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Chapter 1 Overview of Common Interest Realty Associations

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100 What Are Common Interest Realty Associations?

100.1 Condominium associations, homeowners' associations, and cooperative housing corporations are the main types of common interest realty associations. They are similar, in some respects, to the neighborhood associations often found in real estate developments of single-family residences. The neighborhood associations typically are concerned about matters such as neighborhood security, development, zoning, traffic, and beautification. Some associations also enforce architectural or other deed restrictions, such as requiring homes to be constructed of brick or fences of a certain design.

100.2 The sole purpose of both types of associations is to serve the collective needs of the neighboring property owners. As the term implies, however, “common interest realty associations” or “CIRAs” refer to organizations of property owners who—

- own or have the exclusive right to use their individual living quarters and
- share the exclusive use of certain property with all of the other property owners in the development.

Common interest realty association is the term used in FASB ASC 972, *Real Estate—Common Interest Realty Association*. *Community association* and *common interest development (CID)* are frequently used in the industry, as well. For simplicity, the AICPA's terminology will be used in this *Guide*.

Common Characteristics

100.3 As explained beginning at paragraph 100.4, the specific characteristics of CIRAs vary depending on the type of real estate that is owned by the association and by the individual property owners that are members of the association. Even so, all CIRAs have three primary functions—to serve as a business, as a governance structure, and as a community. In addition, the principal activities of all CIRAs are essentially the same: (a) to manage, maintain, repair and replace the common property used by all of the property owners, (b) to provide other services for their members, such as security and trash removal, (c) to enforce compliance with governing documents and state and local statutes and regulations relating to the operations of the CIRA, (d) to enforce rules for the mutual benefit of their members, (e) to equitably assess and collect funds from their members to

finance the expenses of operating the CIRA, and (f) to design programs to foster a sense of community. The following characteristics are common to all CIRAs:

- CIRAs are separate legal entities established under state laws and composed of the property owners within a specific real estate development.
- Property owners in the specific real estate developments may own lots and improvements, defined interior spaces, or shares of stock or membership certificates.
- Membership in the CIRA is automatic and cannot be separated from ownership of the underlying real estate.
- Funding of the CIRA's operations by periodic assessment of all members.
- Association members share the use of common area property within the real estate development (that is, property such as landscaped areas, parking lots, building elevators, and recreational facilities that is not owned and used exclusively by individual members).
- Association members are bound by restrictive covenants.
- The associations provide a means for self-government of their members through boards of directors that enforce the CIRAs' governing documents and carry out their operations.

Types of CIRAs

100.4 It is generally impossible to distinguish CIRAs by the physical appearance of the real estate development. Instead, CIRAs are primarily distinguished by the property that is owned by the CIRA's members and by the CIRA. The principal types of CIRAs are as follows:

- *Condominium Associations.* All unit owners in condominiums own their individual living quarters. They also have an undivided percentage interest in the common property that is inseparable from ownership of the unit itself. Condominium associations generally do not have title to any real property within the development.

- *Homeowners' Associations (HOAs)*. Members of homeowners' associations own their own dwelling and the land on which the dwelling sits. The HOAs, rather than the residents, have title to all of the common property within the development.

- *Cooperative Housing Corporations*. Residents of cooperatives own shares of stock (or membership certificates) in the cooperative corporation, which gives them the right to occupy a specific unit in the cooperative. The cooperative housing corporations, rather than the tenant-shareholders, have title to all real estate within the development, both the common property and the individual units.

- *Timeshare Developments*. The user of a timeshare development is entitled to (a) the right to use a certain accommodation or class of accommodations, generally in weekly increments that occur annually or on some other repeating basis or (b) a fee simple ownership interest in an accommodation, coupled with specified use rights. A resort condominium is an example of a timeshare development.

100.5 Accountants also may encounter the following types of common interest ownership developments:

- *Townhomes*. Townhomes are a form of property ownership in which the property owners own their individual unit and share a common wall and may also share ownership of other common property. If the development does not include other common property, the ownership is typically recorded as conventional real estate with a common wall agreement, and a CIRA is not established. If the development includes other common property, it is typically owned by the CIRA, and accounting would be similar to that for homeowners' associations. "Townhome" may also be used to refer to the style of home rather than the type of association. They may be found in homeowners' associations or condominium associations.

- *Condominium Trusts*. In some states, condominium developments establish nonprofit trusts rather than associations of property owners to manage the common property. If the trusts own all of the property, accounting is similar to that of a cooperative housing corporation.

- *Master Associations*. Developers may establish "master associations" (also referred to as "umbrella associations") when two or more common interest housing developments share recreational facilities or other common property or receive services as part of a contract covering more than one development. They are responsible for administering the shared common property or providing the shared services and assessing residents of the participating developments for their portion of the related expenses. Alternatively, the master association may assess each participating association for its expenses and the

participating association would in turn assess its residents. (The legal environment and income tax issues unique to master associations are discussed in sections 204 and 506, respectively.)

- *Cohousing Communities.* Those communities are less common in the United States and are based on a shared space concept from Denmark. The residents own their individual homes and share in the ownership of common areas, such as dining halls, parking lots, and community gardens. They also contribute a designated number of hours per week to community services, such as gardening, cooking meals, or cleaning up after meals.

- *Commercial Associations.* Those associations provide nonresidential facilities. Examples are industrial parks, shopping centers, professional buildings, parking facilities, marinas, and docks. (The legal environment and income tax issues unique to commercial associations are discussed in sections 204 and 508, respectively.)

- *Condo-hotel Developments.* Condo-hotels are unique in that the legal structure of the development is that of a typical full ownership condominium association, but the operations mimic those of a timeshare association, or a hotel operation. That is, buyers own a unit in the condo-hotel development for a designated number of weeks. The remainder of the year, the condo-hotel unit is rented out as a hotel room. They are generally developed at the high-end, luxury portion of the market and currently are most common in the states of Florida, Nevada, California, and Hawaii.

100.6 Although timeshare developments and commercial associations are similar in some respects to residential associations, they may be subject to unique regulatory, accounting, and tax requirements. The legal environments of timeshare developments and commercial associations are discussed in sections 205 and 206. Unique accounting and tax considerations for timeshare developments are discussed in Chapter 10. Where they differ from residential associations, accounting considerations and tax implications for other nonresidential associations are covered in other chapters of this *Guide*.

100.7 Residents of some common interest housing developments also may participate in voluntary membership associations that provide security or other services to their members. Voluntary membership associations such as those are not CIRAs; they are governed by FASB ASC 972.

100.8 **Condominium Associations**

The condominium form of ownership is a fee simple ownership of defined space, usually within a multi-unit building. (*Fee simple ownership* is an unrestricted ownership of rights to property, including the right to use and dispose of the property.) The physical boundaries of each unit generally are the interior surfaces of the unit's perimeter walls, floor, and ceiling. The building's structure—its foundation; exterior and common walls; roof, plumbing, and electrical components; and hallways—as well as the land under the building, are part of the

common areas, as are amenities such as landscaped areas, parking lots, courtyards, swimming pools, and clubhouses. Exclusive use common areas include balconies and patios. However, the physical boundaries of some condominium units include only the interior airspace and the airspace above the building while the real property belongs to the condominium association.

100.9 Unlike homeowners' associations and cooperatives, condominium associations (sometimes referred to as unit owners' associations) generally do not have title to the common property within the condominium development. Rather, each unit owner has an undivided percentage interest in the common property that is inseparable from ownership of the unit itself; it is said to be *appurtenant* to the unit. Condominium ownership gives each unit owner the right to share the use of the common areas with other unit owners and an obligation for a pro rata share of the expenses to manage, maintain, and repair them.

100.10 Although unit owners in a condominium development own only airspace, condominium ownership is a form of real property ownership. Thus, in certain respects, condominium ownership is similar to single-family residence ownership in that (a) individual financing of unit purchases is possible, (b) property taxes are assessed directly to unit owners, and (c) unit owners retain the right to sell their units. Courts generally have struck down the associations' right to approve the sales of individual units but have upheld their right to screen prospective purchasers and their right of first refusal. (On the other hand, leasing restrictions of various kinds are common and also have been widely upheld in court.)

100.11 Because condominium owners are often told that they own only airspace, they can be surprised to learn that they may own and be responsible for interior features such as wallpaper, flooring, painted surfaces, bathroom and electrical fixtures, built-in appliances, cabinets, etc. The condominium declaration describes in detail the boundaries of the individual units, as well as the items within the unit boundaries that are part of the units. (See section 201 for more information about the condominium declaration.)

100.12 Homeowners' Associations

Homeowners' associations or "HOAs" generally are established by developers of "planned unit developments" or "PUDs." PUDs (sometimes also referred to as planned residential developments or PRDs) are land developments that typically cluster (a) residential units, often of varying design, (b) open space, and (c) recreational and other amenities for optimal use of the property. PUDs are a fee simple type of residential real estate ownership in which the owners not only have title to their individual dwelling but also to the land on which the dwelling sits. Unlike the condominium form of ownership, the HOA, rather than the residents, has title to all of the common property within the development. The common property may be as minimal as the space between homes or include property such as roads and utilities within the development, parklands, and recreational facilities. Property ownership automatically conveys a membership interest in the homeowners' association to the residents who are responsible for paying assessments to the HOA to cover the cost of maintaining the common areas and providing necessary services. In turn, their property deeds allow them access to the common elements.

100.13 Like condominium owners, property owners in HOA communities also share many similarities with owners of single-family residences. They may separately mortgage their homes and are directly liable for the related property taxes. There are usually no restrictions on selling the property.

100.14 Cooperative Housing Corporations

Cooperatives (sometimes also referred to as cooperative apartment developments) are a form of residential housing in which the tenants are stockholders in a corporation that owns the land, building, and any improvements. Residents of cooperatives do not own their individual living quarters. Rather, as stockholders of the cooperative housing corporation, the tenants enter into proprietary leases that give them (a) the right to occupy defined living areas and (b) the right of access to the common property owned by the cooperative (that is, the property not included in the individual units, such as the public portion of the building—lobby, elevators, and hallways—and access roads, sidewalks, and parks). Stock or membership certificates issued by the cooperative to the purchaser of the membership interest are evidence of ownership in cooperatives.

