark and percentage to be used across all of the firm's audits.

SAS No. 107 (AU 312.30) makes clear that "once materiality is established, the auditor should consider materiality when planning and evaluating the same way regardless of the inherent business characteristics of the entity being audited." In some CIRAs, financial statements include elements with a high degree of estimation uncertainty, such as capitalized common property contributed by the developer/sponsor. A user's needs and expectations might be influenced by knowledge of the degree of inherent uncertainty associated with such measurements, but the auditor's materiality judgments in planning and evaluation should not be affected by the degree of uncertainty. In other words, for audit purposes a high degree of measurement uncertainty does not cause the auditor to follow different judgments than those applicable to other entities.

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 test 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 (however, see the discussion of "Determining Materiality for Particular Items of Lesser Amounts"). Also, the auditor should 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 needs to decide whether an audit test must be extensive enough to detect misstatements over $5,000 or over $10,000.

Recommended Benchmark. The recommended approach for determining an amount material to the financial statements for planning purposes is to use the larger of total assets or revenue as the benchmark. This benchmark has the advantages of relative stability, predictability, and representativeness of CIRA size. Using these criteria, the larger of total assets or revenue often provides a sound benchmark. Nevertheless, the auditor should identify whether there are financial statement items on which, for the particular CIRA, users' attention tends to be focused. If a financial statement item is more important to users than the larger of total assets or revenue, then the auditor should 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, a lower planning materiality amount will have implications for the efficiency of audit testing. Auditors must 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 should 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.

It is important to note that 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. SAS No. 107 contains no guidance on selecting a percentage. Using total assets or 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 should be adjusted in relation to the size of an entity. They believe the percentage should 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.

Planning materiality judgments should be reconsidered as the audit progresses. 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 should made. At the conclusion of the audit, the auditor should consider whether the scope of the audit has been adequate in the circumstances. If planning materiality based on unadjusted amounts is too large, 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

In addition to determining a planning materiality amount for the financial statements taken as a whole, the auditor should consider whether, in the specific circumstances of the CIRA, misstatements of particular items of lesser amounts than planning materiality could be expected to influence economic decisions of users. According to SAS No. 107 (AU 312.31), "any such amounts determined represent lower materiality levels to be considered in relation to the particular items 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 financial statement items for which a lower planning materiality amount is appropriate based on user perceptions of the particular items.

The auditor should consider consulting 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. Lower levels of materiality for particular items in the financial statements should be documented.

Determining Tolerable Misstatement

The auditor must 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 tolerable misstatement at the individual account balance, class of transaction, or disclosure level. SAS No. 107 (AU 312.34) defines tolerable misstatement as "the maximum error in a population (for example, the class of transactions or account balance) that the auditor is willing to accept." SAS No. 107 (AU 312.69) requires documentation of the level of tolerable misstatement, the basis on which it was determined, and any changes thereto as the audit progresses.

Guidance on determining tolerable misstatement is provided in SAS No. 107 (AU 312.35), which indicates, "the auditor should determine one or more levels of tolerable misstatement," and such levels are "normally lower than the materiality levels." In other words, generally tolerable misstatement should be lower than the materiality level for the financial statements taken as a whole. Also, for particular items in the financial statements for which a lesser amount than financial statement materiality has been determined, the tolerable misstatement should be commensurately lower as well. Therefore, the auditor may determine and document more than one level of planning materiality and more than one level of tolerable misstatement.

SAS No. 39 (AU 350.18), *Audit Sampling*, as amended by SAS No. 111, provides the following additional guidance on tolerable misstatement:

> This maximum monetary misstatement that the auditor is willing to accept for the balance or class is called *tolerable misstatement* for the sample. Tolerable misstatement is a planning concept and is related to the auditor's determination of materiality for planning the financial statement audit in

> such a way that tolerable misstatement, combined for all of the tests in the entire audit, does not exceed materiality for the financial statements. This means that auditors should normally set tolerable misstatement for a specific audit procedure at less than financial statement materiality so that when the results of the audit procedures are aggregated, the required overall assurance is attained.

Although this guidance appears in relation to audit sampling, it is applicable to all further audit procedures not just those involving sampling.

Professional standards do not discuss how tolerable misstatement should be calculated or any rules of thumb that have been used in practice to calculate tolerable misstatement. The approach used in this course is to determine tolerable misstatement 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 detected misstatements. Using this approach, a common rule of thumb is to calculate tolerable misstatement 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 detected misstatements decreases. Typically, for most CIRAs, the larger adjustment of 75% is believed to normally be satisfactory. When the auditor expects a relatively large amount of known misstatements to remain uncorrected or relatively large likely misstatements, an adjustment closer to 50% should be used.

Determining Individually Significant Dollar Items. A concept closely related to tolerable misstatement is individually significant items. This term encompasses two types of items in a financial statement component. These include:

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

b. Individually significant dollar items.

Generally, when performing tests of details, the auditor should at least examine all items that equal or exceed tolerable misstatement. Accordingly, the cutoff amount for determining individually significant dollar items generally should not exceed tolerable misstatement. As a rule of thumb, the auditor may use one-third of tolerable misstatement as the cutoff for individually significant dollar items. However, the auditor may choose any amount less than tolerable misstatement to get the percent of coverage desired. 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 "Recommended Benchmark" discussion mentions 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, and mentions that 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 the $7 million revenue figure as the base would result in the following amounts: planning materiality of $29,000 and tolerable misstatement of $22,000. If one-third of tolerable misstatement was selected to determine individually significant items, the resulting scope of $7,300 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. It is believed that 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.

Assessing Risks of Material Misstatement at the Financial Statement Level

Audit risk is the risk that the auditor may unknowingly fail to appropriately modify his or her 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.

The auditor must consider audit risk for the financial statements taken as a whole. When considering audit risk at the overall financial statement level, the auditor should consider risks of material misstatement that relate pervasively to the financial statements taken as a whole and potentially affect many relevant assertions. (These risks are also referred to as *overall risks*.)

Professional standards establish a presumptively mandatory requirement for the auditor to assess and document the risks of material misstatement at the financial statement level (SAS No. 107, AU 312.12 and SAS No. 109, AU 314.122). 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.

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." It is believed that 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.

SAS No. 110 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.
- 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.

Before considering how to assess the risk of material misstatement at the assertion level the auditor needs to understand several basic concepts, including:

- The audit risk model.
- The risk of material misstatement.
- Relevant assertions.

The Audit Risk Model

SAS No. 107 states that audit risk (AR) for relevant assertions related to account balances, classes of transactions, or disclosures consists of the following:

- The risk (consisting of inherent risk and control risk) that the relevant assertions related to balances, classes, or disclosures contain misstatements (whether caused by error or fraud) that could be material to the financial statements when aggregated with misstatements in other relevant assertions related to account balances, transaction classes, or disclosures.

- The risk (detection risk) that the auditor will not detect such misstatements.

The way the auditor should consider these component risks and combine them involves professional judgment and depends on the auditor's approach or methodology.

The definitions of the components of audit risk are as follows:

a. *Inherent Risk (IR).* The susceptibility of a relevant assertion to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming that there are no related controls.

b. *Control Risk (CR).* The risk that a misstatement that could occur in a relevant assertion and that could be material, either individually or when aggregated with other misstatements, will not be prevented or detected on a timely basis by the entity's internal control.

c. *Detection Risk (DR).* The risk that the auditor's procedures will not detect a misstatement that exists in a relevant assertion that could be material, either individually or when aggregated with other misstatements.

Detection risk is a function of the effectiveness of the substantive procedures applied by the auditor and can be disaggregated into additional components of test of details risk (TD) and substantive analytical procedures risk (AP). The greater the risk of material misstatement, the less the detection risk that can be accepted by the auditor.

Risk of Material Misstatement

The risk of material misstatement is a combination 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 product 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:

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

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

An assertion is a relevant assertion if it has a meaningful bearing on whether the class of transactions, account balance, or disclosure is 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 [SAS No. 107 (AU 312.19)].

Assessing the Risk of Material Misstatement at the Relevant Assertion Level

The components of audit risk may be assessed in quantitative terms such as percentages or in nonquantitative terms such as high, moderate, or low. The assessment of audit risk at the relevant assertion level, whether made in quantitative or nonquantitative terms, is a judgment rather than a precise measurement of risk. The auditor should 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.

The auditor can assess the risks of material misstatement at the relevant assertion level in nonquantitative terms or, if the auditor wishes, in quantitative terms using the formula for the risk model. 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. SAS No. 111 (AU 350.20) provides the following guidance on using the risk model to determine detection risk for a test of details using audit sampling:

> . . . the auditor should determine an acceptable audit risk and subjectively quantify his or her 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 equal to tolerable misstatement . . .

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.

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 should be considered in determining which audit areas should be deemed significant:

- Relative materiality of the account balance to the overall financial statements.
- Relative significance of the transaction class to the CIRA's operation 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, 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.

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 taken as a whole. Judgment is required 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 tolerable misstatement would generally be regarded as quantitatively immaterial and not significant. Account balances that are some multiple of tolerable misstatement are generally quantitatively significant. Account balances that are approximately equal to tolerable misstatement require careful consideration as to the nature of the account balance and prior experience with the client in evaluating significance.

Relative Significance to the Financial Statements. 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. The auditor should determine which of the risks identified by risk assessment procedures are risks that require special audit consideration. The auditor's determination of significant risks should be based primarily on the consideration of inherent risk, that is, it should be before consideration of the effect of identified controls related to the risk. The auditor should determine whether the risk is such that it requires special audit consideration by focusing on the following:

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

The nature of the risk should be evaluated by considering the following:

- Is the risk a risk of fraud?
- 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 nonroutine transactions outside the normal course of business or that otherwise appear unusual?
- Hypothetically, if the auditor had a time constraint to perform the audit, would the risk be one that would absolutely need to be addressed through substantive tests of details?

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, he or she should identify those 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, the auditor should identify any areas where substantive procedures alone will not be effective. 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. In such situations, it might not be possible or practicable to perform only substantive procedures in response to the risk because of the importance of effective controls over the accuracy and completeness of available audit evidence.

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

Establishing an Overall Audit Strategy

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. It includes the identification of overall risks, the 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. SAS No. 108 (AU 311.14) provides that in establishing the overall audit strategy the auditor should do the following:

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

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

c. Consider the important factors that will determine the focus of the audit team's efforts.

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 required. 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.

The overall audit strategy includes and is significantly influenced by the auditor's judgments about materiality and the risks of material misstatement at the financial statement level. Important aspects of overall audit strategy that determine the focus of the audit team's efforts generally include the following:

- Materiality considerations, including:
  - Planning materiality.
  - Preliminary identification of material account balances.
- Preliminary identification of areas where there may be higher risks of material misstatement, including those due to fraud.
- Effect of assessed risk of material misstatement at the overall financial statement level.
- 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.
- Determination of the composition and deployment of the audit team (and if necessary, the engagement quality control reviewer), including the assignment of audit work to team members, especially the

assignment of appropriately experienced team members to areas identified as having a higher risk of material misstatement.

