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American Institute of Certified Public Accountants. Common Interest Realty Associations Task Force

AICPA Audit and Accounting Guide

Common Interest Realty Associations

With Conforming Changes as of May 1, 2004

American Institute of Certified Public Accountants

AICPA

Common Interest Realty Associations With Conforming Changes as of May 1, 2004 AICPA

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

AICPA Audit and Accounting Guide

COMMON INTEREST REALTY ASSOCIATIONS

With Conforming Changes as of May 1, 2004

This edition of the AICPA Audit and Accounting Guide *Common Interest Realty Associations*, which was originally issued in 1991, has been modified by the AICPA staff to include certain changes necessary because of the issuance of authoritative pronouncements since the Guide was originally issued (see page iv). The changes made for the current year are identified in a schedule in appendix E of the Guide. The changes do *not* include all those that might be considered necessary if the Guide were subjected to a comprehensive review and revision.

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NOTICE TO READERS

This AICPA Audit and Accounting Guide has been prepared by the Common Interest Realty Associations Task Force to assist preparers of financial statements in preparing financial statements in conformity with generally accepted accounting principles and to assist auditors in auditing and reporting on such financial statements in accordance with generally accepted auditing standards.

Descriptions of accounting principles and financial reporting practices in Audit and Accounting Guides are approved by the affirmative vote of at least two-thirds of the members of the Accounting Standards Executive Committee, which is the senior technical body of the AICPA authorized to speak for the AICPA in the areas of financial accounting and reporting. Statement on Auditing Standards (SAS) No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Audit and Accounting Guides that have been cleared by the Financial Accounting Standards Board (FASB) as sources of accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. This Audit and Accounting Guide has been cleared by the FASB. AICPA members should consider the accounting principles described in this Audit and Accounting Guide if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatments specified by this Audit and Accounting Guide should be used, or the member should be prepared to justify another treatment, as discussed in paragraph 7 of SAS No. 69.

This AICPA Audit and Accounting Guide, which contains auditing guidance, is an interpretive publication pursuant to SAS No. 95, *Generally Accepted Auditing Standards*. Interpretive publications are recommendations on the application of SASs in specific circumstances, including engagements for entities in specialized industries. Interpretive publications are issued under the authority of the Auditing Standards Board. The members of the Auditing Standards Board have found this Guide to be consistent with existing SASs.

The auditor should be aware of and consider interpretive publications applicable to his or her audit. If the auditor does not apply the auditing guidance included in an applicable interpretive publication, the auditor should be prepared to explain how he or she complied with the SAS provisions addressed by such auditing guidance.

Public Accounting Firms Registered With the PCAOB

Subject to the Securities and Exchange Commission (Commission) oversight, Section 103 of the Sarbanes-Oxley Act (Act) authorizes the Public Company Accounting Oversight Board (PCAOB) to establish auditing and related attestation, quality control, ethics, and independence standards to be used by registered public accounting firms in the preparation and issuance of audit reports as required by the Act or the rules of the Commission. Accordingly, public accounting firms registered with the PCAOB are required to adhere to all PCAOB standards in the audits of issuers, as defined by the Act, and other entities when prescribed by the rules of the Commission.

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Accounting and Auditing Publications

This edition of the Audit and Accounting Guide *Common Interest Realty Associations*, has been modified by the AICPA staff to include certain changes necessary due to the issuance of authoritative pronouncements since the guide was originally issued. This guide reflects relevant guidance contained in authoritative pronouncements through May 1, 2004:

FASB Statement No. 150, *Accounting for Certain Financial Instruments With Characteristics of Both Liabilities and Equity*, and Revised FASB Statements issued from May 1, 2003 through May 1, 2004, including

FASB Statement No. 132 (revised 2003), *Employers' Disclosures About Pensions and Other Postretirement Benefits*

FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51*

FASB Technical Bulletin 01-1, *Effective Date for Certain Financial Institutions of Certain Provisions of Statement 140 Related to the Isolation of Transferred Financial Assets*

FASB Staff Positions issued through April 1, 2004

FASB Emerging Issues Task Force (EITF) consensus positions adopted at meetings of the EITF held through November 2003

Practice Bulletin No. 15, *Accounting by the Issuer of Surplus Notes*

SAS No. 101, *Auditing Fair Value Measurements and Disclosures*

SOP 03-5, *Financial Highlights of Separate Accounts: An Amendment to the Audit and Accounting Guide* Audits of Investment Companies

SSAE No. 12, *Amendment to Statement on Standards for Attestation Engagements No. 10,* Attestation Standards: Revision and Recodification

The changes made are identified in a schedule in appendix E of the Guide. The changes do not include all those that might be considered necessary if the guide were subjected to a comprehensive review and revision.

This edition includes Statement of Position (SOP) 93-5, *Reporting on Required Supplementary Information Accompanying Compiled or Reviewed Financial Statements of Common Interest Realty Associations*. In using this guide, readers should refer to the material in the SOP (appendix C), which was not available when the guide was originally issued. SOP 93-5 has also been integrated into the text of this edition of the guide.

Substantial Changes to Audit Process Proposed

(Note: This discussion is not applicable to public accounting firms registered with the PCAOB and their associated persons in connection with their audits of the financial statements of entities subject to the Sarbanes-Oxley Act or the rules of the Securities and Exchange Commission.)

In December 2002, the AICPA's Auditing Standards Board (ASB) issued an exposure draft proposing seven new Statements on Auditing Standards (SASs) relating to the auditor's risk assessment process. The ASB believes that the requirements and guidance provided in the proposed SASs, if adopted, would result in a substantial change in audit practice and in more effective audits. The primary objective of the proposed SASs is to enhance auditors' application of the audit risk model in practice by requiring:

(continued)

- More in-depth understanding of the entity and its environment, including its internal control, to identify the risks of material misstatement in the financial statements and what the entity is doing to mitigate them.
- More rigorous assessment of the risks of material misstatement of the financial statements based on that understanding.
- Improved linkage between the assessed risks and the nature, timing and extent of audit procedures performed in response to those risks.

The exposure draft consists of the following proposed SASs:

- *Amendment to Statement on Auditing Standards No. 95,* Generally Accepted Auditing Standards
- *Audit Evidence*
- *Audit Risk and Materiality in Conducting an Audit*
- *Planning and Supervision*
- *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*
- *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*
- *Amendment to Statement on Auditing Standards No. 39,* Audit Sampling

The proposed SASs establish standards and provide guidance concerning the auditor's assessment of the risks of material misstatement in a financial statement audit, and the design and performance of audit procedures whose nature, timing, and extent are responsive to the assessed risks. Additionally, the proposed SASs establish standards and provide guidance on planning and supervision, the nature of audit evidence, and evaluating whether the audit evidence obtained affords a reasonable basis for an opinion regarding the financial statements under audit.

Readers can access the proposed standards at AICPA Online (www.aicpa.org) and should be alert to future progress on this project.

Preface

This audit and accounting guide has been prepared to assist independent public accountants in conducting compilations, reviews, and audits of financial statements of common interest realty associations (CIRAs). This guide describes conditions and procedures unique to the industry and illustrates the form and content of the financial statements of common interest realty associations as well as informative disclosures relating to such statements.

This audit and accounting guide provides guidance on the following matters:

- *Financial reporting of common property and facilities.* This guide provides guidance for the reporting of assets, other than common real property, maintained or owned by a CIRA. This guide describes practice for the reporting of common real property maintained or owned by a CIRA. The effect of the manner in which the assets were acquired and depreciation policies are also discussed.
- *Major repairs and replacements.* Because a CIRA's primary function is to maintain and replace common property, some CIRAs' legal documents and some state statutes require it to accumulate funds for future major repairs and replacements. Disclosure of such designated funds and supplementary disclosures of anticipated major repairs and replacements are discussed.
- *Financial reporting.* The widespread use of financial reports of CIRAs by potential buyers, lenders, sellers, and others creates a need for financial statement formats that are comparable. A recommended format is discussed and illustrations are presented in appendix A.
- *Method of accounting.* Under generally accepted accounting principles (GAAP), CIRAs report their financial activities using the accrual basis of accounting. Alternatively, the cash basis of accounting may be used if the results of applying that basis do not differ substantially from the results using the accrual basis. This guide discusses the various methods.
- *Budgets.* CIRAs are generally required by their governing documents to base members' assessments on annual budgets. This guide discusses the development of budgets and their implementation in the operations of CIRAs.
- *Income taxes.* The Internal Revenue Service (IRS) considers most CIRAs to be taxable entities that are required to file federal income tax returns. Guidelines for determining the tax filing alternatives for CIRAs are discussed in this guide.
- *Audit considerations.* Audit procedures specifically applicable to CIRAs are discussed.
- *Review and compilation engagements.* Since many CIRA engagements are compilations or reviews, procedures specifically applicable to CIRAs are discussed.
- *Cooperative housing corporations.* Issues unique to audits of cooperative housing corporations and financial reporting requirements for these entities are discussed.

Effective Date

The provisions of this guide should be applied to financial statements for periods beginning on or after September 15, 1991. Earlier application is encouraged. The effects of reporting accounting changes caused by implementing this guide should be reported retroactively.

TABLE OF CONTENTS

Chapter		Paragraph
1	Industry Background and Unique Characteristics	.01-.37
	General Description and History	.01-.07
	Condominiums	.03
	Planned Unit Developments (PUDs)	.04-.05
	Cooperatives	.06
	Time-Share Developments	.07
	Regulatory Framework	.08-.19
	General State Statutes	.09-.10
	Specific State Statutes	.11-.12
	Declarations and Master Deeds	.13
	Membership Agreements and Proprietary Leases	.14
	Articles of Incorporation	.15-.16
	Bylaws	.17
	Board of Directors' Actions	.18-.19
	Federal Legislation and Regulatory Considerations	.20
	Creation and Governance of CIRAs	.21-.26
	Management of CIRAs	.27-.30
	Unique Characteristics of CIRAs	.31
	Users of Financial Statements of CIRAs	.32-.37
2	Reporting on Common Property	.01-.20
	Methods of Acquisition of Common Property	.02-.06
	Property Transferred by the Developer	.03-.04
	Property Bought by CIRAs	.05
	Property Acquired by Buying Leasehold Interests	.06
	Kinds of Common Property	.07
	Prevalent Industry Practice for Recognizing Common Real Property as Assets	.08-.10
	Real Property Directly Associated With the Units	.09
	Real Property Not Directly Associated With the Units	.10
	Personal Property	.11
	Measurement of Common Property Recognized as Assets	.12
	Impairment or Disposal of Long-Lived Assets	.13-.16
	Disclosure	.17-.18
	Depreciation	.19
	Expenditures for Major Repairs or Replacements and Acquisition of Assets	.20
3	Future Major Repairs and Replacements	.01-.08
	Reporting Considerations	.08

Chapter		Paragraph
4	Financial Statement Presentation	.01-.34
	General Method of Presentation	.01-.02
	Method of Accounting	.03-.04
	Financial Statements	.05-.18
	Balance Sheet	.06-.11
	Deferred Revenue	.12
	Statement of Revenues and Expenses	.13-.16
	Statement of Changes in Fund Balances	.17
	Statement of Cash Flows	.18
	Comparative Financial Statements	.19
	Accompanying Information	.20-.21
	Note Disclosures	.22-.34
	Related Parties	.24
	Significant Sources of Revenue	.25
	Common Property	.26
	Future Major Repairs and Replacements	.27-.32
	Required Supplementary Information	.33-.34
5	Budgets	.01-.09
	The Budget Process	.04
	Format and Components of a Budget	.05-.09
	Operations	.06
	Future Major Repairs and Replacements	.07
	Other Expenditures	.08
	Presentations of Budget Information in Financial Statements	.09
6	Income Tax Considerations	.01-.10
	Methods of Filing	.02
	Federal Form 1120	.03-.04
	Federal Form 1120H	.05
	Federal Form 990	.06
	Specific Areas for Review	.07-.10
	Basis for Contributed Property	.07-.08
	Developer Settlements	.09
	Recognition of Receipts as Current Revenue Versus Capital Contributions	.10

Chapter		Paragraph
7	Audit Considerations	.01-.75
	Establishing an Understanding of the Engagement	.02
	Independence	.03
	A CIRA's Documents	.04-.06
	Minutes	.07
	Management of a CIRA	.08
	Understanding Internal Control and Assessing Control Risk	.09-.18
	Internal Control	.10-.16
	Documentation	.17-.18
	Initial Operating Period	.19
	Consideration of Fraud in a Financial Statement Audit	.20-.44
	The Importance of Exercising Professional Skepticism	.23
	Discussion Among Engagement Personnel Regarding the Risks of Material Misstatement Due to Fraud	.24-.25
	Obtaining the Information Needed to Identify the Risks of Material Misstatement Due to Fraud	.26-.29
	Identifying Risks That May Result in a Material Misstatement Due to Fraud	.30-.33
	Assessing the Identified Risks After Taking Into Account an Evaluation of the Entity's Programs and Controls That Address the Risks	.34-.35
	Responding to the Results of the Assessment	.36
	Evaluating Audit Evidence	.37-.38
	Responding to Misstatements That May Be the Result of Fraud	.39-.41
	Communicating About Possible Fraud to Management, the Audit Committee, and Others	.42
	Documenting the Auditor's Consideration of Fraud	.43
	Practical Guidance	.44
	Related Parties	.45
	Budgets	.46-.48
	Assessment Revenues	.49
	Assessments Receivable	.50
	Investments	.51
	Contracts	.52
	Insurance	.53
	Future Major Repairs and Replacements	.54-.56
	Representation Letters	.57-.58
	Audit Documentation	.59-.63
	Auditor's Report	.64-.67
	Reporting on Required Supplementary Information	.68-.75

Chapter		Paragraph
8	Review and Compilation Engagements	.01-.16
	Engagement Letter	.02
	Reporting Obligation	.03-.04
	Compilation and Review Procedures	.05-.07
	Representation Letters	.08-.11
	Reporting on Required Supplementary Information Accompanying Compiled or Reviewed Financial Statements of Common Interest Realty Associations	.12-.16
9	Cooperative Housing Corporations	.01-.26
	Balance Sheet	.10-.12
	Statement of Operations	.13
	Statement of Changes in Shareholders' Equity	.14
	Statement of Cash Flows	.15
	Notes to Financial Statements	.16-.17
	Income Tax Considerations	.18-.24
	Financial Statements	.25
	Auditor's Report	.26

Appendix

A	Illustrative Financial Statements
B	Illustrative Engagement and Representation Letters
C	Statement of Position 93-5, Reporting on Required Supplementary Information Accompanying Compiled or Reviewed Financial Statements of Common Interest Realty Associations
D	Information Sources
E	Schedule of Changes Made to *Common Interest Realty Associations*
	Glossary

Chapter 1

Industry Background and Unique Characteristics

General Description and History

1.01 In the 1960s, new forms of real estate ownership, such as **condominiums,**[1] **cooperatives, timeshare associations,** and **planned unit developments,** emerged, and the terms used to describe them became common. A key feature of these forms of real estate ownership is the existence of an **association** of owners, referred to in this guide as a *common interest realty association* (CIRA), which is responsible for providing certain services and maintaining certain property that all the owners share or own in common. **Homeowners' associations (HOAs)** and **condominium associations** are two examples of CIRAs.

1.02 The main characteristics of such ownership are the following:

- Individual ownership of a lot, defined interior space, or shares of stock
- Ownership of an undivided interest in the **common property**, with all owners bound by covenant, restriction, or contract through an association of owners
- Automatic membership in a CIRA that has been established under state laws and that performs maintenance and other service activities for the owners
- Funding of the CIRA's activities by periodic assessments of all owners

Condominiums

1.03 The term *condominium* indicates a legal form of ownership in which each owner has title to a defined interior space within a building or combination of buildings[2] and an **undivided ownership interest** in *common property* within a development, such as the grounds, recreational facilities, and exteriors of buildings shared in common with all other owners. A *condominium association* generally owns no real property, but it is responsible for maintaining the common property and providing necessary services. In certain jurisdictions, condominiums may be established as condominium trusts; such entities may own the real estate and all the improvements. If they do, the accounting and reporting for condominium trusts are the same as for cooperatives.

Planned Unit Developments (PUDs)

1.04 A PUD is a form of land development in which various residential and nonresidential structures are clustered to allow optimal use of the property and to provide certain open spaces and amenities not otherwise available in traditional forms of subdivision developments. In many PUDs, tracts of land are set aside for all owners to use for active or passive recreational purposes, parking areas, and streets.

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[1] Words or terms printed in boldface are defined in the glossary.

[2] The ownership of a defined interior space in a condominium is referred to as a *unit* in subsequent discussions in this guide.

1.05 To become an owner in a PUD, one buys a lot and improvements on the lot. The title to common property is held by a CIRA, generally an HOA, which has obtained it at no cost to the association. The CIRA assesses owners for funds needed to maintain common property and provide necessary services.

Cooperatives

1.06 The term *cooperative* refers to a form of ownership in which a corporation owns the common property, including all of the improvements, and is responsible for its maintenance, debt service, repairs, and so forth. The owners do not own any of the common property, but they own shares of stock of the corporation. Their ownership interests permit them only to lease from the cooperative, to occupy their individual units, or to sell their shares. Members are assessed **carrying charges** for units they occupy or lease. The corporation functions in the same way as other CIRAs in maintaining common property and providing services.

Time-Share Developments

1.07 A time-share is a form of ownership in which each owner has a time-share interest, commonly referred to as *interval use*, that represents a right to use a unit in a time-share development for a specified number of weeks during a year. Such interests may be in a form of (*a*) fee-simple ownership, evidenced by a **deed** that specifies the amount of time the deedholder is entitled to use the unit, or (*b*) a lease giving the owner the right to use a unit for a predetermined lease term. These types of entities may also be referred to as *fractional ownership associations*.

Regulatory Framework

1.08 CIRAs derive their authority for all matters, including financial matters, from specific statutes and legal **documents**. CIRAs operate under the following:

- General state statutes, such as corporate statutes or not-for-profit corporate statutes
- Specific state statutes, such as state horizontal property acts or state condominium acts
- Declarations of covenants, condominium declarations, or **master deeds** (for condominiums and HOAs)
- Membership agreements and proprietary leases (for cooperatives)
- **Articles of incorporation** or association
- **Bylaws**
- **Boards of directors'** actions (including **house rules**)

General State Statutes

1.09 Most CIRAs are subject to state corporate or not-for-profit corporate statutes, unless they are specifically excluded. HOAs normally are incorporated to permit them to hold title to common property and to limit their liability. Depending on the nature of the state statute, not all condominium associations are incorporated. Many residential cooperatives are organized under state corporate statutes using provisions originally created for rural and farm cooperatives.

1.10 CIRAs that are corporations are also subject to corporate statutes that prescribe broad provisions within which corporations function, including, for example, provisions for annual reporting requirements, participation by members, and protection of assets.

Specific State Statutes

1.11 Generally, no unique state statutes are necessary to create cooperatives or HOAs. However, specific state enabling statutes are necessary to create the condominium form of ownership. By 1969, all states had adopted some form of condominium or horizontal property statute. Some of these are simple enabling statutes that briefly describe the format for creating condominiums, whereas others prescribe operational and developmental procedures for condominium developers, managers, and boards of directors. A specific state statute for CIRAs generally supersedes conflicting provisions of general statutes and possibly supersedes the documents of a CIRA that are subject to it. Such statutes are frequently revised.

1.12 In an effort to standardize state statutes governing CIRAs, the National Conference of Commissioners on Uniform State Laws has developed a **uniform condominium act**, a uniform planned communities act for PUDs, a model cooperative act, a uniform real estate time-share act, and a uniform common interest ownership act, each of which applies to one or more forms of a CIRA. At the time this guide was published, some states had adopted such uniform statutes, with or without revision.

Declarations and Master Deeds

1.13 To establish the rules under which CIRAs exist and function, HOAs use declarations of covenants on the land, and condominium associations use condominium declarations or master deeds. Declarations of covenants and **declarations of condominium** or master deeds are the fundamental governing documents of CIRAs. Typically, they state the owners' rights and restrictions on the use of common property as well as their obligations to participate in governing and funding CIRAs.

Membership Agreements and Proprietary Leases

1.14 Membership agreements and **proprietary leases** are unique to cooperatives. A membership agreement or **subscription agreement** is executed between a member and a cooperative and establishes the terms of ownership, including restrictions on resales. A proprietary lease or occupancy agreement is also executed between an owner and a cooperative and establishes the terms of occupancy of a particular unit. These documents create certain ownership rights and obligations.

Articles of Incorporation

1.15 Articles of incorporation may or may not be used by a CIRA, depending on its state's statutes. Articles of incorporation often are not required in states with statutes directed to CIRAs. They are used only to provide a broad framework within which a CIRA's corporate structure functions.

1.16 Cooperative corporations own the real estate and may or may not have covenants to restrict its use. Cooperatives are governed through the articles of incorporation, the fundamental legal document, and other documents providing for the use of leasehold space, apartments, and homes.

Bylaws

1.17 Bylaws are organizational documents used to establish the specific operating procedures of CIRAs for such matters as meetings, voting procedures, leadership positions, duties and responsibilities of specific officers, and committees. The declaration and the articles of incorporation always take precedence over the bylaws.

Board of Directors' Actions

1.18 The policies, procedures, and resolutions of a CIRA's board of directors are established to carry out the association's responsibilities as prescribed in the declaration or articles of incorporation and the bylaws, and they set forth internal operating practices for handling financial and other matters.

1.19 The board of directors adopts rules and regulations that deal mostly with restrictions on the use of property and on the behavior of unit owners. Financial matters occasionally are prescribed in the rules and regulations, particularly those concerning delinquent assessments.

Federal Legislation and Regulatory Considerations

1.20 The operations of CIRAs are regulated by the individual states and not by the federal government. Federal regulations, court cases, revenue rulings, and federal legislation, however, apply to the income tax treatment of CIRAs, as discussed in chapter 6. In addition, various federal and quasi-federal lending and lending-related organizations, such as the Federal Housing Administration (FHA), the Department of Veterans Affairs (VA), the Federal Home Loan Mortgage Corporation (Freddie Mac), and the Federal National Mortgage Association (Fannie Mae), have regulations to guide developers and others in establishing CIRAs as well as in the sales and financing of units. The legal documents of CIRAs may contain language to serve the needs and regulations of such organizations. Although compliance with such regulations may not be mandatory, many believe that CIRAs should seek to comply with them, if practical, to facilitate sales and resales, because not doing so may restrict available sources of funds and secondary financing.

Creation and Governance of CIRAs

1.21 The establishment of a CIRA as a legal entity and the transfer of control of the CIRA from the **declarant** (developer or **converter**), who established the CIRA, to unit owners may involve competing interests and potential problems. The establishment of a CIRA and transfer of control are discussed in the legal documents of most CIRAs. Before the declarant can sell units or shares, the declarant must file legal documents that create the CIRA and specify its nature, form, powers, and duties. The legal documents provide for the election of a board of directors and state its duties, responsibilities, and authority.

1.22 All CIRAs are governed substantially the same way regardless of their legal form. A board of directors of individual unit owners usually is elected from among all owners to serve as a governing body. A CIRA's board of directors is responsible for guiding the CIRA's administration; setting its policies; establishing budgets and **assessments**; managing its finances; and directing consultants, contractors, and staff in carrying out the CIRA's operations.

1.23 The declarant appoints or elects the first board of directors. Directors are replaced and additional directors are elected from among unit owners through a process specified in the statutes or the documents. Transfer of control from the declarant to the unit owners, however, may not be gradual if the provisions of the documents specify that a completely new board should be elected from unit owners when a stated percentage of units has been sold or at a specific subsequent date.

1.24 Whatever the transfer procedure may be, the auditor should be aware that there is a period when the declarant controls both the CIRA and the development company. That situation may create a potential conflict with the unit owners' interests, such as in the allocation of expenses between the periods before and after control shifts from the development company to the unit owners.

1.25 The legal documents may include provisions limiting the CIRA's operations during the project's development to prevent the CIRA from acting in a manner that may harm that process. Such limitations may continue to be imposed until the declarant's majority control of the board of directors has shifted to unit owners, or until the declarant has completed selling units. Even after majority control on the board of directors has shifted, the declarant may still be able to influence the CIRA's actions, because the declarant usually retains the right to vote on behalf of unsold units.

1.26 An auditor engaged by a CIRA should consider the effects, if any, of the declarant's influence on the CIRA's financial condition during the initial operating period in which the developer (declarant) generally controls the CIRA's management, policy setting, and finances. (The initial operating period is discussed further in paragraph 7.19.)

Management of CIRAs

1.27 CIRAs are managed in various ways. For example, while some CIRAs contract with property management companies, others hire employees to work directly for the board of directors and carry out its management responsibilities. Still other CIRAs rely almost exclusively on volunteer management and occasional contractors and consultants, as needed.

1.28 Management personnel, on staff or by contract, are primarily responsible for the CIRA's financial administration as well as the physical maintenance of the property or the supervision of contractors that physically maintain the property.

1.29 In most CIRAs, management personnel, or designated volunteers, prepare periodic financial reports for the board of directors. Such reports may or may not be available to unit owners. Most CIRAs, however, have annual meetings at which financial statements for the preceding year and budgets for the following year are presented to unit owners. Financial statements may also be provided to others, such as the CIRA's insurance agents, lenders on individual unit mortgages, lenders on the CIRA's mortgages in cooperatives, prospective buyers of new or resale units, and local and state regulatory agencies.

1.30 CIRAs often retain legal counsel to assist in enforcing their rules and for other purposes. CIRAs engage accountants to provide accounting, auditing, tax, and consulting services to CIRAs.

Unique Characteristics of CIRAs

1.31 The following characteristics are common to all CIRAs:

- A CIRA's functions are to operate, preserve, maintain, repair, and replace common property and provide other services. Its activities relate primarily to these functions. CIRAs generally provide services such as security guards, swimming pool lifeguards, snow removal, and rubbish removal.

- A CIRA's members, who provide its resources, expect to receive benefits in the form of maintenance and replacement of the common property.
- Membership in a CIRA is generally mandatory for owners and is a condition in the agreement to purchase either shares in a cooperative or a unit in a condominium or HOA.
- A CIRA's members have defined ownership interests that they can transfer to buyers of their shares or units and are entitled to share in the distribution of resources in the event of liquidation.
- A CIRA's excess of assessments over expenses at year-end may be distributed to members, credited toward members' assessments in the following year, or allocated to a **major repairs and replacements fund**, depending on actions taken by the board of directors, requirements of the governing documents, or state statutes.

Users of Financial Statements of CIRAs

1.32 The rapid growth of CIRAs has created a corresponding growth in the demand for financial information to satisfy the needs of users of the financial statements of such entities.

1.33 The primary users of the financial information of a CIRA are unit owners, whose periodic payments of assessments or carrying charges enable the CIRA to perform its functions. They are primarily interested in information that indicates whether assessments are used for their designated budgetary purposes, and whether adequate funds have been accumulated for future major repairs and replacements. Adequate financial reporting may assist owners in assessing the extent to which the CIRA is meeting its responsibilities to maintain the common property.

1.34 Members of a CIRA's board of directors need timely, comprehensive financial information to make financial decisions. Information on operating expenses and capital expenditures is a vital tool for identifying unusual trends and fluctuations in operating costs and, ultimately, in determining the assessments or carrying charges that a CIRA should collect from its members.