100.15 Cooperatives are financed by mortgages of the entire property. Because the corporation owns the real estate, it is directly liable for the debt rather than the individual tenant-shareholders. Similarly, municipalities assess property taxes to the corporation based on the total value of the cooperative, rather than to the individual tenants for their units. The tenant-shareholders, on the other hand, are responsible for monthly assessments (sometimes referred to as maintenance fees or carrying charges) according to the terms of their proprietary leases. The assessments represent tenants' proportionate share of the costs of operating and maintaining the building, which includes mortgage payments, real estate taxes, insurance, and personnel costs. Although the tenant-shareholders are not personally liable to creditors, it is in their best interests to ensure that the cooperative's obligations are satisfied. For example, mortgage lenders are able to foreclose on the entire building if a cooperative defaults on its debt. Likewise, local governments have authority to file a tax lien on the entire building if property taxes are unpaid. In both cases, the interests of all tenant-shareholders are jeopardized. Thus, if residents default on their assessments, the remaining tenant-shareholders usually are assessed additional amounts to make up the deficiency.

100.16 Because of the financial interdependence of all of the tenant-shareholders, they generally are unable to transfer their interests in the cooperative without approval of the cooperative's board of directors.

100.17 Comparison of Certain Common Interest Realty Associations

Exhibit 1-1 compares the primary characteristics of condominium associations, homeowners' associations, and cooperatives.

Exhibit 1-1

Comparison of Certain Common Interest Realty Associations

Characteristic	Condominium Association	Homeowners' Association	Cooperative
Type of real estate development that creates the CIRA	Condominium	Planned unit development	Cooperative housing corporation
Architectural design of development	Generally one or more multiunit buildings		Generally one or more multiunit buildings

Characteristic	Condominium Association	Homeowners' Association	Cooperative
	composed of numerous apartments	Single-family detached homes or townhouses and open areas	composed of numerous apartments
Type of property owned by the CIRA's members	Generally interior airspace and proportionate interest in the common property (real property ownership)	Home and the land on which it sits (real property ownership)	Membership interest in the cooperative corporation represented by shares of stock or membership certificates (personal property ownership)
Property owned by the CIRA	Generally only common personal property purchased with CIRA funds (However, in certain circumstances, the CIRA owns the real property.)	All common property (both personal and real property)	All real and personal property (both common property and property occupied by the individual units)
Who owns the common property	Unit owners	CIRA	CIRA
Transferability of unit owners' interests	No restrictions, but CIRA may have right of first refusal	No restrictions, but CIRA may have right of first refusal	Generally only with approval of the cooperative's board of directors
Legal form of association	Corporation or unincorporated association based on state laws	Corporation or unincorporated association based on state laws	Corporation
Legal authority for association	State nonprofit laws and condominium statutes	State nonprofit laws and, if enacted, specific state statutes	State business or nonprofit corporation laws
Income tax status (See Chapters 5 and 11.)	Allowed to file Forms 1120 or 1120-H	Allowed to file Forms 1120, 1120-H, or 990	Required to file Form 1120-C
Basic legal documents of association (See Chapter 2.)	Condominium Declaration (or Master Deed); CIRA bylaws; articles of incorporation; rules and regulations (or house rules)	Declaration of Covenants, Conditions, and Restrictions; CIRA bylaws; articles of incorporation; rules and regulations (or house rules)	Membership agreements; proprietary leases; articles of incorporation; rules and regulations (or house rules)
Liability for mortgage and property taxes	Unit owners	Unit owners	CIRA (Owners' monthly maintenance fees cover their proportionate share.)
Form of financial statements (See Chapter 4.)	May use fund accounting or entity accounting	May use fund accounting or entity accounting	Many use fund accounting or entity accounting

Mixed-use Associations

100.18 A growing trend within the industry is the formation of mixed-use associations related to the development of mixed-use property. These associations can be generally broken down into two configurations: the *layered* association and the *combined* association. In either configuration, a mixed-use association may include a combination of residential, timeshare, and commercial (retail, manufacturing, or office) condominium units within the same association or groups of associations.

100.19 Layered Associations

The layered association configuration generally consists of a master association for the development and one or more special use associations that are members of the master association. A common example of this is a high-rise building in a downtown area that contains commercial or retail units on street or lower levels, with residential units on upper floors. In some cases, the commercial or retail units are formed as an association. In other cases, they are simply rental units that pay rent on the units owned by the master association. The residential units are generally formed as a separate association.

100.20 A general benefit of a layered association is that the residential association will usually qualify as a residential condominium association for tax purposes. It also means that the maintenance activities of the residential association are usually confined to interior common areas, as the master association normally assumes responsibility for exterior common areas. The master association may or may not qualify as residential for tax purposes, depending upon the portion of square footage devoted to residential use.

100.21 If the commercial or retail units are formed as a separate commercial association, the commercial condominium units are individually owned. The owner of the unit generally pays assessments both to the commercial association and to the master association. Often, for convenience, the owner pays a single assessment to the commercial association, and the commercial association pays an assessment on behalf of all owners to the master association. This simplifies operations and assures the master association that it will collect all assessments promptly, as the collection risk is passed to the commercial association.

100.22 If the commercial or retail units are not formed as a separate association, then the units are generally owned by the master association and rented to users. In this case, the tenant will pay rent to the master association. This generally means that the master association will not qualify as a homeowners' association under IRC Sec. 528 for tax purposes since it may have difficulty meeting the residential test, the 60% exempt function income test, and the 90% exempt function expenditures test. (See further discussion of IRC Sec. 528 in section 502.)

100.23 Combined Associations

The combined association consists of a single association with one or more special use activities. The physical property development of a combined association can be identical to that of the physical property development of a layered association (for example, either type of property development can consist of a high-rise building in a downtown area that contains commercial or retail units on street or lower levels, with residential units on

upper floors). However, because of the structure of a combined association, the combined nature of the activities generally provides for more complex operations.

100.24 The assessment structure for a combined association will necessarily require allocations between residential and nonresidential activities. In addition, because of the combined activities, the association often will not qualify as a homeowners' association under IRC Sec. 528 for tax purposes, as it may have difficulty meeting the residential test, the 60% exempt function income test, and the 90% exempt function expenditures test.

How CIRAs Are Established

100.25 In today's fast-paced and busy environment, although many people want to own their own home, they have no desire to spend the time and money associated with maintaining a single-family home. Also, as leisure time becomes increasingly important to most people, they want easy access to recreational amenities and open space at an affordable price. Others simply cannot afford a single-family home. Those factors, plus the premium on land in some parts of the country and the potential for cost economies in developing multi-family housing, often convince real estate developers that it is more profitable to build condominiums or planned communities rather than the traditional single-family detached home. In some cases, existing rental properties have been converted to condominium ownership.

100.26 State and local laws may require developers to establish a CIRA or may effectively prohibit them from transferring property to a local governmental unit. For example, as stated in paragraph 101.11, all 50 states have enacted laws regulating condominium development and management, and they require CIRAs to be formed to manage and maintain the common areas in condominium projects. Similarly, local jurisdictions are beginning to require developers of planned communities to establish CIRAs before they will approve their site plans because they do not want the responsibility for maintaining the common property after the development is completed. In other cases, developers turn to CIRAs for the following reasons:

- They perceive that prospective purchasers will prefer that alternative. Using any vehicle other than a CIRA to manage common property ultimately means that it can no longer be restricted for the exclusive use of the property owners in the development but must be open to others. Because restricted use of the common property is viewed by most prospective purchasers as one of the primary advantages of living in planned communities, many developers view CIRAs as the only viable alternative.

- Prospective purchasers may decide not to buy in a particular development if they are uncertain whether voluntary membership organizations will be able to generate enough revenue to maintain and repair recreational amenities in the future.

- Federal lending and lending-related organizations such as the Federal National Mortgage Association (FNMA or Fannie Mae), the Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac), the Department of Veterans Affairs (VA), and the Federal Housing Administration (FHA) have requirements

with which developers must comply before the organizations will become involved in the financing process for condominium or similar real estate projects either through loan guarantees, mortgage insurance, or providing a market for mortgages in the secondary market.

100.27 Whatever the developers' decision, it generally is made early in the development process since it ultimately affects how the development will be designed, financed, and marketed.

100.28 **Selecting a Method for Managing the Common Property**

When developers choose to build a project that involves the shared use of common property, they must provide a vehicle for managing and maintaining that common property after construction is completed. The nature of the cooperative form of ownership automatically means that the common property will be managed by the tenant-shareholders. For condominiums and HOA communities, however, developers may consider several alternatives. For example, they may:

- transfer the responsibility of the common property to a CIRA;

- dedicate the common areas to a governmental unit, such as the city where the development is located;

- convey the property to a voluntary membership organization, such as a social club;

- dedicate some common property, such as roads and utilities, to a governmental unit and convey the recreational amenities, such as the swimming pool and tennis courts, to a voluntary membership organization; or

- sell or lease operating amenities that are revenue-producing, such as golf courses or restaurants, to a separate company to operate.

100.29 **Preparing the Necessary Legal Documents**

The unique nature of the property ownership in common interest ownership developments generally requires developers to file certain legal documents in the property records of the local government where the development is located to create the project. Since the creation of a condominium is prescribed by state law, each state details the specific documents that must be filed and the manner of recording them. At a minimum, however, the documents (a) define the space for the development and divide it into numerous individual parcels and common areas, (b) create the CIRA to manage the common areas and explain how it will operate, and (c) describe the owners' rights and restrictions on the use of the common property and their obligation to

fund future maintenance and repairs for it. As stated in paragraph 100.3, CIRAs are separate legal entities, and some states require them to be incorporated. Thus, in addition to the documents relating to the real estate itself, developers often must file a charter or articles of incorporation establishing the condominium association with the state.

100.30 HOAs are created by covenants rather than being required by state law, and the individual property deeds in HOA communities are subject to those covenants. Some states do regulate the operation of HOA communities; but typically, the legal requirements are less detailed and less stringent than those for condominiums. Depending on state laws, the documents creating HOA communities may be similar to those for condominiums and address essentially the same matters listed in paragraph 100.29 or may more closely resemble the documents for real estate transactions involving the construction and sale of single-family detached homes. Like condominium associations, many HOAs are incorporated. If so, developers also must file incorporation papers with the state.