- Determination of the extent of involvement of professionals possessing specialized skills.
- Additional emphasis on 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 financial statement 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 where client assistance is expected to be minimal.

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. This course maintains 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, this course maintains 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.

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. Information technology (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 other 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.

Communicating with Those Charged with Governance. The auditor may discuss elements of the overall audit strategy with those charged with governance. SAS No. 114 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. One method the auditor can use to effectively establish the overall audit strategy is to complete the various steps in the "General Planning Procedures" program in *PPC's Guide to Homeowners' Associations*. Professional standards do not 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, and there is no need for a separate memorandum.

Although professional standards do not require documentation of the audit strategy itself, they do require documentation of any significant revisions to the overall audit strategy to respond to changes in circumstances. However, SAS No. 108 (AU 311.18) observes that a brief memorandum prepared at the conclusion of the previous audit, based on a review of audit documentation and highlighting issues identified in the audit just completed, can be updated and changed in the current period to provide a basis for planning the current audit. The update can be based on discussions with CIRA management.

SELF-STUDY QUIZ

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

26. Which of the following methods will allow an auditor to select an intuitive materiality percentage?

    a. The percentage must be selected as described in SAS No. 107.

    b. The percentage should be larger for a small company and smaller for a large company.

    c. The percentage is chosen based on unadjusted financial information.

27. Define *tolerable misstatement*.

    a. Misstatements of particular items of lesser amounts than planning materiality.

    b. A level of misstatement higher than the materiality level for the financial statements as a whole.

    c. The maximum error in a population that the auditor is willing to accept.

    d. Items with audit significance by their nature and individually significant dollar items.

28. Which of the following statements best describes how an auditor can assess the risks of material misstatement at the financial statement level?

    a. The auditor must consider inherent and control risks at the financial statement level.

    b. The auditor can determine a precise percentage of audit risk to facilitate audit planning.

    c. At the financial statement level, risks of material misstatement often relate to the control environment.

    d. The overall assessment of risk of material misstatement at the financial statement level is made after audit planning is complete.

29. What is the susceptibility of a relevant assertion to a misstatement that could be material (individually or in the aggregate) assuming that there are no related controls?

    a. Inherent risk.

    b. Control risk.

    c. Detection risk.

30. Which of the following is a factor to be considered when determining which audit areas are deemed significant?

    a. Relative significance of the transaction class compared with the financial statements of other entities in this industry.

    b. The susceptibility of a transaction class or an account balance to fraud—both theft and management misstatement.

    c. The nature and complexity of systems (including IT use) that an entity uses to process and control information related to an assertion.

    d. The mathematical calculation used by the auditor to assess the risk of material misstatement at the relevant assertion level.

31. Carson has been engaged to audit the Boardwalk Place Homeowner's Association (BPHA). BPHA is a small CIRA, and its president runs the entity similar to an owner/manager in a small commercial business. Which of these factors should influence Carson's audit strategy since BPHA is such a small CIRA?

    a. Planning materiality and preliminary identification of material account balances.

    b. The effect of any assessed risk of material misstatement at the overall financial statement level.

    c. Emphasis on the use of professional skepticism.

    d. Concentration of operational control in BPHA's president.

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.)**

26. Which of the following methods will allow an auditor to select an intuitive materiality percentage? **(Page 486)**

    a. The percentage must be selected as described in SAS No. 107. [This answer is incorrect. SAS No. 107 contains no guidance on selecting a percentage. There are no authoritative percentage guides for materiality.]

    b. The percentage should be larger for a small company and smaller for a large company. [This answer is correct. Using total assets or 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 should be adjusted in relation to the size of an entity. They believe the percentage should 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 increase risks that usually accompany bigness and the fact that a large enough absolute amount is often considered material.]

    c. The percentage is chosen based on unadjusted financial information. [This answer is incorrect. Planning materiality judgments should be reconsidered as the audit progresses. 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 should be made.]

27. Define *tolerable misstatement*. **(Page 486)**

    a. Misstatements of particular items of lesser amounts than planning materiality. [This answer is incorrect. When determining planning materiality, auditors should be aware of particular items of lesser amounts than planning materiality that, in the CIRA's specific circumstances, could be expected to influence economic decisions of users. However, these items are not part of tolerable misstatement.]

    b. A level of misstatement higher than the materiality level for the financial statements as a whole. [This answer is incorrect. Normally, tolerable misstatement will be *lower* than the materiality levels.]

    c. The maximum error in a population that the auditor is willing to accept. [This answer is correct. This is the definition of tolerable misstatement as found in SAS No. 107. The auditor needs to establish a tolerable misstatement at the individual account balance, class of transaction, or disclosure level.]

    d. Items with audit significance by their nature and individually significant dollar items. [This answer is incorrect. These are the two components that make up *individually significant dollar items*. This concept is closely related to tolerable misstatement.]

28. Which of the following statements best describes how an auditor can assess the risks of material misstatement at the financial statement level? **(Page 488)**

    a. The auditor must consider inherent and control risks at the financial statement level. [This answer is incorrect. It is believed that these risk model components do *not* need to be considered at the financial statement level. These risks are considered at the individual account balance, class of transaction, or disclosure level.]

    b. The auditor can determine a precise percentage of audit risk to facilitate audit planning. [This answer is incorrect. Audit risk cannot be precisely measured as a percentage; thus, consideration of audit risk is necessarily judgmental, not mathematical.]

c. At the financial statement level, risks of material misstatement often relate to the control environment. [This answer is correct. These risks 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.]

d. The overall assessment of risk of material misstatement at the financial statement level is made after audit planning is complete. [This answer is incorrect. This assessment 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.]

29. What is the susceptibility of a relevant assertion to a misstatement that could be material (individually or in the aggregate) assuming that there are no related controls? **(Page 489)**

a. Inherent risk. [This answer is correct. This is the definition of inherent risk. According to SAS No. 107, inherent risk, control risk, and detection risk are all part of audit risk for relevant assertions related to account balances, classes of transactions, or disclosures.]

b. Control risk. [This answer is incorrect. This is the risk that a misstatement that could occur in a relevant assertion and that could be material, either individually or when aggregated with other misstatements, will not be prevented or detected on a timely basis by the entity's internal control.]

c. Detection risk. [This answer is incorrect. This is the risk that the auditor's procedures will not detect a misstatement that exists in a relevant assertion that could be material, either individually or when aggregated with other misstatements.]

30. Which of the following is a factor to be considered when determining which audit areas are deemed significant? **(Page 490)**

a. Relative significance of the transaction class compared with the financial statements of other entities in this industry. [This answer is incorrect. For this factor to be considered, the relative significance of the transaction class should be compared with the CIRA's operation or the overall financial statements. Another example of a factor to consider when determining significant audit areas is the audit areas that have traditionally required significant adjustments.]

b. The susceptibility of a transaction class or an account balance to fraud—both theft and management misstatement. [This answer is correct. When determining significant audit areas, this is a factor that should be considered. Another factor that should be considered is the relative materiality of the account balance to the overall financial statements.]

c. The nature and complexity of systems (including IT use) that an entity uses to process and control information related to an assertion. [This answer is incorrect. This factor would be used to identify relevant assertions during an audit, not significant audit areas.]

d. The mathematical calculation used by the auditor to assess the risk of material misstatement at the relevant assertion level. [This answer is incorrect. 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. In either case, this element is not a factor to consider when determining significant audit areas.]

31. Carson has been engaged to audit the Boardwalk Place Homeowner's Association (BPHA). BPHA is a small CIRA, and its president runs the entity similar to an owner/manager in a small commercial business. Which of these factors should influence Carson's audit strategy since BPHA is such a small CIRA? **(Page 493)**

a. Planning materiality and preliminary identification of material account balances. [This answer is incorrect. This would be a focus of an audit team's efforts in any CIRA audit, but it is not a specific consideration related to the BPHA audit and the CIRA's small size.]

b. The effect of any assessed risk of material misstatement at the overall financial statement level. [This answer is incorrect. Due to BPHA's small size, Carson must consider certain special factors. Though this factor is important in any audit, it is not unique to the scenario in this question.]

c. Emphasis on the use of professional skepticism. [This answer is incorrect. It is important for auditors to use professional skepticism in any audit, including this one; however, this consideration is not unique to the small size of the CIRA Carson is auditing in this scenario.]

d. Concentration of operational control in BPHA's president. [This answer is correct. The small size of BPHA is one of the most important influences in Carson's preliminary planning. If he used the same audit strategy that he would for a large entity, it might lead to overauditing. One other factor that would be of particular importance to the audit of a small CIRA like BPHA is the limited segregation of duties and functions within the accounting system.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (HOATG094)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

9. Julia accepts an engagement to audit the Huntington Homeowners' Association (HHA). HHA employs a managing agent. How does this affect Julia's audit planning?

    a. Because the audit will be performed on HHA, not the managing agent, the managing agent will not be a factor in Julia's audit planning.

    b. Julia is only allowed to include the managing agent in her audit of HHA if the CIRA provides her with a written release to do so.

    c. Though the managing agent will be included in Julia's audit of HHA, the presence of such an agent will not affect either Julia's audit strategy or her audit plan.

    d. Julia must consider items such as if the managing agent's financial reporting system allows the application of audit procedures sufficient enough for her to express an opinion.

10. Which of the following steps in the audit planning process would be considered detailed audit planning at the relevant assertion level?

    a. Evaluation of compliance with ethical and independence requirements.

    b. Making a determination of tolerable misstatement.

    c. Performing preliminary analytical procedures.

    d. Identification of fraud risk factors, including any overall responses.

11. To whom should an auditor address an inquiry about aspects of a CIRA and its environment?

    a. Management, including a managing agent.

    b. Internal auditors.

    c. Parties outside the CIRA.

    d. Those charged with governance.

12. Leo accepts an engagement to audit a CIRA. During the planning portion of the engagement, Leo makes inquiries of management. When those inquiries are completed, Leo decides that he should make inquiries of employees at different levels and in different departments within the CIRA. One piece of information Leo would like to obtain during these inquiries is how the CIRA's management and board of directors are compensated. Who should Leo address this question to?

    a. All employees.

    b. Human resources.

    c. Accounting and finance.

    d. Purchasing.

13. Which type of preliminary analytical procedures does SAS No. 99 specifically require?

    a. Procedures to identify unusual or unexpected relationships related to revenue.

    b. Procedures to enhance the auditor's understanding of the client's business.

    c. Procedures to identify specific risk areas relevant to the audit.

    d. Do not select this answer choice.

14. Which of the following statements best describes the engagement team's discussion about an audit engagement?

    a. All members of the engagement team, including specialists who will have an ongoing role in the engagement, should be included.

    b. If multiple locations are involved in the audit, an engagement team discussion has to happen in each of the locations.

    c. SAS No. 103 requires that audit documentation procedures be covered during the engagement team's discussion.

    d. A discussion of possible material misstatement due to fraud under SAS No. 99 is the only topic that the engagement team is required to discuss.