1.35 An understanding of a CIRA's financial condition is helpful to potential buyers in assessing their possible investments. A CIRA's financial statements revealing that the CIRA has a deficit in operating funds or that it has not obtained funds needed for property replacements or major repairs may alert a prospective buyer to seek other investment opportunities or to modify the offer. In contrast, financial information indicating that a CIRA is fiscally sound may help owners sell their units and enhance the value of individual units.

1.36 Other parties that may be interested in a CIRA's financial statements include the following:

- Lenders that hold the financing on the property during the development period
- Second mortgage lenders
- Direct lenders to buyers of units
- Government lending-related organizations
- Trade vendors
- Federal, state, and local taxing authorities
- Insurers

1.37 Financial information about amounts due from unit owners and about a CIRA's policies for accumulating funds to meet future major repair and replacement costs on common property is a major concern of lenders, as well as of unit owners and prospective unit owners.

Chapter 2

Reporting on Common Property[*]

2.01 Common property of a CIRA includes all real property to which title or other evidence of ownership is held (*a*) by individual members in common or (*b*) by the CIRA directly, as indicated by a CIRA's declaration or covenants. (Paragraphs 1.01 to 1.08 of this guide discuss the ways in which title to, or other evidence of ownership of, common property of various kinds of CIRAs is held.) It also includes personal property, such as furnishings and recreational and maintenance equipment, that is owned by the CIRA and used on common real property. Each member of a CIRA has a beneficial or undivided interest in the property.

Methods of Acquisition of Common Property

2.02 A CIRA can acquire common property in various ways. For example, it may receive the property by transfer from the developer, it may buy property formerly leased by members or by the CIRA, or it may buy property on the open market.

Property Transferred by the Developer

2.03 During the development of a common interest realty project, the developer or converter determines which property, real or personal, will be common property. In a condominium, each unit owner usually holds legal title to an undivided interest in property constituting common property. In contrast, HOAs usually have legal title to such property.

2.04 Developers or converters occasionally transfer to CIRAs property not specifically mentioned in the governing documents. Title to such property is usually conveyed to CIRAs and may be transferred before or after control of the CIRA is turned over to the unit owners. Such property may include unsold residential units, furniture and equipment, parcels of land, improvements, and commercial units. A CIRA may obtain some of those kinds of real or personal property from legal settlements of claims against the developer or converter.

Property Bought by CIRAs

2.05 CIRAs may use their own funds to pay for additions, improve the property, and replace common property. Such purchases may be funded by the following:

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[*] On June 29, 2001, the Accounting Standards Executive Committee (AcSEC) released an exposure draft of a proposed AICPA Statement of Position (SOP), *Accounting for Certain Costs Related to Property, Plant, and Equipment*. The proposed SOP provides guidance on accounting for certain costs and activities related to property, plant, and equipment (PP&E). Concurrent with the issuance of this proposed SOP, the Financial Accounting Standards Board (FASB) has released an exposure draft of a proposed Statement of Financial Accounting Standards, *Accounting in Interim and Annual Financial Statements for Certain Costs Related to Property, Plant, and Equipment*, that would amend FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, FASB Statement No. 51, *Financial Reporting by Cable Television Companies*, Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*, and APB Opinion No. 73, *Interim Financial Reporting*. It also would rescind FASB Statement No. 73, *Reporting a Change in Accounting for Railroad Track Structures*. Readers should be alert to the issuance of the final Standards.

- **Special assessments** designated for acquisitions
- Cumulative excesses of normal operating revenues over normal operating expenses
- Borrowing
- Monies accumulated in the replacement fund
- Grants and similar monies from government programs for CIRAs that are used in low/moderate income housing

Property Acquired by Buying Leasehold Interests

2.06 Members of a CIRA may hold title to their units, subject to long-term lease obligations, for example, on recreational facilities or land. The lessor is often an entity owned by the developer. A CIRA may negotiate on behalf of its members to buy the property from the lessor. If so, the CIRA generally holds title to the property. Funds for such purchases may be generated by assessments of members, external financing, or both. Alternatively, to be released from future lease obligations, members may buy pro rata shares of the leased facilities. If so, title is held by the members and not by the CIRA. Any portion of leased facilities not bought by members or the CIRA itself continues to be owned by the lessor.

Kinds of Common Real Property

2.07 Common real property falls into two broad categories:

a. *Property that is directly associated with the unit.* This category includes common property without which the units could not be occupied and exterior property that is normally part of a freestanding unit. Examples include exterior walls, roofs, public hallways, underlying land, sidewalks, driveways, roads, some parking spaces, and greenbelts.

b. *Property that is not directly associated with the unit.* This property includes community resource property that is not necessary for the primary use of the unit, although individual unit owners may benefit from its use. Examples include recreational facilities, such as swimming pools or clubhouses; managers' apartments; properties that are primarily used for commercial operations directed at non-unit owners or at unit owners for which they pay a fee based on usage.

Prevalent Industry Practice for Recognizing Common Real Property as Assets

2.08 Cooperatives recognize common real property as assets. Because of their legal structure, cooperatives have title to all their common property and have the authority to dispose of it and retain the proceeds. Other CIRAs, such as condominiums and HOAs, have adopted other practices for recognizing common real property. Paragraphs 2.09 and 2.10 of this guide do not provide recommendations but rather describe the prevalent industry practices followed by CIRAs other than cooperatives for recognizing common real property as assets.

Real Property Directly Associated With the Units

2.09 Most CIRAs other than cooperatives, regardless of whether they have title, do not recognize as assets real property directly associated with the units.

Real Property Not Directly Associated With the Units

2.10 Most CIRAs other than cooperatives recognize real property not directly associated with the units as assets when (*a*) the CIRA has title or other evidence of ownership of the property and (*b*) either of the following conditions are met:

(1) The CIRA can dispose of the property, at the discretion of its board of directors, for cash or claims to cash, with the CIRA retaining the proceeds.

(2) The property is used by the CIRA to generate significant cash flows from members on the basis of usage or from nonmembers.

However, some CIRAs recognize as assets all real property to which they have title or other evidence of ownership and that is not directly associated with the units, regardless of whether condition (1) or (2) is met.

Personal Property

2.11 CIRAs should recognize common personal property, such as furnishings, recreational equipment, maintenance equipment, and work vehicles, that is used by the CIRA in operating, preserving, maintaining, repairing, and replacing common property and providing other services, as assets.

Measurement of Common Property Recognized as Assets

2.12 Common property recognized as assets of a CIRA should be measured at the CIRA's cost to acquire it if the CIRA acquired the property in a monetary transaction. If the CIRA acquired the property in a nonmonetary transaction, such as by a nonreciprocal transfer from the developer, and if the property is recognized as an asset of the CIRA, the CIRA should recognize the property using fair values at the date of its acquisition. It may be helpful to consider the developer's cost, if it is known, in determining those fair values.

Impairment or Disposal of Long-Lived Assets

2.13 In conformity with Financial Accounting Standards Board (FASB) Statement No. 144,* *Accounting for the Impairment or Disposal of Long-Lived Assets*, common property that is recognized as a long-lived asset (asset group) should be tested for recoverability whenever events or changes in circumstances indicate that the carrying amount of the property may not be recoverable. An impairment loss should be recognized only if the carrying amount of a long-lived asset (asset group) is not recoverable and exceeds its fair value. The carrying amount of a long-lived asset (asset group) is not recoverable if it exceeds the sum

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* On December 15, 2003, the FASB issued an exposure draft of a proposed FASB Statement, *Accounting Change and Error Corrections*, that would replace APB Opinion No. 20, *Accounting Changes*, and FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements*. It would carryforward the guidance in APB Opinion No. 20 except that it would replace reporting the cumulative effect of a change in accounting principle with retrospective application of the change, unless it is impracticable to determine either the cumulative effect or the period-specific effects of the change. The guidance in FASB Statement No. 3 would be carried forward. In addition, the proposed Statement would supersede FASB Statement No. 73 and FASB Interpretation No. 20. It would amend ARB No. 43, APB Opinion Nos. 22, 25, 26, 28, 30, FASB Statement Nos. 5, 16, 19, 25, 52, 67, 71, 123, 142, 143, 144, and FASB Interpretation Nos. 1, 7, and 18 to replace references in those pronouncements to APB Opinion No. 20 and FASB Statement No. 3 with references to the proposed Statement. Readers should be alert to the issuance of the final Standard.

of the undiscounted cash flows expected to result from the use and eventual disposition of the asset (asset group). That assessment should be based on the carrying amount of the asset (asset group) at the date it is tested for recoverability.[1] The impairment loss should be measured as the amount by which the carrying amount of a long-lived asset (asset group) exceeds its fair value.

2.14 When a long-lived asset (asset group) is tested for recoverability, it also may be necessary to review depreciation estimates and methods as required by APB Opinion No. 20,[*] *Accounting Changes*, or the amortization period as required by FASB Statement No. 142, *Goodwill and Other Intangible Assets*.[2] Any revision to the remaining useful life of a long-lived asset resulting from that review also should be considered in developing estimates of future cash flows used to test the asset (asset group) for recoverability. However, any change in the accounting method for the asset resulting from that review should be made only after applying FASB Statement No. 144.

2.15 Estimates of future cash flows used to test the recoverability of a long-lived asset (asset group) should include only the future cash flows (cash inflows less associated cash outflows) that are directly associated with and that are expected to arise as a direct result of the use and eventual disposition of the asset (asset group). Those estimates should exclude interest charges that will be recognized as an expense when incurred.

2.16 FASB Statement No. 144 contains additional extensive requirements about the recognition and measurement of an impairment loss, long-lived assets to be disposed of by sale and other than by sale.

Disclosure

2.17 The following information about a CIRA's common property should be disclosed in the notes to its financial statements:

- The accounting policy for recognition and measurement of common property
- A description of common property recognized as assets in the CIRA's balance sheet
- A description of common property to which the CIRA has title, or other evidence of ownership, that is not recognized as assets in the CIRA's balance sheet
- The CIRA's responsibility to preserve and maintain the common property
- Terms and conditions of existing land or **recreation leases**
- Restrictions on the use or disposition of the common property

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[1] Paragraph 10 of FASB Statement No. 144 provides that for purposes of recognition and measurement of an impairment loss "a long-lived asset or assets shall be grouped with other assets and liabilities at the lowest level for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities." Paragraph 11 provides that in limited circumstances, "a long-lived asset . . . may not have identifiable cash flows that are largely independent of the cash flows of other assets and liabilities and of other asset groups. In those circumstances, the asset group for the long-lived asset shall include all assets and liabilities of the entity."

[*] See footnote * to paragraph 2.13.

[2] Paragraphs 10 and 31–33 of APB Opinion No. 20 address the accounting for changes in estimates; paragraphs 23 and 24 of APB Opinion No. 20 address the accounting for changes in the method of depreciation. Paragraph 11 of FASB Statement No. 142 addresses the determination of the useful life of an intangible asset.

2.18 FASB Statement No. 144 contains reporting and disclosure requirements concerning impairment losses and the disposal of long-lived assets.

Depreciation

2.19 Property and equipment recognized as assets by CIRAs should be depreciated based on their estimated useful lives. The following information should be disclosed:

- Depreciation expense for the period
- Balances of major classes of depreciable assets, by nature or function, at the reporting date
- Accumulated depreciation, either by major classes of depreciable assets or in total, at the reporting date
- A general description of the method or methods used in computing depreciation for major classes of depreciable assets

Expenditures for Major Repairs or Replacements and Acquisition of Assets

2.20 CIRAs that use fund accounting should charge expenditures for major repairs or replacements to the fund or funds established for major repairs or replacements. If an expenditure from the major repairs and replacement fund relates to common property recognized as an asset, the amount expended should be reported as a transfer to the operating fund (or property fund, if such a fund is established; chapter 4 of this guide provides guidance about the funds in which assets should be reported). Assets transferred to the CIRA by the developer and recognized in the balance sheet should be reported as additions to the operating fund balance (or property fund, if such a fund is established).

Chapter 3
Future Major Repairs and Replacements

3.01 One of a CIRA's primary duties are to maintain and preserve the common property. Because the costs of maintaining and preserving common property are shared by all owners, it is the CIRA's duty to decide how to fund the cost of future major repairs and replacements. While CIRAs often fund these costs through contributions over the life of the components, CIRAs also fund the costs by assessing owners when funds are needed, or by borrowing. If a CIRA chooses to fund the costs over extended time periods, it reports assessments in the fund for major repairs and replacements.[1]

3.02 CIRAs may be required to assess its members for future major repairs and replacements by statute, association documents, lenders' requirements, or a decision of the board of directors supported by unit owners. Inadequate funding for future major repairs and replacements may adversely affect the ability of owners to sell or refinance their units, because of the concerns of prospective buyers, or because of the difficulty of obtaining mortgage financing under programs of various federal and quasi-federal lending-related organizations. In addition, a lack of funding can directly affect the CIRA's property values since the funds may not be available to provide for the necessary major repairs and replacements.

3.03 Before developing a funding policy for major repairs and replacements of common property, the board of directors should review the governing documents, applicable state statutes as well as consider their fiduciary responsibility to adequately fund for these costs. The board has the following options, subject to such documents and statutes, in developing a policy:

a. Funding through periodic assessments over the estimated life of the common property

b. Funding through special assessments at the time a major repair or replacement of common property is needed

c. Borrowing

d. Although less common, seeking grants or other kinds of programs from governmental entities (e.g., energy retrofits, arbor plantings, etc.)

e. Although less common, seeking assistance from governmental agencies, e.g., if the association is geared to or established for low-moderate income homeowners, financial programs are sometimes available

f. A combination of these options

3.04 To implement a policy to accumulate funds for major repairs and replacements, a CIRA's board of directors often needs to educate owners about the benefits of accumulating such funds in advance through periodic assessments and to understand that the systematic accumulation of funds is—

a. A means of assuring that funds for major repairs and replacements will be available when needed.

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[1] The fund is commonly referred to as a *reserve fund* in the legal documents of CIRAs and in the industry. The term *reserves* is not used in this guide because different meanings are attached to it, and misinterpretations could result.

b. An equitable method of charging current rather than future owners with the cost of the current use of assets.

c. A means of preserving the market value of individual units or shares.

d. Required by the governing documents, statutes, mortgages, bonds, etc.

3.05 While this is not common, the documents of some CIRAs authorize their boards of directors to fund major repairs or replacements by levying special assessments when the money is needed. Often, the documents require that special assessments be approved by a vote of the unit owners. If a special assessment is not approved, the CIRA will not be able to fulfill its obligation to replace and repair the common property. In addition, because there may be uncertainties about the ability of some owners to pay large special assessments, the board may consider it preferable to fund in advance through periodic assessments. Above all, boards of directors need to be aware that the goal of whatever policies they set should be to enable them to meet their **fiduciary duties** to maintain and preserve the common property.

3.06 In developing a plan,[2] the age and condition of the components of the common property are considered. The possibility that new types of material and equipment may be available may also be considered. The preparer[3] calculates a suggested annual funding amount and, in doing so, may consider such factors as which components to include, estimated replacement costs, useful lives, inflation, and interest or other earnings rates. Annual contributions to the replacement fund may be based on studies, such as engineering studies (more commonly known as a "Reserve Study"), developed to determine the timing and costs for future major repairs and replacements. A study generally includes the following:[4, 5]

- Identification and analysis of each major component of common property
- Estimates of the remaining useful lives of the components
- Estimates of the costs of replacements or repairs
- A cash flow projection showing anticipated changes in expenditures and contributions over a time period generally ranging between 20 and 30 years
- The "Funding Goal" (also known as the funding mechanism or plan) which is generally one of the following:
  - — Component Full Funding which is a goal of attaining and maintaining the cumulative cash balance at or near 100 percent funded

[2] Although not used within this chapter, the term generally used within the industry for this Plan is called a "Reserve Study." The general requirements for a study of this type are presented within *The National Reserve Study Standards of the Community Associations Institute*, which is referenced in appendix D of this publication.

[3] The *Community Associations Institute* provides qualified Preparers with a *Reserve Professionals Designation* (R.S.) upon confirmation of both educational background as well as minimum experience levels in the preparation of "Reserve Studies." There is no requirement in this Guide that reserve preparers be engineers; they can be board members, accountants, contractors, managing agents, etc.

[4] National standards for "Reserve Studies" are also available from the Community Associations Institute. Their publication, *The National Reserve Study Standards of the Community Associations Institute*, indicates that "Reserve Studies" include: (1) a physical analysis and (2) a financial analysis. In addition, the study provides readers with, among other things, a description of the service levels offered as well as the types of funding plans available. (Contact information for CAI appears in appendix D of this publication.)

[5] A materiality threshold may need to be established.

- — Threshold Funding which is a goal of keeping the cash balance above a specified dollar or percent funded amount
- — Baseline Funding which is a goal of keeping the cash balance in the account above zero
- — Statutory Funding which is a goal of setting aside the specific minimum amount of Reserves required by local statutes

- The level of service used in the preparation of the Study

3.07 Replacement information may also be obtained from contractors, suppliers, technical specialists (e.g., with the widespread use of IT, cable, fiber optics, etc, typical contractors, etc. may not be sufficient), "Reserve Study" specialists or from using tables in technical manuals on useful lives of various components. It is useful for a CIRA board to reevaluate its funding level each year based upon changes to the common elements as well as changes to replacement costs and component conditions. The specific components of common property that a CIRA may decide to include in its funding plan depend on the kind of project, its construction, and the CIRA's applicable governing documents and state statutes. Such components are generally limited to those with a useful life of 30 to 40 years[6] or less from the time of the study preparation depending on the philosophy of the individual performing the "Reserve Study." The components may include roofing, electrical systems, plumbing, Information Technology equipment, floor coverings, seawalls, air conditioning systems, heating and hot water equipment, roads, recreational facilities, and furniture and equipment owned or maintained by the CIRA. Components for which there are maintenance contracts may not be included if the contracts provide for maintenance and replacement of the components. CIRAs generally also often include within their overall budget a deferred maintenance account for those components requiring periodic maintenance which does not occur annually.[7] Typically, the deferred maintenance account would include such components as painting, staining, and caulking.

Reporting Considerations

3.08 CIRAs that assess owners annually for portions of future major repairs and replacements should report those assessed amounts separately from amounts assessed for normal operations. If a CIRA uses fund reporting, amounts assessed for future major repairs and replacements should be reported in the major repair and replacement fund separately from transactions in the operating fund. Transfers between funds that are not part of the current-period operating revenues should be presented only in a statement of changes in fund balances or in a statement of changes in members' equity, if a nonfund reporting approach is used. (See paragraphs 4.27 and 4.33 of this guide for recommended disclosures.)

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[6] Please note that some state statutes may not have a maximum age requirement or it may be different. Auditors should refer to those for further guidance.

[7] A comprehensive description of "Reserve Studies" can be found in the publication title *A Complete Guide to Reserve Funding and Reserve Investment Strategies* published by the Community Associations Institute, which is referenced in appendix D of this publication.

Chapter 4

Financial Statement Presentation

General Method of Presentation

4.01 As discussed in chapter 1 of this guide, CIRAs conduct and report on two primary kinds of activities: (*a*) the CIRA's normal maintenance and service operations, such as gardening, management, snow removal, minor repairs, and janitorial services, and (*b*) the CIRA's long-term major repair and replacement requirements, such as roof replacements, street resurfacing, and painting. CIRAs usually assess their members for both purposes and generally should report such assessments separately. This guide recommends fund reporting, which is commonly used by not-for-profit organizations, because the AICPA Task Force on Accounting for Common Interest Realty Associations believes that it is the most informative method of presenting these separate activities.[1] Some CIRAs may also conduct commercial operations or separate business activities, such as rental operations, in addition to their primary activities. Such activities may be reported on as one or more additional funds. Total amounts of all fund groups should be reported for each financial statement presented.

4.02 Nonfund reporting is an alternative to fund reporting. The task force, however, believes that fund reporting is more informative to users, because financial statements using nonfund reporting often do not disclose whether assessments have been used for purposes other than those for which they were designated. For example, if nonfund reporting is used, a user of financial statements may be unable to determine whether assessments for future major repairs and replacements have been used in current operations.[2] A CIRA may not need to use fund reporting if it does not assess for future major repairs and replacements.

Method of Accounting

4.03 Generally accepted accounting principles (GAAP) requires the use of the accrual basis of accounting. Financial statements presented on an accrual basis are particularly useful for CIRAs, which assess members based on annual budgets, because they include information about amounts payable and assessments receivable from members and thus enable users to compare the results of operations to budgeted amounts.

4.04 If a CIRA prefers to present its financial statements on a cash basis, and the amounts differ materially from those in statements presented on an

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[1] The discussion of fund reporting does not apply to the financial statements of cooperative housing corporations. However, a presentation using fund reporting may be more informative to users of the financial statements of cooperative housing corporations if a separate fund is maintained for future major repairs and replacements. Exhibits A-1 to A-4 of appendix A illustrate the fund reporting approach.

[2] Because this guide primarily addresses the fund reporting approach, readers should substitute the term *members' equity* for the term *fund balance* if financial statements using nonfund reporting are presented. Furthermore, the fund for major repairs and replacements would be presented as an appropriation of retained earnings in such financial statements. Exhibit A-12 of appendix A illustrates that appropriation.

accrual basis, the financial statements are not in conformity with GAAP and are considered to be prepared on another comprehensive basis of accounting.[3]

Financial Statements

4.05 Full presentations of financial statements for CIRAs presented in conformity with GAAP should include the following:

- A balance sheet
- A statement of revenues and expenses
- A statement of changes in fund balances[4]
- A statement of cash flows
- Notes to financial statements

Balance Sheet

4.06 Information about the operating fund should present assets, liabilities, and the fund balance specifically associated with the CIRA's normal maintenance and service activities. For example, the operating fund should include information about cash, assessments receivable, prepaid expenses, and trade payables. Property and equipment, if reported as assets, are generally reported in the operating fund. If the amount of property and equipment held by a CIRA is significant, the CIRA may account for it in a separate fund.

4.07 The presentation of information about the fund for major repairs and replacements (referred to in the illustrative financial statements in appendix A as the *replacement fund*) should include information about assets, liabilities, and the fund balance specifically associated with the CIRA's long-term major repair and replacement activities. The fund includes all assets that are held, for example, for the future replacement of roofs, roads, and furniture (some CIRAs may have a deferred maintenance fund which is utilized for painting or refinishing of building exteriors as discussed in paragraph 3.07). Those assets usually consist of cash, marketable securities, and short-term investments. Liabilities in that fund generally are for work done on contracts for major repairs and replacements.

4.08 CIRAs may have interfund receivables and payables resulting from either of the following:

a. Obligations of one fund are paid for with the assets of another fund.

b. Amounts assessed for the activities of one fund are collected, but not transferred, by another fund.

Corresponding interfund receivables and payables should be presented to highlight the transactions resulting in those balances and to provide information about amounts assessed and collected that were not used in accordance with the budget.

4.09 Illustrations of transactions resulting in obligations of one fund being paid for with the assets of another fund include the following:

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[3] Statement on Auditing Standards (SAS) No. 62, *Special Reports*, provides guidance on auditors' reports on financial statements prepared on a comprehensive basis of accounting other than generally accepted accounting principles.

[4] A statement of changes in members' equity if nonfund reporting is used.

- Roof replacement, which is an expenditure of the replacement fund, paid for by the operating fund
- Insurance premiums, which are an expenditure of the operating fund, paid for by the replacement fund
- Interest income, which may be earned by one fund but then allocated via the budget to the operating fund

The following is an illustration of a transaction in which amounts assessed for the activities of one fund are collected, but not transferred, by another fund:

> A CIRA's budget includes an annual assessment of $80,000 for future major repairs and replacements, which is reported as revenue of the replacement fund. However, due to an unexpected increase in operating costs, the CIRA's board of directors transferred only $50,000 of the $80,000 to the replacement fund. Under these circumstances, the CIRA's financial statements should reflect $30,000 as a receivable from the operating fund and as a payable to the replacement fund. If the operating fund is unable to or does not intend to repay that amount or a portion of it to the replacement fund, a permanent transfer between the funds should be reported for the portion that will not be repaid. (Exhibits A-2 and A-3 and Note 4 of exhibit A-5 of appendix A illustrate that presentation.)

4.10 CIRAs can generally present unclassified balance sheets. CIRAs having significant commercial operations, however, should consider presenting classified balance sheets.

4.11 The difference between the assets and the liabilities of each fund group should be presented as the fund balance of the respective fund group. Changes in those balances should be presented in a statement of changes in fund balances. Additional analysis of fund balances, although not required, may be presented in the notes to the financial statements or schedules (Exhibit A-7 of appendix A provides an illustration).

Deferred Revenue

4.12 Deferred revenue may include items such as special assessments designated for specific costs that have not yet been incurred. Such amounts should be reported as revenues when the corresponding liabilities and expenses are reported.

Statement of Revenues and Expenses

4.13 The statement of revenues and expenses should present information about all assessments, other revenues, and expenses. All CIRA activities, except for replacement fund activities, should be presented in the operating fund in the statement of revenues and expenses unless the CIRA has other funds such as deferred maintenance fund or capital improvement fund, etc. Depreciation should be reported as an expense of the fund in which the asset is reported. Periodic assessments for funding future major repairs and replacements should be reported in the replacement fund in statements of revenues and expenses in the periods in which they are assessed, regardless of whether they have been collected or expended.

4.14 Information about revenues should include amounts for regular and special assessments from members and amounts for such items as assessments charged to the developer, developer contributions and subsidies, lawsuit settlements, interest income, laundry and vending machine income, or special-use charges from members and nonmembers. Individual categories of revenues may be combined if not material. Interest earned should be presented as revenue of the appropriate fund unless the CIRA has a specific policy to treat it otherwise.

4.15 Special assessments should be reported as revenue, unless they are deferred in accordance with the guidance in paragraph 4.12 of this guide.

4.16 Because income taxes are generally not related to the excess of revenues over expenses as in commercial entities, they may be presented in the same manner as other operating expenses. CIRAs should follow the guidance in FASB Statement No. 109, *Accounting for Income Taxes.*

Statement of Changes in Fund Balances

4.17 The financial statements should include a statement of changes in fund balances, which reconciles beginning and ending fund balances with results of operations for the period. The statement may be presented separately or may be combined with the statement of revenues and expenses. Permanent transfers between funds should be presented as interfund transfers in the statement of changes in fund balances, not as revenues (see exhibit A-2 of appendix A). For example, if the board of directors transfers excess operating funds to the replacement fund at the end of an operating year, the interfund transfer should be shown in the statement of changes in fund balances, not by reclassifying revenues.

Statement of Cash Flows

4.18 A CIRA should present a statement of cash flows when it presents a balance sheet and statement of revenues and expenses. The statement may be presented using the direct method or the indirect method. The direct method begins with the total revenue that provided cash during the period and deducts the costs and expenses that required the payment of cash during the period. (Exhibit A-3 of appendix A illustrates the direct method using a fund approach. Exhibit A-11 of appendix A illustrates the direct method using a nonfund approach.) The indirect method begins with an excess of revenues over expenses, or of expenses over revenues, and is adjusted for items not requiring cash. (Exhibit A-4 of appendix A illustrates the indirect method.)