100.31 A few states have adopted statutes to regulate the operation and management of cooperatives, but generally there is no statutory authority for them. In most cases, cooperatives derive their authority from their articles of incorporation, bylaws, and the proprietary leases between the cooperative corporation and its tenant-shareholders. Other than recordings associated with the cooperative's articles of incorporation, their governing documents, unlike those of condominium associations and HOAs, generally are not recorded.

100.32 Chapter 2 discusses the legal documentation relating to CIRAs in detail.

100.33 **Transferring Control of the CIRA to the Property Owners**

As explained in paragraph 100.29, CIRAs typically are formed when the appropriate legal documents—the declaration or covenants—are filed. Because developers create CIRAs before the property is sold or even constructed, they control them during the initial period by appointing individuals to serve on the CIRAs' boards of directors. State law or the CIRAs' legal documents, however, detail how control is to be transferred to the property owners and establish the timetable for the transfer. The process of transferring control, referred to as the transition period, is a gradual process. For example, it may begin when the first unit is sold or after the sale of a specified percentage of units. To illustrate, some states may prescribe that 25% of the CIRA's board of directors be elected by the unit owners after 25% of the units are sold, one-third of the CIRA's board be elected by unit owners after 50% of the units are sold, and all of the CIRA's board be elected by unit owners after 75% of the units are sold. Often, the transfer of control is required to be completed within a specified period, such as within two years after the sale of the first unit.

100.34 Since the developers' interests are not necessarily consistent with those of the property owners, the CIRAs' governing documents sometimes limit the authority of developer-controlled boards of directors. For example, they may be precluded from amending the CIRAs' bylaws or increasing its operating budget. Some states also mandate that CIRAs be audited when control is transferred from the developer to the property owners.

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101 Regulatory Environment

101 Regulatory Environment

Federal Regulations

101.1 The CIRA industry is not specifically regulated at the federal government level. Currently no federal laws have been enacted that regulate the creation of CIRAs or prescribe rules for performing their functions of maintaining common property and providing services for their members. Federal laws do regulate certain aspects of selling units in real estate developments, however, including condominiums and HOA communities. For example, the Interstate Land Sales Full Disclosure Act requires developers to register with the Office of Interstate Land Sales Registration before commencing any interstate sales. The Securities Act of 1933 applies if units are sold with emphasis on the economic benefits to the purchaser, such as when they are offered with a mandatory rental pool arrangement, if, according to the SEC's criteria, the sale is considered to be the offering of a security in the form of an investment contract. Real estate developments subject to the Securities Act of 1933 are not discussed in this *Guide*.

101.2 Some federal laws, such as those designed to ensure fair housing practices, focus on broad public policy issues and aim to protect consumers who purchase units in condominiums, HOA communities, or cooperatives. For example—

- The Fair Housing Amendments Act of 1988 prohibits discrimination in housing on the basis of handicap or familial status. It applies to almost all residential real estate sales and leases, including those in condominiums, homeowners' associations, and cooperatives. Under the law, unlawful discrimination based on familial status is subject to fines. There are exemptions to the Act, however, that apply to housing of older persons. (See discussion beginning at paragraph 812.53.)
- The Condominium and Cooperative Conversion Protection and Abuse Relief Act offers, among other things, limited protection to unit owners from developer abuses that occur (a) during conversion of rental units to condominium or cooperatives and (b) before control of the CIRA is transferred to unit owners. For example, under the Act, the CIRA may be able to terminate long-term contracts or leases with the developer that were entered into before transition.

101.3 The Americans with Disabilities Act of 1990 gives civil rights protections to individuals with disabilities. The two sections of the Act that affect CIRAs—the “employment” and “public accommodation” provisions—are briefly summarized below:

- Under the Act's employment provisions, employers may not use qualification standards, employment tests, or other selection criteria that screen out individuals with disabilities unless the standards or other criteria are shown to be job related and necessary for the position. The Act also requires that employers make reasonable accommodations to enable disabled workers to perform their jobs. That may include making office facilities readily accessible to disabled workers as well as modifying work schedules and revising personnel policies and training manuals. The Act's employment provisions do not apply to employers with less than 15 employees.
- The Act's public accommodation provisions provide that disabled persons must be provided with opportunities to “full and equal enjoyment of the goods, services, facilities, privileges, advantages, or accommodations” enjoyed by other members of society. The public accommodation provisions apply only to CIRAs with facilities that may be used by nonmembers (for example, commercial condominiums, mixed-use residential and commercial CIRAs, or CIRAs that open certain of their facilities to nonmembers, such as recreational facilities). In other words, CIRAs are only exempt from the provisions of the Act if the use of their facilities is limited to members and their guests. In addition, the authors believe that the accommodation provisions also probably apply to any sales office maintained by the CIRA. The Act requires removal of barriers to disabled persons in places of public accommodation when it is “readily achievable” to do so, that is, when removal can be accomplished without much difficulty or expense. Examples of the types of modifications that would be readily achievable in most cases are adding wheelchair ramps and installing grab bars in toilets. When barrier removal is not readily achievable, an entity must provide access through alternative means. For example, assume a CIRA's club house, normally unused during the day, is rented to a day-care center that is open to both members and nonmembers. In lieu of adding a wheelchair ramp, the day-care center might have an employee accompany the children of disabled parents out to the driveway at the end of the day and remain with the children at curbside until the parent arrives to pick them up.

Section 812 discusses auditors' responsibilities for violations of laws and regulations.

101.4 **Lending and Lending-related Agencies**

Federal and quasi-federal agencies may be involved with common interest ownership developments in three primary ways:

- They may make mortgage loans to individuals purchasing units in the developments [for example, the Department of Veterans Affairs (VA)].

- They may provide mortgage insurance to lending institutions that make loans to individual purchasers [for example, the Federal Housing Administration (FHA)].
- They may provide a market for mortgages in the secondary market [for example, the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac)].

Each agency has established requirements that developments must meet before the agency will become involved in the financing process. Generally the requirements relate to the project's physical construction or occupancy rate or mandate that the CIRA's governing documents include certain minimum provisions regarding the authority of both the property owners and the CIRA to operate and maintain the property. Thus, the requirements generally do not directly affect the CIRA's financial statements.

101.5 Federal agencies place different levels of importance on insurance coverage and reserve funds. FHA requires certain reserve fund levels when providing blanket mortgage insurance to a cooperative association. Fannie Mae and Freddie Mac require reserve funds to be kept separate from operating funds. Freddie Mac also requires CIRAs to set aside funds for insurance deductibles within the CIRA's reserve funds. Freddie Mac requires condominium associations in high-risk areas of California either to have earthquake insurance before it buys mortgages for those units or pay an interest rate override to compensate the lender for the added risk assumed. Some lenders may penalize those CIRAs that do not have reserves through higher underwriting charges. Accountants for CIRAs with federal agency financing should consult the most recent information available from that federal agency.

101.6 HUD Assisted Projects

HUD has enacted numerous programs that provide direct loans, rent and interest subsidies, or mortgage insurance to condominiums and cooperatives. The objective of most of the programs enacted in recent years is to encourage the construction and maintenance of housing for a targeted segment of the population, such as low and moderate income families or the elderly. Many of the older HUD assistance programs, however, were not tied to financial ability but provided a method of financing cooperatives and condominiums before conventional financing from private institutional lenders was available.

101.7 The principal HUD programs covering cooperatives and condominiums are as follows:

Cooperative Programs

- *Section 213 Cooperative Housing* insures mortgages made by private lending institutions for new construction and substantial rehabilitation of cooperative housing projects. While this program is authorized, few new projects are insured under this program. Most cooperatives now receive assistance under the Section 221(d)(3) insured loan programs.

- *Section 221(d)(3) Mortgage Insurance for Single Room Occupancy Projects* also provides mortgage insurance for new construction and substantial rehabilitation of cooperative housing projects. It serves a similar purpose as the Section 213 program described above but differs in terms of maximum allowable funding, down payment requirements for cooperative shares, and how insurance claim benefits will be paid to HUD approved lenders. The principal difference between the Section 221(d)(3) and 221(d)(4) programs is the loan-to-value ratios available to project owners. HUD insures up to 100% of replacement cost under Section 221(d)(3) projects owned by nonprofit or cooperative owners. Profit-motivated owners of Section 221(d)(3) projects and all Section 221(d)(4) projects can finance only up to 90% of replacement cost.

- *Section 223(f) Mortgage Insurance for Purchase or Refinancing of Existing Multifamily Rental Housing* insures mortgages to purchase or refinance existing rental property not in need of substantial rehabilitation. Under the program, mortgage insurance is available (a) to refinance existing cooperative housing projects or (b) for the purchase and conversion of existing rental projects to cooperative housing.

- *Section 202 Supportive Housing for the Elderly* provides capital advances for the construction, rehabilitation, or acquisition with or without rehabilitation of structures that will serve as supportive housing for very low-income elderly persons, including the frail elderly. It provides rent subsidies for the projects to help make them affordable. Occupancy in Section 202 housing is open to any very low-income household comprised of at least one person who is at least 62 years old at the time of initial occupancy.

- *Section 811 Supportive Housing for Persons with Disabilities* provides capital advances for the construction or rehabilitation of housing occupied by disabled persons. The advance does not have to be repaid as long as the housing remains available for very low-income persons with disabilities for at least 40 years.

Condominium Programs

- *Section 234(d) Condominium Mortgage Insurance* insures mortgages to finance the construction or rehabilitation of housing projects that owners intend to sell as condominiums. No loans have been insured under this program for several years. Condominium developers typically obtain their own

construction financing and use FHA insurance under Section 234(c) to finance the sales of the individual units.

101.8 All cooperatives and condominiums receiving financial assistance are subject to specific HUD program requirements, which often include the following:

- Complying with criteria for resident eligibility and allowable financial assistance for low and moderate income housing

- Obtaining approval for expenditures for construction, repairs and replacements, and operations

- Accumulating funds for contingencies (referred to as “general operating reserves” or “GOR”) and for future major repairs and replacements

- Maintaining accounting records in accordance with HUD guidelines

- Periodic compliance and financial reporting including submission of annual audited financial statements

101.9 Specific considerations for accountants providing services to HUD assisted cooperatives and condominiums and reporting on their financial statements are discussed in paragraph 103.3.