15. Which of the following is **not** one of the key components in the auditor's understanding of an entity and its environment?

    a. The nature of the entity.

    b. The entity's internal control.

    c. Objectives, strategies, and any related business risks.

    d. Materiality level for the financial statements as a whole.

16. Which of these items would an auditor consider when obtaining an understanding of an entity's industry, regulatory, and other external factors?

    a. Government policies.

    b. Revenue sources.

    c. Director's fees.

    d. Industry specific accounting practices.

17. Michael wants to develop an understanding of the nature of his CIRA client. Select from the following list all of the matters Michael should consider when attempting to gain an understanding of the nature of his CIRA client.

    i. Involvement in e-commerce.
    ii. Financial consequences of business risks.
    iii. Conduct of operations.
    iv. Important suppliers.
    v. Forecasts, budgets, and variance analyses.
    vi. Major assets.
    vii. Major operating expenses.
    viii. Employment and human resource matters.
    ix. Employee performance measures.
    x. Changes in the CIRA's accounting policies.
    xi. Tax status.
    xii. Related parties and related party transactions.

    a. ii., v., ix., and x.

    b. i., iii., iv., vi., vii., viii., xi., and xii.

    c. iii., iv., v., vi., viii., x., xi., and xii.

    d. i., ii., iii., iv., v., vi., vii., viii., ix., x., xi., and xii.

18. The nature and extent of the risk assessment procedures used by an auditor to obtain an understanding of the client's selection and application of accounting policies will normally depend, in part, on which of the following factors?

    a. The number of accounting procedures that the client has used for many years.

    b. The length of time the auditor anticipates having a relationship with the client.

    c. The degree of sophistication found in the client's financial reporting standards.

    d. Do not select this answer choice.

19. What are the five components of internal control described in the Committee of Sponsoring Organizations of the Treadway Commission's (COSO) *Internal Control—Integrated Framework*?

    a. Control environment, risk assessment, information and communication, peer review, and control activities.

    b. Control environment, fraud prevention, information and communication, monitoring, and control activities.

    c. Control environment, risk assessment, information and communication, monitoring, and control activities.

    d. Control environment, risk assessment, sampling, monitoring, and control activities.

20. Alma has been engaged to audit a CIRA. While obtaining an understanding of her CIRA client's internal control, she documents the existence of a control procedure. Is her understanding of that control's operating effectiveness complete?

    a. Yes.

    b. No.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

21. In which of the following situations, should the auditor consider hiring an IT specialist to help obtain the proper understanding of the client's internal control?

    a. The client uses emerging technologies and participates in e-commerce.

    b. The client uses only purchased software with no access to source code.

    c. The client uses a service organization with a recent SAS 70 report for its computer services.

    d. Manual control procedures are adequate to detect or prevent material misstatements in computer-processed information.

22. Which of these statements applies when an auditor has an IT specialist on the engagement team?

    a. The auditor must be an expert in information technology to communicate effectively with the IT specialist.

    b. The auditor's responsibility for the IT specialist is higher than for any other CPAs on the engagement team.

    c. The auditor must be able to communicate audit objectives to the specialist and evaluate if the specialist's procedures meet the objectives.

    d. The nature, timing, and extent of other planned procedures will not be affected by any procedures performed by the specialist.

23. In which of the following scenarios, should the auditor be wary of risks of material misstatement due to deficiency in the CIRA's control environment?

    a. The Abernathy Villas Homeowner's Association had significant changes in operations during the period to be audited.

    b. The Centennial Group, a common interest realty association, has had rapid growth in the past year, accompanied by many new services and programs offered to its members.

    c. Compensation of the management of the Dunn Homeowner's Association is dependent on incentives. The incentive value depends on the CIRA meeting performance targets.

    d. Do not select this answer choice.

24. All of the following statements about control activities are true, **except**:

    a. Control activities can be either automated or manual and are performed at different levels within the organization.

    b. Control activities consist of a policy that establishes what should be done and a procedure to implement the policy.

    c. A financial statement audit requires the auditor to understand all control activities for each class of transactions.

    d. Communication of control policies can be done either orally or in writing.

25. The Oceanfront Homeowner's Association employs a managing agent. The CIRA does not have sufficient controls over the information produced by the agent and a SAS No. 70 report is unavailable. Where can the auditor find information about the agent's controls?

    i. Any documentation available about the agent's operating process.
    ii. The contract between the agent and the CIRA.
    iii. Reports by service auditors on the information system and other controls used by the agent.
    iv. Inquiry or observation of the CIRA's or the agent's personnel.
    v. Prior experience with the agent.

    a. i. and ii.

    b. iii. and iv.

    c. i., ii., and v.

    d. i., ii., iii., iv., and v.

26. Define *planning materiality*.

    a. A materiality level for the financial statements as a whole, as determined by the auditor during audit planning.

    b. A collective group of judgments about the audit approach, including the overall responses that will be made to risks.

    c. Tolerable misstatement at the level of the disclosure, account balance, or and individual class of transactions.

    d. A benchmark consisting of .5–1% of a CIRA's total revenue.

27. Which example benchmark would be more appropriate during the audit planning phase?

    a. Error over $10,000 is material.

    b. Error under $5,000 is immaterial; error over $10,000 is material; error between $5,000 and $10,000 may be material.

    c. Use the larger of total assets or revenue.

    d. Do not select this answer choice.

28. What is an acceptable rule of thumb for determining the cutoff amount for individually significant dollar items?

    a. One-third of tolerable misstatement.

    b. One-half of tolerable misstatement.

    c. Tolerable misstatement.

    d. Two times tolerable misstatement.

29. During the course of an audit, an auditor might unknowingly fail to modify his or her opinion appropriately on financial statements that are materially misstated. What term is used in this situation?

    a. Overall risks.

    b. Audit risk.

    c. Fraud risk.

    d. Risk of material misstatement.

30. How is the risk of material misstatement expressed?

    a. Inherent risk combined with control risk.

    b. Tests of details combined with substantive analytical procedures risk.

    c. Detection risk combined with substantive analytical procedures risk.

    d. Inherent risk combined with control risk and detection risk.

31. In which scenario would an auditor be most likely to encounter risks for which substantive procedures alone will not be sufficient?

    a. The Alpha Common Interest Realty Association does not use any IT services or automated functions in its day-to-day business.

    b. The Beta Common Interest Realty Association's management do have a positive control environment and there is risk of management override of internal control.

    c. The Gamma Common Interest Realty Association's financial statement include capitalized common property contributed by the developer.

    d. The Delta Common Interest Realty Association uses highly automated processing of information with little manual intervention.

Lesson 3: Specialists, Sampling, Workpapers, and Initial Engagements

INTRODUCTION

This lesson covers special considerations that may affect the audit of a CIRA, including using the work of a specialist, audit sampling, the organization and structure of workpapers, and initial engagements.

Learning Objectives:

Completion of this lesson will enable you to:

- Plan for issues related to using the work of a specialist and audit sampling.
- Develop procedures for organizing and structuring audit plans and workpapers.
- Identify planning considerations unique to initial engagements.

USING THE WORK OF A SPECIALIST

During planning, the auditor should 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, SAS No. 73 (AU 336), *Using the Work of a Specialist*, applies if the client engages a specialist to prepare amounts or disclosures in the financial statements or if the auditor decides to use a specialist in auditing a financial statement amount or disclosure that management prepared.

SAS No. 73 does not apply to specialists employed by the auditor's firm who are participating in the audit. For instance, if the auditor's firm employs an appraiser and uses that appraiser as part of the audit team to evaluate carrying values of common property, then SAS No. 73 does not apply. SAS No. 108, *Planning and Supervision*, applies in that situation and the specialist requires the same supervision and review as any member of the engagement team. Also, if the auditor uses an IT specialist as part of the audit team to help determine the effect of information technology on the audit, understand the entity's controls, or design and perform tests of controls (when applicable) and substantive tests, SAS No. 108, rather than SAS No. 73, applies to the work of that specialist.

SAS No. 73 requires the auditor to evaluate the professional qualifications of the specialist to determine that the specialist possesses the necessary skills and knowledge in the particular field. The following are suggested considerations when evaluating the professional qualifications:

- Professional certification, license, or other recognition of competence in the specialist's field.
- The specialist's reputation and standing in the views of peers and others familiar with the specialist's capability and performance.
- Experience of the specialist in the type of work to be performed.

The auditor should also gain an understanding of the nature of the work performed by the specialist. The auditor should:

- Understand the objectives and scope of the specialist's work and the appropriateness of using it for the intended purpose.
- Evaluate the relationship of the specialist to the client. SAS No. 73 does not prohibit using specialists who are employees of or related to the client as long as the relationship does not impair the specialist's objectivity. Objectivity might be impaired if the client can directly or indirectly control or significantly influence the specialist because of an employment, ownership, contractual right, or family relationship with the specialist. In such circumstances, the auditor should assess the risk that the specialist's objectivity may be impaired and may need to perform additional procedures to test the reasonableness of the specialist's

assumptions, methods, or findings. The auditor might decide that another specialist should be engaged for this purpose.

- Understand the methods and assumptions used by the specialist and compare them with those used in the preceding period.

- Make appropriate tests of the data, whether financial or nonfinancial, provided to the specialist (such as the number of employees or other employee data included in pension information provided to an actuary), taking into account the auditor's assessment of control risk. The implication is that the auditor would need to substantiate data provided to the specialist unless the data is produced by a system with a relatively low control risk. Also, the extent of testing considered necessary would depend on the nature and materiality of the related financial statement assertion.

- Evaluate whether the specialist's findings support particular financial statement assertions.

Those considerations should generally be documented in the audit workpapers.

SAS No. 73 states that, normally, the auditor should not make reference to the specialist in an unqualified audit report because doing so might imply that the audit opinion is qualified or that the auditor is not taking responsibility for the work of the specialist. However, the auditor may mention a specialist's work when a qualified or adverse opinion is issued.

THE BASICS OF AUDIT SAMPLING

SAS No. 39 (AU 350), *Audit Sampling*, as amended by SAS No. 111, observes that the basic concept of sampling is well established in auditing practice and imposes several specific requirements for the planning, selection, performance, and evaluation of audit samples. In addition, the AICPA Audit and Accounting Guide, *Audit Sampling*, explains how to apply SAS No. 39. The AICPA Audit Sampling Guide does not include guidance from SAS No. 111 and the other risk assessment standards. The AICPA expects to issue a revised Audit Sampling Guide at a future date. Subsequent editions of the *Guide* will be updated for the revised AICPA Audit Sampling Guide when issued.

SAS No. 39 at AU 350.01 defines audit sampling as "the application of an audit procedure to less than 100% of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of the balance or class." Many audit procedures involve application to less than 100% of the items in a balance or class, but do not involve audit sampling. For example, a walkthrough of the processing of disbursements to obtain an understanding of the financial reporting system and testing the details of all transactions above a specified cutoff dollar amount are not audit sampling. Thus, the key distinguishing feature for identifying an audit sampling application is deciding whether the purpose of the procedure is to project a characteristic of the items tested to the balance or class from which the items were selected.