Comparative Financial Statements

4.19 GAAP does not require comparative financial statements. Nonetheless, Accounting Research Bulletin (ARB) No. 43,[*] chapter 2A, *Comparative Financial Statements,* states that "the presentation of comparative financial statements in annual and other reports enhances the usefulness of such reports and brings out more clearly the nature and trends of current changes affecting the enterprise." Because of space limitations and to avoid cumbersome or confusing formats, some CIRAs present total-of-all-funds information for the prior period rather than information by individual funds. A continuing auditor need not report on the prior period financial statements if only summarized comparative information of the prior period is presented. Nonetheless,

[*] On December 15, 2003, the FASB issued an exposure draft of a proposed FASB Statement, *Accounting Change and Error Corrections*, that would replace APB Opinion No. 20, *Accounting Changes*, and FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements*. It would carryforward the guidance in APB Opinion No. 20 except that it would replace reporting the cumulative effect of a change in accounting principle with retrospective application of the change, unless it is impracticable to determine either the cumulative effect or the period-specific effects of the change. The guidance in FASB Statement No. 3 would be carried forward. In addition, the proposed Statement would supersede FASB Statement No. 73 and FASB Interpretation No. 20. It would amend ARB No. 43, APB Opinion Nos. 22, 25, 26, 28, 30, FASB Statement Nos. 5, 16, 19, 25, 52, 67, 71, 123, 142, 143, 144, and FASB Interpretation Nos. 1, 7, and 18 to replace references in those pronouncements to APB Opinion No. 20 and FASB Statement No. 3 with references to the proposed Statement. Readers should be alert to the issuance of the final Standard.

in some circumstances the client may request the auditor to express an opinion on the prior period as well as the current period. In those circumstances, the auditor should consider whether the information included for the prior period contains sufficient detail to constitute a fair presentation in conformity with GAAP. (Exhibits A-1, A-2, and A-4 of appendix A illustrate comparative financial statements using a multicolumn format for the current period and a single total-of-all-funds column for the prior period.)

Accompanying Information

4.20 A CIRA's records usually contain more details than are necessary to present financial statements in conformity with GAAP. Consequently, the financial statements may include accompanying information that is not required but may be meaningful to users. Accompanying schedules that compare details of the CIRA's expenses with budgeted amounts provide users with additional information that is helpful in evaluating the performance of the CIRA's board and management team. For example, although CIRAs budget and account separately for costs of insurance for property, liability, and directors' liability insurance, expenses may be presented as a single line item in the financial statements. An accompanying schedule presenting insurance expenses by classification with comparative budget information provides more detailed information. Further schedules comparing budgeted amounts with actual expenses for all accounts and reconciling them to the financial statements may be helpful to users.

4.21 A CIRA's financial statements may be accompanied by a schedule analyzing the CIRA's program for major repairs and replacements. That schedule may present beginning balances, additions, expenditures, and ending balances of funds for future major repairs and replacements by individual categories of common property. (Exhibit A-7 of appendix A illustrates that.)

Note Disclosures

4.22 In addition to disclosures required by GAAP for other entities, the notes to a CIRA's financial statements should also include disclosures about—

- The CIRA's legal form (corporation or association) and that of the entity for which it provides services (for example, condominium, HOA, cooperative), areas it controls, and the number of units. (In place of the number of units, cooperative housing corporations may disclose the number of shares and time-share associations may disclose the number of weeks.)
- Common property, as required by paragraph 2.17.
- Services (such as maintenance) and subsidies provided by the developer.
- The CIRA's income tax filing status and its liability for income taxes.
- The proposed use for funds collected in special assessments.
- The number of units (shares for cooperative housing corporations and weeks for time-share associations) owned by the developer.
- Credits from taxing authorities that will be phased out in future reporting periods.
- Assessments that were used for purposes other than those for which they were designated.
- Funding for future major repairs and replacements, as required by paragraph 4.27 of this guide.

4.23 In conformity with SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, CIRAs should include in their financial statements disclosures about the nature of their operations and about the use of estimates in the preparation of financial statements. In addition, if specified disclosure criteria are met, CIRAs should include in their financial statements disclosures about certain significant estimates and about current vulnerability due to certain concentrations, such as cash in the same bank which exceeds FDIC limits.

Related Parties

4.24 Some individual board members, officers, or developers may provide CIRAs with insurance, maintenance, or management services. Such services may require disclosure in conformity with FASB Statement No. 57, *Related Party Disclosures*.

Significant Sources of Revenue

4.25 The developer or other parties may provide the CIRA with some of its revenues. If 10 percent or more of a CIRA's revenues are derived from any one source, that fact and the amount of revenue from each source should be disclosed.

Common Property

4.26 Paragraph 2.17 of this guide requires CIRAs to disclose in the notes to their financial statements certain information concerning common property.

The following *Note X* illustrates disclosure in the notes to the financial statements of a CIRA, ABC Homeowners' Association, Inc., given the following facts:

Property

The CIRA holds title to common property consisting of the following:

(a) A golf course and a restaurant, on 200 and two acres of land, respectively. This property is used to generate significant cash flows from members on the basis of usage and from nonmembers.

(b) Other common real property consisting of sidewalks, roads, and greenbelts on 20 acres of land; a clubhouse on two acres of land; and five acres of partially developed land that is the future site of a swimming pool expected to be built in 20X5. This common property—

(1) Is *not* used to generate significant cash flows from members on the basis of usage or from nonmembers.

(2) Cannot be sold and the proceeds cannot be retained by the CIRA.

(c) Common personal property consisting of equipment.

The disposition and use of some of that property is restricted by the CIRA's governing documents.

Accounting Policy

The CIRA's policy for recognizing common property as assets in its balance sheet is to recognize (*a*) common personal property and (*b*) real property to which it has title and that it can dispose of for cash while retaining the proceeds or that is used to generate significant cash flows from members on the basis of usage or from nonmembers. Therefore, the CIRA recognizes as assets the golf course (design fees and land improvements), restaurant, land on which the golf course and restaurant were built, and the equipment.

Note X. Common Property

Major classifications of property and equipment and their respective lives are summarized below:

	December 31		Depreciable Life
	20X2	*20X1*	
Land related to the golf course and the restaurant	$3,030,000	$3,030,000	
Golf course	1,000,000	1,000,000	
Restaurant	160,000	160,000	25 years
Equipment	25,000	20,000	5 years
	4,215,000	4,210,000	
Accumulated depreciation	21,800	10,400	
Net property and equipment	$4,193,200	$4,199,600	

Depreciation expense is computed on the straight-line basis for financial reporting purposes and was $11,400 and $10,400 for the years ended December 31, 20X2 and 20X1, respectively.

On December 31, 20X2 and 20X1, the Association held title to common real property consisting of a golf course on 200 acres of land, sidewalks, roads, and greenbelts on 20 acres of land, a clubhouse on two acres of land, a restaurant on two acres of land, and five acres of partially developed land that is the future site of a swimming pool expected to be built in 20X5. The Association is responsible for preserving and maintaining the properties and may dispose of them only with the unanimous consent of the unit owners, with all proceeds from the disposition remitted to the unit owners. In conformity with industry practice, the Association recognizes the following common property as assets:

(a) Common personal property

(b) Common real property to which it has title and that it can dispose of for cash while retaining the proceeds or that is used to generate significant cash flows from members on the basis of usage or from nonmembers

Accordingly, the Association recognized the acquisition of the restaurant, the golf course, and the land on which they are built as assets at their fair values on December 31, 20X0, the date on which they were transferred from the developer. Other common property, primarily consisting of sidewalks, roadways, and greenbelts; a clubhouse on two acres of land; and five acres of partially developed land that is the future site of a swimming pool expected to be built in 20X5 is not recognized assets.

Future Major Repairs and Replacements

4.27 A CIRA should disclose information in its financial statements about its funding for future major repairs and replacements. Disclosures about such funding should include the following:

- Requirements, if any, in statutes or the CIRA's documents (or mortgage or governmental bodies funding requirements, e.g., FHA often has such requirements) to accumulate funds for future major repairs and replacements and the CIRA's compliance or lack of compliance with them

- A description of the CIRA's funding policy, if any, and compliance with that policy
- A statement that funds, if any, are being accumulated based on estimated future (or current) costs, that actual expenditures may vary from these estimates, and that the variations may be material
- Amounts assessed for major repairs and replacements in the current period, if any
- A statement indicating whether a study was conducted to estimate the remaining useful lives of common property components and the costs of future major repairs and replacements

CIRAs that fund future major repairs and replacements by special assessments or borrowings when needs occur should disclose that information.

4.28 If the disclosure about a CIRA's funding for major repairs and replacements required by paragraph 4.27 of this guide is absent or inadequate, the auditor should consider modifying his or her report as discussed in SAS No. 58, *Reports on Audited Financial Statements.*

4.29 Note 4 of exhibit A-5 in appendix A, alternative B, illustrates disclosure about a study that was conducted by a consultant to estimate expenditures for major repairs and replacements and the recommendations of which were adopted by the board of directors. The following illustrate disclosures that may be used in other circumstances:

- The CIRA elects to only partially adopt the study's recommendations.

  Disclosure

  The disclosure would be the same as that in Note 4 of exhibit A-5 of appendix A, alternative B, but the next-to-the-last paragraph and the paragraph preceding it would be replaced by the following:

  The board of directors has decided to fund in 20X3 only 50 percent of the amount recommended by the study. Accordingly, $149,000 has been included in the 20X3 budget. For that reason, and because actual expenditures may vary from estimated future expenditures and the variations may be material, amounts accumulated in the replacement fund may not be adequate to meet all future needs for major repairs and replacements. If additional funds are needed, the Association has the right, subject to membership approval, to increase regular assessments, pass special assessments, or delay major repairs and replacements until funds are available.

- The board of directors has conducted a study to estimate future expenditures for major repairs and replacements. Unit owners have decided not to fund those needs currently.

  Disclosure

  The disclosure would be the same as in Note 4 of exhibit A-5 of appendix A, alternative A, but the next-to-the-last paragraph and the paragraph preceding it would be replaced by the following:

  The funding program was included in the proposed budget for 20X3, which was presented to unit owners at a general meeting on December 1, 20X2. At that meeting, a majority of owners voted not to include funding for major repairs and replacements in the annual budget for 20X3. For that reason, and because actual expenditures may vary from estimated future expenditures and the variations may be material, amounts accumulated in the replacement fund may not be adequate to meet all future needs for major repairs and replacements. When funds are needed for those purposes, the Association has the right, subject to membership approval, to increase the regular assessments, pass special assessments, or delay major repairs and replacements until funds are available.

4.30 The following illustrates disclosure in the financial statements of an association that has not conducted a study to estimate the remaining useful lives and the costs of future major repairs and replacements of the common property that will be required in the future.

Disclosure

Note 4 of exhibit A-5 of appendix A might be stated as follows:

The Association has not conducted a study to determine the remaining useful lives of the components of common property and current estimates of costs of major repairs and replacements that may be required in the future. The board has also not developed a plan to fund those needs. When replacement funds are needed to meet future needs for major repairs and replacements, the Association has the right to increase regular assessments, pass special assessments, or delay major repairs and replacements until funds are available. The effect on future assessments has not been determined at this time.

4.31 Although this is not a requirement of the Guide, CIRAs may also consider disclosing the type of funding plan goal that was used in the "Reserve Study" so the readers of the financial statements are able to understand the implications of the method chosen to make informed and educated decisions. The three types of non-statutory funding plans are full funding, threshold funding and baseline funding. Depending on the method used, there could be significant fluctuations in assessment levels. When the threshold method is used, the CIRA may also consider disclosing the threshold level dollar amount that is being utilized. If averaging techniques are used, CIRAs may consider disclosing that fact as well.

4.32 Another disclosure that also is not a requirement of the Guide that may be considered by the CIRA is the disclosure of the level of service used to perform the "Reserve Study." The National Reserve Study Standards include three levels of service, which are (1) Full, (2) Update, with site-visit and on-site review, and (3) Update, with no site-visit or off-site review. Disclosure will let the reader know what level of service was performed, as they vary greatly in detail.

Required Supplementary Information

4.33 CIRAs should disclose the following as unaudited supplementary information:

- Estimates of current or future costs of future major repairs and replacements of all existing components, such as roofs, including estimated amounts required, methods used to determine the costs, the basis for calculations (including assumptions, if any, about interest and inflation rates), sources used, and the dates of studies, made for this purpose, if any.[5]

- A presentation of components to be repaired and replaced, estimates of the remaining useful lives of those components, estimates of current or future replacement costs, and amounts of funds accumulated for each to the extent designated by the board.

4.34 Exhibit A-8 of appendix A, alternative A, illustrates unaudited supplementary disclosure based on a study conducted by the board of directors about the estimates of current costs of major repairs and replacements. Alternative B illustrates unaudited supplementary disclosure based on a study conducted by a consulting firm about the estimates of future costs of major repairs and replacements. Paragraph 7.70 of this guide illustrates an additional explanatory paragraph that would be added to the auditor's report if that information is not presented. Paragraph 7.71 through 7.73 of this guide illustrates additional explanatory paragraphs that would be added to the auditor's report in the event any of the following situations occurred:

- That information materially departs from information required in paragraph 4.33 of this guide.
- The procedures prescribed in paragraph 7.56 of this guide were not completed.
- The auditor has unresolved doubts about the adherence of the information to the information required in paragraph 4.33 of this guide.

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[5] There is no requirement for CIRAs to obtain studies prepared by professional engineers. The estimates may be made by the board of directors or estimates obtained from licensed contractors, as discussed in paragraph 3.07 of this Guide.

Chapter 5
Budgets

5.01 Budget information is not a required part of the basic financial statements. If presented, that information should be identified as supplementary and clearly marked as not covered by the independent auditor's report.

5.02 The legal documents creating most CIRAs require that assessments be based on budgets. The budgets of CIRAs are the monetary expression of their goals and objectives and emphasize the stewardship responsibility of their boards of directors. According to FASB Statement of Financial Accounting Concepts No. 4, *Objectives of Financial Reporting by Non-Business Organizations,* budgets are used to allocate and control the use of resources. Budgets are also used to obtain resources. For example, budgets are pivotal in establishing levels of dues, taxes, and fees to be imposed.

5.03 The boards of directors of CIRAs use the budgeting process to determine the required assessments from owners to fund current services and to provide for future major repairs and replacements and deferred maintenance needs. Unit owners use budgets to evaluate the performance of boards of directors. Other users, such as creditors, realtors, and potential buyers, may use budgets to compare CIRAs with other CIRAs and to monitor the ability of CIRAs to provide acceptable levels of service.

The Budget Process

5.04 A CIRA's board of directors or governing body establishes the budget. The budget's effectiveness depends on the board's willingness to take prompt corrective action on unfavorable variations from the budget. In developing the budget, the board establishes standards and levels of service for the CIRA, which may involve using outside management firms, polling the CIRA's owners through surveys or public hearings, and relying on the reports and plans of various board committees. The budget process includes the following:

- A review of the CIRA's documents, board minutes, and statutory requirements
- A comparison of historical financial statements with related budgets
- A review of existing contracts
- The development of specifications to solicit bids from outside contractors
- Consultation with public utilities to estimate future rates
- Line-by-line analysis of current expenses and consideration of proposed changes and alternatives
- Integration of special programs that may overlap the current budget cycle
- Identification of seasonal and monthly variations
- Forecasts of current period operating results and monthly cash flow forecasts

Other major factors that may be considered in the budget process are the level of deterioration of major common property components, the need for a provision for contingencies, and evaluation of outside contractors responding to bid requests. Ongoing budget reviews help refine estimates and spread the budget-preparation workload throughout the year.

Format and Components of a Budget

5.05 It is useful to present budgets in a format that is consistent with the financial statements of CIRAs and comparable with prior periods. Budget presentations vary widely and many include descriptions of various line items and formulas to compute certain expenses, individual fees, or assessment calculations. Although such additional information is useful, its inclusion in the basic budget documents may confuse readers.

Operations

5.06 A budget's provision for operations includes amounts for the CIRA's routine operating expenses, such as management fees, utilities, staff payroll, insurance, rubbish removal, routine maintenance of common property, and certain minor additions to common property.

Future Major Repairs and Replacements

5.07 A budget's provision for future major repairs and replacements includes amounts for repairs or replacements of major components of common property, such as roofs, parking areas, elevators, and swimming pools, and for painting. Budgeting for future major repairs and replacements involves establishing amounts of assessments needed to fund anticipated expenditures as well as amounts necessary to fund major repairs or replacements required during the current period. The noncurrent element of this portion of the budget would ideally be part of a plan spanning the present and future periods.

Other Expenditures

5.08 Provisions for other expenditures include amounts for significant nonrecurring expenditures or income-tax-related items that cannot be classified as operating or major repair and replacement activities, for example, capital additions, nonrecurring major expenditures such as legal fees or construction-related items, and replacements for which there are no other provisions. Such expenditures may be funded by CIRAs through special assessments or borrowings.

Presentation of Budget Information in Financial Statements

5.09 CIRAs that present interim financial statements commonly include comparisons with the budget to determine areas that require management's action. Budget compliance is particularly significant for CIRAs, because users of their financial statements compare budgeted to actual amounts to evaluate the board's fiscal responsibility. Despite the helpfulness of such comparisons, budget information is not always presented in the annual reports of CIRAs, although such reports often may be the only financial information about the operations of CIRAs available to owners and other users.

Chapter 6

Income Tax Considerations[1]

6.01 All CIRAs are required to file federal, and possibly state and local, income tax returns, and they may be required to pay income taxes. The tax life of a CIRA begins on the earlier of the date of incorporation or the date it begins business operations as a corporation or as an unincorporated association taxable as a corporation. A review of a CIRA's legal documents usually reveals that date.

Methods of Filing

6.02 As a general rule, CIRAs annually file income tax returns using Federal Form 1120 (US Corporation Income Tax Return). If the association qualifies as a homeowners association under IRC section 528, it may annually elect to file Federal Form 1120-H (US Income Tax Return for Homeowners Associations). CIRAs that are exempt under IRC section 501 must file Federal Form 990 (Return of Organizations Exempt from Income Tax). The filing method selected depends on the CIRA's circumstances and its available income-tax-planning alternatives.

Federal Form 1120

6.03 CIRAs filing Federal Form 1120 are taxed, in general, as regular corporations. However, Internal Revenue Code section 277 requires nonexempt membership organizations other than cooperative housing corporations that file under subchapter T* of the Code to separate income and expenses into membership and nonmembership activities. Under IRC section 277, certain CIRAs are generally taxed on both net membership and net nonmembership income. Revenue Ruling 70-604 (see par. 6.10) provides an election, however, such that net membership income can be excluded from taxation. If the election is made, the excess of membership assessments over expenditures, if actually or constructively refunded to members or applied to the following year's assessments, is not taxable income. A CIRA's taxable income on form 1120 is subject to income taxes at the graduated corporate rates.

6.04 The following specific issues may affect a CIRA (other than a housing cooperative) that elects to file as a regular corporation on Form 1120. Section

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[1] This chapter should not be considered to be a detailed explanation of the Internal Revenue Code and rulings issued by the IRS as they apply to CIRAs. Its purpose is to inform auditors about several areas of federal income taxation they need to know to audit the tax provision and to be aware of noncompliance with tax laws.

* In late 1998, an important development regarding the federal taxation of cooperatives occurred. At that time, although the statutory language under section 277 did not explicitly exclude cooperative housing corporations from its language, the IRS informally indicated that it would no longer subject cooperative housing corporations to IRC section 277. The IRS indicated that it will honor both original and amended returns filed pursuant to subchapter T. Filing under subchapter T can be advantageous because it allows qualifying cooperatives more leniency with regard to taxation of interest and other income than filing under IRC section 277. Practitioners can refer to applicable court cases and the IRC for more specific information regarding the tax filings of cooperative housing corporations.

277(a) of the IRC provides that a nonexempt membership organization operated primarily to furnish services or goods to members may deduct expenses attributable to providing its members with services, insurance, goods, or other items of value only to the extent of income derived during the year from members or transactions with members. The excess of deductions over such income in any taxable year is available as an unlimited carryover and is added to deductions for such amounts paid or incurred in succeeding taxable years for services, insurance, goods, or other items of value provided to members. Deductions covered by sections 243, 244, and 245, which relate to dividends received by corporations, are not allowed for organizations to which section 277 applies for the taxable year.

Federal Form 1120-H

6.05 CIRAs that qualify as homeowners associations may elect to be taxed under IRC section 528 utilizing Form 1120-H. Qualifying CIRAs are taxed at a 30 percent flat rate (32 percent for timeshare associations)* on income in excess of $100, generally from sources other than membership dues, fees, and assessments. Net operating loss and dividends received deductions are not permitted.

The following benefits are often associated with an election to file under section 528:

- Income from member assessments is generally exempt from tax.
- An election to file under section 528 does not jeopardize the tax treatment applicable to individual unit owners.
- CIRAs filing under section 528 need not segregate amounts collected in advance for replacements and deferred maintenance, because members' assessments are tax exempt. (Contributions to capital retain their character, regardless of the election.)

Filing under section 528 involves the following disadvantages:

- A CIRA's taxable income in excess of $100 is taxed at a flat 30 percent rate, preventing its use of the benefits of the lower income tax brackets associated with regular corporate entities.
- CIRAs filing under section 528 may not use net operating loss deductions. An association may not revoke its section 528 elections made in previous years to obtain the tax benefits of a net operating loss carryback.[2]
- A CIRA filing under section 528 is not entitled to use the alternative tax rate imposed by section 1201(a).

Federal Form 990

6.06 CIRAs that file Federal Form 990 do so because they are exempt under IRC sections 501(c)(4), 501(c)(7), or 501(c)(12). Few CIRAs meet the eligibility requirements of section 501(c). The exemptions of CIRAs should be reviewed annually to make sure that all tests have been met to maintain eligibility for the exempt status. If a section 501(c) exemption no longer applies, the CIRA is required to file Form 1120 or 1120-H.

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* The Taxpayer Relief Act of 1997 (PL 105-34) extended IRC section 528 taxation rules to timeshare associations.

[2] The IRS has ruled that a CIRA may revoke its section 528 election if a professional tax adviser had provided inadequate advice on the benefits of the election.

Specific Areas for Review

Basis for Contributed Property

6.07 A significant question to be considered is whether a CIRA is entitled to receive an adjusted basis in property contributed to it by its developer. If property is contributed to a corporate entity under section 351 on formation of the CIRA, the basis of the property in the corporation's hands is determined under section 362.

6.08 Section 362 also applies to property acquired by a corporation as paid-in surplus or as a capital contribution under section 118 of the IRC. A CIRA may receive a basis in property that is at least equal to the contributor's basis in the property before the contribution plus the amount of gain, if any, recognized by the contributor on the exchange.

Developer Settlements

6.09 Private Letter Ruling 8004028, issued by the IRS in September 1980, indicates that settlement proceeds received by a CIRA as a result of a class action suit against a developer are not includable in a CIRA's gross income. Revenue Ruling 81-152 states that, providing certain conditions are met, settlements represent recoveries of capital that reduce the bases of individual unit owners.

Recognition of Receipts as Current Revenue Versus Capital Contributions

6.10 The accountant should consider the following revenue rulings:

- *70-604*. Assessments by a *condominium management corporation* that are in excess of the amounts used for the operation of the condominium property, and that are returned to the owner-stockholders, or applied to the following year's assessments, are not taxable income to the operation.
- *74-563*. A special assessment collected by an *incorporated home-owner's association* from its members and set aside in a special bank account for paving a community parking area constitutes a contribution to the capital of the nonexempt association under section 118 of the code.
- *75-370*. Special assessments collected by a *nonexempt condominium management corporation* from its *unit owner-stockholders* and accumulated in a separate bank account for replacement of the roof and elevators in the condominium are not includable in the corporation's gross income. Revenue Ruling 75-370 does not apply to funds collected by a condominium for services such as maintenance of common elements, including painting, repairs, gardening, janitorial services, and so forth.
- *75-371*. Special assessments for the replacement of personal property, collected by a *nonexempt condominium management corporation* from its unit owner-stockholders and accumulated in a separate bank account, are contributions to capital. Revenue Ruling 75-371 indicates that contingency reserves are includable in the entity's gross income.

Chapter 7
Audit Considerations

7.01 Generally accepted auditing standards apply to audits of the financial statements of CIRAs in the same manner as they do to audits of other financial statements for other businesses. This chapter provides guidance on audit procedures that apply specifically to audits of CIRAs in addition to some general auditing matters. These procedures should be considered in addition to the audit procedures customarily performed in audits of financial statements.

Establishing an Understanding of the Engagement

7.02 Pursuant to SAS No. 83, *Establishing an Understanding With the Client*, as amended by SAS No. 89, *Audit Adjustments* (AICPA, *Professional Standards,* vol. 1, AU sec. 310), the auditor should establish and document, preferably through a written communication with the client, an understanding of the services to be performed and the terms and objectives of the engagements. It should include management's (such as professional management or managing agent) responsibilities and that of the board of directors of the community association, the auditor's responsibilities, and limitations of the engagement. This understanding with the client association should include management's responsibility for determining the appropriate disposition of financial statement misstatements aggregated by the auditor. (A letter establishing such an understanding with respect to audit services is illustrated in exhibit B-1 of appendix B.) It is important to make clear that two entities may be involved in the audit: the association (through its board of directors and possible staff) and a community association management (CAM) company.

Independence

7.03 A member of the AICPA who is engaged to audit a CIRA in accordance with generally accepted auditing standards (GAAS) must be independent. In making a judgment about whether he or she is independent, the member should be guided by Rule 101, *Independence*, of the AICPA Code of Professional Conduct, its interpretations, and the Ethics Rulings under it.[1] A member may also seek advice from the AICPA's Professional Ethics Division on the application of interpretations and rulings to specific situations. In assessing their independence, auditors should also consider the guidance set forth under Ethics Ruling No. 31 under Rule 101.

A CIRA's Documents

7.04 The legal and other documents that create a CIRA generally describe the rights and responsibilities of the board of directors, including responsibilities to unit owners, and its obligation to maintain the property and provide for

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[1] "Revised Ruling No. 31 under Rule 101, *Performance of Services for Common Interest Realty Associations Including Cooperatives, Condominium Associations, Planned Unit Developments, Homeowners Associations, and Timeshare Developments*" states that an auditor's independence would not be considered to be impaired if certain conditions are met with respect to an engagement to perform services for a CIRA if the member or member's firm is associated with, or is a member of, the CIRA as the result of ownership or lease of real estate.

future major repairs and replacements. In the planning phase of the audit, the auditor should review relevant documents, including bylaws, if any; the declarations for a condominium or HOA; or the corporate charter for a cooperative housing corporation.

7.05 CIRAs may also be governed by state statutes or local ordinances, federal regulations, contracts, mortgage and finance agreements and other similar legally binding arrangements. SAS No. 54, *Illegal Acts by Clients,* requires auditors to consider laws and regulations that are generally recognized by auditors to have a direct and material effect on the determination of financial statement amounts, and states that the auditor's responsibility to detect and report misstatements resulting from illegal acts having a direct and material effect on the determination of financial statement amounts is the same as that for errors and fraud as described in SAS No. 99, Consideration of Fraud in a Financial Statement Audit. That is, based on an assessment of the risk that errors and fraud may cause the financial statements to include a material misstatement, the auditor should design the audit to provide reasonable assurance of detecting errors or fraud that is material to the financial statements.