State Regulations

101.10 Uniform Laws

The CIRA industry is regulated primarily at the state level. Most recent state legislation is based on the following group of uniform state laws drafted by the National Conference of Commissioners on Uniform State Laws:¹

- Condominium Act

- Planned Community Act

- Common Interest Ownership Acts (applies to all types of common interest ownership developments; versions enacted in 1992, 1994, and 2008)

The uniform laws were drafted to encourage consistency among state statutes and also attempted to equitably address the conflicting interests of developers, purchasers, lenders, and other parties involved in common interest housing developments. Only a minority of states has adopted the uniform laws as their own. Many states, however, have used them as models for enacting their own legislation.

101.11 **Specific State Condominium Statutes**

All 50 states have enacted statutes to regulate condominium developments and condominium associations. States generally refer to the statute as a state condominium act, a state horizontal property act, or a state unit ownership act. Although the laws differ among the states, most include the key provisions of the Uniform Condominium Act. (See paragraph 101.10.) They are similar in their treatment of many aspects of creating and managing condominiums, generally covering the following matters:

- How to create the condominium
 - Contents of legal documents to be filed
 - Where the documents should be recorded
- Unit owners' rights and obligations
 - Contents of unit deeds
 - Description of the property owned by each unit owner including allocation of common property
 - Provision for access to common property
 - Restriction against conveying units and common property separately

- • Responsibility for maintenance of common property and allocation of common expenses

- Transition
 - • How control will be transferred from the developer to the individual property owners

 - • Developers' responsibilities for assessments on unsold units and other costs

- Operating the condominium
 - • Organization and authority of CIRA

 - • Board of directors and officers

 - • Meeting requirements

 - • Allocation of voting interests and voting majority

 - • Lien rights of the CIRA and rights of secured lenders

- Financial management

- Responsibility to maintain financial records

 - Unit owners' right of access to financial records

 - Requirement for accountants' report on annual financial statements
-
- Modifying the covenants that govern the condominium
 - Amending the condominium declaration

 - Terminating the condominium

101.12 Not surprisingly, states with concentrations of condominium developments, most notably California and Florida, have developed more extensive regulations, and they generally prescribe more specific operational procedures. For example, some state laws require CIRAs to incorporate or address matters such as obtaining insurance for the condominium, method of handling casualty losses, and explicit duties and functions of the CIRA's boards of directors. Chapter 12 discusses unique state requirements in greater detail, with emphasis on California and Florida.

101.13 HOA and Cooperative State Statutes

As a general rule, states do not regulate HOA communities or cooperatives as strictly as condominiums. Only a few states have adopted statutes specifically governing their operation and management. Absent detailed laws, the states rely primarily on their general property laws, in the case of HOA communities, and on their business or nonprofit corporation laws, in the case of cooperatives. In many respects, cooperatives are treated as any other landlord, and laws governing tenant/landlord relationships may apply.

Privacy Regulations

101.14 Protection of personal and financial information has become an increasingly important issue over the last decade as the incidence of failure to adequately protect personal information has become common. Congress has already enacted certain privacy laws to specifically regulate some industries, such as financial

institutions and health care providers. A discussion of prominent federal regulations addressing privacy that may affect CIRAs follows.

101.15 The Fair and Accurate Credit Transactions Act

The Fair and Accurate Credit Transactions Act (FACTA), enacted in December 2003, was passed in part to protect consumers against identity theft. All entities within the United States that regularly use consumer credit information or report information to national consumer reporting agencies are subject to the provisions of FACTA.

101.16 One important provision of FACTA requires appropriate measures to dispose of information derived from consumer reports. Any entity that maintains or possesses consumer report information for a business purpose (in electronic or paper form) must take reasonable measures to protect against unauthorized access or use of such information in connection with its disposal. While FACTA provides disposal guidelines, the standard for disposal is intentionally flexible so that individual entities can determine what measures are reasonable based on the sensitivity of the information, the costs and benefits of different disposal methods, and relevant changes in technology over time. FACTA directed various agencies, including the FTC, the Federal Reserve Board, the FDIC, the SEC, and others, to adopt comparable and consistent rules regarding the disposal of sensitive consumer report information. The FTC's website has information to educate businesses about these requirements at www.ftc.gov/bcp. Associations (and their accountants) should consider whether the association's operational practices require compliance with these regulations. Noncompliance can include civil liability damages, class-action lawsuits, and both federal and state fines.

101.17 Privacy Considerations

As a result of continuing significant confidentiality issues, including millions of instances of identity theft, privacy regulations continue to develop. Future editions of this *Guide* will provide updates on new privacy protection legislation affecting CIRAs.

Significance to Accountants

101.18 Accountants should be familiar with laws and regulations governing CIRAs because they may affect the CIRA's operations or the manner of reporting transactions in their financial statements. For example, common provisions of state laws require the CIRA's financial statements—

- to be audited, reviewed, or compiled by independent accountants, depending on the amount of the CIRA's annual revenues;

- to disclose certain information not required by GAAP, such as specific categories of revenues and expenses;

- to be delivered to all unit owners within a specified period of time after the CIRA's year-end.

Often, laws govern levying and collecting assessments, assessing late charges for delinquent payments, or establishing separate bank accounts for funds for major repairs and replacements of common property. Other laws require CIRAs or their members to engage in some form of alternative dispute resolution (ADR) before filing a lawsuit. Some state laws, such as those prohibiting CIRAs from levying fines for covenant violations, may directly affect the amounts reported in the financial statements.

101.19 Sections 812 and 905 discuss accountants' responsibilities for detecting and communicating violations of laws and governmental regulations.

¹ Information about the uniform state laws is available through the National Conference's website at www.uniformlaws.org.

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Some Statistics

102.1 The United States CIRA industry has experienced explosive growth, especially in condominiums, HOA communities, and, more recently, timeshare units. In 2010, there were nearly 1,600 timeshare resorts, representing 8.1 million intervals owned. The Community Associations Institute (CAI) (see paragraph 102.12) estimated that there were 10,000 community associations in 1970; in 2011, CAI estimated 314,200 community associations exist. Consider the following statistics from CAI:

- Approximately 62 million Americans live in community associations.
- In 2011, community associations have estimated annual assessments approximating \$40 billion. Additionally, more than \$35 billion is maintained in investment accounts for the long-term maintenance and replacement of common property.

Community associations have demonstrated the ability to satisfy a full range of housing needs, from starter homes to retirement communities, primary residences to vacation homes, and low-income housing to the most expensive housing available.

102.2 Condominiums and HOA communities account for most of the recent growth in the CIRA industry. Approximately 45-48% of the community association housing units in the U.S. are condominiums and 50-53% are HOAs. Cooperatives, which represent 3-4% of community association housing units, are prevalent primarily on the east coast and were used extensively to provide individual ownership of large real estate projects before the existence of state legislation enabling the condominium form of ownership. Most new developments in urban areas today, however, are condominiums.

102.3 While there are CIRAs in every state, the majority of them are spread throughout the Sunbelt and concentrated in the northeastern U.S. Almost 40% of all condominium associations in the United States are in

California, Florida, and South Carolina. Other states with high concentrations of condominiums are Hawaii, Arizona, Colorado, Connecticut, Illinois, Maryland, Massachusetts, Michigan, New Jersey, New York, Ohio, Pennsylvania, Texas, and Virginia.

What Accounts for the Growth?

102.4 Economic Pressures

Today, with local governments fighting budget restrictions, real estate developers are often forced to provide certain infrastructure traditionally provided by government, such as streets and water and sewer facilities. Land costs also have increased dramatically. In the face of that pressure, some developers turn to CIRA developments to reduce housing costs by constructing higher density projects, such as condominiums and planned communities, with associations of property owners that will be responsible for the ongoing maintenance of that infrastructure. Many homeowners themselves face similar economic pressures. Comparable single-family homes may be more expensive, and mortgage costs and home operating and maintenance expenses continue to escalate.

102.5 Community Considerations

Some associations now serve homeowners who choose to live in an “exclusive” community. Certain homeowners' associations cater to upper-income individuals who select community associations based on lifestyle and community considerations rather than economic considerations. Many “gated” communities are being created to provide an increased level of security for association residents and a wide range of high-end amenities to enrich resident lifestyle. Other associations cater to active adult, senior citizen, and young family lifestyles. In addition, some specialized homeowners' associations may cater to boaters, while others are “fly-in” associations with their own private airports.

102.6 Demographic Factors and Life-style Changes

An aging population, a growing number of working couples, and an increased desire for leisure time also create a demand for the low maintenance property ownership and recreational amenities that CIRA developments offer. Previous living patterns that emphasized the desirability of suburban living are frequently being replaced by preferences toward residing nearer to urban centers to take advantage of the proximity to job markets, cultural attractions, and social activities.

102.7 Scarcity of Natural Resources

The basic law of supply and demand also is influencing the move toward CIRA developments. The scarcity of land in many metropolitan areas, land use restrictions enacted by city and county governments, energy shortages, lack of water and sewer capabilities in outlying areas, and environmental concerns all support the trend toward CIRA developments.

The Future

102.8 The trend toward common interest housing communities does not mean that the conventional single-family residence is a thing of the past, but it does indicate that CIRA developments remain an increasingly

important factor in the housing future of this country. CAI predicts that some of the trends for the future of community associations include the following:

- Living in a community association will continue to be a popular housing choice.

- There will be more emphasis placed on community harmony.

- Community associations will continue to reflect the racial and cultural diversity of the U.S.

- Associations will continue to adapt to address social issues such as the need for residential day care and aging facilities for members.

- Community associations will provide inclusionary housing to low-income and moderate-income homebuyers.

- “Smart communities” will incorporate new technologies to improve connectivity with schools, hospitals, municipal government, and businesses.

