

# PROPOSED ETHICS RULING ON AUDITOR INDEPENDENCE

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The American Institute of Certified Public Accountants (AICPA) has proposed, in an Exposure Draft issued September 16, 1997, to revise the rules affecting auditor independence. Specifically, this is a proposed revision of Ruling No. 31 under Rule 101.

Ruling No. 31 under Rule 101 was established in 1989, and was the subject of an article in The Ledger Quarterly Summer 1990 issue. The current Rule states that if the auditor, or any member of the auditor's firm, is a member of a homeowners association, cooperative, condominium association, planned unit development, timeshare association, or other common interest realty association (CIRA), then the firm is considered to have a direct financial interest in the association, which would impair the firm's independence. As a result, the firm would be prohibited from performing an audit or review, and could perform a compilation only by including in the compilation report appropriate wording to disclose the lack of independence with respect to the association.

The current proposal would revise that Ruling to provide an exception to the above-stated Ruling by allowing a CPA firm to consider itself independent if all of the following conditions are met:

- A. The CIRA performs functions similar to local governments, such as public safety, road maintenance, and utilities.
- B. The member or member's firm's annual assessment is not material to either the member or member's firm or the CIRA's operating budgeted assessments.

## Executive Summary

***“Proposed revisions to Ruling No. 31 under Rule 101 would allow the audit firm to consider itself independent with respect to a homeowners association, even if a lot or unit in the association is owned by a firm member, if certain conditions are met.”***

- C. The liquidation of the CIRA or the sale of common assets would not result in a distribution to the member or the member's firm.
- D. Creditors of the CIRA would not have recourse to the member or member's firm if the CIRA became insolvent.
- E. The member or member's firm does not act or appear to act in any capacity equivalent to a member of management or as an employee for the CIRA, including membership on the board of directors or committees (excluding advisory committees as defined in ethics Ruling No. 72).

The above conditions would probably allow a CPA firm to consider itself independent in most circumstances. However, the wording in each of the conditions must be carefully evaluated to determine if the CPA firm is truly independent.

“A” above requires that the nature of the association's operations be evaluated to determine if the association really “performs functions similar to local



## Proposed Ethics Ruling on Auditor Independence (continued)

governments.” This may be subject to interpretation. Most associations do provide functions relating to public safety. Most small associations probably do not perform road maintenance functions, unless you would consider the driveways in a small condominium association to be “roads.” Likewise, most associations do not provide utility services. Probably the most common (and often only) utility service provided is cable TV to the association.

“B” above requires that the CPA firm consider three different materiality tests:

- 1) The member - The question that immediately arises is against what is the annual assessment measured to determine materiality? Is it the member’s gross annual income? Gross assets?
- 2) The member’s firm - If you can get past the “member” materiality test, this one should be automatic, since the firm’s income and assets would be larger than that of the individual member.
- 3) The CIRA’s operating budgeted assessments - This almost implies that if the CIRA does not have a budget, then this test could not be performed. However, the “budget” would probably be the gross annual operating assessment in the absence of a budget. This amount would exclude any reserve assessments. If 3% is used as the materiality level, then the association would have to have more than 33 units for the member to consider himself independent under this test. This would eliminate very small associations

“C” above requires that the member closely review the articles of incorporation, bylaws, and CC&R’s or other controlling documents to determine how assets are to be distributed upon termination of the association. Many documents call for distribution to the members on termination, which would prevent the CPA firm from qualifying for independence under this proposed

Ruling.

“D” above deals with creditors, who normally do not exist in the community association industry. However, bank loans are becoming much more common as associations borrow to fund their reserves. If a bank loan does exist, the documents would need to be reviewed carefully to determine if the member would ever become liable in the event of an association default on the loan. While that is virtually unthinkable, the proposed Ruling requires that you must consider this possibility. If the bank loan is secured/collateralized by member assessments that could be recorded as a lien on the member’s underlying real estate interest, then I believe independence would be impaired.

“E” above requires that the member not participate as a board or committee member for the association. This is no different than independence requirements in any other industry.

I have attempted to illustrate that while the proposed Ruling may benefit be a benefit to the industry, CPA firms must still be very careful in evaluating their independence under the proposed new Ruling. Since the comment deadline for the proposed Ruling was December 15, 1997, it is anticipated that, if unopposed, the Ruling would take effect early in 1998.

**Note:** A modified version of this article was published in CAI’s “Ledger Quarterly,” Winter 1998 Issue