7.06 SAS No. 54 recognizes that entities may be affected by laws and regulations that relate more to an entity's operating aspects than to its financial and accounting aspects. The financial statement effect of such laws and regulations is usually indirect. State statutes and local ordinances that affect CIRAs are generally operational in nature and therefore have an indirect effect on financial statements. Even when violations of such laws and regulations can have consequences material to the financial statements, the auditor may not become aware of the existence of the illegal act unless he or she is informed by the client, or there is evidence of a governmental agency investigation or enforcement proceeding in the records, documents, or other information normally inspected in an audit of financial statements.

Minutes

7.07 The board of directors of a CIRA generally meets periodically. Minutes of those meetings are generally prepared. The minutes usually document such matters as approvals and revisions of budgets and assessments, authorizations for expenditures for capital improvements, approvals of contracts for services to be performed, and authorizations for changes in the management company's fees. Auditors should review minutes and consider matters that may affect the CIRA's financial statements.

Management of a CIRA

7.08 The board of directors of a CIRA has the authority and responsibility to manage the CIRA. The board may engage a managing agent to provide various services. The agent normally operates under an arrangement (the management agreement) with the CIRA. The management agreement defines the relationship between the CIRA and the managing agent, presents details of the services to be performed, and states the fees for those services. The management agreement may provide for bookkeeping and accounting services in addition to bidding and evaluating contracts, collections, resolving disputes and similar items to be provided by the managing agent to the CIRA. Such services may affect the nature, timing, and extent of substantive audit procedures to be performed by the auditor of a CIRA. If a managing agent provides the CIRA with bookkeeping and accounting services, the auditor should consider SAS No. 70,[2] *Service Organizations*, as amended by SAS No. 88, *Service Organizations and Reporting on Consistency,* which provides guidance on the factors an independent auditor[3] should consider when auditing the financial statements of an entity that uses a service organization to process certain transactions.

Understanding Internal Control and Assessing Control Risk

7.09 The second standard of field work requires the auditor to obtain a sufficient understanding of internal control to plan the audit and to determine the nature, timing, and extent of tests to be performed. Guidance on assessing control risk and carrying out this responsibility is included in SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55* and SAS No. 94, *The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit*. In all audits, the auditor should obtain an understanding of internal control sufficient to plan the audit by performing procedures to understand the design of controls relevant to an audit of financial statements and determining whether they have been placed in operation. In obtaining this understanding, the auditor considers how an entity's use of information technology (IT) and manual procedures may affect controls relevant to the audit. The auditor then assesses control risk for the assertions embodied in the account balance, transaction class, and disclosure components of the financial statements. The AICPA Audit Guide *Consideration of Internal Control in a Financial Statement Audit* provides further guidance on the application of SAS No. 55 in audits of financial statements performed in accordance with generally accepted auditing standards. Auditors should also comply with the provision of SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, which provides guidance in identifying and reporting conditions that relate to an entity's internal control observed during an audit of financial statements.

Internal Control

7.10 Internal control is a process—effected by an entity's board of directors, management, and other personnel—designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (*a*) reliability of financial reporting, (*b*) effectiveness and efficiency of operations, and (*c*) compliance with applicable laws and regulations. Internal control consists of the following five interrelated components:

a. Control environment

b. Risk assessment

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[2] The AICPA Audit Guide entitled *Service Organizations: Applying SAS No. 70, as Amended,* includes illustrative control objectives as well as three new interpretations that address the responsibilities of service organizations and service auditors with respect to forward-looking information, subsequent events, and the risk of projecting evaluations of controls to future periods. The Guide also clarifies that the use of a service auditor's report should be restricted to existing customers and is not meant for potential customers.

[3] A member performing an attest engagement must be independent pursuant to Rule 101 of the AICPA Code of Professional Conduct. Other applicable independence rules/regulations may also apply to members and other accountants while performing attest engagements (e.g., SEC, PCAOB, GAO, state licensing boards, etc.).

c. Control activities

d. Information and communication systems

e. Monitoring

7.11 The auditor should obtain an understanding of each of the five components of internal control sufficient to plan the audit by performing procedures to understand the design of controls relevant to an audit of financial statements and whether the controls have been placed in operation.[4]

7.12 In making a judgment about the understanding of internal control necessary to plan the audit, the auditor considers knowledge obtained from sources including previous audits and his or her understanding of the entity's industry. The auditor also considers his or her assessments of inherent risk, judgments about materiality, and the complexity and sophistication of the entity's operations and systems.

7.13 Paragraph 26 of SAS No. 55 states that auditors should obtain sufficient knowledge of the control environment to understand management's (and the board of directors') attitude, awareness, and actions concerning the control environment. The auditor should consider the following in obtaining an understanding of a CIRA's control environment:

- The role of a managing agent, if any, and the board of directors
- The frequency of board meetings
- The qualifications of board members
- The board members' involvement in the operations of the CIRA
- The organizational structure (as defined by its governing documents)
- Management's failure to commit sufficient resources to address security risks presented by IT
- External influences (including regulatory and other reporting requirements)
- The existence, limits and conditions of fidelity insurance for both the CIRA and management

7.14 Paragraph 36 of SAS No. 55, as amended by SAS No. 94, discusses obtaining sufficient knowledge of the information system relevant to financial reporting. To understand a CIRA's information system relevant to financial reporting, the auditor should consider the division of responsibility for control of the accounting system and records. That responsibility may be divided among—

a. The managing agent, if any

b. Employees of the CIRA

c. An outside accountant or bookkeeper

d. Board of directors or a member of the board

e. An outside IT specialist that may be needed to place certain financial information online

f. A combination of the preceding

7.15 Paragraph 32 of SAS No. 55, as amended by SAS No. 94, defines control activities as "the policies and procedures that help ensure that management directives are carried out." They help ensure that necessary actions are taken to address risks to achievement of the entity's objectives. Control activities, whether automated or manual, have various objectives and are applied at various organizational and functional levels. The auditor may identify control

[4] The AICPA Audit Guide *Consideration of Internal Control in a Financial Statement Audit* should be referred to for additional guidance relating to understanding internal control.

activities in obtaining the understanding of the information system relevant to financial reporting objectives discussed in paragraph 7.14. The auditor should consider the following in understanding a CIRA's control activities:

- The policies instituted by the board of directors to insure proper authorization of transactions and activities
- Independent control over the bidding process for significant contracts, such as insurance
- The policy for comparing actual results with budgeted amounts and investigating significant variances
- Documentation of significant transactions in board minutes
- The use of a managing agent
- The use of association staff
- Billing and collection procedures, such as the use of a lock box
- Purchasing procedures, such as the use of competitive bidding
- Payment procedures, such as a requirement for board approval before invoices are paid

7.16 If a CIRA uses a managing agent, the auditor should consider—

- The extent to which the board of directors monitors and controls the managing agent's activities related to the CIRA.
- The use of imprest cash funds.
- The manner in which the managing agent is compensated, such as the use of a fixed fee or otherwise.
- The extent, if any, to which the managing agent commingles operating funds, deferred maintenance funds, and replacement funds of entities under his or her control.
- Whether the CIRA maintains separate records for transactions initiated by the managing agent, if any.
- Whether the CIRA controls funds separately from funds controlled by the managing agent.
- The policy or board review of managing agent reports.
- The frequency of managing agent reports.
- The control program used by the agent with respect to its client, the association.

Documentation

7.17 SAS No. 55 requires the auditor to document his or her understanding of the entity's internal control components obtained to plan the audit. The form and extent of this documentation is influenced by the nature and complexity of the entity's controls. Generally, the more complex the entity's internal control and the more extensive the procedures performed by the auditor, the more extensive the documentation should be.

7.18 Having obtained the requisite understanding of internal control, the auditor should assess control risk. SAS No. 55, as amended by SAS No. 94, defines assessing control risk as "the process of evaluating the effectiveness of an entity's controls in preventing or detecting material misstatements in the financial statements." SAS No. 55, as amended by SAS No. 94, requires the auditor to document his or her conclusions about the assessed level of control risk. If the auditor assesses control risk below the maximum, documentation should include the basis for conclusion that the effectiveness of the design and operation of controls supports that assessed level. The nature and extent of the auditor's documentation are influenced by the assessed level of control risk, the nature of the entity's internal control, and the nature of the entity's documentation of internal control. In obtaining the understanding of internal control, the auditor may have performed some procedures that may also provide evidential matter about the effectiveness of controls and, consequently, can serve as tests of controls. However, if the auditor assesses control risk at the maximum level, SAS No. 55 requires only that conclusion itself and not the rationale for the conclusion to be documented.

Initial Operating Period

7.19 In determining the nature, timing, and extent of audit procedures, the auditor performing an audit of a CIRA's first period of operations should determine the date on which the CIRA's operations began. During the initial operating period, the CIRA's board of directors is generally controlled by the developer (declarant). The auditor should review documents such as closing statements to evaluate the completeness of the recording of **initial working capital contributions such as membership fees and/or escrow deposits collected from unit owners on behalf of the CIRA. The auditor should also obtain evidence about whether—**

- The developer (declarant) has fulfilled its obligation to pay assessments on unsold units or to fund operating deficits and/or contribute to the replacement fund.
- The CIRA has not been paying for developer (declarant) related expenses.
- Assets received from the developer (declarant) are reported in accordance with the guidelines for common property in this guide.
- Contracts and agreements signed by the developer meet statutory or similar guidelines (some states prohibit developers from entering into contracts of longer than a certain number of years).

Consideration of Fraud in a Financial Statement Audit

7.20 SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), is the primary source of authoritative guidance about an auditor's responsibilities concerning the consideration of fraud in a financial statement audit. SAS No. 99 supersedes SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*, and amends SAS No. 1, section 230, *Due Professional Care in the Performance of Work* (AICPA, *Professional Standards*, vol. 1, AU sec. 230). SAS No. 99 establishes standards and provides guidance to auditors in fulfilling their responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud as stated in SAS No. 1, section 110, *Responsibilities and Functions of the Independent Auditor* (AICPA, *Professional Standards*, vol. 1, AU sec. 110.02). (SAS No. 99 also amends SAS No. 85, *Management Representations.*)

7.21 There are two types of misstatements relevant to the auditor's consideration of fraud in a financial statement audit:

- Misstatements arising from fraudulent financial reporting.
- Misstatements arising from misappropriation of assets.

7.22 Three conditions generally are present when fraud occurs. First, management or other employees have an *incentive* or are under *pressure,* which provides a reason to commit fraud. Second, circumstances exist—for example, the absence of controls, ineffective controls, or the ability of management to override controls—that provide an *opportunity* for a fraud to be perpetrated. Third, those involved are able to *rationalize* committing a fraudulent act.

The Importance of Exercising Professional Skepticism

7.23 Because of the characteristics of fraud, the auditor's exercise of professional skepticism is important when considering the risk of material misstatement due to fraud. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. The auditor should conduct the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the entity and regardless of the auditor's belief about management's honesty and integrity. Furthermore, professional skepticism requires an ongoing questioning of whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred.

Discussion Among Engagement Personnel Regarding the Risks of Material Misstatement Due to Fraud

7.24 Members of the audit team should discuss the potential for material misstatement due to fraud in accordance with the requirements of paragraphs 14 through 18 of SAS No. 99. The discussion among the audit team members about the susceptibility of the entity's financial statements to material misstatement due to fraud should include a consideration of the known external and internal factors affecting the entity that might (*a*) create incentives/pressures for management and others to commit fraud, (*b*) provide the opportunity for fraud to be perpetrated, and (*c*) indicate a culture or environment that enables management to rationalize committing fraud. Communication among the audit team members about the risks of material misstatement due to fraud also should continue throughout the audit.

7.25 Listed below are some examples of possible fraud risk factors that may exist in the CIRA industry: Please note that this list is not inclusive of all potential fraud risk factors.

Part 1: Fraudulent Financial Reporting

A. *Incentives/Pressures*

1. Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or indicated by):

   a. The community association changes CAM companies frequently.

   b. "Reserve Study" preparers are under pressure to report longer useful lives of components or lower replacement costs, so that the report recommendations does not result in an unacceptable increase in monthly dues to catch up on reserves. The auditor should examine previous reports and inquire about the conditions surrounding the current report.

   c. Boards who feel threatened about losing control may feel the pressure to establish an unrealistically low budget. Also, the board could try to find ways to shift operating expenses to expenses of the major repairs and replacement fund, thereby distorting operating income.

   d. Managing agent or board member who has check signing authority.

B. *Opportunities*

1. The nature of the CIRA industry provides opportunities to engage in fraudulent financial reporting that can arise from the following:

   a. In CIRAs, there usually is a separation between "management" and the corporate officers of the CIRA. "Management" may be a management company or an onsite manager that keeps accounting records and does financial management off site, away from the CIRA and the CIRA officers.

   b. Management companies have access to multiple bank accounts for a portfolio of clients and may be able to mask money movements among them. Similarly, because a vendor may do work for multiple clients within the management company portfolio, payments to a vendor from one client for work at another client CIRA would not raise suspicion for the reader.

   c. Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.

      (1) Board members live in the CIRA and have friendships that may improperly enter into consideration when hiring professionals and contractors.

2. There is ineffective monitoring of management as a result of the following:

   a. CIRA board members and officers do not necessarily have business or financial skills and may not be diligent or keen readers of financial information supplied to them. For the typical board member, the CIRA is the biggest business that the board member is associated with in a management or oversight capacity.

3. Internal control components are deficient as a result of the following:

   a. Changes in internal control procedures and policies can be made by the management company without the knowledge or approval of CIRA corporate officers.

   b. Some CIRAs are managed by volunteers and may not have adequate internal controls.

   c. Some management companies consist of few employees and may be only family members involved in the management company so there are few internal controls leading to lack of segregation of duties.

C. *Attitudes/Rationalizations*

1. Management company employees have no ownership interest or residual interest (pension) in the CIRA and no exposure to loss as a result of fraud within the CIRA's activities.

2. Boards are volunteers and they feel they "deserve" the perks (such as free landscaping, interior repairs, etc.) due to the time they put in for the Association.

3. Managing agents may also feel they "deserve" the perks (such as free landscaping, interior repairs, etc.).

Part 2: Misappropriations of Assets

A. *Incentives/Pressures*

1. Adverse relationships between the CIRA and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by the following:
   a. Management companies are typically owned by one person or a very small group of people. They have a few highly compensated employees, and the rest are lightly compensated (underpaid). CIRA employees are also typically underpaid. A CIRA that is volunteer-managed may put an undue work burden on one or more volunteers, who may feel pressure to "reward" himself or herself.
2. The CIRAs use similar products and services used by an employee or board member. Thus, it is easy to include one additional utility bill to the payment or payment for extra landscaping or office supplies.

B. *Opportunities*

1. Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:
   a. Some CIRAs, for example cooperatives, serve low and moderate income people who may not have bank accounts and therefore pay bills, including CIRA dues, by cash.

   b. Board members do not closely review the checks they sign. Sometimes checks are signed in advance or signed without backup of invoices. Some management companies have signatory power and/or use signature stamps.

   c. The management contract gives the management company broad powers to spend and to negotiate contracts and to recommend or select vendors.

   d. While ostensibly governed by a board of directors and established in corporate or "weak mayor" form, some CIRAs function under what is called a "strong mayor" governance model, where the president or another board member wields considerable power, and is highly involved in day to day management. The auditor needs to exert skepticism toward the person in these cases, since this person may exercise unusual power over the management company and the board of directors.

   e. Management companies also may have their own landscape or repair and maintenance departments where the same employees can bill two different associations. Or, due to lack of competitive bidding by use of internal employees there is an overcharging of time and materials. There can also be duplication of product invoicing, for example, one invoice for light bulbs and another for fertilizer may be billed to several associations.

Obtaining the Information Needed to Identify the Risks of Material Misstatement Due to Fraud

7.26 SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards,* vol. 1, AU sec. 311.06–.08), provides guidance about how the auditor obtains knowledge about the entity's business and the industry in which it operates. In performing that work, information may come to the auditor's attention that should be considered in identifying risks of material misstatement due to fraud. As part of this work, the auditor should perform the following procedures to obtain information that is used (as described in paragraphs 35 through 42 of SAS No. 99) to identify the risks of material misstatement due to fraud:

a. Make inquiries of management and others within the entity to obtain their views about the risks of fraud and how they are addressed. (See paragraphs 20 through 27 of SAS No. 99.)

b. Consider any unusual or unexpected relationships that have been identified in performing analytical procedures in planning the audit. (See paragraphs 28 through 30 of SAS No. 99.)

c. Consider whether one or more fraud risk factors exist. (See paragraphs 31 through 33 of SAS No. 99, the Appendix to SAS No. 99, and paragraph 7.24 above.)

d. Consider other information that may be helpful in the identification of risks of material misstatement due to fraud. (See paragraph 34 of SAS No. 99.)

7.27 In planning the audit, the auditor also should perform analytical procedures relating to revenue with the objective of identifying unusual or unexpected relationships involving revenue accounts that may indicate a material misstatement due to fraudulent financial reporting.

1. For example, in the CIRA industry an auditor may want to examine changes in laundry income by comparing it with prior year and/or budget amounts. In the case of laundry, an analysis of water and gas usage may be used to determine the projected revenue.

7.28 ***Considering Fraud Risk Factors***. As indicated in item *c* above, the auditor may identify events or conditions that indicate incentives/pressures to perpetrate fraud, opportunities to carry out the fraud, or attitudes/rationalizations to justify a fraudulent action. Such events or conditions are referred to as "fraud risk factors." Fraud risk factors do not necessarily indicate the existence of fraud; however, they often are present in circumstances where fraud exists.

7.29 SAS No. 99 provides fraud risk factor examples that have been written to apply to most enterprises. Paragraph 7.25 to this chapter contains a list of fraud risk factors specific to the CIRA industry. Remember that fraud risk factors are only one of several sources of information an auditor considers when identifying and assessing risk of material misstatement due to fraud.

Identifying Risks That May Result in a Material Misstatement Due to Fraud

7.30 In identifying risks of material misstatement due to fraud, it is helpful for the auditor to consider the information that has been gathered in accordance with the requirements of paragraphs 19 through 34 of SAS No. 99. The auditor's identification of fraud risks may be influenced by characteristics such as the size, complexity, and ownership attributes of the entity. In addition, the auditor should evaluate whether identified risks of material misstatement due to fraud can be related to specific financial statement account balances or classes of transactions and related assertions, or whether they relate more pervasively to the financial statements as a whole. Certain accounts, classes of transactions, and assertions that have high inherent risk because they involve a high degree of management judgment and subjectivity also may present risks of material misstatement due to fraud because they are susceptible to manipulation by management. Such items and related risks in the CIRA industry may include:

1. Cash
2. Inventory and supplies
3. Internet access
4. EFT and similar economic transactions over the Internet
5. Lack of effective fidelity insurance
6. Operating expenses (possible misclassifications to reserve fund)
7. Allowance for uncollectible receivables
8. Payables and accrued expenses
9. Special assessment expenses
10. Capital lease obligations

A Presumption That Improper Revenue Recognition Is a Fraud Risk

7.31 Material misstatements due to fraudulent financial reporting often result from an overstatement of revenues (for example, through premature revenue recognition or recording fictitious revenues) or an understatement of revenues (for example, through improperly shifting revenues to a later period). Therefore, the auditor should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition (see paragraph 41 of SAS No. 99). For example, there is often pressure on the board of directors not to increase dues and therefore there is increased pressure to understate expenses or overstate revenue in order to show a surplus for the year. Some revenue related considerations for CIRAs include:

1. Use of fines and penalties as an unreasonable revenue source.
2. CIRAs that serve as seasonal, rather than year round homes to residents may have significant prepaid revenue from absentee members.
3. CIRA managers may place a resident in a unit, but still carry the unit on the books as vacant. The manager could then collect and keep the rent or CIRA assessments. Cooperatives are more susceptible to this practice than condominiums or HOAs; however, the opportunity also presents itself in condominiums and HOAs for units where there has been a bankruptcy stay.
4. Resort and second home CIRAs with integrated rental operations provide the manager with an opportunity to hide short term rental income.
5. Not matching special assessments with future expenses. The special assessment is in year 1 and the Association wants to book it in year 1. However, the special assessment was for a specific purpose—of which the expense has not occurred or has not occurred in full.

A Consideration of the Risk of Management Override of Controls

7.32 Even if specific risks of material misstatement due to fraud are not identified by the auditor, there is a possibility that management override of controls could occur, and accordingly, the auditor should address that risk (see paragraph 57 of SAS No. 99) apart from any conclusions regarding the existence of more specifically identifiable risks. Specifically, the procedures described in paragraphs 58 through 67 of SAS No. 99 should be performed to further address the risk of management override of controls. These procedures include (1) examining journal entries and other adjustments for evidence of possible material misstatement due to fraud, (2) reviewing accounting estimates for biases that could result in material misstatement due to fraud, and (3) evaluating the business rationale for significant unusual transactions.

7.33 Key estimates and related issues in the CIRA industry may include:

1. Future repairs and maintenance reserves
2. Extending remaining useful lives of assets unrealistically
3. Improperly excluding assets from "Reserve Studies"

Wide diversity in practice exists as to how Associations develop the reserves for future major repairs and deferred maintenance. Developers sometimes understate these estimates to keep maintenance assessments artificially low. There is a tendency to use prior years' numbers without getting reliable updates. "Reserve Study" specialists and professional engineers may need to be consulted from time to time.

Assessing the Identified Risks After Taking Into Account an Evaluation of the Entity's Programs and Controls That Address the Risks

7.34 Auditors should comply with the requirements of paragraphs 43 through 45 of SAS No. 99 concerning an entity's programs and controls that address identified risks of material misstatement due to fraud. Controls that may exist at a CIRA include:

1. Checking if signature cards are updated when the board members or managers change
2. Requiring two signers on reserve withdrawals
3. Maintaining a reasonable budget process
4. Use of lockboxes and electronic transfers for collection of assessments is a strong control on the major revenue sources for CIRAs

7.35 The auditor should consider whether such programs and controls mitigate the identified risks of material misstatement due to fraud or whether specific control deficiencies exacerbate the risks. After the auditor has evaluated whether the entity's programs and controls have been suitably designed and placed in operation, the auditor should assess these risks taking into account that evaluation. This assessment should be considered when developing the auditor's response to the identified risks of material misstatement due to fraud.

Responding to the Results of the Assessment

7.36 Paragraphs 46 through 67 of SAS No. 99 provide requirements and guidance about an auditor's response to the results of the assessment of the risks of material misstatement due to fraud. The auditor responds to risks of material misstatement due to fraud in the following three ways:

a. A response that has an overall effect on how the audit is conducted—that is, a response involving more general considerations apart from the specific procedures otherwise planned (see paragraph 50 of SAS No. 99).

b. A response to identified risks involving the nature, timing, and extent of the auditing procedures to be performed (see paragraphs 51 through 56 of SAS No. 99).

c. A response involving the performance of certain procedures to further address the risk of material misstatement due to fraud involving management override of controls, given the unpredictable ways in which such override could occur (see paragraphs 57 through 67 of SAS No. 99 and paragraph 7.34 above).

Evaluating Audit Evidence

7.37 Paragraphs 68 through 78 of SAS No. 99 provide requirements and guidance for evaluating audit evidence. The auditor should evaluate whether analytical procedures that were performed as substantive tests or in the overall review stage of the audit indicate a previously unrecognized risk of material misstatement due to fraud. The auditor also should consider whether responses to inquiries throughout the audit about analytical relationships have been vague or implausible, or have produced evidence that is inconsistent with other evidential matter accumulated during the audit.

7.38 At or near the completion of fieldwork, the auditor should evaluate whether the accumulated results of auditing procedures and other observations affect the assessment of the risks of material misstatement due to fraud made earlier in the audit. As part of this evaluation, the auditor with final responsibility for the audit should ascertain that there has been appropriate communication with the other audit team members throughout the audit regarding information or conditions indicative of risks of material misstatement due to fraud.

Responding to Misstatements That May Be the Result of Fraud

7.39 When audit test results identify misstatements in the financial statements, the auditor should consider whether such misstatements may be indicative of fraud. See paragraphs 75 through 78 of SAS No. 99 for requirements and guidance about an auditor's response to misstatements that may be the result of fraud. If the auditor believes that misstatements are or may be the result of fraud, but the effect of the misstatements is not material to the financial statements, the auditor nevertheless should evaluate the implications, especially those dealing with the organizational position of the person(s) involved.

7.40 If the auditor believes that the misstatement is or may be the result of fraud, and either has determined that the effect could be material to the financial statements or has been unable to evaluate whether the effect is material, the auditor should:

a. Attempt to obtain additional evidential matter to determine whether material fraud has occurred or is likely to have occurred, and, if so, its effect on the financial statements and the auditor's report thereon.[5]

b. Consider the implications for other aspects of the audit (see paragraph 76 of SAS No. 99).

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[5] See SAS No. 58 for guidance on auditors' reports issued in connection with audits of financial statements.

c. Discuss the matter and the approach for further investigation with an appropriate level of management and the board of directors that is at least one level above those involved, and with senior management and the audit committee.[6]

d. If appropriate, suggest that the client consult with legal counsel.

7.41 The auditor's consideration of the risks of material misstatement and the results of audit tests may indicate such a significant risk of material misstatement due to fraud that the auditor should consider withdrawing from the engagement and communicating the reasons for withdrawal to the audit committee or others with equivalent authority and responsibility. The auditor may wish to consult with legal counsel when considering withdrawal from an engagement.

Communicating About Possible Fraud to Management, the Audit Committee, and Others

7.42 Whenever the auditor has determined that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management. See paragraphs 79 through 82 of SAS No. 99 for further requirements and guidance about communications with management, the audit committee, and others.

Documenting the Auditor's Consideration of Fraud

7.43 Paragraph 83 of SAS No. 99 requires certain items and events to be documented by the auditor. Auditors should comply with those requirements.

Practical Guidance

7.44 The AICPA Practice Aid, *Fraud Detection in a GAAS Audit—Revised Edition*, provides a wealth of information and help on complying with the provisions of SAS No. 99. Moreover, this practice aid will assist auditors in understanding the requirements of SAS No. 99 and whether current audit practices effectively incorporate these requirements. This Practice Aid is an Other Auditing Publication as defined in SAS No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150). Other Auditing Publications have no authoritative status; however, they may help the auditor understand and apply SASs.

Related Parties

7.45 The auditor should refer to the guidance in paragraph 2 of SAS No. 45, *Omnibus Statement on Auditing Standards—1983*, "Related Parties," for guidance in reviewing the kinds of related party transactions discussed in paragraph 4.24.

Budgets

7.46 The operations of most CIRAs are based on budgets, which are used as bases for assessments from unit owners. The auditor should consider the CIRA's budgeting procedures in obtaining an understanding of internal control and assessing control risk. SAS No. 56, *Analytical Procedures*, provides guidance on the use of analytical procedures and requires the use of analytical procedures in the planning and overall review stages of all audits. The auditor should consider

[6] If the auditor believes senior management may be involved, discussion of the matter directly with the audit committee may be appropriate.

comparing budgeted amounts with actual amounts as an analytical procedure in the audit of a CIRA.