102.9 A significant future trend that will impact CIRA developments as profoundly as it will affect all segments of American society is the aging population. The *older* population [defined by the U.S. Department of Health and Human Services (HHS) as persons 65 or older] totaled 40.4 million persons in 2010. In 2010, almost one in every eight persons (or 13.1% of the U.S. population) was an older American. However, this aging trend is just beginning as the *Baby Boom* generation approaches retirement age. HHS projects 88.5 million persons (20% of the U.S. population) will be at least age 65 by the year 2050. The social, economic, and physical health of the *older* population will naturally impact CIRA developments.

102.10 In addition to future changes in community associations, the common interest ownership concept also is expanding into areas other than residential housing, such as the following:

- Commercial and industrial condominiums, such as industrial parks, shopping centers, and professional buildings.

- Mixed-use condominiums that include facilities such as a shopping mall, a hotel, offices, and residential units. (See discussion beginning at paragraph 100.18.)

- Resort condominiums, such as timeshare and condo-hotel developments.
- Land condominiums, such as parking facilities, marinas, docks, and recreational vehicles.

What Does It Mean for Accountants?

102.11 Obviously, any growing industry offers practice development opportunities, and the potential for reaching new clients and expanding services is not limited to just CIRAs themselves. Marketing efforts can be directed toward all parties involved in each aspect of the industry, such as architects, developers, contractors, financiers, management companies, and unit owners. Accountants' involvement with CIRAs is discussed in section 103.

CIRA Membership Organizations

102.12 The following membership organizations can provide more information about CIRAs:

- *Community Associations Institute* (CAI) is a nonprofit educational organization serving the CIRA industry. It provides educational seminars and publishes a wide variety of newsletters and books on various aspects of CIRAs. Information about membership, publications, and seminars may be obtained by contacting:

Community Associations Institute
6402 Arlington Blvd.
Suite 500
Falls Church, VA, 22042
(888) CAI-4321
www.caionline.org

- *National Association of Housing Cooperatives* (NAHC), a nonprofit organization promoting the interests of cooperative housing communities, publishes newsletters and other information on various aspects of cooperatives. It is the only national cooperative housing organization. Information about membership, publications, and conferences may be obtained by contacting:

National Association of Housing Cooperatives
1444 I Street, N.W.

Suite 700
Washington, DC 20005-6542
(202) 737-0797
www.coophousing.org

• *American Resort Development Association (ARDA)* is a trade association representing the vacation ownership and resort development industries. ARDA's membership includes companies with interests in vacation ownership resorts, community development, fractional ownership, camp resorts, land development, lot sales, second homes, and resort communities. Members range from small, privately held firms to publicly traded companies and international corporations. Information about membership, publications, and seminars may be obtained by contacting:

American Resort Development Association
1201 15th St. NW
Suite 400
Washington, DC 20005
(202) 371-6700
www.arda.org

• *National Board of Certification for Community Association Managers (NBC-CAM)* is an independent certification organization incorporated by CAI. Its sole purpose is to provide a certification program for community association managers resulting in a nationally recognized credential. Information about manager certification can be obtained by contacting:

National Board of Certification for Community Association Managers
1402 Arlington Blvd.
Suite 510
Falls Church, VA 22042
(866) 779-CMCA
www.nbccam.org

- *Institute of Real Estate Management* (IREM) is a nonprofit organization serving the needs of real estate professionals. Unlike the other organizations listed previously, IREM is not designed to provide services solely to the CIRA industry. IREM focuses on commercial real estate and residential management, which includes CIRA management. Information on membership and services provided can be obtained by contacting:

Institute of Real Estate Management
430 N. Michigan Avenue
Chicago, IL 60611
(800) 837-0706
www.irem.org

Management Designations within the CIRA Industry

102.13 The following is a list of nationally recognized management or other community association professional credentials or designations, presented by issuing organization:

- Community Associations Institute (CAI)
 - AMS—Association Management Specialist
 - PCAM—Professional Community Association Manager
 - AAMC—Accredited Association Management Company
 - LSM—Large-Scale Manager
 - RS—Reserve Specialist
 - CIRMS—Community Insurance and Risk Management Specialist

- National Board of Certification for Community Association Managers (NBC-CAM)
 - CMCA—Certified Manager of Community Associations

- American Resort Development Association (ARDA)
 - RRP—Registered Resort Professional

 - ARP—Associate Resort Professional

- Institute of Real Estate Management (IREM)
 - CPM—Certified Property Manager

 - ARM—Accredited Residential Manager

 - AMO—Accredited Management Organization

- National Association of Housing Cooperatives (NAHC)
 - RCM—Registered Cooperative Manager

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Reporting on Financial Statements

103.1 Virtually all CIRAs are subject to annual financial reporting requirements imposed by either state statute or their own governing documents. Thus, accountants primarily are involved with CIRAs because they are engaged to audit, review, or compile and report on the CIRA's annual financial statements. The level of service that accountants provide depends on the specific requirements that govern the CIRA. Generally, however, they will be engaged to perform the highest level of service called for by any of the requirements. For example, state law may require the CIRA's financial statements to be reviewed if they report gross income from assessments in excess of \$75,000, but the CIRA's bylaws require an annual audit. Usually, accountants will be engaged to perform an audit in those circumstances, and, since it is a higher level of service than a review, the audit will be considered as evidence of compliance with state law. Sections 601 and 703 discuss accountants' responsibilities if they are engaged to render a lower level of service than that required by state statutes or the CIRA's governing documents.

103.2 Accountants may also be requested to provide financial statement services for an entity closely affiliated with, but separate from, the CIRA. A common example would be a social or recreation club that is administered by the CIRA and consists of certain, but not all, of the members of the CIRA. Since membership in the organization is not mandatory and is not an inseparable part of the common property, the club is not a part of the CIRA. Paragraph 301.13 begins a discussion on other types of cash funds CIRAs may hold and the related financial statement treatment.

103.3 As noted in paragraph 101.8, cooperatives and condominiums receiving HUD financial assistance are required to submit annual audited financial statements to HUD. The audits are required to be performed in accordance with both generally accepted auditing standards (GAAS) and generally accepted governmental auditing standards (GAGAS), which exceed GAAS requirements in certain respects. Providing services to HUD assisted CIRAs is not specifically discussed in this *Guide*. However, *Government Auditing Standards* and numerous HUD Handbooks provide detailed guidance on accountant qualifications, specific program compliance, financial statement format and disclosures, and reporting. Also, *PPC's Guide to HUD Audits* can be ordered by calling (800) 431-9025, or online at ppc.thomsonreuters.com.

Tax Services

103.4 Due to the complexity of income tax rules, CIRAs usually depend on the expertise of outside accountants for tax services. Most CIRAs are taxed on nonexempt function, nonmember income, or nonpatronage income. They generally are taxed as corporations. Condominium associations, HOAs, and timeshare associations may elect to file their federal income tax returns either on Form 1120 or on a special corporate tax return for homeowners' associations, Form 1120-H. Effective for tax years ending on or after December 31, 2006, all subchapter T cooperatives should file special Form 1120-C for cooperative associations. In rare cases, HOAs are exempt from taxation but still must file an information return on Form 990.

103.5 As paragraph 100.15 states, in a cooperative, the corporation, rather than its individual tenant-shareholders, is directly liable for mortgage interest and property taxes for the entire building. If the cooperative meets certain conditions, however, IRS rules permit the tenant-shareholders to deduct their proportionate share of the mortgage interest and real estate taxes paid by the cooperative on their personal income tax returns. Thus, in addition to preparing income tax returns for the CIRA itself, cooperatives usually engage accountants to provide annual information to their tenant-shareholders about their allowable deductions for mortgage interest and real estate taxes.

103.6 Chapters 5, 10, and 11 discuss the taxation of CIRAs in detail.

Replacement Fund Studies

103.7 As explained in paragraph 100.3, one of the CIRA's primary responsibilities is to maintain the project's common property. To carry out that responsibility, some CIRAs either elect or are required to assess their members to provide funds for future major repairs and replacements of the property. Often the amount to be assessed is determined after the following studies of the property:

A “component” study

- Inventories the common property
- Assesses its current condition
- Estimates its remaining life
- Estimates its replacement cost

A “funding” study

- Determines required funding levels
- Provides alternative funding models

103.8 Although replacement fund studies (often called “reserve studies”) generally are performed by professional engineers or licensed contractors, accountants sometimes also accept engagements to perform

them. Accountants' responsibilities for those engagements depend on the nature of the engagement. For example, a CIRA's board of directors may conduct a study to estimate future expenditures for major repairs and replacements and engage accountants to report on the reliability of that study. The authors believe that type of engagement is governed by the AICPA's Statement on Standards for Attestation Engagements No. 10, *Attestation Standards: Revision and Recodification*, as amended, because the accountants are expressing a conclusion about the reliability of a written assertion that is the responsibility of the CIRA. On the other hand, accountants may be asked to develop assumptions about the future costs of maintaining the CIRA's common property, often with the assistance of specialists. In that case, the authors believe that the engagement is a consulting engagement rather than an attest engagement because the accountants, not the CIRA, are assuming responsibility for the assumptions. In conducting and reporting on consulting engagements, accountants should look to the AICPA's Statement on Standards for Consulting Services for guidance. Accountants should not accept any engagement involving reserve studies, however, unless they have adequate knowledge of the subject matter and the requisite expertise to evaluate the assumptions inherent in the presentation.

103.9 Accountants who perform the CIRA's audit may also be asked to develop or assist in the development of the CIRA's replacement fund study. The replacement fund study generally provides the basis for the supplementary information required to be disclosed in conjunction with a set of CIRA financial statements. Because the required supplementary information derived from the reserve study is not part of the basic financial statements, Ethics Interpretation 101-3, "Performance of Nonattest Services" (ET 101.05), does not explicitly prohibit auditors from performing or assisting in the performance of the CIRA's replacement fund study. However, auditors who perform certain nonattest services for their CIRA clients must comply with the *Conceptual Framework for Independence Standards* within the *AICPA Code of Professional Conduct* to maintain independence. Accordingly, auditors should exercise caution when evaluating the facts and circumstances of their particular situation with the CIRA client to ensure that independence is not impaired by participating in such an engagement. Further, the authors strongly caution auditors against accepting reserve study consulting services without first carefully considering whether independence may be impaired. Maintaining independence under Ethics Interpretation 101-3 is further discussed beginning at paragraph 103.10. (Engagements involving reserve studies are not discussed in this *Guide*.)