Determining Audit Sampling Applications

Because the auditor usually has several alternatives in designing the mix of audit procedures to be applied to a particular account balance or transaction class, the auditor may design a particular procedure as a sampling or a nonsampling application based primarily on considerations of audit efficiency. 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.

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.* There is typically no reason to perform a test of assessment transactions unless that is the most appropriate procedure to address the assessed risks of material misstatement. Normally, other substantive procedures can be used to effectively and more efficiently address the assessed risk.	Rare
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

* * *

Sampling Approaches and Methods

SAS No. 39 (AU 350), as amended by SAS No. 111, discusses audit sampling in two categories—sampling in tests of details and sampling in tests of controls. Although SAS No. 39 applies equally to statistical and nonstatistical sampling and uses audit rather than statistical terminology, it is helpful to recognize that sampling for tests of details corresponds to the statistical method known as variables sampling, including probability proportional to size sampling, and that sampling for tests of controls corresponds to attribute sampling. This correspondence of approaches is worth noting because in practice the attribute sampling approach is efficient and effective to use for transaction testing, which may include both substantive and control aspects. That is, attribute sampling can be used to test the accuracy of recording transactions as to account, amount, and period as well as the effective performance of controls related to approvals and recomputation. For this reason, the discussion in this section is divided into two basic types of sampling referred to as balance testing and transaction testing.

Balance Testing. As explained in SAS No. 39 (AU 350), a test of details using audit sampling, referred to here as balance testing, involves evaluation of the results of the sample in monetary terms. In planning this type of sample, the auditor considers how much monetary misstatement in the related account balance may exist without causing the financial statements to be materially misstated (tolerable misstatement) and the allowable risk of incorrectly accepting a balance misstated by that amount. In evaluating sample results for this type of sample, the auditor normally considers the upper dollar limit on the amount of misstatement of the balance at the planned allowable risk of incorrect acceptance. When statistical sampling is used, both the dollar amount of misstatement and the sampling risk are quantified. When nonstatistical sampling is used, dollar amounts can be quantified, but risks can only be approximated and considered in qualitative terms.

Transaction Testing. Transaction testing using audit sampling ordinarily takes the form of what was once called a dual-purpose test because it is directed to both accounting accuracy of transaction processing and the operating

effectiveness of related internal controls. SAS No. 39, as amended by SAS No. 111, at AU 350.43 states that ". . . the auditor may design a sample that will be used for dual purposes: testing the operating effectiveness of an identified control and testing whether the recorded monetary amount of transactions is correct." The correctness of the monetary amount usually includes whether the transaction is recorded correctly as to account, amount, and period. The auditor also ordinarily tests transaction details for compliance with entity requirements and controls.

Although the auditor is concerned with certain substantive aspects of transactions in this type of testing, the sampling approach used is analogous to attribute sampling rather than variables sampling. The primary distinction is that the auditor's planning and evaluation of the sample is focused on the rate rather than the monetary amount of misstatement. For this approach to be appropriate, all transactions in the class from which the sample is selected should be processed through the same financial reporting system and the likelihood of a mistake being made in processing a particular transaction should be independent of its dollar amount.

Designing Tests of Transactions Using Audit Sampling

SAS No. 39 (AU 350.30–.42), as amended by SAS No. 111, establishes requirements for the planning, selection, performance, and evaluation of sampling in tests of transactions. This course discusses an efficient nonstatistical sampling approach that meets these requirements that approximates a statistical attribute sampling method that is sometimes referred to as stop-or-go sampling.

Planning. Two basic conditions for using this approach are (a) that the audit procedure being applied using sampling is not the only procedure that contributes to the objective of the test and (b) a relatively low rate of processing mistakes is expected. These conditions are intended to compensate for the fact that judgments about sample size and sample results using this approach are approximations rather than exact statistical computations. Normally, using this approach, the auditor need only make a choice between a sample size of 60 and a sample size of 25. A sample of 25 with no misstatements or deviations would approximate an upper limit on the rate of misstatement of 10% and allowable sampling risk of 10%. A sample of 60 with no misstatements or deviations would approximate an upper limit rate of 5%–8% and a sampling risk of 5%.

The basic condition that requires that there be other audit procedures that contribute to the same objective as the procedure being applied using sampling is normally satisfied by performing analytical procedures.

The condition that permits a sample of 25 rather than 60 is that, based on the auditor's understanding of internal control, there are controls that are pertinent to the aspects of transaction processing being tested that appear to be effective and that are being tested simultaneously. These controls may exist even though the auditor may have assessed the control risk at maximum and may not have performed tests of controls.

Sample Selection. SAS No. 39 (AU 350), as amended by SAS No. 111, requires a "representative sample" for audit sampling applications. This means that the items must be selected in such a manner that all items have an opportunity to be selected. Among the methods that meet this requirement are simple random selection using random numbers, systematic selection (every *n*th item), or haphazard selection. The first two methods are explained in detail in sampling textbooks and the AICPA Audit and Accounting Guide, *Audit Sampling*. The concept of haphazard selection is explained in *Audit Sampling* as selecting in no specific pattern without bias for or against any items in the population. In other words, to achieve haphazard selection, the auditor's selection should not be influenced by the size, location, or appearance of the item.

Whenever practical, the auditor should use random selection (with computer-generated random numbers or a random number table) or systematic selection with a random start. Using these approaches does not make the audit sampling application a statistical sample. Haphazard selection may be used when the population is not numbered or when other circumstances make use of one of the other methods impractical. Using computer-generated random numbers is recommended because it is more efficient than using a table.

Evaluation. The evaluation of sample results for the transaction testing approach differs for a sample size of 25 versus a size of 60. The sample size of 25 is used when the auditor is simultaneously testing internal controls that help ensure accounting accuracy. The auditor should identify and test only those controls that are pertinent to these matters and that would make a difference to the auditor's control risk assessment. To support an assessment of control risk below the maximum, the sample results for a sample of 25 should contain no deviations from the

identified controls. In qualitative terms, no deviations in a sample of 25 may be interpreted as a moderate level of control risk. For this reason and for reasons of efficiency, the auditor should not identify and test control activities that would not change the control risk assessment, and any deviations from unimportant controls that turn up in sample results should be ignored. Generally, a mistake in accounting processing, that is, recording in the wrong account, amount, or period, should be treated in the same manner as a deviation from internal controls. The reason for this is that a misstatement can usually be traced to a deficiency in the system. However, it is always important to make a qualitative analysis of the nature and cause of the misstatement. The auditor needs a good understanding of the cause of the misstatement to consider what steps should be taken to help ensure that there is not an unacceptable risk that similar misstatements could accumulate to a material amount. In the rare case when a misstatement is an isolated instance and there are no indications of a deficiency in controls, the auditor need not change the control risk assessment. However, most misstatements are not isolated incidents, and the auditor should make this judgment carefully. For example, a keying error not detected by the system is a deficiency in the system and not an isolated incident simply because it occurred randomly.

When the auditor has initially selected a sample of 25 and sample results include one deviation from controls that are important to the control risk assessment, the sample size for the test should be expanded to 60. The reason for this is that a sample size as small as 25 to assess accounting accuracy is only appropriate when control risk can be assessed below the maximum level. When sample results do not support a control risk assessment below the maximum, expanded testing of accounting accuracy is necessary.

When the auditor has initially selected a sample of 60 or expanded the sample size to 60, the focus of the evaluation shifts primarily to a qualitative analysis of the nature and cause of any misstatements detected. Based on the understanding obtained of why the misstatements occurred, the auditor must assess whether there is an unacceptable risk of similar misstatements accumulating to a material amount. This type of analysis requires a good understanding of the client and its industry and internal control. No quantitative analysis can substitute for a seasoned qualitative assessment of the nature and cause of misstatement and the steps that should be taken in the particular case to detect additional misstatements if they exist.

Documentation of Transaction Testing

Auditors should document the decisions and sample results for transaction testing using audit sampling. One method for doing so is to use the forms available in *PPC's Guide 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.

32. What piece of authoritative guidance applies when an auditor uses the work of a specialist?

    a. SAS No 39.

    b. SAS No. 73.

    c. SAS No. 114.

    d. Practice Alert 2002-2.

33. What type of audit sampling can be used to test both the accounting accuracy of transaction processing and the operating effectiveness of the related internal controls?

    a. Balance testing.

    b. Transaction testing.

34. George plans to use audit sampling procedures during his CIRA audit engagement. He uses the nonstatistical sampling approach described in this course. The population from which George will choose his samples is not numbered. What sample selection method would be most appropriate?

    a. Random selection.

    b. Systematic selection.

    c. Haphazard selection.

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.)**

32. What piece of authoritative guidance applies when an auditor uses the work of a specialist? **(Page 507)**

    a. SAS No 39. [This answer is incorrect. SAS No. 39, *Audit Sampling*, defines audit sampling as "the application of an audit procedure to less than 100% of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of the balance or class."]

    b. SAS No. 73. [This answer is correct. SAS No. 73, *Using the Work of a Specialist*, applies both if the client engages a specialist to prepare amounts or disclosures in the financial statements or if the auditor decides to use a specialist in auditing a financial statement amount or disclosure that management prepared.]

    c. SAS No. 114. [This answer is incorrect. SAS No. 114 requires the auditor to communicate with those charged with governance about the planned scope and timing of the audit.]

    d. Practice Alert 2002-2. [This answer is incorrect. The Professional Issues Task Force issued Practice Alert 2002-2, *Use of Specialists*, to assist auditors in understanding their responsibilities both with respect to specialists engaged or employed by the client and specialists engaged or employed by the auditor. The Practice Alert is nonauthoritative.]

33. What type of audit sampling can be used to test both the accounting accuracy of transaction processing and the operating effectiveness of the related internal controls? **(Page 509)**

    a. Balance testing. [This answer is incorrect. Balance testing is a test of details using audit sampling, and involves evaluation of the results of the sample in monetary terms.]

    b. Transaction testing. [This answer is correct. Transaction testing using audit sampling ordinarily takes the form of what was once called a dual-purpose test because it is directed to both accounting accuracy of transaction processing and the operating effectiveness of related internal controls.]

34. George plans to use audit sampling procedures during his CIRA audit engagement. He uses the nonstatistical sampling approach described in this course. The population from which George will choose his samples is not numbered. What sample selection method would be most appropriate? **(Page 510)**

    a. Random selection. [This answer is incorrect. Random selection involves the use of random numbers. If the population were numbered, George could select his sample using computer-generated random numbers or a random number table.]

    b. Systematic selection. [This answer is incorrect. Systematic selection calls for a numbered population. If using systematic selection with a numbered population, George would select every *n*th item.]

    c. Haphazard selection. [This answer is correct. In this scenario, George can use haphazard selection because the population is not numbered. Whenever possible, however, random selection or systematic selection should be used to select the sample.]