7.47 CIRAs sometimes present budget information in documents that contain audited financial statements. SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents,* requires that auditors report on all information in documents containing audited financial statements that they submit to clients or others. Budget information for *unexpired* periods is considered to be prospective financial information and should be reported on in accordance with the AICPA's Statement on Standards for Attestation Engagements (SSAE) No. 10, *Attestation Standards: Revision and Recodification,* Chapter 3, "Financial Forecasts and Projections" (AICPA, *Professional Standards*, vol. 1, AT sec. 301), as amended by SSAE No. 11, *Attest Documentation*. Budget information for *expired* periods that accompanies audited financial statements in an auditor-submitted document should be reported on as described in SAS No. 29. Because such information is generally not susceptible to auditing procedures, it is usually necessary for the auditor to disclaim an opinion on such information. The following is an example of a disclosure of a disclaimer opinion that would be appropriate in such circumstances:

> Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The budget information is presented for purposes of additional analyses and is not a required part of the basic financial statements. Such information has not been subjected to the auditing procedures applied in the audit of the basic financial statements, and, accordingly, we express no opinion on it.

If such information is included in a client-prepared document that contains audited financial statements, the auditor should refer to SAS No. 8, *Other Information in Documents Containing Audited Financial Statements.* SAS No. 8 requires that, at a minimum, the auditor read such other information to determine whether the information and the manner in which it is presented are consistent with information in the financial statements. SAS No. 98, *Omnibus Statement on Auditing Standards—2002,* amends SAS No. 8 by stating that if certain other information[7] has been subjected to auditing procedures applied in the audit of the basic financial statements, the auditor may express an opinion on whether the information is fairly stated in all material respects in relation to those financial statements taken as a whole. In those circumstances, the auditor's report on the information should describe clearly the character of the auditor's work and the degree of responsibility the auditor is taking. The auditor may report on such information using the guidance of SAS No. 29 (AICPA, *Professional Standards,* vol. 1, AU sec. 551.12 and .14).

7.48 If an accountant assists a CIRA in preparing its budget, he or she may be required to report on the budget. In such circumstances, the accountant should refer to the SSAE No. 10, *Attestation Standards: Revision and Recodification,* Chapter 3, "Financial Forecasts and Projections" (AICPA, *Professional Standards*, vol. 1, AT sec. 301), as amended by SSAE No. 11, *Attest Documentation*, for guidance.

Assessment Revenues

7.49 Audit procedures applied to assessment revenues should include comparing total reported assessments for the period under audit with budgeted

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[7] This information may include supplementary information required by generally accepted accounting principles.

amounts and testing whether amounts assessed to individual owners have been computed in accordance with the CIRA's documents.

Assessments Receivable

7.50 In auditing assessments receivable, the auditor should design tests to provide reasonable assurance that—

- All assessments receivable owed to the CIRA at the balance-sheet date are recorded.
- Recorded assessments receivable represent amounts owed to the CIRA at the balance-sheet date.
- Assessments receivable are properly described and classified in the financial statements.

The auditor may achieve these objectives by performing substantive tests or a combination of substantive tests and tests of control activities. Substantive tests for determining the existence and accuracy of receivables includes confirmation of the amount receivable by direct communication with parties owing amounts to the entity being audited and tests of subsequent receipts. SAS No. 67, *The Confirmation Process* provides guidance about the confirmation process in audits performed in accordance with generally accepted auditing standards. If replies to confirmation requests are not received or if the replies are not satisfactory, the auditor should obtain satisfaction about the existence and accuracy of assessment receivable balances by alternative procedures such as examining subsequent cash receipts and the existence of liens filed against units, although such liens do not assure the collectibility of assessments receivable.

Investments

7.51 CIRAs often invest excess funds and reserve funds in savings accounts or other interest-bearing investments. In auditing investments, the auditor should design tests to provide reasonable assurance that—

- Investments exist and the CIRA has legal title to them at the balance-sheet date.
- All investments owned by the CIRA at the balance-sheet date are included in the investment accounts.
- The values at which investments are carried in the financial statements are appropriate and are adequately disclosed.
- Investments pledged as collateral or otherwise restricted are appropriately identified and disclosed.
- Income from investments, including gains and losses on sales and adjustments in valuation allowances, is appropriately reflected in the financial statements.
- Investments conform to the CIRA's legal requirements and its governing documents.
- Investments are insured or otherwise protected.
- Appropriate accrual of interest receivable is made.

The auditor may achieve these objectives by performing substantive tests or a combination of substantive tests and tests of control structure policies and procedures. The auditor should consider confirming investments with the appropriate financial institution or custodian. Establishing the existence and ownership of investments is paramount to the audit process, particularly because many securities are readily negotiable.

Contracts

7.52 CIRAs often enter into agreements or contracts with agents or others not directly managed by the CIRA to provide services, such as operation of recreational facilities or garages, to unit owners. The auditor may find it necessary to review provisions of such contracts or agreements and consider whether the board was authorized to enter into the contracts and transactions pursuant to the contracts and whether related account balances are appropriately recorded and disclosed in the financial statements. The auditor should also consider whether commitments for long-term contracts have been disclosed when appropriate.

Insurance

7.53 The auditor should consider whether a CIRA's insurance coverage complies with statutory or other documentary requirements. Although FASB Statement No. 5,* *Accounting for Contingencies*, does not require the disclosure of noninsured or underinsured risks, it states specifically that it does not discourage such disclosures.

Future Major Repairs and Replacements

7.54 CIRAs may be required by state statutes, mortgage documents or their governing documents to set aside funds on a systematic basis for future major repairs and replacements. The auditor should review the CIRA's governing documents and relevant state statutes to determine whether such requirements exist. The auditor should also review the CIRA's policy for accumulating the required funds.

7.55 If the disclosure about a CIRA's funding for future major repairs and replacements as required by paragraph 4.27 of this guide is absent or inadequate, the auditor should consider modifying his or her report, as discussed in SAS No. 58, *Reports on Audited Financial Statements.*

7.56 The auditor should apply certain limited procedures to the required supplementary information discussed in paragraph 4.33 of this guide. Specifically, procedures that the auditor should consider include the following:

- Determine by physical inspection of the property or review of the CIRA's legal or governing documents whether the disclosure includes all major property components.
- Compare estimates of the costs of major repairs and replacements with current period expenditures and with the annual budget, if any.
- Inquire of management about whether the CIRA's property maintenance records, which reflect each component's replacement history, if any, were considered in determining the information to be disclosed.

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* On December 15, 2003, the FASB issued an exposure draft of a proposed FASB Statement, *Accounting Change and Error Corrections*, that would replace APB Opinion No. 20, *Accounting Changes*, and FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements*. It would carryforward the guidance in APB Opinion No. 20 except that it would replace reporting the cumulative effect of a change in accounting principle with retrospective application of the change, unless it is impracticable to determine either the cumulative effect or the period-specific effects of the change. The guidance in FASB Statement No. 3 would be carried forward. In addition, the proposed Statement would supersede FASB Statement No. 73 and FASB Interpretation No. 20. It would amend ARB No. 43, APB Opinion Nos. 22, 25, 26, 28, 30, FASB Statement Nos. 5, 16, 19, 25, 52, 67, 71, 123, 142, 143, 144, and FASB Interpretation Nos. 1, 7, and 18 to replace references in those pronouncements to APB Opinion No. 20 and FASB Statement No. 3 with references to the proposed Statement. Readers should be alert to the issuance of the final Standard.

- Inquire of management about whether the age and condition of the components were considered in determining the information and amounts to be disclosed.
- Check the mathematical accuracy of amounts disclosed.
- Inquire of management about whether the study was prepared by the board or a professional engineer and whether the methods and bases for estimating the amounts disclosed are documented. Consider whether those methods and bases are reasonable. If the study was conducted by the board, consider whether the source of the information used to estimate the useful lives and current or future repair and replacement costs, for example, bids from contractors or technical manuals on useful lives of various components are reasonable. Also, the auditor may consider determining whether or not the preparer has their Reserve Specialist designation as a way of confirming that the study was completed in conformance with the National Reserve Study Standards which are referenced in chapter 3 of this Guide.
- Inquire of management as to the age of the study.

Representation Letters

7.57 SAS No. 85, *Management Representations*, as amended by SAS No. 89, *Audit Adjustments* (AICPA, *Professional Standards,* vol. 1, AU sec. 333) and SAS No. 99 (AICPA, *Professional Standards,* vol. 1, AU sec. 316), establishes a requirement that an auditor obtain written representations from management and board of directors for all financial statements and periods covered by the auditors report. Management and board representatives signing the report might include officers of the CIRA and the managing agent, if any. The Statement also provides guidance concerning the representations to be obtained. SAS No. 89 amends SAS No. 85 to require that the management representation letter include an acknowledgement by management that it has considered the financial statement misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented, and has concluded that any uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. It also requires that a summary of the uncorrected misstatements be included in or attached to the representation letter. SAS No. 99 amends SAS No. 85 to revise the guidance for management representations about fraud currently found. (A representation letter for an audit is illustrated in exhibit B-4 of appendix B.)

7.58 The auditor should consider obtaining representations about the following matters in addition to those described in SAS No. 85:

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

Audit Documentation

7.59 The auditor should prepare and maintain audit documentation, the form and content of which should be designed to meet the circumstances of the particular audit engagement. Audit documentation is the principal record of auditing procedures applied, evidence obtained, and conclusions reached by the auditor in the engagement. The quantity, type, and content of audit documentation are matters of the auditor's professional judgment.

7.60 Audit documentation serves mainly to:

a. Provide the principal support for the auditor's report, including the representation regarding observance of the standards of fieldwork, which is implicit in the reference in the report to generally accepted auditing standards.[8]

b. Aid the auditor in the conduct and supervision of the audit.

7.61 Examples of audit documentation are audit programs,[9] analyses, memoranda, letters of confirmation and representation, abstracts or copies of entity documents, and schedules or commentaries prepared or obtained by the auditor. Audit documentation may be in paper form, electronic form, or other media.

7.62 Audit documentation should be sufficient to (*a*) enable members of the engagement team with supervision and review responsibilities to understand the nature, timing, extent, and results of auditing procedures performed, and the evidence obtained;[10] (*b*) indicate the engagement team member(s) who performed and reviewed the work; and (*c*) show that the accounting records agree or reconcile with the financial statements or other information being reported on.

7.63 In addition to the requirements discussed in paragraphs 7.59–7.62 above, SAS No. 96, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), provides further requirements about the content, ownership and confidentiality of audit documentation. Moreover, Appendix A to SAS No. 96 lists the audit documentation requirements contained in other statements on auditing standards.

Auditor's Report

7.64 Under certain circumstances, such as when the disclosure about funding for future major repairs and replacements required in paragraph 4.27 of this guide is inadequate, the auditor should consider whether to modify his or her opinion because of a departure from GAAP.

7.65 The auditor would not modify the report solely because the CIRA or unit owners have decided not to fund the need for major repairs and replacements of common property even though the CIRA has determined current or future estimates of costs that may be required in the future.

7.66 The auditor may, however, decide to add an emphasis-of-matter paragraph to draw the user's attention to the note discussing funding for future major repairs and replacements. The following illustrates a paragraph that may be added to the standard report if the board of directors decides to only partially adopt the recommendations of a study:

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[8] However, there is no intention to imply that the auditor would be precluded from supporting his or her report by other means in addition to audit documentation.

[9] See SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311.05), for guidance regarding preparation of audit programs.

[10] A firm of independent auditors has a responsibility to adopt a system of quality control policies and procedures to provide the firm with reasonable assurance that its personnel comply with applicable professional standards, including generally accepted auditing standards, and the firm's standards of quality in conducting individual audit engagements. Review of audit documentation and discussions with engagement team members are among the procedures a firm performs when monitoring compliance with the quality control policies and procedures that it has established. (Also, see SAS No. 25, *The Relationship of Generally Accepted Auditing Standards to Quality Control Standards* [AICPA, *Professional Standards*, vol. 1, AU sec. 161].) Readers should be aware that SAS No. 98 among other things amends SAS No. 25 by clarifying the relationship between Statements on Quality Control Standards (SQCSs) and engagements performed under SASs.

> As more fully explained in Note 4 to the financial statements, the board of directors has elected to only partially adopt the funding recommendations of a study conducted to determine current estimates of major repairs and replacements required in the future.

7.67 The following illustrates a paragraph that may be added to the standard report if owners vote not to fund for future major repairs and replacements:

> As more fully explained in Note 4 to the financial statements, a majority of the unit owners voted not to fund the association's future needs for major repairs and replacements through systematic assessments.

Reporting on Required Supplementary Information

7.68 Paragraph 4.33 of this guide requires CIRAs to disclose supplementary information about estimates of current or future costs of major repairs and replacements of common property that will be required in the future. SAS No. 29 states that the auditor should (*a*) express an opinion on the information if the auditor has been engaged to examine the information, (*b*) report on the information using the guidance in SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents, as amended*, (AICPA, *Professional Standards*, vol. 1, AU sec. 551.12–.14), provided such information has been subjected to the auditing procedures applied in the audit of the basic financial statements, or (*c*) disclaim an opinion on the information. The following is an example of a disclaimer that an auditor might use in conjunction with the presentation of that supplementary information outside the basic financial statements in an auditor-submitted document:

> The [*identify the supplementary information*] on page XX is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

7.69 Since supplementary information generally is not audited and is not a required part of the basic financial statements, the auditor need not add an explanatory paragraph, notwithstanding the condition described in 7.68, to the report on the audited financial statements to refer to the supplementary information or to his or her limited procedures, except in the following circumstances:

a. The supplementary information that GAAP requires to be presented in the circumstances is omitted.

b. The auditor has concluded that the measurement or presentation of the supplementary information departs materially from prescribed guidelines.

c. The auditor is unable to complete the procedures prescribed in paragraph 7.56.

d. The auditor is unable to remove substantial doubts about whether the supplementary information conforms to prescribed guidelines.

7.70 The following illustrates a paragraph that may be added to the standard auditor's report if the unaudited supplementary information required in paragraph 4.33 of this guide is not presented. (That information is required even if a CIRA's governing documents and state statutes do not require the CIRA to fund systematically for future major repairs and replacements.)

> As discussed in Note 4, the Association has not estimated the remaining lives and replacement costs of the common property and, therefore, has not presented information about the estimates of future costs of major repairs and replacements that will be required in the future that accounting principles generally accepted in the United States of America has determined is required to supplement, although not required to be a part of, the basic financial statements.

7.71 The following illustrates an explanatory paragraph that an auditor might use in circumstances in which the supplementary information materially departs from information required by paragraph 4.33 of this guide:

> The supplementary information on future major repairs and replacements on page XX is not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. However, we have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. As a result of such limited procedures, we believe that the supplementary information on future major repairs and replacements is not in conformity with guidelines established by accounting principles generally accepted in the United States of America [*describe the material departures*].

7.72 The following illustrates an explanatory paragraph that an auditor might use in circumstances in which the procedures prescribed by paragraph 7.56 of this guide were not completed:

> The supplementary information on future major repairs and replacements on page XX is not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. Furthermore, we were unable to apply to the information certain procedures prescribed by professional standards because [*state the reasons*].

7.73 The following illustrates an explanatory paragraph that an auditor might use in circumstances in which the auditor has unresolved doubts about the adherence of the information to the information required by paragraph 4.33 of this guide:

> The supplementary information on future major repairs and replacements on page XX is not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. However, we have applied certain limited procedures prescribed by professional standards that raised doubts that we were unable to resolve regarding whether material modifications should be made to the information for it to conform with guidelines established by accounting principles generally accepted in the United States of America. [*The auditor should consider including in the report the reason(s) the auditor was unable to resolve these doubts.*]

7.74 Even though the auditor is unable to complete the prescribed procedures, if, on the basis of facts known to him or her, the auditor concludes that the supplementary information has not been measured or presented within prescribed guidelines, he or she should suggest appropriate revision; failing that, he or she should describe the nature of any material departure(s) in the report.

7.75 In conjunction with the audit of the financial statements, the auditor may subject the supplementary information to certain auditing procedures. If the procedures are sufficient to enable the auditor to express an opinion on whether the information is fairly stated in all material respects in relation to the financial statements taken as a whole, the auditor may expand the audit report in accordance with SAS No. 8 (AICPA, *Professional Standards*, vol. 1, AU sec. 550.07).

Chapter 8

*Review and Compilation Engagements**

8.01 The needs of CIRAs for accounting services may vary significantly. Factors that management considers in determining its needs for an accountant's services include the CIRA's—

- Legal requirements. (See paragraph 1.10 of this Guide.)
- Size.
- Annual operating and replacement fund budgets.
- Total assets.
- Scope of operations.
- Internal control and use of external management agents.
- Degree of supervision by the board of directors.

Statements on Standards for Accounting and Review Services (SSARSs) require that the accountant establish an understanding with the entity, preferably in writing, regarding services to be performed.

Engagement Letter

8.02 Engagement letters for reviews and compilations of financial statements of CIRAs are illustrated in exhibits B-2 and B-3 of appendix B.

Reporting Obligation

8.03 SSARSs provide guidance to accountants engaged to review or compile the financial statements of CIRAs. SSARS No. 8, *Amendment to Statement on Standards for Accounting and Review Services No. 1,* Compilation and Review of Financial Statements, provides communication and performance requirements for unaudited financial statements submitted to a client that are not expected to be used by a third party. Since the financial statements of CIRAs are often used by third parties, the guidance in this chapter assumes third party usage. SSARS No. 8 provides guidance on communication and performance requirements when unaudited financial statements are not expected to be used by a third party.

8.04 The following illustrates a paragraph that would generally be included in the accountant's review or compilation report if the CIRA did not disclose the required supplementary information about future major repairs and replacements:

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* In January 2004 the AICPA's Accounting and Review Services Committee (ARSC) issued an exposure draft of a proposed Statement on Standards for Accounting and Review Services (SSARS), *Standards for Accounting and Review Services*, which would establish a SSARS hierarchy that would help practitioners by making them aware of the appropriate literature to look to when performing an engagement under SSARS. In addition, this proposed Statement would correct SSARS No. 2, *Reporting on Comparative Financial Statements*, by revising footnote 9 so that it conforms with the guidance in SAS No. 58, *Reports on Audited Financial Statements*, as amended, which states that a successor auditor may name the predecessor auditor in his or her report if the predecessor auditor's practice was acquired by, or merged with that of the successor auditor. The proposed Statement would be effective upon issuance. Readers should be alert to the issuance of the final Statement.

As discussed in Note 4, the Association has not estimated the remaining lives and replacement costs of the common property and, therefore, has not presented estimates of future costs of major repairs and replacements that will be required in the future, which the American Institute of Certified Public Accountants has determined is required to supplement, although not required to be a part of, the basic financial statements. [*Note: The following sentence may be added, if applicable: However, management believes it is impracticable to develop this information.*]

Compilation and Review Procedures

8.05 SSARS No. 1,* *Compilation and Review of Financial Statements*, provides accountants with general guidance on the inquiries and analytical procedures that should be performed in review engagements. Some specific procedures that may be performed on a review engagement of a CIRA, if appropriate, include the following:

- A review of minutes of the meetings of the board of directors and annual meetings of owners
- A comparison of the actual revenue and expenditures to the current year's budget and to the prior year's actual revenue and expenditures
- Inquiries about late fees and lien filing procedures for delinquent member assessments
- Inquiries about violations of the CIRA's legal documents or state statutes
- Inquiries about the CIRA's income tax filing status in prior years
- Inquiries about whether local governments may be imposing property taxes on both the CIRA and unit owners for the same property
- Inquiries about restrictions on cash accounts
- Inquiries about special bank accounts, if any, not maintained in the general ledger
- Examination of the management contract

8.06 Most CIRAs are required by law, mortgage documents and agreements or their governing documents to establish a plan for funding future major repairs and replacements, and information about the funding should be disclosed in the notes to the financial statements. Therefore, an accountant engaged to review the financial statements of a CIRA should extend his or her inquiries to include the CIRA's funding plan for future major repairs and replacements.

8.07 State laws or regulations, or a CIRA's governing documents, may prescribe whether a CIRA should have its financial statements compiled, reviewed, or audited. If an accountant who is engaged to compile a CIRA's financial statements becomes aware that the CIRA is required to have a review or

* In January 2004 the AICPA's Accounting and Review Services Committee (ARSC) issued an exposure draft of a proposed Statement on Standards for Accounting and Review Services (SSARS), *Performance of Review Engagements*, which would revise SSARS No. 1 to (*a*) expand existing guidance regarding analytical procedures, inquiries, and other review procedures, (*b*) provide the accountant with inquiries he or she should make regarding fraud in a review engagement, (*c*) require representation regarding fraud in the management representation letter, and (*d*) clarify and provide guidance regarding workpaper documentation in a review engagement. The proposed Statement would be effective for reviews of financial statements for periods ending on or after December 15, 2004. Readers should be alert to the issuance of the final Statement.

an audit, the accountant should communicate to management and the association board of directors that a compilation will not satisfy the applicable legal, regulatory, or contractual requirements. An accountant who is engaged to review a CIRA's financial statements has a similar duty if he or she becomes aware that the CIRA is required to have an audit. Management's and the association board of director's actions in response to such communications should be considered by the accountant in relation to other aspects of the engagement.

Representation Letters

8.08 SSARS No. 1, *Compilation and Review of Financial Statements*, as amended by SSARS No. 7, *Omnibus Statement on Standards for Accounting and Review Services—1992* and SSARS No. 9, *Omnibus Statement on Standards for Accounting and Review Services—2002*, requires that, as part of every review engagement, the accountant obtain a representation letter from members of management and the board of directors whom the accountant believes are responsible for and knowledgeable, directly or through others in the organization, about the matters covered in the representation letter. Normally, the representation letter should be signed by officers of the CIRA and the managing agent, if any. (A representation letter for a review engagement is illustrated in exhibit B-5 of appendix B.)

8.09 Written representations are required from management and the board of directors for all financial statements and periods covered by the accountant's review report. For example, if comparative financial statements are reported on, the representations obtained at the completion of the most recent review should address all periods being reported on. The specific written representations obtained by the accountant will depend on the circumstances of the engagement and the nature and basis of presentation of the financial statements. In connection with a review of financial statements presented in accordance with generally accepted accounting principles, specific representations should relate to the following matters:[1]

a. Management's and the board's acknowledgement of its responsibility for the fair presentation in the financial statements of financial position, results of operations, and cash flows in conformity with generally accepted accounting principles.

b. Management's and the board's belief that the financial statements are fairly presented in conformity with generally accepted accounting principles.

c. Management's and the board's full and truthful response to all inquiries.

d. Completeness of information.

e. Information concerning subsequent events.

8.10 The representation letter ordinarily should be tailored to include additional appropriate representation from management and the board relating to matters specific to the entity's business or industry.

8.11 The written representations should be addressed to the accountant. Because the accountant is concerned with events occurring through the date of

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[1] Specific representations also are applicable to financial statements presented in conformity with a comprehensive basis of accounting other than generally accepted accounting principles. The specific representations to be obtained should be based on the nature and basis of presentation of the financial statements being reviewed.

the report that may require adjustment to or disclosure in the financial statements, the representations should be made as of a date no earlier than the date of the accountant's report. The letter should be signed by those in management and the board whom the accountant believes are responsible for and knowledgeable, directly or through others in the organization, about the matters covered in the representation letter. Normally, the chief executive officer and chief financial officer or others with equivalent positions in the entity should sign the representation letter. If the current management and board of directors was not present during all periods covered by the accountant's report, the accountant should nevertheless obtain written representation from current management and board of directors on all such periods.

Reporting on Required Supplementary Information Accompanying Compiled or Reviewed Financial Statements of Common Interest Realty Associations[2]

8.12 When the basic financial statements have been compiled or reviewed, the required supplementary information accompanying the basic financial statements should, at a minimum, be compiled. If the entity chooses to omit the required supplementary information, the guidance in paragraph 8.15 should be followed. To compile the required supplementary information, the accountant should—

a. Establish an understanding with the entity regarding the services the accountant will perform with respect to the required supplementary information and how that information will affect the report the accountant expects to render.

b. Consider what supplementary information is required by this guide and how that information is to be presented.

c. Obtain an understanding of how the required supplementary information was developed. This understanding ordinarily includes the following:
   - The source of the information, for example, engineering reports, estimates obtained from licensed contractors, tables in technical manuals on useful lives
   - Whether the required supplementary information is based on current or future replacement costs
   - The interest and inflation rates used to determine funding requirements if the information is based on future replacement costs

d. Consider whether it will be necessary to perform other accounting services in order to compile the required supplementary information.

e. Read the required supplementary information and consider whether it appears to be appropriate in form and free from obvious material error.

f. Obtain additional or revised information, if the accountant becomes aware that the required supplementary information is incorrect, incomplete, or otherwise unsatisfactory.

g. If the entity is unable or refuses to provide additional or revised information, consider whether a modification of the standard report

[2] Incorporated from Statement of Position (SOP) 93-5, *Reporting on Required Supplementary Information Accompanying Compiled or Reviewed Financial Statements of Common Interest Realty Associations*. SOP 93-5 is included as appendix C of this guide.

is adequate to disclose the deficiency in the measurement or presentation of the required supplementary information. If modification of the standard report is adequate to disclose the deficiency, the accountant should follow the guidance in paragraph 8.14. If modification of the standard report is not adequate to disclose the deficiency, the accountant should withdraw from the engagement.

8.13 When the basic financial statements have been compiled or reviewed and the accompanying required supplementary information has been compiled, the accountant should indicate in the report, or in a separate report, the degree of responsibility he or she is taking for the supplementary information. The report should—

a. Identify the required supplementary information accompanying the financial statements. (Identification may be by descriptive title or page number of the document.)

b. State that the supplementary information is not a required part of the basic financial statements but is supplementary information required by the AICPA.

c. State that the accountant has compiled the accompanying supplementary information from information that is the representation of management, without audit or review.

d. State that the accountant does not express an opinion or any other form of assurance on the supplementary information.

An example of an additional paragraph that may be added to a compilation report follows:

> The [*identify the supplementary information*] on page XX is not a required part of the basic financial statements but is supplementary information required by the American Institute of Certified Public Accountants. We (I) have compiled [*identify the supplementary information*] from information that is the representation of management of XYZ Company, without audit or review. Accordingly, we (I) do not express an opinion or any other form of assurance on the supplementary information.

8.14 If, on the basis of facts known to him or her, the accountant becomes aware that the supplementary information has not been measured or presented in accordance with prescribed guidelines, the accountant should indicate in his or her report that the information does not conform to the guidelines and should describe the nature of any material departure(s). An example of a sentence that might be added to the illustrative paragraph presented in paragraph 8.13 follows:

> However, we (I) did become aware that the supplementary information about future major repairs and replacements of common property is not presented in conformity with the guidelines established by the American Institute of Certified Public Accountants because [*describe the material departure from the AICPA guidelines*].

8.15 When the compiled or reviewed financial statements are not accompanied by the required supplementary information, a paragraph should be added to the compilation or review report * indicating that the required supplementary information has been omitted. The accountant need not present the supplementary information in the accountant's report. The following is an example of a paragraph that the accountant might use in these circumstances:

> The American Institute of Certified Public Accountants has determined that supplementary information about future major repairs and replacements of common property is required to supplement, but not required to be a part of, the basic financial statements. The Association has not presented this supplementary information.