Nonattest Services

103.10 CIRAs often engage outside accountants to provide nonattest services such as preparing the CIRA tax return or providing other accounting and bookkeeping assistance. Whether the CIRA engages outside accountants to provide accounting and bookkeeping assistance often depends on whether their financial records are maintained internally or by a managing agent. If the CIRA hires a managing agent, its services generally include preparing the CIRA's annual operating budget; billing, collecting, and maintaining accountability for assessments from residents; preparing payroll tax returns; maintaining financial records; and preparing periodic financial reports for the CIRA's board of directors. On the other hand, self-managed CIRAs may engage outside accountants to assist in those areas.

103.11 Maintaining independence is a critical concern for accountants who perform CIRA audit services and also provide additional client assistance. According to Interpretation 101-3, before accountants perform

nonattest services, they should determine that the requirements of Interpretation 101-3 have been met. Interpretation 101-3 requires the following with respect to the performance of nonattest services:

- The accountant should not perform management functions or make management decisions for the attest client.

- The client must agree to perform certain specific functions in connection with the nonattest services.

- The accountant must document in writing the understanding with the client regarding the nonattest services and the client's responsibilities.

103.12 Under the Interpretation, independence is considered to be impaired if an auditor (or his or her firm) performs management functions or makes management decisions for an attest client. However, the auditor may assist management in those functions or decisions. For the auditor to remain independent, the client should agree to perform all of the following functions in connection with the engagement to perform nonattest services:

- Assume all management responsibilities.

- Designate an individual (preferably within senior management) who possesses suitable skill, knowledge, or experience to oversee the services.

- Evaluate the adequacy and results of the services performed.

- Accept responsibility for the results of the services.

It is not intended that the designated individual possess a level of technical expertise equal to the practitioner's. The individual need only understand the nonattest services enough to be able to provide general direction for the services; understand the key issues the practitioner identifies; make any required management decisions; and evaluate the adequacy of, and accept responsibility for, the results of the practitioner's work.

103.13 In addition, the auditor should be satisfied that CIRA management will be able to meet all of these criteria and make an informed judgment on the results of the nonattest services. If the CIRA is unable or unwilling to assume all of these responsibilities, the auditor's performance of the nonattest services would impair independence.

103.14 The Interpretation also requires the auditor to *document in writing* the auditor's understanding with the CIRA regarding the following:

- Objectives of the engagement (i.e., the nonattest services).

- Services to be performed.

- CIRA's acceptance of its responsibilities.

- Auditor's responsibilities.

- Any limitations of the engagement.

103.15 The Interpretation does not specify how the understanding is to be documented, so the auditor has flexibility. For example, the understanding might be documented in a separate engagement letter, in the workpapers, in an internal memo, or in the engagement letter obtained in conjunction with an audit engagement. The authors believe it is common in many small CIRA engagements for auditors to also provide nonattest services, such as tax return preparation or bookkeeping services. Therefore, the sample engagement letter at HOA-CL-1.1 includes the language necessary to meet the auditor's documentation requirements under Ethics Interpretation 101-3. If the auditor chooses to document the understanding with the client about the performance of nonattest services other than in the engagement letter, the checklist at HOA-CX-1.2, "ET Interpretation 101-3 Documentation Form" can be used.

103.16 Certain activities performed as part of a nonattest service are considered to be management functions and, therefore, impair independence regardless of whether the auditor complies with the other requirements of Ethics Interpretation 101-3. The Interpretation lists common nonattest service activities and notes whether they are or are not considered to impair independence. The interpretation specifically states that the performance of the following general activities would impair an auditor's independence (that is, these activities would preclude the auditor from being independent):

- Exercising authority on behalf of the CIRA, such as authorizing, executing, or consummating a transaction, or having the authority to do so.

- Preparing source documents, in electronic or other form, that evidence the occurrence of a transaction.

- Having custody of CIRA assets.

- Supervising CIRA employees performing their normal recurring activities.

- Determining which of the auditor's recommendations should be implemented.

- Reporting to the board of directors on behalf of CIRA management.

- Serving as the CIRA's escrow agent, registrar, or general counsel.

- Establishing or maintaining internal controls, including performing ongoing monitoring activities for the CIRA.^{2 3}

103.17 Interpretation 101-3 (ET 101.05) also addresses tax compliance services. Preparing a tax return and transmitting the tax return and related payment, either electronically or in paper form, to a taxing authority does not impair independence as long as the auditor does not have custody or control of the CIRA's funds and the individual overseeing the tax services (a) reviews and approves the return and payment and (b) signs the return prior to transmittal, if required for the filing. Signing and filing a tax return impairs independence unless the auditor has legal authority to do so and—

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

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

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

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

- That the individual authorizes the auditor to sign and file the return on behalf of the CIRA.

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

103.18 In addition, under Interpretation 101-3 (ET 101.05), certain appraisal, valuation, or actuarial services are considered to impair independence. Performing appraisal, valuation, or actuarial services impairs independence if the results are material to the financial statements and the service involves significant subjectivity. For example, a material asset appraisal or business valuation generally involves significant subjectivity, and therefore would impair independence if performed for financial statement purposes. However, an actuarial valuation of a client's pension liabilities ordinarily does not require significant subjectivity and, therefore, would not impair independence even if the amount was material.

103.19 Under Interpretation 101-3 certain types of forensic accounting services may impair independence. Independence is impaired if an auditor conditionally or unconditionally agrees to provide expert witness testimony for a client. However, under certain defined conditions, independence is not impaired if the auditor provides expert witness testimony for a large group of plaintiffs or defendants that includes the auditor's client. If the auditor provides litigation services in which the auditor is a trier of fact, special master, court-appointed expert, or arbitrator in a matter involving a client, independence is impaired.

103.20 Auditors may perform non-bookkeeping services such as the following:

- Assist in formalizing or establishing a capitalization policy. (See paragraph 304.20.)

- Assist in selecting a method of storing and retrieving CIRA documents on electronic media.

- Educating and training CIRA staff on accounting issues, tax regulations, and software.

- Educating the board of directors on financial matters, such as the distinction between available for sale and held to maturity securities (as discussed in paragraph 302.3). Auditors may assist the board members in understanding the financial statements and the tax return and educate them on their responsibilities as board members. They may also educate management company personnel on financial matters.
- Assist in formulating an investment policy.

103.21 Exhibit 1-2 provides a table adapted from Ethics Interpretation 101-3 that lists various types of nonattest services an accountant may perform and addresses the impact of those services on the auditor's independence.

Exhibit 1-2

Impact on Independence of Performance of Nonattest Services ^a

Type of Nonattest Service	Independence Would Not Be Impaired	Independence Would Be Impaired
Bookkeeping	<ul style="list-style-type: none"> • Record transactions for which management has determined or approved the appropriate account classification, or post coded transactions to a client's general ledger. • Prepare financial statements based on information in the trial balance. • Post client-approved entries to a client's trial balance. • Propose standard, adjusting, or correcting journal entries or other changes affecting the financial statements to the client provided the client reviews the entries and the member is satisfied that management understands the nature of the proposed entries and the impact the entries have on the financial statements. 	<ul style="list-style-type: none"> • Determine or change journal entries, account codings or classification for transactions, or other accounting records without obtaining client approval. • Authorize or approve transactions. • Prepare source documents. • Make changes to source documents without client approval.
Nontax disbursement	<ul style="list-style-type: none"> • Using payroll time records provided and approved by the client, generate unsigned checks, or process client's payroll. • Transmit client-approved payroll or other disbursement information to a financial institution provided the client 	<ul style="list-style-type: none"> • Accept responsibility to authorize payment of client funds, electronically or otherwise, except as specifically provided for with respect to electronic payroll tax payments.

Type of Nonattest Service	Independence Would Not Be Impaired	Independence Would Be Impaired
	<p>has authorized the member to make the transmission and has made arrangements for the financial institution to limit the corresponding individual payments as to amount and payee. In addition, once transmitted, the client must authorize the financial institution to process the information.</p>	<ul style="list-style-type: none"> • Accept responsibility to sign or cosign client checks, even if only in emergency situations. • Maintain a client's bank account or otherwise have custody of a client's funds or make credit or banking decisions for the client. • Sign payroll tax return on behalf of client management. • Approve vendor invoices for payment.
<p>Benefit plan administration^b</p>	<ul style="list-style-type: none"> • Communicate summary plan data to plan trustee. • Advise client management regarding the application or impact of provisions of the plan document. • Process transactions (e.g., investment/benefit elections or increase/decrease contributions to the plan; data entry; participant confirmations; and processing of distributions and loans) initiated by plan participants through the member's electronic medium, such as an interactive voice response system or Internet connection or other media. • Prepare account valuations for plan participants using data collected through the member's electronic or other media. • Prepare and transmit participant statements to plan participants based on data collected through the member's electronic or other medium. 	<ul style="list-style-type: none"> • Make policy decisions on behalf of client management. • When dealing with plan participants, interpret the plan document on behalf of management without first obtaining management's concurrence. • Make disbursements on behalf of the plan. • Have custody of assets of a plan. • Serve a plan as a fiduciary as defined by ERISA.
<p>Investment—advisory or management</p>	<ul style="list-style-type: none"> • Recommend the allocation of funds that a client should invest in various asset classes, depending upon the client's desired rate of return, risk tolerance, etc. • Perform recordkeeping and reporting of client's portfolio balances including providing a comparative analysis of the client's investments to third-party benchmarks. 	<ul style="list-style-type: none"> • Make investment decisions on behalf of client management or otherwise have discretionary authority over a client's investments. • Execute a transaction to buy or sell a client's investment. • Have custody of client assets, such as taking temporary possession of securities purchased by a client.