THE ORGANIZATION AND STRUCTURE OF DETAILED AUDIT PLANS AND WORKPAPERS

SAS No. 108 (AU 311.19–.20) states that "the auditor must develop an audit plan in which the auditor documents the audit procedures to be used that, when performed, are expected to reduce audit risk to an acceptably low level. The audit plan is more detailed than the audit strategy and includes the nature, timing, and extent of audit procedures to be performed by audit team members in order to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level."

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. SAS No. 108 (AU 311.17) notes that "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 overall decision of which further audit procedures will be performed is referred to as the selection of an audit "approach." In this course, the approach selected by the auditor to respond to the risk assessment and document in the forms or workpapers for each audit area is whether to:

- Perform only limited procedures and not develop a separate audit program,
- Perform basic procedures from the core audit programs,
- Perform basic procedures plus certain extended procedures from the core audit programs, or
- Perform procedures on the specified risk audit programs.

Limited Procedures Approach. The auditor should first consider 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 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, ordinarily an audit program is 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.

Basic and Extended Approaches (Core). The PPC core audit programs discussed in this course and reflected in the audit programs found in *PPC's Guide to Homeowners' 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 (or Extended Procedures)*, which include procedures that may be warranted due to the specific circumstances of the engagement.

Auditors using the core 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. The particular tests selected, whether they are basic or extended, should 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 should perform 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 particular tests selected should be tailored to the nature, cause, and direction of expected potential misstatements at the relevant assertion level. The selection of extended additional assurance procedures needed to address a particular risk is a matter of auditor judgment. If the auditor has a higher level of assessed risk and wants to perform extended procedures, he may want to consider extending the level of detail testing performed in the Basic Procedures section of the audit program.

Specified Risk Audit Programs. 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.
- 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 transaction 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 should consider whether it is appropriate to use the specified risk approach or whether the core audit programs should be used.

The audit programs for the individual audit areas in the specified risk programs 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 should 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 should 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. 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 Response. The auditor should document which approach has been selected. Comments may also be appropriate concerning the audit program, including the linkage between risks and responses. Comments might include:

- 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 audit plan) will be performed to respond to an identified risk.

Audit Documentation (Workpapers)

SAS No. 103 (AU 339), *Audit Documentation*, requires the auditor to prepare and retain workpapers, addresses the form, content, and extent of audit documentation, and specifies requirements for revisions made to documentation after the date of the auditor's report. The main purpose of workpapers, as identified in SAS No. 103 (AU 339.3), is to provide the principal support for the auditor's report that includes:

- The representation that the audit was 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 discussed later in this section.

Support for Auditor's Report. Auditors *must* 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. SAS No. 103 emphasizes that audit documentation is a critical component of audit quality. 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 SAS No.103 (AU 339.11):

> Oral explanations on their own do not represent sufficient support for the work the auditor performed or conclusions the auditor reached but may be used by the auditor to clarify or explain information contained in the audit documentation. It is, however, neither necessary nor practicable to document every matter the auditor considers during the audit.

While an auditor will not document every consideration made during the course of the audit, care should be taken to ensure that the audit documentation meets the overall requirement of providing a clear understanding of what was done, the evidence gathered, and conclusions that were reached based on the procedures and evidence obtained.

Auditors should 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 requires more than just an oral explanation.

Other Purposes of Workpapers. While audit workpapers must achieve the primary purpose noted previously, 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 workpapers include:

- Aids in the planning and performance of the current and future engagements.
- Provides guidance for newer team members.
- Reinforces and demonstrates accountability.
- Aids in supervision and review.
- Aids in external review.

Basic Requirements for Content. An auditor has a great deal of discretion in deciding on the specific workpapers to prepare; however, SAS No. 103 provides criteria auditors can use in making documentation decisions and defines significant findings and other matters requiring documentation in the workpapers. According to SAS No. 103 (AU 339.10), 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 conclusions reached on significant matters.

d. That the financial statements (or other audited information) agree or reconcile to the underlying accounting records.

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 requires little or no oral explanation as to what was done, who performed the work, and the reasons for the conclusions. The SAS considers an experienced auditor to be an individual with 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.

There are few stringent requirements as to what should be contained in the workpapers. Accordingly, the form, content, and extent of the workpapers will be dependent on factors that are unique to the engagement. In determining the documentation appropriate for a particular engagement, auditors should consider:

a. The risk of material misstatement associated with the assertion, account balance, or class of transactions, including disclosures.

b. The nature of the auditing procedure.

c. The amount of judgment that will be necessary in carrying out the procedure and evaluating the results.

d. The significance of the audit evidence obtained to the assertion tested.

e. The nature and extent of exceptions.

f. The need to document or support a conclusion not readily apparent from the documentation of the work performed or evidence gathered.

SAS No. 103 provides the following specific audit documentation requirements:

a. *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.

b. *Identification of Items Tested*. Documentation of procedures performed, including tests of controls and substantive tests of details involving inspection of documents or confirmation, should identify the items tested.

c. *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 of the review.

d. *Significant Findings or Issues*. Auditors are required to document information related to significant audit findings or issues.

e. *Departures from the Requirements in the SASs*. In the rare instances where an auditor deems it necessary to depart from a presumptively mandatory requirement of the SASs, documentation *must* be made justifying the departure and how alternative procedures performed were sufficient to achieve the objectives of the requirement.

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.
- Subsequent discovery of facts that existed at the date of the report.
- Other reasons an auditor considers it necessary to make an addition or change to the workpapers after the documentation completion date.

g. *Report Release Date*. The report release date should be recorded in the audit documentation.

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 specifically includes tests of the operating effectiveness of controls and substantive tests of details involving inspection of documents or confirmation. SAS No. 103 also provides examples for documenting the identifying characteristics of inquiry and observation procedures. Therefore, also applying the requirement to observation and inquiry procedures is recommended. For inspection of documents and confirmation procedures, it is believed that 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 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 an analytical procedure is used as the principal substantive procedure for a significant financial statement assertion, SAS No. 56, *Analytical Procedures* (AU 329), requires the auditor to 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 procedures performed to address significant 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 (for example, a percentage of tolerable misstatement).

Documenting the Identification of Preparer and Reviewer. Auditors should record who performed the audit procedures and when such work was completed. In most situations, this is a simple process; normally it only requires the individual who performed the procedure to initial and date the specific workpaper, checklist, or program step that specifies the work performed. However, if a program step is supported by workpapers, there is no need to date both the program step and the supporting workpapers. Doing so creates the possibility of discrepancies in the dating, which should be avoided. Therefore, when completing audit program steps that are supported by workpapers, some auditors may choose to sign, but not date, such program steps because the supporting workpapers should indicate the date the procedures were performed. In such cases, it is preferable to cross-reference the program steps to the supporting workpapers.

SAS No. 103 also requires documentation of who reviewed *specific* audit documentation and the *date* of the review. The statement 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 may also be used.

Documenting Significant Findings or Issues. On some CIRA audits, the engagement team may be faced with difficult issues that require 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.

SAS No. 103 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 basis for the auditor's conclusions.

Discussions of significant findings or issues that occur between the auditor and management should also be documented in a timely manner, including (a) the items discussed, (b) when and with whom they were discussed, and (c) the responses obtained. 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 board or audit committee members (if applicable), lower level employees, record keepers, or other third-party service providers. 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 differences in professional judgment among audit team members or between the team and others consulted.

The matters in these paragraphs can be documented in a memorandum. It is recommended 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 should be clearly stated, along with his or her reasoning process supporting the conclusion. Other items that should be documented include any discussions of significant findings, the existence of conflicting evidence or guidance supporting contrary points of view, and any consultation that occurred in resolving the issue.

Documenting Revisions after the Date of the Auditor's Report. Timely completion of audit documentation is critical to assure audit quality. As a practical matter, the auditor should 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 should ensure that the documentation meets the objectives discussed previously. 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* should be the date that the auditor has obtained sufficient appropriate audit evidence to support his or her opinion on the financial statements. Typically, such evidence includes evidence that:

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

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.

According to AICPA Technical Practice Aid, *The Effect of Obtaining the Management Representation Letter on Dating the Auditor's Report* (TIS 9100.06–.07), the auditor does not need to be in physical receipt of the management representation letter on the date of the auditor's report, but should 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.

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. SAS No. 103 requires the auditor to document the report release date in the workpapers. In most cases, the report release date should be close to the date of the auditor's report. A delay in releasing the report of more than two weeks after the report date should result in extending the subsequent events review to the later date and redating the report. (This matter should be covered in the firm's quality control policies and procedures.) If there are significant delays in releasing the report, auditors should consider subsequent events.

SQCS No. 7, paragraph 62, states that firms "should establish policies and procedures for engagement teams to complete the assembly of final engagement files on a timely basis, as appropriate for the nature of the engagement, after the engagement reports have been released." Those policies and procedures should 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. Completing workpapers on a timely basis as the engagement progresses is recommended. However, the final assembly and completion of the audit file should occur within 60 days of the report release date. SAS No. 103 refers to this date as the *documentation completion date*. After that date, the auditor must 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 policy of quality control. In addition, the auditor should consider whether there are regulatory or state requirements that require a shorter documentation completion period.

At any time prior to the documentation completion date, the auditor is permitted to make changes to the workpapers to:

- Finalize the documentation and assemble the evidence that was obtained, discussed, and agreed among the audit team prior to the date of the auditor's report, including discarding to-do lists and superceded 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. The auditor should not make changes after the report date that would have impacted the documentation of the work performed, the evidence obtained, the conclusions reached, or the review that was conducted prior to that date.

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 for other than those activities noted in the previous paragraph, the auditor should make changes to the audit documentation to record the performance of the new procedure or the new conclusions that were reached. In addition, the documentation of the changes should include:

- When and by whom the changes were made and, if applicable, reviewed.

- The specific reasons for the change.
- The effect of any changes on conclusions reached.

The auditor should also consider whether there are regulatory or state requirements that differ from GAAS.

Audit Documentation Recommendations. There are a number of practical workpaper documentation techniques that this course recommends 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 work 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.
- Indicate how conflicting audit evidence was resolved.

Additional Purposes of Workpapers. 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 draft the financial statements, tax returns, and other reports that might be required. 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 will probably 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, accounts receivable 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 accounts receivable, 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 adoption of a simple indexing approach is encouraged.

SELF-STUDY QUIZ

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

35. In which case would specified risk audit programs be appropriate?

    a. The audit area has a low risk of material misstatement and is not significant.

    b. The audit area has a low or moderate risk of material misstatement and is significant.

    c. The auditor plans to rely on the operating effectiveness of controls.

    d. A lack of segregation of duties by onsite personnel exists

36. What is the *primary purpose* of audit workpapers?

    a. Aid in planning and performing current and future engagements.

    b. Provide principal support for the auditor's report.

    c. Reinforce and demonstrate accountability.

    d. Assist successor auditors.