8.16 In an engagement to review the basic financial statements, the required supplementary information is not subjected to the inquiry and analytical procedures applied in the review of the basic financial statements; therefore, SSARSs are not applicable to the review of this information. If the accountant has been engaged to review the required supplementary information, he or she may do so in accordance with the SSAE No. 10, *Attestation Standards: Revision and Recodification*, Chapter 1, "Attest Engagements" (AICPA, *Professional Standards*, vol. 1, AT sec. 101), as amended by SSAE No. 11, *Attest Documentation*.

* In September 2003, Accounting and Review Services Interpretation No. 24, "Reference to the Country of Origin in a Review or Compilation Report," of SSARS No. 1, *Compilation and Review of Financial Statements* was issued. The SSARS interpretation states that it does not require the reference to the country of origin as review and compilation reports refer to the American Institute of Certified Public Accountants. However, there is no prohibition of the reference if the accountant believes it is appropriate under the circumstances to include it in the report.

Chapter 9
Cooperative Housing Corporations

9.01 This chapter provides guidance on GAAS and financial reporting principles and practices to audits of and for cooperative housing corporations and should be considered in addition to the guidance for CIRAs, other than cooperatives, contained in the other chapters of this guide.

9.02 A cooperative housing corporation (cooperative) is organized to acquire and hold title to property. Shares of stock or membership interests in the corporation are sold to a **tenant-shareholder** who is given the right to occupy a specific dwelling unit as a result of agreements with the corporation. That agreement is commonly referred to as a *proprietary lease* in conventionally financed cooperatives and an *occupancy agreement* in cooperatives, the mortgages of which are insured by the Department of Housing and Urban Development (HUD). A shareholder's rights include (*a*) the right to occupy a defined interior space as well as (*b*) an undivided interest in the cooperative's common property.

9.03 The governing documents of a cooperative give tenant-shareholders the right to participate in governing the cooperative. The board of directors is required to inform tenant-shareholders of important financial and management matters.

9.04 The three basic forms of cooperatives are independent market-rate cooperatives, limited-equity cooperatives, and leasing cooperatives. Independent market-rate cooperatives are organized as corporations, the shares of which are sold at market value. Shares are normally bought and sold on the open market (usually through real estate listings), although they could be sold by the cooperative.

9.05 Bylaws of limited-equity cooperatives restrict the amount of appreciation when shares are sold by tenant-shareholders. Generally, such cooperatives have the option to repurchase the shares and resell them with only a small amount of appreciation to prevent the cost of shares in the cooperative from increasing because of inflation. Such cooperatives may also limit the amounts of dividends paid on the investments of tenant shareholders. Dividends, also referred to as **patronage dividends**, are year-end refunds of rents received from tenant shareholders in excess of actual expenses incurred by the corporation. If the governing documents so state, it is possible that no dividends are paid.

9.06 Limited-equity cooperatives are usually organized with government financing and are directed towards low and moderate-income buyers. Financing may be received from state or local housing agencies at interest rates below market or through various HUD programs.

9.07 Many leasing cooperatives are associated with outside investors. In such an arrangement, it is common for a cooperative to lease a building from an investor who receives all the tax benefits from owning the building. In some arrangements, the cooperative receives a fee for managing the building. The cooperative may buy the building when the lease expires. This form of cooperative is also used by housing authorities, which retain ownership of the buildings for the sole purpose of keeping units at below-market purchase prices.

9.08 The financial statements of cooperatives are generally presented like those of commercial entities. However, a cooperative may present financial statements using fund reporting. Because depreciation is a noncash item, it is often presented in the income statement as the last line item after all income and operating expenses have been listed.

9.09 Cooperatives should present the following:

- A balance sheet
- A statement of operations
- A statement of changes in shareholders' equity
- A statement of cash flows
- Notes to financial statements
- The supplementary information required by paragraph 4.33 of this guide

Balance Sheet

9.10 The balance sheet includes information on all assets and liabilities resulting from the cooperative's operations and shareholders' equity.

9.11 All property owned by a cooperative is presented on its balance sheets. Cooperatives generally own the real estate and have the ability to borrow and pledge their assets as collateral. Some cooperatives, therefore, do not accumulate funds for future major repairs and replacements. The notes to the financial statements should disclose a cooperative's funding policy, if any, for future major repairs and replacements, as discussed in chapter 4 of this guide.

9.12 Components of retained earnings or deficit should not be disclosed. Allocating a portion of retained earnings to an amount equal to accumulated depreciation is an unacceptable practice.

Statement of Operations

9.13 Statements of operations of cooperatives should present information about all revenues and expenses. Reported revenues should include all charges to tenant-shareholders and other income. If per-share data are deemed useful, they should be considered for disclosure in the notes to the financial statements.

Statement of Changes in Shareholders' Equity

9.14 A statement of retained earnings (deficit) may be combined with the statement of operations (see exhibit A-15 of appendix A). If there is activity in paid-in capital, a separate statement of shareholders' equity should be prepared.

Statement of Cash Flows

9.15 A cooperative's financial statements should include a statement of cash flows, as do the financial statements of other CIRAs.

Notes to Financial Statements

9.16 In addition to all the notes normally required by GAAP, the notes should include the disclosures discussed in chapter 4 of this guide.

9.17 A cooperative's financial statements should include the supplementary information required by paragraph 4.33 of this guide.

Income Tax Considerations

9.18 Cooperatives are generally taxed as regular corporations and are required to file corporate tax returns on Form 1120. Cooperatives are taxed on the excess of rents and other patronage income over operating expenses incurred and not returned to tenant-shareholders at the end of the year, and on other nonpatronage income, if any, such as interest income and dividends.

9.19 If predetermined assessments collected from tenant-shareholders exceed expenditures paid or incurred, a refund to tenant-shareholders in the same year results in an adjustment in the cooperative's receipts from tenant-shareholders and only the net amount of receipts is included in income for income tax purposes. A cooperative can thus avoid being taxed on excess income by distributing cash in that amount as a *patronage dividend* to shareholders. Under the provisions of subchapter T, cooperatives can deduct patronage dividends declared and paid within eight-and-a-half months after the end of the fiscal year. Such dividends are required to be paid 20 percent in cash and 80 percent constructively, with a qualified written notice of allocation, and are not included in gross income by tenant-shareholders, unless the property is used in a trade or business. If expenditures exceed the amount collected from tenant-shareholders in a taxable year, the excess is not deductible in that year, but may be carried forward to offset income in subsequent years.

9.20 Section 216 of the IRC defines the requirements that corporations must meet to be treated as cooperative housing corporations for tax purposes for that year as follows:

a. The corporation has only one class of stock outstanding.

b. Each shareholder is entitled to occupy a corporate-owned or based unit for dwelling purposes solely as a result of stock ownership.

c. No shareholder is entitled to receive distributions that are in excess of the income and profits of the corporation, except in complete or partial liquidation of the corporation.

d. The corporation derives 80 percent or more of its gross income from tenant-shareholders in any year.

9.21 Under the IRC, cooperatives are allowed to depreciate the property they lease to tenant-shareholders. Pursuant to section 216(c) of the IRC, qualified tenant-shareholders in a qualified cooperative housing corporation are allowed to treat all or a portion of their stock as property subject to the allowance for depreciation under section 167(a) if both of the following criteria are met:

a. The associated occupancy right or proprietary lease relates to a unit or lease that is itself depreciable or amortizable.

b. That occupancy right or lease is used by the tenant-shareholder in a trade or business or for the production of income.

Tenant-shareholders are allowed to deduct their proportionate shares of interest and real estate taxes paid or incurred by the cooperative. Those amounts are deductible only to the extent that tenant-shareholders' payments are current.

9.22 Assessments to fund future major repairs and replacements, which are required under state statutes, or by HUD or Federal Housing Administration (FHA) regulations and are not available for distributions to shareholders, are held to be capital contributions. Amounts collected for future major repairs and replacements in excess of state statute, HUD, or FHA requirements are considered to be surplus funds available for distribution and are, therefore, includable in the corporation's gross income unless the total amount assessed is recorded as a capital contribution.

9.23 Tenant-shareholders selling their shares of stock in cooperatives that have legal limitations on their resale prices may have to forfeit to the corporation proceeds in excess of legal resale prices, if any. If there are no restrictions on the use of these forfeitures, they are includable in the corporation's gross income.

9.24 Paragraphs 6.03 and 6.04 of this guide discuss the applicability of subchapter T and section 277 of the IRC to cooperative housing corporations.

Financial Statements

9.25 Financial statements and notes for cooperatives are illustrated in exhibits A-14 to A-17 of appendix A.

Auditor's Report

9.26 The auditor should follow the guidance in chapter 7 of this guide for circumstances that may require the report to be modified.

Appendix A

Illustrative Financial Statements

The following exhibits illustrate a fund accounting presentation and a set of nonfund accounting financial statements for condominium and HOAs, as well as a set of financial statements for a cooperative housing corporation. The notes to the illustrative financial statements are representative of the basic kind of disclosure for CIRAs and may not all be necessary for some CIRAs. Additional disclosure may be appropriate, depending on the circumstances. A summary of the exhibits follows:

- Exhibits A-1 through A-8 illustrate financial statements and supplementary information for a condominium association. Condominiums generally do not hold title to property transferred to them by the developers. Exhibits A-1 and A-2 present a balance sheet and a statement of revenues and expenses using fund reporting in a multicolumn format with a total funds column for the current and prior years. Exhibit A-3 illustrates a statement of cash flows using the direct method. Exhibit A-4 illustrates a statement of cash flows using the indirect method. This set of financial statements reflects an interfund receivable and payable of $20,000, which the board of directors intends for the operating fund to repay to the replacement fund in the next fiscal year. The statements also disclose a transfer of $10,000 from the replacement fund to the operating fund, which is an amount that the board of directors does not intend for the operating fund to repay to the replacement fund.
- The illustrative notes in exhibit A-5 include alternative presentations for Note 4, which discloses information about a CIRA's fund for future major repairs and replacements. Alternative A illustrates disclosure based on a study conducted by the board of directors. Alternative B is based on a study conducted by an independent consulting firm. Note 4 also illustrates disclosure for a loan from the replacement fund to the operating fund as well as a permanent transfer.
- Exhibits A-6 and A-7 present detailed schedules of actual and budgeted amounts of revenues and expenses for the operating fund, and of changes in replacement fund balances. These schedules are not a required part of the basic financial statements; however, if they are included with the financial statements in an auditor-submitted document, the auditor should refer to SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*, as amended, for reporting guidance.
- Exhibit A-8 presents unaudited supplementary information required by paragraph 4.33 of this guide. Alternative A illustrates disclosure based on a study conducted by the board of directors and presents estimates of current replacement costs. Alternative B is based on a study conducted by an independent consulting firm and presents estimates of future replacement costs, which are calculated considering inflation and estimated investment income.
- Exhibits A-9, A-10, and A-11 illustrate, respectively, an HOA's balance sheet, statement of revenues and expenses, and statement of cash flows for a presentation using non-fund-reporting financial state-

ments.[1] Exhibit A-12 illustrates a statement of changes in members' equity, which would be presented with those financial statements. The statements reflect common real property that has been reported as assets of a CIRA.

- Exhibit A-13 illustrates a schedule of expenditures for major repairs and replacements. This schedule is not a required part of the basic financial statements; however, if it is included in an auditor-submitted document, the auditor should refer to SAS No. 29 for reporting guidance.
- Exhibits A-14 through A-17 present financial statements and notes for a cooperative housing corporation.
- Exhibit A-18 presents unaudited supplementary information, based on a study conducted by the board of directors, for a cooperative housing corporation required by paragraph 4.33 of this guide and presents estimates of current replacement costs.

The financial statements illustrated do not include immaterial amounts.

[1] Paragraphs 4.01 and 4.02 of this guide state that nonfund reporting is permitted, although fund reporting is preferred.

Exhibit A-1

XYZ Condominium Association, Inc.
Balance Sheets
as of December 31, 20X2
(With Comparative Totals for 20X1)

	20X2			*20X1*
	Operating Fund	*Replacement Fund*	*Total*	*Total*
ASSETS				
Cash and cash equivalents	$ 110,000	$ 364,000	$ 474,000	$ 298,000
Assessments receivable	28,000		28,000	9,000
Prepaid expenses	7,000		7,000	7,000
Due from operating fund		20,000	20,000	
Due to replacement fund	(20,000)		(20,000)	
Equipment, net of accumulated depreciation of $8,000 and $5,000	21,000		21,000	17,000
TOTAL ASSETS	$ 146,000	$ 384,000	$ 530,000	$ 331,000
LIABILITIES				
Accounts payable	$ 20,000	$ 4,000	$ 24,000	$ 6,000
Wages payable	6,000		6,000	
Income taxes payable		1,000	1,000	5,000
Prepaid assessments	20,000		20,000	15,000
	46,000	5,000	51,000	26,000
FUND BALANCES	100,000	379,000	479,000	305,000
TOTAL LIABILITIES AND FUND BALANCES	$ 146,000	$ 384,000	$ 530,000	$ 331,000

The accompanying notes are an integral part of the financial statements.

Exhibit A-2

XYZ Condominium Association, Inc.
Statements of Revenues and Expenses
and Changes in Fund Balances
for the Year Ended December 31, 20X2
(With Comparative Totals for 20X1)

	20X2			*20X1*
	Operating Fund	*Replacement Fund*	*Total*	*Total*
REVENUES				
Member assessments	$ 747,000	$ 247,000	$ 994,000	$ 909,000
Interest		49,000	49,000	46,000
Lawsuit settlements		141,000	141,000	91,000
Other	22,000		22,000	20,000
TOTAL REVENUES	769,000	437,000	1,206,000	1,066,000
EXPENSES				
Wages and benefits	294,000		294,000	284,000
Utilities	160,000		160,000	141,000
Roofs		144,000	144,000	160,000
Service and contracts	129,000		129,000	134,000
Exterior siding		94,000	94,000	98,000
Repairs and supplies	92,000		92,000	61,000
Insurance and licenses	50,000		50,000	46,000
Administrative	28,000		28,000	18,000
Income taxes	1,000	11,000	12,000	13,000
Legal fees		10,000	10,000	
Recreational equipment		5,000	5,000	2,000
Solar equipment		5,000	5,000	
Streets		4,000	4,000	20,000
Tennis courts				12,000
Depreciation	3,000		3,000	3,000
Bad debts	2,000		2,000	
Pools and spas				18,000
TOTAL EXPENSES	759,000	273,000	1,032,000	1,010,000
Excess of revenues over expenses	10,000	164,000	174,000	56,000
Beginning fund balances	80,000	225,000	305,000	249,000
Transfer from replacement fund	10,000	(10,000)		
ENDING FUND BALANCES	$ 100,000	$ 379,000	$ 479,000	$ 305,000

The accompanying notes are an integral part of the financial statements.

Exhibit A-3

Direct Method

XYZ Condominium Association, Inc.
Statement of Cash Flows
for the Year Ended December 31, 20X2
(With Comparative Totals for 20X1)

	20X2			*20X1*
	Operating Fund	*Replacement Fund*	*Total*	*Total*
Cash flows from operating activities:				
Member assessments collected	$ 733,000	$ 247,000	$ 980,000	$ 920,000
Interest received		49,000	49,000	46,000
Lawsuit settlement		141,000	141,000	91,000
Other income received	22,000		22,000	20,000
Cash paid for operating expenditures[2]	(735,000)		(735,000)	(673,000)
Replacement expenditures paid		(258,000)	(258,000)	(310,000)
Income taxes paid	(1,000)	(15,000)	(16,000)	(26,000)
Transfers from replacement fund	10,000	(10,000)		
Net borrowings from replacement fund	20,000	(20,000)		
Net cash provided by operating activities	49,000	134,000	183,000	68,000
Cash flows from investing activities:				
Equipment purchases	(7,000)		(7,000)	(3,000)
Net increase in cash and cash equivalents	42,000	134,000	176,000	65,000
Cash and cash equivalents at beginning of year	68,000	230,000	298,000	233,000
Cash and cash equivalents at end of year	$ 110,000	$ 364,000	$ 474,000	$ 298,000

(continued)

The accompanying notes are an integral part of the financial statements.

[2] As an alternative presentation, this line item can be further detailed as shown in exhibit A-11.

XYZ Condominium Association, Inc.
Statement of Cash Flows
for the Year Ended December 31, 20X2
(With Comparative Totals for 20X1)

	20X2			*20X1*
	Operating Fund	*Replacement Fund*	*Total*	*Total*
Reconciliation of excess of revenues over expenses to net cash provided by operating activities:				
Excess of revenues over expenses	$ 10,000	$ 164,000	$ 174,000	$ 56,000
Adjustments to reconcile excess of revenues over expenses to net cash provided by operating activities:				
Increase (decrease) in interfund balances	20,000	(20,000)		
Transfers from replacement fund	10,000	(10,000)		
Depreciation	3,000		3,000	3,000
Increase in assessments receivable	(19,000)		(19,000)	(1,000)
Decrease in prepaid expenses				1,000
Increase in accounts payable	14,000	4,000	18,000	2,000
Increase in wages payable	6,000		6,000	
Decrease in income taxes payable		(4,000)	(4,000)	
Increase in prepaid assessments	5,000		5,000	7,000
Total adjustments	39,000	(30,000)	9,000	12,000
Net cash provided by operating activities	$ 49,000	$ 134,000	$ 183,000	$ 68,000

The accompanying notes are an integral part of the financial statements.

Exhibit A-4

Indirect Method

XYZ Condominium Association, Inc.
Statement of Cash Flows
for the Year Ended December 31, 20X2
(With Comparative Totals for 20X1)

	20X2			*20X1*
	Operating Fund	*Replacement Fund*	*Total*	*Total*
Excess of revenues over expenses	$ 10,000	$ 164,000	$ 174,000	$ 56,000
Adjustments to reconcile excess of revenues over expenses to net cash provided by operating activities:				
Increase (decrease) in interfund balances	20,000	(20,000)		
Transfers from replacement fund	10,000	(10,000)		
Depreciation	3,000		3,000	3,000
Increase in assessments receivable	(19,000)		(19,000)	(1,000)
Decrease in prepaid expenses				1,000
Increase in accounts payable	14,000	4,000	18,000	2,000
Increase in wages payable	6,000		6,000	
Decrease in income taxes payable		(4,000)	(4,000)	
Increase in prepaid assessments	5,000		5,000	7,000
Total adjustments	39,000	(30,000)	9,000	12,000
Net cash provided by operating activities	49,000	134,000	183,000	68,000
Cash flows from investing activities:				
Equipment purchases	(7,000)		(7,000)	(3,000)
Net increase in cash and cash equivalents	42,000	134,000	176,000	65,000
Cash and cash equivalents at beginning of year	68,000	230,000	298,000	233,000
Cash and cash equivalents at end of year	$ 110,000	$ 364,000	$ 474,000	$ 298,000

The accompanying notes are an integral part of the financial statements.

Exhibit A-5

XYZ Condominium Association, Inc.
Notes to Financial Statements
December 31, 20X2 and 20X1

1. Organization

The XYZ Condominium Association is a statutory condominium association organized as a not-for-profit corporation for the purposes of maintaining and preserving common property of the XYZ condominium. The XYZ condominium consists of 800 residential units occupying a site of approximately 10 acres located at ____________. The Association began its operations in June 20XX.

2. Summary of Significant Accounting Policies

Pervasiveness of Estimates. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Fund accounting. The Association uses fund accounting, which requires that funds, such as operating funds, deferred maintenance funds, and funds designated for future major repairs and replacements, be classified separately for accounting and reporting purposes. Disbursements from the operating fund are generally at the discretion of the board of directors and property manager. Disbursements from the replacement fund generally may be made only for designated purposes.

Interest earned. The board's policy is to allocate to each fund interest earned on all cash accounts net of income taxes.

Recognition of assets and depreciation policy. The Association recognizes personal property assets at cost. The property is depreciated over its estimated useful life using the straight-line method of depreciation.

3. Owners' Assessments

Monthly assessments to owners were $103.54 and $94.69 in 20X2 and 20X1. Of those amounts, $25.73 and $22.50 were designated to the replacement fund.

The annual budget and assessments of owners are determined by the board of directors and are approved by the owners. The Association retains excess operating funds at the end of the operating year, if any, for use in future operating periods.

4. Future Major Repairs and Replacements

Alternative A. The Association's governing documents require that funds be accumulated for future major repairs and replacements. Accumulated funds are held in separate savings accounts and generally are not available for expenditures for normal operations.

The board of directors conducted a study in November 20X2 to estimate the remaining useful lives and the replacement costs of the components of common property. The estimates were obtained from licensed contractors who inspected the property. The table included in the unaudited supplementary information on Future Major Repairs and Replacements is based on the study.

The board is funding for major repairs and replacements over the remaining useful lives of the components based on the study's estimates of current replacement costs and considering amounts previously accumulated in the replacement fund. Accordingly, the funding requirement of $302,000, based on a full funding plan, has been included in the 20X3 budget.

Funds are being accumulated in the replacement fund based on estimates of future needs for repairs and replacements of common property components. Actual expenditures may vary from the estimated future expenditures, and the variations may be material. Therefore, amounts accumulated in the replacement fund may not be adequate to meet all future needs for major repairs and replacements. If additional funds are needed, the Association has the right, subject to membership approval, to increase regular assessments, pass special assessments, or delay major repairs and replacements until funds are available.

The Association used $30,000 from the replacement fund for operations during 20X2. The board intends to repay $20,000 of that amount during 20X3 and has, therefore, reflected $20,000 as an interfund receivable and payable. The board does not intend to repay $10,000 of the amount and has, therefore, reflected $10,000 as a transfer from the replacement to the operating fund.

Alternative B. The Association's governing documents require that funds be accumulated for future major repairs and replacements. Accumulated funds are held in separate savings accounts and are generally not available for expenditures for normal operations.

The ABC Consulting Company conducted a study in November 20X2 to estimate the remaining useful lives and the replacement costs of the components of common property. The estimates were based on future estimated replacement costs. Funding requirements consider an annual inflation rate of 5 percent and interest of 8 percent, net of taxes, on amounts funded for future major repairs and replacements. The table included in the unaudited supplementary information on Future Major Repairs and Replacements is based on the study.

The board is funding for major repairs and replacements over the remaining useful lives of the components based on the study's estimates of future replacement costs and considering amounts previously accumulated in the replacement fund. Accordingly, the funding requirement of $374,000, based on a threshold funding plan, has been included in the 20X3 budget.

Funds are being accumulated in the replacement fund based on estimated future costs for repairs and replacements of common property components. Actual expenditures and investment income may vary from the estimated amounts, and the variations may be material. Therefore, amounts accumulated in the replacement fund may not be adequate to meet all future needs for major repairs and replacements. If additional funds are needed, the Association has the right, subject to membership approval, to increase regular assessments, pass special assessments, or delay major repairs and replacements until funds are available.

The Association used $30,000 from the replacement fund for operations during 20X2. The board intends to repay $20,000 of that amount during 20X3 and has, therefore, reflected $20,000 as an interfund receivable and payable. The board does not intend to repay $10,000 of the amount and has, therefore, reflected $10,000 as a transfer from the replacement to the operating fund.

5. Federal and State Taxes

In 20X2, the Association filed its income tax return, form 1120, as a regular corporation. The Association had an excess of expenses for the maintenance of the common property over membership source income. That excess may be carried over to future periods to offset future income from membership sources when the Association files as a regular corporation. In 20X1, the Association elected to file as a homeowners' association in accordance with Internal Revenue Service Code section 528, using form 1120-H. Under that section, the Association excludes from taxation exempt function income, which generally consists of revenue from uniform assessments to owners. In both years, the Association's investment income and other nonexempt income were subject to tax.

6. Lawsuit Settlements

During 20X1, the Association settled a lawsuit against the developer for defective construction and received a partial settlement of $91,000. During 20X2, the Association received another settlement of $141,000. Legal fees of $10,000 were incurred in connection with that lawsuit.

The following net amounts have been added to the replacement fund:

	20X2	*20X1*
Roof	$ 131,000	$ 66,000
Tennis courts	0	23,000
Pools and spas	0	1,000
Streets	0	1,000
TOTAL	$ 131,000	$ 91,000

7. Assessments Receivable

The Association's policy is to retain legal counsel and place liens on the properties of homeowners whose assessments are thirty days in arrears and therefore considered delinquent. As of December 31, 20X2, the Association had assessments receivable of $28,000, of which $22,000 were delinquent. As of February 12, 20X3, judgments and settlements of approximately $15,000 have been received. It is the opinion of the board of directors that the Association will ultimately prevail against the remaining homeowners whose assessments are delinquent, and, accordingly, no allowance for uncollectible accounts is deemed necessary.

Exhibit A-6

XYZ Condominium Association, Inc.
Schedules of Operating Fund Revenues and Expenses[3]
for the Years Ended December 31, 20X2 and 20X1

	20X2		*20X1*	
	20X2 Actual	*20X2 Budget (Unaudited)*	*20X1 Actual*	*20X1 Budget (Unaudited)*
REVENUES				
Assessments	$ 747,000	$ 747,000	$ 693,000	$ 693,000
Other charges	22,000	23,000	20,000	20,000
TOTAL	769,000	770,000	713,000	713,000
EXPENSES				
Wages and Benefits				
Grounds	130,000	144,000	106,000	128,000
Maintenance	87,000	100,000	98,000	100,000
Payroll taxes and benefits	37,000	31,000	31,000	30,000
Office	27,000	31,000	34,000	35,000
Workers' compensation insurance	13,000	16,000	15,000	15,000
	294,000	322,000	284,000	308,000
Utilities				
Electricity	111,000	108,000	100,000	95,000
Water	29,000	33,000	33,000	33,000
Gas	20,000	9,000	8,000	12,000
	160,000	150,000	141,000	140,000
Service and Contracts				
Security	43,000	45,000	45,000	50,000
Cable T.V.	21,000	20,000	19,000	20,000
Trash disposal	19,000	19,000	18,000	20,000
Pool service	18,000	18,000	17,000	15,000
Janitorial	15,000	21,000	21,000	20,000
Pest control	13,000	14,000	14,000	10,000
	129,000	137,000	134,000	135,000

(continued)

[3] *Note:* Paragraph 7.47 of this Guide discusses the auditor's reporting responsibility with respect to such information.