Type of Nonattest Service	Independence Would Not Be Impaired	Independence Would Be Impaired
	<ul style="list-style-type: none"> • Review the manner in which a client's portfolio is being managed by investment account managers, including determining whether the managers are (a) following the guidelines of the client's investment policy statement; (b) meeting the client's investment objectives; and (c) conforming to the client's stated investment styles. • Transmit a client's investment selection to a broker-dealer or equivalent provided the client has authorized the broker-dealer or equivalent to execute the transaction. 	
Corporate finance—consulting or advisory	<ul style="list-style-type: none"> • Assist in developing corporate strategies. • Assist in identifying or introducing the client to possible sources of capital that meet the client's specifications or criteria. • Assist in analyzing the effects of proposed transactions including providing advice to a client during negotiations with potential buyers, sellers, or capital sources. • Be named as a financial advisor in a client's private placement memoranda or offering documents. 	<ul style="list-style-type: none"> • Commit the client to the terms of a transaction or consummate a transaction on behalf of the client. • Act as a promoter, underwriter, broker-dealer, or guarantor of client securities, or distributor of private placement memoranda or offering documents. • Maintain custody of client securities.
Executive or employee search	<ul style="list-style-type: none"> • Recommend a position description or candidate specifications. • Solicit and perform screening of candidates and recommend qualified candidates to a client based on the client-approved criteria (e.g., required skills and experience). • Participate in employee hiring or compensation discussions in an advisory capacity. 	<ul style="list-style-type: none"> • Commit the client to employee compensation or benefit arrangements. • Hire or terminate client employees.
Business risk consulting	<ul style="list-style-type: none"> • Provide assistance in assessing the client's business risks and control processes. • Recommend a plan for making improvements to a client's control processes and assist in implementing these improvements. 	<ul style="list-style-type: none"> • Make or approve business risk decisions. • Present business risk considerations to the board or others on behalf of management.

Type of Nonattest Service	Independence Would Not Be Impaired	Independence Would Be Impaired
Information systems—design, installation, or integration	<ul style="list-style-type: none"> • Install or integrate a client's financial information system that was not designed or developed by the member (e.g., an off-the-shelf accounting package). • Assist in setting up the client's chart of accounts and financial statement format with respect to the client's financial information system. • Design, develop, install, or integrate a client's information system that is unrelated to the client's financial statements or accounting records. • Provide training and instruction to client employees on an information and control system. 	<ul style="list-style-type: none"> • Design or develop a client's financial information system. • Make other than insignificant modifications to source code underlying a client's existing financial information system. • Supervise client personnel in the daily operation of a client's information system. • Operate a client's local area network (LAN) system.

Notes:

^a This exhibit is adapted from Ethics Interpretation 101-3 (ET 101.05), "Performance of Nonattest Services," of the AICPA *Code of Professional Conduct*.

^b When auditing plans subject to the Employee Retirement Income Security Act (ERISA), Department of Labor (DOL) regulations, which may be more restrictive, must be followed.

103.22 In addition to the services mentioned beginning in paragraph 103.10, outside accountants may be asked to perform other attest services for their CIRA clients. Those services may include agreed-upon procedures related to contracts, litigation, developer transition, or insurance claims. Accountants may be engaged to assist in developing a CIRA's reserve study. (See discussion beginning at paragraph 103.8 for further information on the types of reserve study assistance accountants and auditors may be asked to provide to CIRAs.) *PPC's Guide to Forecasts and Projections* addresses the authoritative references and practical solutions on every aspect of prospective financial information engagements. *PPC's Guide to Nontraditional Engagements* discusses those situations in which a practitioner is asked by a client to perform a service other than the traditional compilation, review, or audit of financial statements. Those *Guides* may be ordered by calling (800) 431-9025 or online at ppc.thomsonreuters.com.

² An AICPA white paper, *Understanding Internal Control and Internal Control Services*, addresses internal

control over financial reporting and the types of internal control services that practitioners may be engaged to perform that would impair independence. The white paper can be found at www.journalofaccountancy.com.

³ On February 28, 2011, the AICPA's Professional Ethics Executive Committee (PEEC) issued an omnibus exposure draft containing proposed revisions to Ethics Interpretation 101-3. An explanation of the proposed changes and a marked copy of the changes are included in the omnibus exposure draft, which is available on the AICPA's website at www.aicpa.org. Future editions of this *Guide* will update the status of this proposed guidance.

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Chapter 1 Overview of Common Interest Realty Associations

104 Current Developments—Clarity Standards

104 Current Developments—Clarity Standards

104.1 In response to growing concerns concerning the complexity of auditing standards and to converge U.S. generally accepted auditing standards with International Standards on Auditing (ISAs), the Auditing Standards Board (ASB) has been working on the Clarity Project to revise all existing standards and to design a format under which all new standards will be issued. In October 2011, the AICPA issued:

- SAS No.122, *Statements on Auditing Standards: Clarification and Recodification*. This represents a completely new set of auditing standards revised in format, structure, style, and content from the existing standards. It supersedes all existing SASs through SAS No. 121, except:

- SAS No. 51, *Reporting on Financial Statements Prepared for Use in Other Countries*. (Subsequently superseded by SAS No.124.)

- SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*. (Currently being redrafted and will be superseded when the clarified version is issued. See discussion in section 805.)⁴

- SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*. (Currently being redrafted and will be superseded when the clarified version is issued.)⁴

- SAS No. 87, *Restricting the Use of an Auditor's Report*. (Subsequently superseded by SAS No.125.)

- SAS No. 117 on compliance audits and SAS Nos. 118-120 on supplementary information. These standards were previously issued in clarified format and are already effective.⁴

- SAS No. 123, *Omnibus Statement on Auditing Standards—2011*. Amends SAS Nos. 117, 118, and 122 to address matters that arose after the clarified standards were finalized.

- SAS No. 124, *Financial Statements Prepared in Accordance with a Financial Reporting Framework Generally Accepted in Another Country*. This is the clarified and recodified version of SAS No. 51, *Reporting on Financial Statements Prepared for Use in Other Countries*.

All auditing interpretations corresponding to a SAS were considered in the development of the clarified standards and incorporated as necessary. Generally, the interpretations have been withdrawn, except for certain interpretations that were retained and revised to reflect the issuance of SAS No. 122. Going forward, the ASB will continue to issue SASs to create, amend, or supersede the auditing standards as necessary.

Effective Date

104.2 With a few exceptions, all of the clarified standards are effective for audits of financial statements for periods ending on or after December 15, 2012. Generally early adoption of SAS Nos. 122-125 is not permitted. However, auditors may implement aspects of SAS Nos. 122-125 early as long as they continue to comply with existing standards. See the discussion of the implementation approach in this *Guide* beginning at paragraph 104.10.

SAS No. 125 and SAS No. 126

104.3 In December 2011, the ASB issued SAS No. 125, *Alert That Restricts the Use of the Auditor's Written Communication*. SAS No. 125 supersedes SAS No. 87 (AU 532), *Restricting the Use of an Auditor's Report*, and amends, among other standards, AU-C 260, *The Auditor's Communication With Those Charged With Governance*, and AU-C 265, *Communicating Internal Control Related Matters Identified in an Audit*. SAS No. 125 is effective for the auditor's written communications related to audits of financial statements for periods ending on or after December 15, 2012. In June 2012, SAS No. 126, *The Auditor's Consideration of An Entity's Ability to Continue as a Going Concern (Redrafted)*, was issued. SAS No. 126 supersedes AU-C 570 (formerly AU 341) and, like SAS No. 125, is effective for audits of periods ending on or after December 15, 2012.

Form and Structure of the Standards

104.4 The clarified standards were developed using formatting techniques, such as bulleted lists, that make them easier to read and understand. In addition, each clarified standard is divided into the following topics:

- *Introduction.* Includes matters such as the purpose and scope of the Statements on Auditing Standards (SAS), subject matter, effective date, and other introductory material.

- *Objectives.* Establishes objectives that allow the auditor to understand what to achieve under the SAS. The auditor uses the objectives to determine whether additional procedures are necessary for their achievement and evaluate whether sufficient appropriate audit evidence has been obtained.

- *Definitions.* Where relevant, provides key definitions that are relevant to the standard.

- *Requirements.* States the requirements that the auditor is to follow to achieve the objectives unless the SAS is not relevant or the requirement is conditional and the condition does not exist.

- *Application and Other Explanatory Material.* Provides further guidance to the auditor in applying or understanding the requirements. While this material does not in itself impose a requirement, auditors should understand this guidance. How it is applied will depend on professional judgment in the circumstances considering the objectives of the SAS. The requirements section references the applicable application and explanatory material. Also, when appropriate, considerations relating to smaller and less complex entities are also included in this section.

104.5 A standard may also contain exhibits or appendices. Appendices to a standard are part of the application and other explanatory material. The purpose and intended use of an appendix is explained in the standard or in the title and introduction of the appendix. Exhibits to standards are interpretive publications. Interpretive publications are not auditing standards and do not contain requirements. Rather, they are recommendations on applying the standards in particular circumstances that are issued under the authority of the Auditing Standards Board. Auditors are required to consider applicable interpretive publications when planning and performing the audit.

104.6 **New AU Section Organization**

Within the AICPA Professional Standards, the clarified standards (SAS Nos. 122-126) use “AU-C” section numbers instead of “AU” section numbers. “AU-C” is being used temporarily to avoid confusion with references to existing “AU” sections, which are still effective through 2013. The “AU-C” identifier will revert to “AU” in 2014, when the clarified standards are fully effective for all engagements. The organization of the new AU-C sections (which aligns with the organization of the ISAs) is as follows:

- Preface.

- Glossary.

- AU-C Section 200-299: General Principles and Responsibilities.

- AU-C Section 300-499: Risk Assessment and Response to Assessed Risks.

- AU-C Section 500-599: Audit Evidence.

- AU-C Section 600-699: Using the Work of Others.

- AU-C Section 700-799: Audit Conclusions and Reporting.

- AU-C Section 800-899: Special Considerations.

- AU-C Section 900-999: Special Considerations in the United States

- Exhibits and Appendixes.

104.7 An exhibit to SAS No. 122 contains a complete two-part cross-reference of AU-C and AU section numbers. One part of the cross-reference shows which existing AU sections are encompassed by each new AU-C section. The other part of the cross-reference shows, for each existing AU section, where the corresponding guidance can be found in the new AU-C sections.

104.8 **Preface**

AU-C Preface—*Principles Underlying an Audit Conducted in Accordance With Generally Accepted Auditing Standards*, contains the principles underlying an audit conducted in accordance with generally accepted auditing standards (the principles). These principles are not requirements and are not authoritative. They provide a framework that is helpful in understanding and explaining an audit and are organized to provide a

structure for the codification of SASs. The structure addresses the purpose of an audit, responsibilities of the auditor, performance of the audit, and reporting.