37. Which of the following is specifically required by SAS No. 103 to be included in audit documentation?

    a. Original copies of the client's records.

    b. Summary of all items tested.

    c. Significant issues or findings.

    d. Revisions after the date of the financial statements.

38. If an auditor must make additions or changes to the audit workpapers after the date of the auditor's report, documentation of those changes should include all of the following, **except**:

    a. When the changes were made.

    b. The performance of a new audit procedure.

    c. Specific reasons for the change.

    d. A new workpaper index.

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.)**

35. In which case would specified risk audit programs be appropriate? **(Page 516)**

    a. The audit area has a low risk of material misstatement and is not significant. [This answer is incorrect. The limited procedures approach would be appropriate in this situation.]

    b. The audit area has a low or moderate risk of material misstatement and is significant. [This answer is incorrect. A basic procedures approach is appropriate in this situation.]

    c. The auditor plans to rely on the operating effectiveness of controls. [This answer is incorrect. If the auditor was *not* intending to rely on the operating effectiveness of controls to reduce the control risk assessment, then specified risk audit programs would be appropriate.]

    d. A lack of segregation of duties by onsite personnel exists [This answer is correct. If this is a known deficiency, specified risk audit programs can be used. Another example of when such programs can be used is when management's accounting personnel are generally competent to process data and make decision necessary to perform their assigned duties.]

36. What is the *primary purpose* of audit workpapers? **(Page 517)**

    a. Aid in planning and performing current and future engagements. [This answer is incorrect. Though this is a purpose served by workpapers, it is not their primary purpose.]

    b. Provide principal support for the auditor's report. [This answer is correct. According to SAS No. 103, that support includes (1) the representation that the audit was performed in accordance with generally accepted auditing standards and (2) the opinion expressed (or disclaimed) on the financial statements.]

    c. Reinforce and demonstrate accountability. [This answer is incorrect. Workpapers should reinforce and demonstrate accountability, but this is not their primary purpose.]

    d. Assist successor auditors. [This answer is incorrect. Assisting successor auditors in their review is one purpose of workpapers, but it is not their primary purpose.]

37. Which of the following is specifically required by SAS No. 103 to be included in audit documentation? **(Page 519)**

    a. Original copies of the client's records. [This answer is incorrect. Abstracts or copies of the client's records, not the originals, should be included in the workpapers, if they are needed to allow an experienced auditor to understand the work performed and conclusions reached.]

    b. Summary of all items tested. [This answer is incorrect. Documentation of procedures performed, including tests of controls and substantive tests of details involving inspection of documents or confirmation, should identify the items tested, not merely give a summary of them.]

    c. Significant issues or findings. [This answer is correct. Auditors are required to document information related to significant audit findings or issues in the workpapers. Another example of something that SAS No. 103 requires in the workpapers is the report release date.]

    d. Revisions after the date of the financial statements. [This answer is incorrect. Auditors are required to document certain items if revisions to the workpapers are necessary after the date of the auditor's report, not the date of the client's financial statements.]

38. If an auditor must make additions or changes to the audit workpapers after the date of the auditor's report, documentation of those changes should include all of the following, **except**: **(Page 522)**

    a. When the changes were made. [This answer is incorrect. When and by whom the changes were made and, if applicable, reviewed should be documented when changes are made after the date of the auditor's report.]

    b. The performance of a new audit procedure. [This answer is incorrect. If changes are made after the date of the auditor's report, the audit documentation must be changed to show the performance of the new procedure and the new conclusions that were reached.]

    c. Specific reasons for the change. [This answer is incorrect. If the auditor makes changes after the date of the auditor's report, documentation must include the specific reasons for the change and the effect of any changes on the conclusions reached. The auditor should also consider whether there are regulatory or state requirements that differ from GAAS.]

    d. A new workpaper index. [This answer is correct. Workpaper indexing or cross-referencing is recommended; however, creating a new such system is not a requirement when changes are made after the date of the auditor's report.]

INITIAL ENGAGEMENTS

SAS No. 108 (AU 311) provides guidance on considerations for planning an initial audit engagement. Because the auditor generally lacks experience with the client, additional planning procedures are generally necessary in order to develop the audit strategy and audit plan. The following matters should normally be considered when beginning an initial audit:

- The nature and extent of audit procedures that will be necessary to obtain sufficient appropriate audit evidence about opening balances.
- The nature and extent of audit procedures necessary to obtain reasonable assurance concerning the consistency of application of accounting principles between the current year and the preceding year.
- Significant issues that were discussed with management and others during the auditor retention process, their impact on the audit strategy and audit plan, and any communication that may be necessary with those charged with governance.
- Arrangements regarding the review of a predecessor auditor's workpapers, when applicable.
- The competence and experience of firm personnel that are necessary to respond to anticipated significant risks.
- Any other procedures for initial audit engagements that are required by the firm's system of quality control such as engagement quality control review of the audit strategy or reports that will be issued.

SQCS No. 7 defines *engagement quality control review* as "a process designed to provide an objective evaluation, by an individual or individuals who are not members of the engagement team, of the significant judgments the engagement team made and the conclusions they reached in formulating the report." (SQCS No. 7 is effective for a firm's system of quality control as of January 1, 2009.)

Reasonableness of Opening Balances

In an initial engagement, the auditor's objective is to assess the reasonableness of opening balances of significant balance sheet accounts. 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. 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, accounts receivable, inventory, and accounts payable).

Naturally, the auditor's additional procedures are most extensive for the first category and, if reliance is placed on a predecessor auditor, the degree of reliance 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 place reliance on the predecessor should be made by audit area (e.g., the auditor may decide to rely on the predecessor's report and his or her review of the predecessor's workpapers extensively in the accounts receivable 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.

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 or their method of application. Usually, there is no problem in identifying significant accounting principles (e.g., inventory and depreciation methods). However, the auditor must also be concerned with the methods of application (e.g., expenditures recorded in the repair and replacement fund). Also, the auditor must be 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).

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 must be applied to opening balances are not reduced when there are previous accounting services. The same additional procedures for an initial engagement when no reliance on a predecessor is planned or possible are appropriate. 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 must be applied to opening balances are the same procedures for circumstances when no reliance on the work of a predecessor is planned or possible. 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 that would require a fourth explanatory paragraph is a scope limitation. Inventory is likely to present the greatest difficulty, but similar problems may arise with accounts receivable and accounts payable.

Even when a scope limitation will preclude expression of an unqualified opinion, the auditor should 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.

Audit of a Previously Audited CIRA

When an CIRA has been audited previously, certain communications with the predecessor auditor are required by professional standards, and other communications can facilitate the successor's audit. SAS No. 84, *Communications Between Predecessor and Successor Auditors*, at AU 315.07 states that "inquiry of the predecessor auditor is a necessary procedure because the predecessor auditor may be able to provide information that will assist the successor auditor in determining whether to accept the engagement." This required communication before acceptance of the engagement is discussed in Lesson 1.

SAS No. 84, as amended, defines the term *predecessor auditor* as an auditor who (a) reported on the most recent audited financial statements or was engaged to perform but did not complete an audit of the financial statements and (b) has resigned, declined to stand for reappointment, or been notified that his or her services have been or may be terminated. 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. SAS No. 84 communication about management integrity and other matters should be made of all predecessor auditors. However, when a predecessor did not complete the audit, it is less likely the auditor will consider it appropriate to review the predecessor's workpapers.

Communications after acceptance that may facilitate the successor's audit generally fall in the following categories:

- Inquiries of the predecessor regarding matters that the successor believes may affect the conduct of the audit, such as audit areas that have required an inordinate amount of time or audit problems that arose from the condition of the financial reporting system and records.

- Review of the predecessor auditor's workpapers.

These communications are not required, but if the auditor believes the predecessor's work can be relied on, considerable audit time can be saved. However, the successor auditor should not make reference to the report or work of the predecessor auditor as the basis, in part, for his own opinion. This type of report reference divides responsibility among auditors for the opinion on the financial statements. Because the predecessor's work is considered as part of the evidence for beginning balances and consistent application of accounting principles, there is no identifiable portion of the financial statements for a meaningful division of responsibility.

The successor auditor has to request the client to authorize the predecessor auditor to allow a review of the predecessor's workpapers. 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 a general review to make a preliminary assessment of whether the predecessor's audit was made in accordance with GAAS and can be relied on. During this phase, the auditor would review the audit plan and audit programs (unless the predecessor considers the programs proprietary in nature), including particularly the analysis of the risk of material misstatements and the understanding of internal control. The auditor would consider the apparent understanding of the client, its systems, its operations, and its accounting policies obtained by the predecessor and the general quality of the documentation of these matters. If there is a summary memorandum of significant accounting and auditing issues, the successor would consider it carefully.

The second aspect of the successor's review is a detailed consideration of trial balances, account balance analyses, adjusting journal entries, and items from the permanent files such as contracts, carryforward schedules, and other workpapers in important audit areas. The successor should request copies of workpapers of continuing accounting significance.

When comparative financial statements are presented, the successor auditor has to select one of the two following reporting options concerning the prior year's statements:

a. have the predecessor reissue his report on the prior year's statements, or

b. refer to the predecessor's report in the scope paragraph of the successor's report.

When a predecessor's report is reissued, according to SAS No. 58, *Reports on Audited Financial Statements*, as amended, at AU 508.71, "a predecessor auditor should (a) read the financial statements of the current period, (b) compare the prior-period financial statements that he or she 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." This letter should state whether the successor has detected any matters that, in the successor's opinion, might have a material effect on, or require disclosure in, the financial statements reported on by the predecessor. Generally, it is simpler to refer to the predecessor's report in the scope paragraph of the successor's report.

Audits of Financial Statements Previously Audited (Reaudits)

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 auditor's procedures when he or she intends to rely on the work of the predecessor auditor for substantiating opening balances are discussed earlier in this section. When the auditor does not intend to place reliance on the work of the predecessor auditor, the auditor performs the additional procedures on opening balances as discussed previously. 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 this situation:

- What communications are required between the successor and predecessor auditors, and when?
- 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?

SAS No. 84 (AU 315), *Communications between Predecessor and Successor Auditors*, provides, among other things, guidance to auditors in this situation.

Communications with the Predecessor Auditor. The successor auditor is required to communicate with the predecessor auditor prior to accepting the prospective client. 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 discussed in Lesson 1, the successor auditor should clearly communicate that the purpose of his or her 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 substantiate beginning balances and to evaluate the consistency in application of accounting principles. In a reaudit situation, the auditor should review the workpapers for the period to be reaudited for purposes of obtaining information to be used in planning his or her reaudit. Before requesting permission from the predecessor auditor, the successor auditor should obtain the client's consent to review the predecessor's workpapers.

According to SAS No. 84, a successor auditor may issue a proposal to a prospective client before making the required inquiries of the predecessor auditor. Successor auditors are encouraged to include a statement in the

proposal advising prospective clients that final acceptance may occur only after the necessary communications with the predecessor auditor. However, the standards do not require such a statement.