	20X2		20X1	
	20X2 Actual	20X2 Budget (Unaudited)	20X1 Actual	20X1 Budget (Unaudited)
Repairs and Supplies				
Landscape supplies	15,000	11,000	9,000	10,000
Equipment repairs	14,000	11,000	13,000	12,000
Equipment rental	13,000	13,000	8,000	7,000
Vehicle maintenance	12,000	14,000	7,000	10,000
Fence repairs	8,000	8,000	8,000	7,000
Plumbing	6,000	5,000	5,000	8,000
Street repairs	5,000	2,000	2,000	6,000
Parts and supplies	5,000	2,000	2,000	1,000
Pool repairs	4,000	5,000	1,000	2,000
Sprinkler supplies	4,000	7,000	3,000	2,000
Electrical	3,000	3,000	2,000	3,000
Tennis courts	3,000	2,000	1,000	2,000
	92,000	83,000	61,000	70,000
Insurance and Licenses				
Insurance	49,000	49,000	45,000	40,000
Licenses	1,000	1,000	1,000	
	50,000	50,000	46,000	40,000
Administrative				
Accounting	11,000	10,000	6,000	7,000
Legal	9,000	11,000	8,000	8,000
Office	4,000	4,000	1,000	1,000
Telephone	4,000	3,000	3,000	4,000
	28,000	28,000	18,000	20,000
Bad Debts	2,000			
Depreciation	3,000		3,000	
Income Taxes	1,000			
TOTAL EXPENSES	759,000	770,000	687,000	713,000
EXCESS OF REVENUES OVER EXPENSES	$ 10,000	$	$ 26,000	$

Exhibit A-7

XYZ Condominium Association, Inc.
Schedules of Changes in Replacement Fund Balances for the Years Ended December 31, 20X2 and 20X1

20X2

COMMON AREA COMPONENT	*Beginning Fund Balance*	*Additions to Fund* [4]	*Charges to Fund*	*Components of Ending Fund Balance*
Roofs	$ 96,000	$ 202,000	$ 144,000	$ 154,000
Streets	17,000	44,000	4,000	57,000
Recreation facilities	50,000	10,000	5,000	55,000
Exterior siding	38,000	104,000	94,000	48,000
Pools, spas, solar equipment	8,000	36,000	5,000	39,000
Tennis courts	4,000	10,000		14,000
Furniture and equipment	12,000			12,000
Lawsuit legal fees		10,000	10,000	
TOTAL	$ 225,000	$ 416,000	$ 262,000	$ 379,000

20X1

COMMON AREA COMPONENT	*Beginning Fund Balance*	*Additions to Fund* [4]	*Charges to Fund*	*Components of Ending Fund Balance*
Roofs	$ 102,000	$ 154,000	$ 160,000	$ 96,000
Streets	11,000	26,000	20,000	17,000
Recreation facilities	35,000	17,000	2,000	50,000
Exterior siding	32,000	104,000	98,000	38,000
Pools, spas, solar equipment	13,000	13,000	18,000	8,000
Tennis courts	2,000	14,000	12,000	4,000
Furniture and equipment		12,000		12,000
TOTAL	$ 195,000	$ 340,000	$ 310,000	$ 225,000

[4] Includes interest income of $49,000, net of income taxes of $11,000 and net of a $10,000 transfer to the operating fund in 20X2 and interest income of $46,000 net of income taxes of $13,000 in 20X1.

Note: These reconciling items may be presented as illustrated here or in separate columns in this schedule.

Exhibit A-8

XYZ Condominium Association, Inc.
Supplementary Information on Future Major Repairs and Replacements
December 31, 20X2
(Unaudited)

Alternative A

The board of directors conducted a study in November 20X2 to estimate the remaining useful lives and the replacement costs of the components of common property. The estimates were obtained from licensed contractors who inspected the property.

The following table is based on the study and presents significant information about the components of common property.

Components	*Estimated Remaining Useful Lives (Years)*	*Estimated Current Replacement Costs*	*20X3 Funding Requirement*	*Components of Fund Balance at Dec. 31, 20X2*
Roofs	5 to 14	$ 1,620,000	$ 120,000	$ 154,000
Streets	5 to 14	96,000	40,000	57,000
Recreation facilities	2 to 11	120,000	12,000	55,000
Exterior siding	7 to 11	760,000	72,000	48,000
Pools, spas, solar equipment	2 to 14	112,000	36,000	39,000
Tennis courts	5 to 10	64,000	10,000	14,000
Furniture and equipment	3 to 7	80,000	12,000	12,000
		$ 2,852,000	$ 302,000	$ 379,000

(continued)

XYZ Condominium Association, Inc.
Supplementary Information on Future Major Repairs and Replacements
December 31, 20X2
(Unaudited)

Alternative B

The ABC Consulting Company conducted a study in November 20X2 to estimate the remaining useful lives and the replacement costs of the components of common property. The estimates were based on future estimated replacement costs. Funding requirements consider an annual inflation rate of 5 percent and interest of 8 percent, net of taxes, on amounts funded for future major repairs and replacements.

The following table is based on the study and presents significant information about the components of common property.

Components	*Estimated Remaining Useful Lives (Years)*	*Estimated Current Replacement Costs*	*20X3 Funding Requirement*	*Components of Fund Balance at Dec. 31, 20X2*
Roofs	5 to 14	$ 3,023,000	$ 152,000	$ 154,000
Streets	5 to 14	179,000	46,000	57,000
Recreation facilities	2 to 11	180,000	15,000	55,000
Exterior siding	7 to 11	1,256,000	93,000	48,000
Pools, spas, solar equipment	2 to 14	174,000	42,000	39,000
Tennis courts	5 to 10	97,000	12,000	14,000
Furniture and equipment	3 to 7	107,000	14,000	12,000
		$ 5,016,000	$ 374,000	$ 379,000

Exhibit A-9

XYZ Homeowners' Association, Inc.
Balance Sheets
as of December 31, 20X2 and 20X1

ASSETS

	20X2	*20X1*
Cash	$ 110,000	$ 68,000
Cash for future major repairs and replacements	64,000	30,000
Certificates of deposit for future major repairs and replacements	300,000	200,000
Member assessments receivable	28,000	9,000
Prepaid expenses	7,000	7,000
Manager's dwelling (net of accumulated depreciation of $20,000 and $10,000)	200,000	210,000
Equipment (net of accumulated depreciation of $8,000 and $5,000)	21,000	17,000
TOTAL ASSETS	$ 730,000	$ 541,000

LIABILITIES AND MEMBERS' EQUITY

Accounts payable	$ 24,000	$ 6,000
Wages payable	6,000	
Income taxes payable	1,000	5,000
Prepaid assessments	20,000	15,000
TOTAL LIABILITIES	51,000	26,000
MEMBERS' EQUITY	679,000	515,000
TOTAL LIABILITIES AND MEMBERS' EQUITY	$ 730,000	$ 541,000

The accompanying notes are an integral part of the financial statements.

Exhibit A-10

XYZ Homeowners' Association, Inc.
Statements of Revenues and Expenses
for the Years Ended December 31, 20X2 and 20X1

	20X2	*20X1*
REVENUES		
Member assessments:		
Operations	$ 747,000	$ 693,000
Future major repairs and replacements	247,000	216,000
Lawsuit settlements	141,000	91,000
Interest	49,000	46,000
Other charges	22,000	20,000
TOTAL REVENUES	1,206,000	1,066,000
EXPENSES		
Wages and benefits	294,000	284,000
Major repairs and replacements[5]	262,000	310,000
Utilities	160,000	141,000
Services and contracts	129,000	134,000
Repairs and supplies	92,000	61,000
Insurance and licenses	50,000	46,000
Administrative	28,000	18,000
Depreciation	13,000	13,000
Income taxes	12,000	13,000
Bad debts	2,000	
TOTAL EXPENSES	1,042,000	1,020,000
EXCESS OF REVENUES OVER EXPENSES	$ 164,000	$ 46,000

The accompanying notes are an integral part of the financial statements.

[5] Expenditures for major repairs and replacements may be presented as one amount, listed separately in this statement, or listed in an accompanying schedule as illustrated in exhibit A-13.

Exhibit A-11

Direct Method

XYZ Homeowners' Association, Inc.
Statements of Cash Flows
for the Years Ended December 31, 20X2 and 20X1
Increase (Decrease) in Cash and Cash Equivalents

	20X2	*20X1*
Cash flows from operating activities:		
Member assessments collected:		
For operations	$ 733,000	$ 704,000
For future major repairs and replacements	247,000	216,000
Lawsuit settlement	141,000	91,000
Interest received	49,000	46,000
Other income received	22,000	20,000
Administrative expenses	(30,000)	(21,000)
Utilities	(160,000)	(143,000)
Services and contracts	(111,000)	(125,000)
Income taxes	(16,000)	(12,000)
Insurance and licenses	(50,000)	(50,000)
Repairs and supplies	(92,000)	(64,000)
Wages and benefits	(288,000)	(284,000)
Expenditures for major repairs and replacements	(262,000)	(310,000)
Net cash provided by operating activities	183,000	68,000
Net cash flows from investing activities:		
Purchase of equipment	(7,000)	(3,000)
Net increase in cash and cash equivalents	176,000	65,000
Cash and cash equivalents at beginning of year	298,000	233,000
Cash and cash equivalents at end of year	$ 474,000	$ 298,000
ANALYSIS OF CASH		
Cash in bank-operating account	$ 110,000	$ 68,000
Cash-designated for future major repairs and replacements	364,000	230,000
TOTAL CASH	$ 474,000	$ 298,000

(continued)

The accompanying notes are an integral part of the financial statements.

XYZ Homeowners' Association, Inc.
Statements of Cash Flows
for the Years Ended December 31, 20X2 and 20X1

	20X2	*20X1*
Reconciliation of excess of revenues over expenses to net cash provided by operating activities:		
Excess of revenues over expenses	$ 164,000	$ 46,000
Adjustments to reconcile excess of revenues over expenses to net cash provided by operating activities:		
Depreciation	13,000	13,000
(Increase) Decrease in member assessments receivable	(19,000)	8,000
Increase in accounts payable	18,000	6,000
Increase in wages payable	6,000	5,000
(Decrease) in income taxes payable	(4,000)	(10,000)
Increase in prepaid assessments	5,000	
Net cash provided by operating activities	$ 183,000	$ 68,000

The accompanying notes are an integral part of the financial statements.

Exhibit A-12

XYZ Homeowners' Association, Inc.
Statements of Changes in Members' Equity
for the Years Ended December 31, 20X2 and 20X1

	20X2			
	Future Major Repairs and Replacements	*Members' Initial Capital Contributions*[6]	*Retained Earnings (Deficit)*	*Total Members' Equity*
MEMBERS' EQUITY-BEGINNING OF YEAR	$ 225,000	$ 265,000	$ 25,000	$ 515,000
Excess of revenues over expenses			164,000	164,000
Amounts allocated to major repairs and replacements[7]	164,000		(164,000)	
Transfer from future major repairs and replacements to retained earnings	(10,000)		10,000	
MEMBERS' EQUITY-END OF YEAR	$ 379,000	$ 265,000	$ 35,000	$ 679,000

(continued)

The accompanying notes are an integral part of the financial statements.

[6] If this column is used, the following note is added to the financial statements:
Members' initial capital contributions. At the time of closing by initial owners, one month's assessment was contributed to the association to provide additional working capital.

[7] Consisting of assessments for future major repairs and replacements, lawsuit settlements, and interest less income taxes, net of expenditures for major repairs and replacements. [*Note:* This amount does not necessarily equal excess of revenues over expenses.] As an alternative presentation, the components of this amount could be summarized in the notes to the financial statements and the "Future Major Repairs and Replacements" column could be omitted.

XYZ Homeowners' Association, Inc.
Statements of Changes in Members' Equity
for the Years Ended December 31, 20X2 and 20X1

	20X1			
	Future Major Repairs and Replacements	*Members' Initial Capital Contributions*[8]	*Retained Earnings (Deficit)*	*Total Members' Equity*
MEMBERS' EQUITY-BEGINNING OF YEAR	$ 195,000	$ 265,000	$ 9,000	$ 469,000
Excess of revenues over expenses			46,000	46,000
Amounts allocated to major repairs and replacements[9]	30,000		(30,000)	
MEMBERS' EQUITY-END OF YEAR	$ 225,000	$ 265,000	$ 25,000	$ 515,000

The accompanying notes are an integral part of the financial statements.

[8] If this column is used, the following note is added to the financial statements:
Members' initial capital contributions. At the time of closing by initial owners, one month's assessment was contributed to the association to provide additional working capital.

[9] Consisting of assessments for future major repairs and replacements, lawsuit settlements, and interest less income taxes, net of expenditures for major repairs and replacements.

Exhibit A-13

XYZ Homeowners' Association, Inc.
Schedules of Expenses
for Major Repairs and Replacements
for the Years Ended December 31, 20X2 and 20X1

	20X2	*20X1*
Roofs	$ 144,000	$ 160,000
Exterior siding	94,000	98,000
Legal fees	10,000	
Recreation	5,000	2,000
Solar equipment	5,000	
Streets	4,000	20,000
Pools and spas		18,000
Tennis courts		12,000
TOTAL	$ 262,000	$ 310,000

Exhibit A-14

ABC Cooperative, Inc.[10]
(A Cooperative Housing Corporation)
Balance Sheet
December 31, 20X2

ASSETS

Cash, including investment in money market fund of $6,850		$ 38,000
Tenant-shareholders' rent receivables		15,000
Prepaid expenses		9,000
Property and equipment		
Land	$ 640,000	
Building	1,720,000	
Building improvements: construction in progress	140,000	
Furniture and equipment	90,000	
	2,590,000	
Less: accumulated depreciation	1,620,000	
Net property		970,000
Mortgage refinancing costs, less accumulated amortization of $15,000		25,000
TOTAL ASSETS		$ 1,057,000

LIABILITIES AND SHAREHOLDERS' EQUITY (DEFICIT)

Accounts payable and accrued expenses		$ 118,000
Prepaid rents		6,000
Mortgage note payable		1,865,000
Security deposits of commercial lessees		8,000
TOTAL LIABILITIES		1,997,000
Shareholders' equity (deficit)		
Common stock—$2.00 par value; authorized 40,000 shares, issued and outstanding 20,000 shares	$ 40,000	
Additional paid-in-capital	420,000	
	460,000	
Deficit	(1,400,000)	
Total shareholders' equity (deficit):		(940,000)
TOTAL LIABILITIES AND SHAREHOLDERS' DEFICIT		$ 1,057,000

The accompanying notes are an integral part of the financial statements.

[10] If separate funds are maintained for future major repairs and replacements or for other purposes, fund reporting may be more informative to users of the financial statements of cooperative housing corporations and may be used as an alternative presentation.

Exhibit A-15

ABC Cooperative, Inc.
(A Cooperative Housing Corporation)
Statement of Revenues, Expenses, and Deficit
Year Ended December 31, 20X2

REVENUES		
Carrying charges		$ 700,000
Commercial rent		89,000
Appliance and air-conditioning charges		45,000
Interest		10,000
Resale fees		3,000
Forfeited security deposits		2,000
TOTAL REVENUES		849,000
EXPENSES		
Wages including fringe benefits	$ 295,000	
Real estate taxes	237,000	
Interest	195,000	
Utilities	121,000	
Repairs and maintenance	53,000	
Management fees	24,000	
Insurance	16,000	
Legal and accounting	10,000	
Security	4,000	
Income taxes	2,000	
TOTAL EXPENSES BEFORE DEPRECIATION AND AMORTIZATION		957,000
Deficiency of revenues over expenses before depreciation		(108,000)
Depreciation		72,000
Deficiency of revenues over expenses		(180,000)
Deficit-beginning of year		(1,220,000)
DEFICIT-END OF YEAR		$ (1,400,000)

The accompanying notes are an integral part of the financial statements.

Exhibit A-16

Direct Method

ABC Cooperative, Inc.
(A Cooperative Housing Corporation)
Statement of Cash Flows
Year Ended December 31, 20X2

Cash flows from operating activities:	
Tenant-shareholder carrying charges, net of $60,000 allocated to financing activities	$ 640,000
Commercial rent	89,000
Appliance and air-conditioning charges and resale fees	48,000
Interest income	10,000
Forfeited security deposits	2,000
Cash paid to employees and suppliers	(437,000)
Real estate taxes	(292,000)
Interest expense	(140,000)
Net cash absorbed by operating activities	(80,000)
Cash flows from financing activities:	
Tenant-shareholder carrying charges	60,000
Repayment of debt	(60,000)
Net cash from financing activities	0
Cash flows from investing activities:	
Additions to building, furniture and equipment	(150,000)
Net decrease in cash and cash equivalents	(230,000)
Cash and cash equivalents:	
Beginning of period	268,000
End of period	$ 38,000

(continued)

The accompanying notes are an integral part of the financial statements.

ABC Cooperative, Inc.
(A Cooperative Housing Corporation)
Statement of Cash Flows
Year Ended December 31, 20X2

Reconciliation of deficiency of revenues over expenses to net cash absorbed by operating activities:	
Deficiency of revenues over expenses	$ (180,000)
Adjustments to reconcile deficiency of revenues over expenses to net cash absorbed by operating activities:	
Revenue allocated to financing activities	(60,000)
Depreciation	72,000
(Increase) in tenant-shareholder rent receivables	(2,000)
Decrease in prepaid expenses	3,000
Increase in accounts payable and accrued expenses	85,000
Increase in prepaid rents	3,000
(Decrease) in security deposits of commercial leases	(1,000)
Net cash absorbed by operating activities	$ (80,000)

The accompanying notes are an integral part of the financial statements.

Exhibit A-17

ABC Cooperative, Inc.
(A Cooperative Housing Corporation)
Notes to Financial Statements
December 31, 20X2

1. Organization

ABC Cooperative, Inc., a cooperative housing corporation, was incorporated in the state of New York in April, 20XX. The Corporation owns the eighteen-story building known as ABC Apartments located at ____________________ in New York City and consisting of 175 residential apartments and ten commercial units.

2. Summary of Significant Accounting Policies

Pervasiveness of Estimates. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Property and equipment. Property and equipment are stated at cost. Depreciation is computed on the straight-line basis, based on a thirty-year life for the building and a ten-year life for building improvements, furniture, and equipment.

Mortgage refinancing costs. Mortgage refinancing costs are amortized by the interest method over the ten-year term of the loan.

3. Revenue

Carrying charges. Carrying charges are based on an annual budget determined by the board of directors. Tenant-shareholders are billed monthly based on their respective stock holdings. The Corporation retains excess operating funds, if any, at the end of the operating year, for use in future operating periods.

Commercial rent. The Corporation has entered into five-year lease agreements with ten commercial tenants providing for annual rentals aggregating $92,000 with increases based on the Consumer Price Index.

4. Mortgage Note Payable

The Corporation has a mortgage note payable, secured by the land and building, to XYZ Bank of New York with interest at the rate of 10 percent. The aggregate amount of required principal payments at December 31, 20X2 is as follows:

20X3	$ 61,000
20X4	62,000
20X5	63,000
20X6	65,000
20X7	67,000
later years	1,547,000
Total	$1,865,000

5. Federal and State Taxes

The cooperative pays federal taxes on net income from patronage and non-patronage income in accordance with Subchapter T. Income tax expense in 20X2 was $2,000.

6. Future Major Repairs and Replacements

The Corporation's governing documents require that funds be accumulated for future major repairs and replacements. The Corporation has not accumulated those funds. When those funds are needed, the Corporation plans to borrow, increase carrying charges, or delay repairs and replacements until funds are available.[11]

The board of directors conducted a study in November 20X2 to estimate the remaining useful lives and the replacement costs of the components of common property. The estimates were obtained from licensed contractors who inspected the property. The table included in the unaudited supplementary information on Future Major Repairs and Replacements is based on the study.

[11] Many co-ops have no corporate requirement for reserves; some have a requirement as a condition of a loan. Some states have statutes dealing with reserves, most are vague, but not all. For instance Florida has the opt-out provision for reserves and Hawaii has specific language and examples that address the calculation of reserve fund status.

Exhibit A-18

ABC Cooperative, Inc.
(A Cooperative Housing Corporation)
Supplementary Information on Future Major Repairs and Replacements
December 31, 20X2
(Unaudited)

In November, 20X2, the board of directors conducted a study to estimate the remaining useful lives and the replacement costs of the components of the building, furniture, and equipment. The estimates were obtained from licensed contractors who inspected the property. The following table is based on that study and presents significant information about the components of the building, furniture, and equipment.

Components	*Estimated Remaining Useful Lives (Years)*	*Estimated Current Replacement Costs*
Roof	15	$ 175,000
Exterior	3	30,000
Recreation Facilities	2-5	25,000
Carpeting	5	45,000
Furniture and equipment	2-7	15,000
		$ 290,000

Appendix B

Illustrative Engagement and Representation Letters

Exhibit B-1

Illustrative Engagement Letter—Audit

[*Date*]

XYZ Condominium Association
12345 Slowhand Road
Highprice, Illinois 00000

Dear _________:

This will confirm our understanding of the arrangement for our audit of the financial statements of XYZ Condominium Association for the year ending December 31, 20X2.

We will audit the Association's balance sheet at December 31, 20X2 and the related statements of revenues, expenses, and changes in fund balances, and cash flows for the year then ended, for the purpose of expressing an opinion on them. The financial statements are the responsibility of the Association's management. Management is responsible for establishing and maintaining effective internal control over financial reporting, making financial records and related information available for audit, and for identifying and ensuring that the association complies with the laws and regulations that apply to its activities. Management also is responsible for adjusting the financial statements to correct material misstatements and for affirming to us in the representation letter that the effects of any uncorrected misstatements aggregated by us during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

We will conduct our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable rather than absolute assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Accordingly, a material misstatement may remain undetected. Also, an audit is not designed to detect error or fraud that is immaterial to the financial statements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit will provide a reasonable basis for our opinion.

We will not determine whether the reserve balances are adequate to meet future repair and replacement costs because such a determination is outside the scope of the engagement.

The audit includes obtaining an understanding of internal control sufficient to plan the audit and to determine the nature, timing and extent of audit procedures to be performed. An audit is not designed to provide assurance on internal control or to identify reportable conditions. However, we are responsible for ensuring that management of the association is aware of any reportable conditions which come to our attention. If, for any reason, we are unable to complete the audit or are unable to form or have not formed an opinion, we may decline to express an opinion or decline to issue a report as a result of the engagement.

Our procedures will include tests of documentary evidence supporting the transactions recorded in the accounts, and direct confirmation of receivables and certain other assets and liabilities by correspondence with selected owners, creditors, legal counsel, and banks. At the conclusion of our audit, management will provide us with a letter that confirms certain written representations made during the audit.

We will review the Association's federal and state income tax returns for the fiscal year ended December 31, 20X2. These returns, we understand, will be prepared by the controller.

Furthermore, we will be available during the year to consult with you on the tax effects of any proposed transactions or contemplated changes in business policies.

Our fee for these services will be at our regular per diem rates, plus travel and other out-of-pocket costs. Invoices will be rendered every two weeks and are payable on presentation.

The cost of printing copies of the annual report to be distributed to unit owners and other expenses we incur on behalf of the Association will be added to our service charges. Our invoices are payable on submission.

If this letter correctly expresses your understanding, please sign the enclosed copy where indicated and return it to us.

Very truly yours,

Certified Public Accountants

XYZ CONDOMINIUM ASSOCIATION

By ____________________________

Date ___________________________

Exhibit B-2

Illustrative Engagement Letter—Review

[*Date*]

XYZ Homeowners' Association, Inc.
12345 Slowhand Road
Highprice, Illinois 00000

Re: XYZ HOMEOWNERS' ASSOCIATION, INC.

Dear _________:

This letter is to confirm our understanding of the terms and objectives of our engagement and the nature and limitations of the services we will provide.

We will perform the following services:

1. We will review the balance sheet of XYZ Homeowners' Association as of December 31, 20X2, and the related statements of revenues, expenses, and changes in fund balances, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Our review will consist primarily of inquiries of Association personnel and analytical procedures applied to financial data and we will require a representation letter from management. A review does not contemplate obtaining an understanding of internal control or assessing control risk, tests of accounting records and responses to inquiries by obtaining corroborating evidential matter, and certain other procedures ordinarily performed during an audit. Thus, a review does not provide assurance that we will become aware of all significant matters that would be disclosed in an audit. Our engagement cannot be relied upon to disclose errors, fraud, or illegal acts that may exist. However, we will inform the appropriate level of management* of any material errors that come to our attention and any fraud or illegal acts that come to our attention, unless they are clearly inconsequential. We will not perform an audit of such financial statements, the objective of which is the expression of an opinion regarding the financial statements taken as a whole, and, accordingly, we will not express such an opinion on them.

   Our report on the financial statements is presently expected to read as follows:

   > We have reviewed the accompanying balance sheet of XYZ Homeowners' Association as of December 31, 20X2, and the related statements of revenues and expenses and changes in fund balances, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review

* When fraud or an illegal act involves senior management, the accountant should report the matter to an individual or group at a higher level within the entity, such as the board of directors.

Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management of XYZ Homeowners' Association.

A review consists principally of inquiries of association personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.

If, for any reason, we are unable to complete our review of your financial statements, we will not issue a report on such statements as a result of this engagement.

2. We will provide your chief accountant with such consultation on accounting matters as may be required in adjusting and closing the books of account and in drafting financial statements for our review. Your chief accountant will provide us with a detailed trial balance and any supporting schedules we require.

3. We will also prepare the federal and state income tax returns for XYZ Homeowners' Association for the fiscal year ended December 31, 20X2.

If reproduction or publication of financial statements, or any portion, reviewed by us, is intended, it is our policy that the master or printer's proofs be submitted to us for review before reproduction or publication if our firm's name will be mentioned.

In estimating our fee, we have assumed that the management agent will maintain a complete double entry set of books and records and provide us with a balanced trial balance as of December 31, 20X2. All subsidiary accounts will reconcile with control accounts and a detailed homeowner receivable account will be maintained and balanced.

To provide the XYZ Homeowners' Association, Inc. with a budget for this work, we estimate our fee to be $——— plus out-of-pocket costs. That estimate is made with the understanding that every effort will be made by us to keep our time to a minimum consistent with the engagement requirements. If the amount of time expended results in a fee less than $———, the lesser amount will be billed.

We will make progress billings during the engagement, payable on receipt.

If the foregoing is in accordance with your understanding, please sign the copy of this letter in the space provided and return it to us.

Sincerely,

Certified Public Accountants

[*Signature of the accountant*]

Accepted by: ______________________

Title: ____________________________

Date: ____________________________

Exhibit B-3

Illustrative Engagement Letter—Compilation

[Date]

XYZ Homeowners' Association, Inc.
12345 Slowhand Road
Highprice, Illinois 00000

Re: XYZ HOMEOWNERS' ASSOCIATION, INC.

Dear _________:

This letter is to confirm our understanding of the terms and objectives of our engagement and the nature and limitations of the services we will provide.

We will perform the following services:

1. We will compile, from information you provide, the annual balance sheets and related statements of revenues and expenses and changes in fund balances, and cash flows of XYZ Homeowners' Association for the year 20X2. We will not audit or review such financial statements. Our report on the annual financial statements of XYZ Homeowners' Association is presently expected to read as follows:

    We have compiled the accompanying balance sheet of XYZ Homeowners' Association as of December 31, 20X2, and the related statements of revenues and expenses and changes in fund balances, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

    A compilation is limited to presenting in the form of financial statements information that is the representation of management. We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

    [Note to Reader: The following paragraph should be included if the statements omit all disclosures.]

    Our report on your financial statements, which will omit substantially all disclosures, will include an additional paragraph that will read as follows:

    Management has elected to omit substantially all of the disclosures and the display of comprehensive income required by generally accepted accounting principles. If the omitted disclosures and the display of comprehensive income were included in the financial statements, they might influence the user's conclusions about the association's financial position, results of operations, and changes in cash flows. Accordingly, these financial statements are not designed for those who are not informed about such matters.