104.9 Overall Objectives and Requirements

AU-C 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*, supersedes the 10 general, fieldwork, and reporting standards and contains the auditor's overall responsibilities in accordance with GAAS. The overall objectives of the auditor in conducting an audit of financial statements are as follows:

- Obtain reasonable assurance about whether the financial statements are free from material misstatement.

- Report on the financial statements, and communicate as required by GAAS, in accordance with the auditor's findings.

The auditor must be independent of the entity when performing an engagement in accordance with GAAS unless (a) GAAS provides otherwise, or (b) law or regulation requires accepting the engagement and reporting on the financial statements. *PPC's Guide to Audits of Nonpublic Companies* discusses the overall objectives and related requirements to achieve the objectives in detail.

Implementation of the Clarified Auditing Standards

104.10 As discussed in paragraph 104.2, With a few exceptions, all of the clarified auditing standards are effective for audits of financial statements for periods ending on or after December 15, 2012. Generally early adoption of SAS Nos. 122-126 (the clarified standards) is not permitted. However, auditors may implement aspects of the clarified standards early as long as they continue to comply with existing standards.

104.11 Implementation in this Guide

The majority of the requirements in the clarified standards are consistent with the requirements in the pre-clarified standards. Thus, the changes to the standards, although extensive, do not create many substantive changes in practice. Therefore, the discussions throughout this *Guide*, references to authoritative literature, and practice aids have been updated for the clarified standards.

104.12 However, there are several areas where changes in practice are expected to occur as a result of the clarified standards. If there has been a change in the standards that will cause a change in practice, the authors have provided a text discussion of both the pre-clarified and clarified auditing standards, including appropriate references to the pre-clarified authoritative literature. In addition, throughout the practice aids, the authors have indicated (by dating or by providing practical considerations) where a requirement has changed. Therefore, unless a difference is specifically highlighted, the auditor using the updated guidance in this *Guide* is also continuing to comply with existing standards. As a result, auditors may use this edition of the *Guide* both before and after the effective date of the clarified standards.

104.13 Changes in Practice

Implementation of the clarified auditing standards results in certain changes in practice due to new requirements or changes in existing requirements. In addition, depending on how auditors apply existing requirements, changes in practice may occur as a result of added emphasis in the clarified standards that makes existing requirements more explicit. The following changes are noted throughout the *Guide* and in the practice aids, as appropriate:

- AU-C 210, *Terms of Engagement*, clarifies procedures for engagement acceptance and results in changes in the audit engagement letter. See section 603.

- AU-C 220, *Quality Control for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards*, specifies quality control requirements at the engagement level that were not included in previous auditing standards and includes specific documentation requirements.

- AU-C 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, contains a requirement to inspect correspondence with licensing or regulatory authorities. See sections 604 and 812.

- AU-C 265, *Communicating Internal Control Related Matters Identified in an Audit*, makes explicit some requirements that were implicit in SAS No. 115. It also adds requirements to (1) communicate to management deficiencies other than significant deficiencies and material weaknesses that are important enough to warrant management's attention and (2) explain the potential effects of significant deficiencies and material weaknesses in the internal control communication. See section 812.

- AU-C 300, *Planning an Audit*, contains an explicit requirement to document the audit strategy. See section 608.

- AU-C 320, *Materiality in Planning and Performing an Audit*, introduces the term *performance materiality*. See section 607.

- AU-C 402, *Audit Considerations Relating to an Entity Using a Service Organization*, requires inquiries of management about its awareness of fraud, noncompliance with laws or regulations, or uncorrected misstatements at the service organization that affect the user entity's financial statements. It also strengthens the requirements for using a service auditor's report and permits reference to the work of a

service auditor in the auditor's report on the financial statements if necessary to explain a modification. See section 606.

- AU-C 450, *Evaluation of Misstatements*, revises some terminology used in evaluating misstatements and modifies the requirements for communicating and evaluating misstatements. See section 807.

- AU-C 501, *Audit Evidence—Specific Considerations for Selected Items*, changes the requirement for when it is necessary to send a letter of inquiry to the client's lawyers, making it a risk-based decision. See section 701.

- AU-C 505, *External Confirmations*, adds certain required procedures if management refuses to allow external confirmations. See section 703.

- AU-C 510, *Opening Balances—Initial Audit Engagements, Including Reaudit Engagements*, clarifies that reviewing a predecessor's workpapers cannot be the only source of audit evidence about opening balances in an initial audit. The clarified standard also states that communication with the predecessor is not required if the most recent audited financial statements are more than *one year* before the beginning of the earliest period to be audited by the successor. The pre-clarified standard had a *two-year* requirement. See section 611.

- AU-C 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures*, makes explicit the need to obtain an understanding of accounting estimates, including related controls, during risk assessment. The clarified standard also requires a retrospective review of estimates during risk assessment, provides specific procedures for estimates that give rise to significant risks, and includes specific documentation requirements. See section 802.

- AU-C 550, *Related Parties*, makes explicit the need to obtain an understanding of related party relationships and transactions, including related controls, during risk assessment, adds a specific requirement to discuss related parties during the engagement team discussion, requires treating significant related party transactions outside the normal course of business as significant risks, and requires additional procedures (a) for significant related party transactions outside the normal course of business, and (b) if related parties not disclosed by management are identified. See section 804.

- AU-C 560, *Subsequent Events and Subsequently Discovered Facts*, expands certain requirements related to omitted procedures and subsequently discovered facts. See section 803.

- AU-C 580, *Written Representations*, revises the wording of several required representations and results in changes in the management representation letter. See section 806.

- AU-C 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, provides guidance on the special considerations that apply to group audits, particularly those involving component auditors. The authors believe that group audits will be uncommon (although not unheard of) for CIRAs. As a result, the related group audit practice aids are included in this *Guide*. Sections 903 and 904 of *PPC's Guide to Audits of Nonpublic Companies* provide detailed guidance on audits of group financial statements, both before and after implementation of the clarity standards. *PPC's Guide to Auditor's Reports* provides guidance on reporting on audits of group financial statements, including illustrative reports, both before and after implementation of the clarity standards.

- AU-C 620, *Using the Work of an Auditor's Specialist*, includes internal specialists in a field other than accounting or auditing that are employed by the firm within the definition of an auditor's specialist. Previously, those specialists were considered members of the engagement team and were subject to less stringent requirements. See section 608.

- AU-C 930, *Interim Financial Information*, requires the auditor to issue a written report when engaged to review interim financial information. See section 707.

In addition, as discussed in detail beginning at paragraph 811.8, the authoritative guidance for auditor's reports also has been revised.

104.14 Use of the Terms *Must* and *Should*

The auditor's degree of responsibility in complying with professional requirements is identified through two categories as follows (AU-C 200.25):

- *Unconditional Requirements*. Unconditional requirements are those that an auditor must follow in all cases if the circumstances apply to the requirement. Auditing standards use the word *must* to indicate an unconditional requirement.

- *Presumptively Mandatory Requirements.* An auditor must comply with a presumptively mandatory requirement in all cases in which such a requirement is relevant except in rare circumstances discussed in AU-C 200.26. Auditing standards use the word *should* to indicate a presumptively mandatory requirement.

The auditor must document the justification for any necessary departure from a presumptively mandatory requirement of GAAS, along with how alternative procedures performed sufficiently achieve the intent of the requirement. Throughout this *Guide*, the authors use the terms *must* and *should* in accordance with AU-C 200.25. The authors also use the term *is required* interchangeably with *should*.

⁴ SAS No. 122 does not supersede these SASs, but it does redesignate the previous AU sections as new AU-C sections. The revised AU-C sections were also updated, if necessary, for conforming changes.

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Homeowners' Associations

Chapter 1 Overview of Common Interest Realty Associations

105 Scope of PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations

105 Scope of *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations*

105.1 Accountants who are familiar with *PPC's Guide to Audits of Nonpublic Companies* will see similarities between it and this *Guide*. This *Guide* builds on the guidance in *PPC's Guide to Audits of Nonpublic Companies* and tailors much of that guidance to CIRAs. It also adapts the engagement approach in *PPC's Guide to Compilation and Review Engagements* to be easily applied when providing compilation and review services to CIRAs. While this *Guide* makes references to *PPC's Guide to Audits of Nonpublic Companies* and *PPC's Guide to Compilation and Review Engagements*, it is designed to be used independently in most CIRA engagements.

105.2 Separate chapters of this *Guide* are included on timeshare developments and cooperatives, and sections are included on nonresidential associations, such as commercial condominiums. In many cases, the same accounting and tax principles apply to both residential and nonresidential associations. Differences between those principles are discussed throughout the *Guide*.

105.3 *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations* is divided into the following 12 chapters:

Chapter 1	Overview of Common Interest Realty Associations
Chapter 2	The CIRA Legal Environment
Chapter 3	Accounting Principles and Practices
Chapter 4	Financial Statement Presentation
Chapter 5	Income Taxes
Chapter 6	Pre-engagement Activities and Audit Planning
Chapter 7	Performing Substantive Procedures

Chapter 8	Concluding the Audit
Chapter 9	Compilation and Review Engagements
Chapter 10	Timeshare Developments
Chapter 11	Cooperative Housing Corporations
Chapter 12	State Requirements

The chapters (a) discuss authoritative accounting literature that applies to CIRAs; (b) provide practical guidance on how to apply auditing, review, and compilation standards to engagements to report on CIRA financial statements; and (c) explain the complex income tax rules that CIRAs must follow. The chapters discuss the legal documentation that governs condominium associations, homeowners' associations, cooperatives, timeshare developments, and commercial associations and provide examples of financial statements; selected income tax rules; audit, review, and compilation reports; and specific state requirements.

105.4 The *Guide* also includes practice aids specifically tailored to CIRA engagements, such as engagement programs (audit, review, and compilation), confirmation letters, checklists, and work sheets.

105.5 The authors believe that this *Guide* will familiarize accountants with the accounting and tax rules that apply to CIRAs and provide guidance for auditing, reviewing, or compiling their financial statements efficiently and effectively.

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