Reliance on the Work of the Predecessor. SAS No. 84 provides guidance on how much reliance can be placed on predecessor's workpapers when a successor is performing a reaudit. 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 "rely" on the predecessor's workpapers as evidence. Instead, the purpose for reviewing the workpapers for the reaudit period must be 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 must be the responsibility of the successor auditor. If the successor relies on the predecessor's workpapers to support his or her 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 as defined in SAS No. 73, *Using the Work of a Specialist*, or as the work of an internal auditor as defined in SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*.

In other words, the successor auditor must 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 rely on the confirmation procedures documented in the predecessor's workpapers as evidence to support the existence of investments. Additional procedures, such as sending additional confirmations, must be performed by the successor auditor.

For purposes of substantiating the beginning balances of the reaudit period and evaluating the consistency in application of accounting principles, this course maintains that the predecessor's workpapers for the period prior to the reaudit period may be relied upon by the successor auditor. The guidance in this section 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 about comparable financial statements in this section would apply.

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 should not be accommodated. This option is acknowledged in SAS No. 84. It states that the predecessor auditor determines the extent, if any, of access a successor auditor may have to the workpapers. One solution is for the predecessor to provide access only to workpapers for the period *prior* to the reaudit period. Another is for the predecessor to obtain written confirmation from the successor that its work will not be relied upon as a basis for the successor's report on the reaudited periods.

SELF-STUDY QUIZ

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

39. During an initial engagement, an auditor must assess the reasonableness of opening balances. Additional audit procedures will be most extensive for which type of opening balance?

    a. All (or a substantial portion) of the ending balance is accounted for by the opening balance, and the auditing approach for a continuing engagement will focus on the items that increase/decrease the opening balance to substantiate the ending balance.

    b. All (or a substantial portion) of the ending balance is accounted for by the opening balance, and the auditing approach for a continuing engagement will substantiate directly most or all of the items in the ending balance.

    c. The account balance turns over once each accounting period, at least, and none of the opening balance items would normally be included in the ending balance.

    d. Performing additional audit procedures on opening balances would be overauditing and, thus, should not be done, even in an initial engagement.

40. Maisy is engaged to perform a reaudit of the Riverside Homeowners' Association's previously audited financial statements. In which of the following scenarios has Maisy dealt appropriately with an aspect of the reaudit engagement?

    a. Maisy contacts the predecessor auditor and relies on his workpapers as evidence.

    b. Maisy contacts the predecessor auditor and assumes responsibility for his work.

    c. Maisy contacts the predecessor auditor prior to accepting the CIRA as a client.

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.)**

39. During an initial engagement, an auditor must assess the reasonableness of opening balances. Additional audit procedures will be most extensive for which type of opening balance? **(Page 528)**

    a. All (or a substantial portion) of the ending balance is accounted for by the opening balance, and the auditing approach for a continuing engagement will focus on the items that increase/decrease the opening balance to substantiate the ending balance. [This answer is correct. Naturally, the auditor's additional procedures are the most extensive for this category of opening balances, and, if reliance is placed on a predecessor auditor, the degree of reliance is normally considerable.]

    b. All (or a substantial portion) of the ending balance is accounted for by the opening balance, and the auditing approach for a continuing engagement will substantiate directly most or all of the items in the ending balance. [This answer is incorrect. The auditor's procedures are generally the least extensive for this category of opening balances because the audit procedures applied to the ending balance also support the opening balance.]

    c. The account balance turns over once each accounting period, at least, and none of the opening balance items would normally be included in the ending balance. [This answer is incorrect. The auditor's primary concern with this category of opening balances is the effect of misstatement of the opening balance on the current period's operating results. This type of opening balance does not require the most extensive additional auditing procedures.]

    d. Performing additional audit procedures on opening balances would be overauditing and, thus, should not be done, even in an initial engagement. [This answer is incorrect. Overauditing is a great source of inefficiency in an initial engagement; however, in an initial engagement, an auditor must assess the reasonableness of the opening balances of significant balance sheet accounts.]

40. Maisy is engaged to perform a reaudit of the Riverside Homeowners' Association's previously audited financial statements. In which of the following scenarios has Maisy dealt appropriately with an aspect of the reaudit engagement? **(Page 531)**

    a. Maisy contacts the predecessor auditor and relies on his workpapers as evidence. [This answer is incorrect. As the successor auditor, Maisy must perform the procedures considered necessary to report on the financial statements as if they had not been audited by the predecessor auditor. The purpose of the successor's review of the predecessor's workpapers for the reaudit period must be to obtain information that might be useful in planning the reaudit.]

    b. Maisy contacts the predecessor auditor and assumes responsibility for his work. [This answer is incorrect. 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.]

    c. Maisy contacts the predecessor auditor prior to accepting the CIRA as a client. [This answer is correct. The successor auditor is required to communicate with the predecessor auditor prior to accepting the prospective client. These communications should also be made when engaged to audit and report on financial statements previously audited and reported on by a predecessor auditor.]

EXAMINATION FOR CPE CREDIT

Lesson 3 (HOATG094)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

32. Under the authoritative literature, what are an auditor's responsibilities when the work of a specialist is used?

    a. To make a series of necessary evaluations to specialists employed by the auditor's firm who participate in the audit, including IT specialists.

    b. To evaluate the professional qualifications, determine the specialist has the necessary knowledge/skills, and understand the nature of the work performed by the specialist.

    c. To make reference to the specialist not only in an unmodified audit report, but also if the auditor expresses a qualified or adverse opinion.

    d. Do not select this answer choice.

33. When an audit area is critical (based on materiality and audit risk considerations), has a high volume of transactions, and individual items within the class do not differ significantly in either dollar amount or details of processing, what type of procedure would be most efficient?

    a. Sampling.

    b. Nonsampling.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

34. Janet decides to use audit sampling in her CIRA audit. She needs her sampling procedures to approximate an upper limit of 5%–8% on the rate of misstatement, as well as a sampling risk of 5%. Using the nonstatistical sampling approach discussed in this course, what should Janet's sample size be?

    a. 10.

    b. 25.

    c. 60.

    d. 75.

35. If an audit area is not significant and has a low risk of material misstatement, what type of audit approach is appropriate?

    a. Limited procedures.

    b. Basic procedures.

    c. Basic and extended procedures.

    d. Do not select this answer choice.

36. According to SAS No. 103, workpapers should allow an "experienced auditor with no previous connection to the audit" to understand all of the following, **except**:

    a. The nature, timing, and extend of the auditing procedures that were performed to comply with professional standards and any applicable legal or regulatory requirements.

    b. The results of the audit procedures that were performed along with the evidence that was gathered.

    c. The composition of the engagement team, including their pay grade, certifications, and other necessary biographical information.

    d. That the entity's financial statements (and other audited information) agree with (or reconcile to) the underlying accounting records.

37. Which of the following should be documented in the audit workpapers related to analytical procedures?

    a. The results of the comparison between the recorded amounts and the expectation.

    b. An aged trial balance on which all items tested are identified.

    c. The dates of inquiries, inquiry made, and names and job functions of client personnel queried.

    d. The matter observed, when and where the observation took place, and individuals involved and their responsibilities.

38. What happens on the audit report date?

    a. The auditor gives the client permission to use the auditor's report in connection with the financial statements.

    b. The auditor has obtained sufficient appropriate audit evidence to support his/her opinion on the financial statements.

    c. The date that, after which, the auditor cannot delete or discard any documentation prior to the five-year retention period.

    d. Do not select this answer choice.

39. What type of CIRA audit engagement will generally be the most time consuming and difficult for the auditor?

    a. A continuing engagement.

    b. An initial engagement when there is a predecessor auditor.

    c. An initial engagement without any previous accounting/auditing services.

    d. The initial audit of a new CIRA.

40. Lisa is evaluating whether to accept an engagement to audit Land's End Homeowner's Association's 2009 financial statements. The CIRA has its financial statements audited annually. Lisa must contact the CIRA's predecessor auditor as part of her client acceptance procedures. Which of these individuals will Lisa need to contact, based on the information in SAS No. 84?

    Stu audited the CIRA's 2007 financial statements.

    Clara audited the CIRA's 2008 financial statements.

    Dwayne was engaged to perform the audit of the CIRA's 2009 financial statements, but did not complete the audit.

    Joe is the CIRA's internal auditor.

    a. Clara.

    b. Stu.

    c. Clara and Joe.

    d. Clara and Dwayne.

GLOSSARY

Audit plan: A more detailed than the audit strategy and documents the nature, timing, and extent of procedures to be performed to obtain sufficient appropriate audit evidence. It is also called the audit program.

Audit planning: Developing an overall audit strategy for the expected conduct, organization, and staffing of the audit.

Audit report date: The date that the auditor has obtained sufficient appropriate audit evidence to support his or her opinion on the financial statements.

Audit risk: The risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated.

Audit sampling: The application of an audit procedure to less than 100% of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of the balance or class.

Audit strategy: The auditor's operational approach to achieving the objectives of the audit. It is a high-level description of the audit scope. 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.

Benchmark: A standard with which to compare a ratio. The benchmark should indicate the optimal level for the ratio.

Client acceptance and continuance procedures: Such procedures should provide reasonable assurance that engagements that are accepted can reasonably be expected to be completed with professional competence and the risks associated with providing professional services in the particular circumstances are appropriately considered.

Control risk: The risk that a misstatement that could occur in a relevant assertion and that could be material, either individually or when aggregated with other misstatements, will not be prevented or detected on a timely basis by the entity's internal control.

Detection risk: The risk that the auditor's procedures will not detect a misstatement that exists in a relevant assertion that could be material, either individually or when aggregated with other misstatements.

Documentation completion date: The final assembly and completion of the audit file should occur within 60 days of the *report release date*. SAS No. 103 refers to this date as the *documentation completion date*. After this date, the auditor must not delete or discard any documentation prior to the required five-year retention period.

Engagement letter: The audit engagement letter states explicitly the terms of the engagement or audit, including what is expected of the auditor and of the client. SAS No. 108, *Planning and Supervision*, requires the auditor to establish an understanding with the client about the services to be performed for each engagement and to document that understanding through a written engagement letter.

Fraud: While fraud has a broad legal concept, the auditor's interest relates to fraudulent acts that would cause a material misstatement of financial statements. Fraud is compared to error and the auditor is concerned whether the action that resulted in material misstatement in the financial statements was intentional, fraud, or unintentional, error.

The auditor is concerned with two types of misstatements in financial statements: (1) misstatements arising from fraudulent financial reporting such as intentional misstatements or omissions of amounts or disclosures and (2) misstatements arising from misappropriation of assets, defalcations, involving such things as theft of the company's assets, which causes the financial statements to not be presented in conformity with GAAP.

Independence: To be free from conflicts of interest and bias, self-governing, impartial, not subject to control by others, not requiring or relying on something else, not contingent, and acting with integrity and objectivity (i.e., with judgment that is unimpaired and without bias or prejudice).

Individually significant dollar items: Two types of items in a financial statement component—unusual items (that is, items that have audit significance by their nature) and individually significant dollar items.