    If, for any reason, we are unable to complete the compilation of your financial statements, we will not issue a report on such statements as a result of this engagement.

2. We will assist your bookkeeper in adjusting the books of account so that he or she will be able to prepare a working trial balance from which the financial statements can be compiled. Your bookkeeper will provide us with a detailed trial balance and any supporting schedules we require.
3. We will also prepare the federal and state income tax returns for XYZ Homeowners' Association for the fiscal year ended December 31, 20X2.

Our engagement cannot be relied upon to disclose errors, fraud, or illegal acts that may exist. However, we will inform the appropriate level of management* of any material errors that come to our attention and any fraud or illegal acts that come to our attention, unless they are clearly inconsequential.

If reproduction or publication of financial statements, or any portion, compiled by us, is intended, it is our policy that the master or printer's proofs be submitted to us for review before reproduction or publication if our firm's name will be mentioned.

In estimating our fee, we have assumed that the management agent will maintain a complete set of double entry books and records and provide us with a balanced trial balance as of December 31, 20X2. All subsidiary accounts will reconcile with control accounts and a detailed homeowners' receivable account will be maintained and balanced.

To provide the Association with a budget for this work, we estimate our fee to be $——— plus out-of-pocket costs. That estimate is made with the understanding that every effort will be made by us to keep our time to a minimum consistent with the engagement requirements. If the amount of time expended results in a fee less than $———, the lesser amount will be billed.

We will make progress billings during the engagement, payable on receipt.

If the foregoing is in accordance with your understanding, please sign the copy of this letter in the space provided and return it to us.

We appreciate the opportunity to be of service to the Association.

Sincerely,

Certified Public Accountants

[*Signature of the accountant*]

Accepted by: ______________________

Title: ___________________________

Date: ___________________________

* When fraud or an illegal act involves senior management, the accountant should report the matter to an individual or group at a higher level within the entity, such as the board of directors.

Exhibit B-4

Illustrative Representation Letter—Audit

[*To be prepared on the CIRA's or managing agent's letterhead*]

[*Date*]

[*To the Independent Auditor*]

We are providing this letter in connection with your audit of the balance sheets and the related statements of revenues, expenses, and changes in fund balances, and cash flows of XYZ Condominium Association as of December 31, 19X2 and 19X1, for the years then ended, for the purpose of expressing an opinion as to whether the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of XYZ Condominium Association in conformity with generally accepted accounting principles. We confirm that we are responsible for the fair presentation in the financial statements of financial position, results of operations, and cash flows in conformity with accounting principles generally accepted in the United States of America.

Certain representations in this letter are described as being limited to matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would be changed or influenced by the omission or misstatement.

We confirm, to the best of our knowledge and belief, [as of (*date of auditor's report*),] the following representations made to you during the audit:

1. The financial statements referred to above are fairly presented in conformity with accounting principles generally accepted in the United States of America.

2. We are responsible for the fair presentation of the information about future major repairs and replacements in the supplementary information accompanying the financial statements.

3. We have made available to you all—

   a. Financial records and related data.

   b. Minutes of the meetings of directors and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.

4. There have been no communications from regulatory agencies concerning noncompliance with or deficiencies in financial reporting practices.

5. There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements.

6. We believe that the effects of the uncorrected financial statement misstatements summarized in the accompanying schedule are immaterial,

both individually and in the aggregate, to the financial statements taken as a whole.

7. We acknowledge our responsibility for the design and implementation of programs and controls to prevent and detect fraud.

8. We have no knowledge of any fraud or suspected fraud affecting the entity involving—

   a. Management,

   b. Employees who have significant roles in internal control, or

   c. Others that could have a material effect on the financial statements.

9. We have no knowledge of any allegations of fraud or suspected fraud affecting the entity received in communications from employees, former employees, or others.

10. We have no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.

11. The following have been properly recorded or disclosed in the financial statements:

    a. Related party transactions, including sales, purchases, loans, transfers, leasing arrangements, and guarantees, and amounts receivable from or payable to related parties.

    b. Guarantees, whether written or oral, under which the Association is contingently liable.

    c. Significant estimates and material concentrations known to management that are required to be disclosed in accordance with the AICPA's SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*. (Significant estimates are estimates at the balance sheet date that could change materially within the next year. Concentrations refer to volumes of business, revenues, available sources of supply, or markets or geographic areas for which events could occur that would significantly disrupt normal finances within the next year.)

12. There are no—

    a. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.

    b. Unasserted claims or assessments that our lawyer has advised us are probable of assertion and must be disclosed in accordance with FASB Statement No. 5, *Accounting for Contingencies*.[1]

    c. Other liabilities or gain or loss contingencies that are required to be accrued or disclosed by FASB Statement No. 5.

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[1] In the circumstance discussed in footnote 7 of SAS No. 85, *Management Representations*, this representation might be worded as follows:

> We are not aware of any pending or threatened litigation, claims, or assessments or unasserted claims or assessments that are required to be accrued or disclosed in the financial statements in accordance with FASB Statement No. 5, *Accounting for Contingencies*, and we have not consulted a lawyer concerning litigation, claims, or assessments.

13. The Association has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged, as collateral.

14. We have complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.

15. The board of directors is collecting funds for major repairs and replacements in conformity with the Association's policy to fund for those needs based on a study conducted in November 19X2. The board of directors believes that the funds will adequately provide for future major repairs and replacements.

16. The board of directors has allocated the excess of the Association's revenues over its expenses during the current year to the fund for future major repairs and replacements.[2]

17. To the best of our knowledge and belief, no events have occurred subsequent to the balance-sheet date and through the date of this letter that would require adjustment to or disclosure in the aforementioned financial statements.

____
Signature and Title

____
Signature and Title

[2] The inclusion of other representations that are unique to the engagement or to the entity's business or industry should be considered by the auditor. In addition, appendix B of SAS No. 85 contains a list of other representations that may be appropriate in certain situations.

Exhibit B-5

Illustrative Representation Letter—Review

[*To be prepared on the CIRA's or managing agent's letterhead*]

[*Date of Accountant's Report*]

[*To the Accountant*]

We are providing this letter in connection with your review of the balance sheet and the related statements of revenues, expenses, and changes in fund balances, and cash flows of XYZ Condominium Association as of December 31, 20X2, and for the year then ended, for the purpose of expressing limited assurance that there are no material modifications that should be made to the statements in order for them to be in conformity with generally accepted accounting principles. We confirm that we are responsible for the fair representation in the financial statements of financial position, results of operations, and cash flows in conformity with generally accepted accounting principles.

Certain representations in this letter are described as being limited to matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would be changed or influenced by the omission or misstatement.[3]

We confirm, to the best of our knowledge and belief, (as of [a date no earlier than the date of review report, see SSARS No. 1, *Compilation and Review of Financial Statements,* (AICPA, *Professional Standards,* vol. 2, AR sec. 100.29]), the following representations made to you during your review.

1. The financial statements referred to above are fairly presented in conformity with generally accepted accounting principles.
2. We have made available to you all:
   a. Financial records and related data.
   b. Minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.
3. There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements.
4. We have no plans or intentions that may materially affect the carrying amounts or classification of assets and liabilities.
5. There are no material losses (such as from purchase or sales commitments) that have not been properly accrued or disclosed in the financial statements.
6. There are no:
   a. Violations or possible violations of laws or regulations, whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.

[3] The qualitative discussion of materiality used in this letter is adapted from FASB Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information.*

b. Unasserted claims or assessments that our lawyer has advised us are probable of assertion that must be disclosed in accordance with FASB Statement No. 5, *Accounting for Contingencies*.[4]

c. Other material liabilities or gain or loss contingencies that are required to be accrued or disclosed by FASB Statement No. 5.

7. The Association has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged as collateral.

8. We have complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.

9. The following have been properly recorded or disclosed in the financial statements:

   a. Related party transactions, including sales, purchases, loans, transfers, leasing arrangements, and guarantees, and amounts receivable from or payable to related parties.

   b. Guarantees, whether written or oral, under which the Association is contingently liable.

   c. Significant estimates and material concentrations known to management that are required to be disclosed in accordance with the AICPA's SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*. (Significant estimates are estimates at the balance sheet date that could change materially within the next year. Concentrations refer to volumes of business, revenues, available sources of supply, or markets for which events could occur that would significantly disrupt normal finances within the next year.)

10. To the best of our knowledge and belief, no events have occurred subsequent to the balance-sheet date and through the date of this letter that would require adjustment to or disclosure in the aforementioned financial statements.

11. We have responded fully and truthfully to all inquiries made to us by you during your review.

12. The board of directors is collecting funds for major repairs and replacements in conformity with the Association's policy to fund for those needs based on a study conducted in November 20X2. The board of directors believes that the funds will adequately provide for future major repairs and replacements.

13. The board of directors has allocated the excess of the Association's revenues over its expenses during the current year to the fund for future major repairs and replacements.

XYZ CONDOMINIUM ASSOCIATION

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[4] If management has not consulted a lawyer regarding litigation, claims, and assessments, the representation might be worded as follows:

> We are not aware of any pending or threatened litigation, claims, or assessments or unasserted claims or assessments that are required to be accrued or disclosed in the financial statements in accordance with FASB Statement No. 5 *Accounting for Contingencies*, and we have not consulted a lawyer concerning litigation, claims, or assessments.

Appendix C

Statement of Position 93-5

Reporting on Required Supplementary Information Accompanying Compiled or Reviewed Financial Statements of Common Interest Realty Associations

April 23, 1993

Amendment to
AICPA Audit and Accounting Guide
Common Interest Realty Associations

Prepared by the Accounting and Review Services Committee
Auditing Standards Division
American Institute of
Certified Public Accountants

NOTICE TO READERS

This statement of position presents the recommendations of the AICPA Accounting and Review Services Committee on the application of Statements on Standards for Accounting and Review Services to compilations and reviews of financial statements of common interest realty associations. It has been reviewed by the chairman of the Accounting and Review Services Committee for consistency with existing compilation and review standards. AICPA members should be prepared to justify departures from the recommendations in this statement of position.

SUMMARY

The AICPA Audit and Accounting Guide *Common Interest Realty Associations* (the CIRA guide) requires common interest realty associations (CIRAs) to disclose certain supplementary information outside the basic financial statements. This requirement also applies to nonpublic CIRAs whose financial statements are compiled or reviewed in accordance with Statements on Standards for Accounting and Review Services (SSARSs). Paragraph 43 of SSARS 1, *Compilation and Review of Financial Statements*, describes the accountant's responsibility when the financial statements are accompanied by information *voluntarily* presented for supplementary analysis purposes; however, SSARSs do not address the accountant's responsibility when the financial statements are accompanied by required supplementary information.

This statement of position (SOP) amends chapter 8, "Review and Compilation Engagements," of the CIRA guide by providing accountants with performance and reporting guidance when required supplementary information accompanies the basic financial statements in a compilation or review engagement.

The SOP—

- Requires that the accountant, at a minimum, compile the required supplementary information accompanying the compiled or reviewed financial statements.
- Specifies the procedures to be performed when compiling the required supplementary information.
- Specifies the elements to be included in a report on required supplementary information accompanying compiled or reviewed financial statements.
- States that Statement on Standards for Attestation Engagements No. 1, *Attestation Standards* (AICPA, *Professional Standards*, vol. 1, AT section 100), is the appropriate guidance for reviewing required supplementary information.
- Is effective for compilations and reviews of financial statements for periods ending on or after December 15, 1993.

Reporting on Required Supplementary Information Accompanying Compiled or Reviewed Financial Statements of Common Interest Realty Associations

1. The American Institute of Certified Public Accountants (AICPA) has issued the Audit and Accounting Guide *Common Interest Realty Associations* (the CIRA guide), which requires common interest realty associations (CIRAs) to disclose certain supplementary information outside the basic financial statements. This requirement also applies to nonpublic CIRAs whose financial statements are compiled or reviewed in accordance with Statements on Standards for Accounting and Review Services (SSARSs). Paragraph 43 of SSARS 1, *Compilation and Review of Financial Statements*, describes the accountant's responsibility when the financial statements are accompanied by information voluntarily presented for supplementary analysis purposes; however, SSARSs do not address the accountant's responsibility when the financial statements are accompanied by required supplementary information. This statement of position (SOP) amends chapter 8, "Review and Compilation Engagements," of the CIRA guide by providing accountants with performance and reporting guidance when required supplementary information accompanies the basic financial statements in a compilation or review engagement.

2. Paragraph 4.31 of the CIRA guide describes the required supplementary information that should accompany the basic financial statements. That information consists of—

- Estimates of current or future costs of future major repairs and replacements of all existing components, such as roofs, including estimated amounts required, methods used to determine the costs, the basis for calculations (including assumptions, if any, about interest and inflation rates), sources used, and the dates of studies made for this purpose, if any.[1]
- A presentation of components to be repaired and replaced, estimates of the remaining useful lives of those components, estimates of current or future replacement costs, and amounts of funds accumulated for each to the extent designated by the board.

3. When the basic financial statements have been compiled or reviewed, the required supplementary information accompanying the basic financial statements should, at a minimum, be compiled. If the entity chooses to omit the required supplementary information, the guidance in paragraph 6 should be followed. To compile the required supplementary information, the accountant should—

a. Establish an understanding with the entity regarding the services the accountant will perform with respect to the required supplementary information and how that information will affect the report the accountant expects to render.

b. Consider what supplementary information is required by the CIRA guide and how that information is to be presented.

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[1] There is no requirement for CIRAs to obtain studies prepared by professional engineers. Estimates made by the board of directors or estimates obtained from licensed contractors are satisfactory, as discussed in paragraphs 3.06 and 3.07 of the CIRA guide.

c. Obtain an understanding of how the required supplementary information was developed. This understanding ordinarily includes the following:
   - The source of the information, for example, engineering reports, estimates obtained from licensed contractors, tables in technical manuals on useful lives
   - Whether the required supplementary information is based on current or future replacement costs
   - The interest and inflation rates used to determine funding requirements if the information is based on future replacement costs

d. Consider whether it will be necessary to perform other accounting services in order to compile the required supplementary information.

e. Read the required supplementary information and consider whether it appears to be appropriate in form and free from obvious material error.

f. Obtain additional or revised information, if the accountant becomes aware that the required supplementary information is incorrect, incomplete, or otherwise unsatisfactory.

g. If the entity is unable or refuses to provide additional or revised information, consider whether a modification of the standard report is adequate to disclose the deficiency in the measurement or presentation of the required supplementary information. If modification of the standard report is adequate to disclose the deficiency, the accountant should follow the guidance in paragraph 5. If modification of the standard report is not adequate to disclose the deficiency, the accountant should withdraw from the engagement.

4. When the basic financial statements have been compiled or reviewed and the accompanying required supplementary information has been compiled, the accountant should indicate in the report, or in a separate report, the degree of responsibility he or she is taking for the supplementary information. The report should—

a. Identify the required supplementary information accompanying the financial statements. (Identification may be by descriptive title or page number of the document.)

b. State that the supplementary information is not a required part of the basic financial statements but is supplementary information required by the AICPA.

c. State that the accountant has compiled the accompanying supplementary information from information that is the representation of management, without audit or review.

d. State that the accountant does not express an opinion or any other form of assurance on the supplementary information.

An example of an additional paragraph that may be added to a compilation report follows:

> The [*identify the supplementary information*] on page XX is not a required part of the basic financial statements but is supplementary information required by the American Institute of Certified Public

> Accountants. We (I) have compiled [*identify the supplementary information*] from information that is the representation of management of XYZ Company, without audit or review. Accordingly, we (I) do not express an opinion or any other form of assurance on the supplementary information.

5. If, on the basis of facts known to him or her, the accountant becomes aware that the supplementary information has not been measured or presented in accordance with prescribed guidelines, the accountant should indicate in his or her report that the information does not conform to the guidelines and should describe the nature of any material departure(s). An example of a sentence that might be added to the illustrative paragraph presented in paragraph 4 follows:

> However, we (I) did become aware that the supplementary information about future major repairs and replacements of common property is not presented in conformity with the guidelines established by the American Institute of Certified Public Accountants because [*describe the material departure from the AICPA guidelines*].

6. When the compiled or reviewed financial statements are not accompanied by the required supplementary information, a paragraph should be added to the compilation or review report indicating that the required supplementary information has been omitted. The accountant need not present the supplementary information in the accountant's report. The following is an example of a paragraph that the accountant might use in these circumstances:

> The American Institute of Certified Public Accountants has determined that supplementary information about future major repairs and replacements of common property is required to supplement, but not required to be a part of, the basic financial statements. The Association has not presented this supplementary information.

7. In an engagement to review the basic financial statements, the required supplementary information is not subjected to the inquiry and analytical procedures applied in the review of the basic financial statements; therefore, SSARSs are not applicable to the review of this information. If the accountant has been engaged to review the required supplementary information, he or she may do so in accordance with Statement on Standards for Attestation Engagements No. 1, *Attestation Standards* (AICPA, *Professional Standards*, vol. 1, AT section 100).

8. This SOP is effective for compilations and reviews of financial statements for periods ending on or after December 15, 1993. Earlier application is encouraged.

Appendix D

Information Sources

Further information on matters addressed in this Guide is available through various publications and services listed in the table that follows. Many non-government and some government publications and services involve a charge or membership requirement.

Fax services allow users to follow voice cues and request that selected documents be sent by fax machine. Some fax services require the user to call from the handset of the fax machine, others allow the user to call from any phone. Most fax services offer an index document, which lists titles and other information describing available documents.

Electronic bulletin board services allow users to read, copy, and exchange information electronically. Most are available using a modem and standard communications software. Some bulletin board services are also available using one or more Internet protocols.

Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

All telephone numbers listed are voice lines, unless otherwise designated as fax (f) or data (d) lines. Required modem speeds, expressed in bauds per second (bps), are listed for data lines.

Information Sources

Organization	General Information	Fax Services	Internet Web Site	Recorded Announcements
American Institute of Certified Public Accountants	*Order Department* Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (888) 777-7077	*24 Hour Fax Hotline* (201) 938-3787	http://www.aicpa.org	*AcSec Telephone Line* (212) 596-6166 (212) 596-6167
Financial Accounting Standards Board	*Order Department* P.O. Box 5116 401 Merritt 7 Norwalk, CT 06856-5116 (800) 748-0659	*24 Hour Access* (203) 847-0700 (ext.14)	http://www.fasb.org	Action Alert Telephone Line (203) 847-0700 (ext. 389)
Community Associations Institute	225 Reinekers Lane Suite 300 Alexandria, VA 22314 (703) 548-8600	(703) 684-1581	http://www.caionline.org	
National Association of Housing Cooperatives	1707 H Street, NW, Suite 201 Washington, DC 20006 (202) 737-0797	(202) 783-7869	http://www.coophousing.org	

Appendix E

Schedule of Changes Made to Common Interest Realty Associations

As of May 2004

Beginning May 2001, all schedules of changes reflect only current year activity for improved clarity.

Reference	Change
Chapter 2 (heading)	Footnote * revised.
Paragraph 2.05	Revised to clarify guidance.
Paragraphs 2.13, 2.14, and 4.19 (footnotes *)	Added.
Paragraphs 7.02 and 7.04	Revised to clarify guidance.
Paragraph 7.05 (footnote *)	Deleted.
Paragraph 7.08 (footnote 3)	Added to clarify guidance; Subsequent footnotes renumbered.
Paragraphs 7.09, 7.13, 7.14, 7.19, 7.25, 7.29, and 7.33	Revised to clarify guidance.
Paragraph 7.44	Revised to reflect the issuance of a revised edition of the AICPA Practice Aid—*Fraud Detection in a GAAS Audit.*
Paragraph 7.47 (footnotes * and **)	Deleted.
Paragraphs 7.51 and 7.52	Revised to clarify guidance.
Paragraphs 7.53 (footnote *)	Added.
Paragraphs 7.56 and 7.68	Revised to clarify guidance.
Paragraph 7.69	Revised to reflect the issuance of SAS No. 98.
Paragraphs 7.74 and 7.75	Added to reflect the issuance of SAS No. 98.
Chapter 8 (heading) and paragraph 8.05	Footnote * added.
Paragraph 8.08 (footnote *)	Deleted.

Reference	Change
Paragraph 8.15 (footnote *)	Added.
Paragraph 8.16 (footnote *)	Deleted.
Appendix A	Revised to clarify guidance; Footnote * deleted.
Appendix B	Revised to clarify guidance and to reflect the issuance of an Accounting and Review Services Interpretation; Footnote 1 deleted; Subsequent footnotes renumbered.

Glossary

articles of incorporation. A document that creates the CIRA as a corporation under state laws.

assessment. A unit owner's proportionate share of the amount of money necessary to pay for the operation, administration, maintenance, and management of the common property, and to accumulate funds for future major repairs and replacements.

association. An organization of unit owners responsible for the operation, administration, and management of the common property. Generally, a not-for-profit corporation with membership of all owners.

board of directors. Individuals, usually unit owners, elected by members to govern the CIRA. (Also referred to as *board of managers, board of trustees, or board of governors.*)

bylaws. The governing rules of a CIRA dealing with routine operational and administrative matters. (Also referred to as the *code of regulations.*)

CC and Rs. See *covenants, conditions, and restrictions* and *declaration of condominium.*

capital expenditures. Funds expended for improvements or major repairs or replacements of common property components that extend their useful lives or service periods.

carrying charges. Charged to tenant-shareholders for operating and capital expenditures based on proprietary lease agreements, in cooperative housing corporations. (Commonly referred to as *rent.*)

commercial unit. A unit in a CIRA, such as a store or office space, used exclusively to produce income.

common areas. See *common property.*

common elements. See *common areas* and *common property.*

common property. A CIRA's real or personal property to which title or other evidence of ownership is held (*a*) by individual members in common or (*b*) by the CIRA directly.

condominium. A form of ownership of real property that combines exclusive ownership of a defined interior space and an undivided interest in the common property. (Also referred to as a *condo.*)

condominium association. See *association.*

converter. A person or entity that converts rental properties to CIRAs.

cooperative housing corporation. An entity established as a not-for-profit corporation that owns the real estate, usually a multi-unit dwelling, and all improvements on it and is responsible for its maintenance and payment of debt service. Ownership in the corporation is evidenced by shares of stock owned by tenant-shareholders who are entitled to occupy a unit under a proprietary lease. (Also referred to as a *coop.*)

covenants, conditions, and restrictions. Restrictive conditions in the deed that limit the use of the property. (See *CC and Rs* and *declaration of condominium.*)

declarant. A person or entity, generally the developer or converter, that legally establishes a CIRA by preparing and filing the required legal documents. (Also referred to as *sponsor.*)

declaration of condominium. A document that creates the condominium form of ownership and the association, and defines unit owners' undivided shares in the common property, membership and voting rights in the association, and covenants and restrictions on the use of units and common property. (Also referred to as the *CC and Rs* or *master deed.*)

deed. A legal document that transfers to a unit owner title in a unit and an undivided interest in the common property.

deferred maintenance. Commonly used in the CIRA industry to refer to repairs and maintenance, which must be made periodically but not each year, such as painting.

documents. A set of papers creating and describing the CIRA, that may include such items as the declaration of condominium, articles of incorporation, bylaws, and leases or contracts entered into by the CIRA.

fiduciary duty. A special relationship of trust and responsibility held by the CIRA's board of directors towards unit owners.

homeowners' association (HOA). See *association.*

house rules. Guidelines prescribed by the bylaws or adopted by the board of directors for the use and operation of common property and for the conduct of unit owners on common property.

initial capital contribution. A term generally used in CIRA offering documents to refer to a one-time assessment paid by all original owners of units. (Sometimes referred to as *working capital.*)

major repairs and replacements fund. Money set aside for future major repairs and replacements of the common property that is separate from money used for operations. (Also referred to as a *reserve fund.*)

managing agent. A manager engaged by the board of directors to manage and operate the property and whose responsibilities usually include collecting and disbursing funds and supervising employees.

master association. An association formed for joint management of recreational facilities shared by several condominium associations.

master deed. See *declaration of condominium.*

mixed-use development. The result of land planning that combines space for residential and commercial use.

noneviction plan. An offering plan for conversion of a rental building to CIRA ownership in which nonpurchasing tenants need not vacate their units as a result of the conversion.

patronage dividend. Money that may be returned to coop members at the end of a fiscal year as a result of an excess of income over expenses.

percentage of ownership. The percentage of ownership interest of a unit in the common property used to determine a unit owner's share of common expenses.

planned-unit development (PUD). A real estate development that consists of separate lots with contiguous or noncontiguous common areas and facilities owned and maintained by a CIRA in which owners have stock or a membership interest.

proprietary lease. An agreement, which is renewed automatically, allowing a tenant-shareholder in a cooperative housing corporation to occupy a unit. (Also known as *occupancy agreement.*)

recreation lease. An agreement by which unit owners lease from the developer, or an unrelated third party, recreational facilities that were developed for use by unit owners but that are not a part of the common property.

rent. See *carrying charges.*

resale fee. A fee that may be charged by a CIRA for administrative expenses associated with the sale of a unit.

reserves. See *major repairs and replacements fund.*

special assessment. An assessment used for expenditures that were not included in the annual budget.

subscription agreement. An agreement to buy stock in a cooperative housing corporation.

tenant-shareholders. Owners of shares in a cooperative housing corporation who are entitled to occupy units under proprietary leases.

timeshare association. See *timesharing.*

timesharing. Use of a unit for a designated period of time (usually expressed in terms of weeks) as a result of deeded ownership of a unit or a right-to-use evidenced by a long-term lease. Includes a requirement for participation in a proportionate amount of the costs of maintaining the property.

undivided ownership interest. Ownership in the common property that is inseparable and cannot be divided or severed.

uniform condominium act. The central source of condominium law.

For additional copies of the *Common Interest Realty Associations Audit & Accounting Guide* or to automatically receive an annual update — immediately upon its release — call 1-888-777-7077.

Additional Common Interest Realty Associations Publications

General Audit Risk Alert (ARA)

Find out about current economic, regulatory and professional developments before you perform your audit engagement. This ARA will make your audit planning process more efficient by giving you concise, relevant information that shows you how current developments may impact your clients and your audits.

2003/04 (022334) AICPA Member $30; Nonmember $37.50

Checklists and Illustrative Financial Statements for Common Interest Realty Associations

Having been updated to reflect recent AICPA and FASB pronouncements, this aid becomes an invaluable tool to both preparers and auditors of employee benefit plan financial statements.

2003 (008903) AICPA Member $32; Nonmember $40

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- *Casinos* (012714)
- *Common Interest Realty Associations* (012574)
- *Construction Contractors* (012584)
- *Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies, and Mortgage Companies* (012733)
- *Government Auditing Standards and Circular A-133 Audits* (012744)
- *Employee Benefit Plans (as of March 1, 2004)* (012594)
- *Entities With Oil and Gas Producing Activities* (012654)
- *Federal Government Contractors* (012604)
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- *Auditing Revenue in Certain Industries (2004)* (012514)
- *Consideration of Internal Control in a Financial Statement Audit (1996)* (012451)
- *Personal Financial Statements (2003)* (012753)
- *Prospective Financial Information (2003)* (012723)
- *Service Organizations: Applying SAS No. 70, as Amended (2004)* (012774)
- *Use of Real Estate Appraisal Information (1997)* (013159)

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