Inherent risk: The susceptibility of a relevant assertion to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming that there are no related controls.

Inquiry: Inquiry is one of the five basic methods of obtaining audit evidence. An inquiry is the seeking of appropriate information from knowledgeable persons inside (both management and staff) or outside the entity (e.g., bankers, attorneys, vendors, customers, predecessor auditor) with the approval of management. Inquiries are generally achieved by asking questions and receiving responses. Inquiries of management are used extensively in investigating unusual fluctuations or items, fraud, errors, and contingent liabilities. The confirmation process consists of obtaining a written response from independent parties to specific inquiry to corroborate information contained in the accounting records.

Internal control: According to the Committee of Sponsoring Organizations of the Treadway Commission's (COSO) *Internal Control—Integrated Framework*, there are five elements of internal control: (1) control environment, (2) risk assessment, (3) information and communication, (4) monitoring, and (5) control activities.

Managing agent: 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, such as bookkeeping and accounting services.

Observation: Observation is one of the five basic methods of obtaining audit evidence. It is looking at a process or procedures being performed by others. Observation is especially useful in the counting of inventory and in testing internal control procedures and computer processing of accounting data and other activities that do not leave an audit trail.

Overall risks: Risks of material misstatement that relate pervasively to the financial statements taken as a whole and potentially affect many relevant assertions.

Planning materiality: The preliminary judgment about materiality at the financial statement level.

Predecessor auditor: An auditor who (1) reported on the most recent audited financial statements or was engaged to perform but did not complete an audit of the financial statements and (2) has resigned, declined to stand for reappointment, or been notified that his or her services have been or may be terminated. 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.

Pre-engagement activities: Activities that involve consideration of the auditor's ability and desire to propose for, accept, or retain a particular CIRA engagement, including the auditor's independence and technical expertise; management's integrity; the scope of the audit; communicating with the predecessor auditor, if there is one; and establishing the terms of the engagement.

Preliminary analytical procedures: Analytical procedures should applied in audits of financial statements to assist the auditor in planning the nature, timing, and extent of other auditing procedures. They focus on (1) enhancing the auditor's understanding of the client's business and the transactions and events that have occurred since the last audit date and (2) identifying areas that may represent specific risks relevant to the audit.

Relevant assertion: An assertion that has a meaningful bearing on whether the class of transactions, account balance, or disclosure is 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.

Risk of material misstatement: At the individual account balance, class of transaction, or disclosure level, the risk of material misstatement consists of inherent risk and control risk.

Service auditor's report: A type of special purpose report described in SAS No. 70 that can be necessary when service organizations are involved.

Specialist: When performing an audit, an auditor often encounters situations in accumulating evidence concerning account balances in which evidence is from fields beyond his expertise. In such cases, the auditor may use the work of a specialist. A specialist is thus defined as a person (or firm) possessing knowledge in a particular field other than accounting or auditing. The auditor may use the findings of the specialist as part of the audit evidence provided the auditor follows the guidelines set forth in AU 336.

Tolerable misstatement: The maximum error in a population (for example, the class of transactions or account balance) that the auditor is willing to accept. Generally, tolerable misstatement should be lower than the materiality level for the financial statements taken as a whole.

Understanding the entity and its environment: The second standard of field work requires an understanding of the "entity and its environment, including its internal control." The auditor's focus in obtaining the required level of understanding should be 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.

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TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations—Course 1—Authoritative Accounting Literature For CIRAs (HOATG091)

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8.	○	○	○	○	18.	○	○	○	○	28.	○	○	○	○	38.	○	○	○	○
9.	○	○	○	○	19.	○	○	○	○	29.	○	○	○	○	39.	○	○	○	○
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EXAMINATION FOR CPE CREDIT ANSWER SHEET

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Birth Month: _____ Licensing State: _____

ANSWERS:

Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ● not like this ⊘ ⊗ ⊘ .

	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.	○	○	○	○

You may complete the exam online by logging onto our online grading system at **OnlineGrading.Thomson.com**, or you may fax completed Examination for CPE Credit Answer Sheet and Course Evaluation to Thomson Reuters at (817) 252-4021, along with your credit card information.

Expiration Date: September 30, 2010

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—Income Taxes For CIRAs

Course Acronym: HOATG092

Your Name (optional): _____ Date: _____

Email: _____

Please indicate your answers by filling in the appropriate circle as shown:
Fill in like this ● not like this ⊘ ⊗ ⊘.

Satisfaction Level:	Low (1) . . . to . . . High (10) 1	2	3	4	5	6	7	8	9	10
1. Rate the appropriateness of the materials for your experience level:	○	○	○	○	○	○	○	○	○	○
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?	○	○	○	○	○	○	○	○	○	○
8. If applicable, was the technological equipment appropriate?	○	○	○	○	○	○	○	○	○	○
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	○	○	○	○	○	○	○	○	○	○
10. If applicable, how well did the audio/visuals contribute to the program?	○	○	○	○	○	○	○	○	○	○

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** ○ ○

For more information on our CPE & Training solutions, visit trainingcpe.thomson.com. Comments may be quoted or paraphrased for marketing purposes, including first initial, last name, and city/state, if provided. If you prefer we do not publish your name, write in "no" and initial here _____

TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations—Course 3—Performing Substantive Procedures and Concluding the Audit (HOATG093)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.

   ONLINE GRADING. Log onto our Online Grading Center at **OnlineGrading.Thomson.com** 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 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 mail or fax your completed answer sheet to the address or number below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products. 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.

   Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

   Thomson Reuters
   Tax & Accounting—R&G
   HOATG093 Self-study CPE
   36786 Treasury Center
   Chicago, IL 60694-6700

   You may fax your completed **Examination for CPE Credit Answer Sheet** and **Course Evaluation** to the Tax & Accounting business of Thomson Reuters at **(817) 252-4021**, along with your credit card information.

   Please allow a minimum of three weeks for grading.

   Note: The answer sheet has four bubbles for each question. However, not every examination question has four valid answer choices. If there are 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. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of $75. Discounts apply for 3 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 $214 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $270 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $319 (a 15% discount on all five courses or more).

4. To receive CPE credit, completed answer sheets must be postmarked by **September 30, 2010**. CPE credit will be given for examination scores of 70% or higher. An express grading service is available for an **additional $24.95** per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your examination for CPE Credit Answer Sheet.

5. Only the **Examination for CPE Credit Answer Sheet** should be submitted for grading. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy for your records.

6. Please direct any questions or comments to our Customer Service department at (800) 323-8724.

EXAMINATION FOR CPE CREDIT

To enhance your learning experience, examination questions are located immediately following each lesson. Each set of examination questions can be located on the page numbers listed below. The 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 each lesson, 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.

Page

CPE Examination Questions (Lesson 1) **309**

CPE Examination Questions (Lesson 2) **388**

EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations—Course 3—Performing Substantive Procedures and Concluding the Audit (HOATG093)

Price $75

First Name: _____

Last Name: _____

Firm Name: _____

Firm Address: _____

City: _____ State /ZIP: _____

Firm Phone: _____

Firm Fax No.: _____

Firm Email: _____

Express Grading Requested: ☐ Add $24.95

Signature: _____

Credit Card Number: _____ Expiration Date: _____

Birth Month: _____ Licensing State: _____

ANSWERS:

Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ● not like this ⊘ ⊗ ⊘ .

	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.	○	○	○	○

You may complete the exam online by logging onto our online grading system at **OnlineGrading.Thomson.com**, or you may fax completed Examination for CPE Credit Answer Sheet and Course Evaluation to Thomson Reuters at (817) 252-4021, along with your credit card information.

Expiration Date: September 30, 2010

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—Performing Substantive Procedures and Concluding The Audit

Course Acronym: HOATG093

Your Name (optional): _____ Date: _____

Email: _____

Please indicate your answers by filling in the appropriate circle as shown:
Fill in like this ● not like this ⊘ ⊗ ⊘.

Satisfaction Level:	Low (1) . . . to . . . High (10) 1	2	3	4	5	6	7	8	9	10
1. Rate the appropriateness of the materials for your experience level:	○	○	○	○	○	○	○	○	○	○
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?	○	○	○	○	○	○	○	○	○	○
8. If applicable, was the technological equipment appropriate?	○	○	○	○	○	○	○	○	○	○
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	○	○	○	○	○	○	○	○	○	○
10. If applicable, how well did the audio/visuals contribute to the program?	○	○	○	○	○	○	○	○	○	○

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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TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations—Course 4—Pre-engagement Activities and Audit Planning for Audits of CIRAs (HOATG094)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.

   ONLINE GRADING. Log onto our Online Grading Center at **OnlineGrading.Thomson.com** 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 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 mail or fax your completed answer sheet to the address or number below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products. 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.

   Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

   Thomson Reuters
   Tax & Accounting—R&G
   HOATG094 Self-study CPE
   36786 Treasury Center
   Chicago, IL 60694-6700

   You may fax your completed **Examination for CPE Credit Answer Sheet** and **Course Evaluation** to the Tax & Accounting business of Thomson Reuters at **(817) 252-4021**, along with your credit card information.

   Please allow a minimum of three weeks for grading.

   Note: The answer sheet has four bubbles for each question. However, not every examination question has four valid answer choices. If there are 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. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of $75. Discounts apply for 3 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 $214 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $270 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $319 (a 15% discount on all five courses or more).

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EXAMINATION FOR CPE CREDIT

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CPE Examination Questions (Lesson 1) **422**

CPE Examination Questions (Lesson 2) **500**

CPE Examination Questions (Lesson 3) **535**

EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations—Course 4—Pre-engagement Activities and Audit Planning for Audits of CIRAs (HOATG094)

Price $75

First Name: _____

Last Name: _____

Firm Name: _____

Firm Address: _____

City: _____ State /ZIP: _____

Firm Phone: _____

Firm Fax No.: _____

Firm Email: _____

Express Grading Requested: ☐ Add $24.95

Signature: _____

Credit Card Number: _____ Expiration Date: _____

Birth Month: _____ Licensing State: _____

ANSWERS:

Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ● not like this ⊘ ⊗ ⊘ .

	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, 2010

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 4—Pre-engagement Activities and Audit Planning for Audits of CIRAs

Course Acronym: HOATG094

Your Name (optional): _____ Date: _____

Email: _____

Please indicate your answers by filling in the appropriate circle as shown:
Fill in like this ● not like this ⊘ ⊗ ⊘.

Satisfaction Level:	Low (1) . . . to . . . High (10) 1	2	3	4	5	6	7	8	9	10
1. Rate the appropriateness of the materials for your experience level:	○	○	○	○	○	○	○	○	○	○
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?	○	○	○	○	○	○	○	○	○	○
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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?	○	○	○	○	○	○	○	○	○	○
8. If applicable, was the technological equipment appropriate?	○	○	○	○	○	○	○	○	○	○
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	○	○	○	○	○	○	○	○	○	○
10. If applicable, how well did the audio/visuals contribute to the program?	○	○	○	○	○	○	○	○	○	○

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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