Is the Investment Balance Shown on Your Association's Balance Sheet Correct?
By Dale Weidner, CPA

Homeowner associations that invest in fixed-income securities can purchase them either in the original issue market or in the secondary market. The effective interest rates on secondary market investments are often better than rates in the original issue market. Thus, secondary market transactions are popular with homeowner associations. But, two accounting issues can surface when securities are purchased in the secondary market: purchased interest, and premium / discount at acquisition. Unless these are handled properly, the association's investment balance (and its interest income) will not be reported correctly.

Accounting for purchased interest and for premium/discount at acquisition can be tricky. The effects of incorrect accounting can be insignificant. However, the amounts involved can be significant – we've had audit adjustments on this item up to $11,000 (reducing the investment account book balance and also reducing interest income by that amount). Not a pleasant surprise for any of the parties – including the auditors. What are the secondary market accounting challenges and what can be done to deal them? An explanation of the calculations and the debits and credits involved in properly accounting for purchased interest and premium/discount at acquisition can be tedious. I'll attempt to keep the following explanations.

Purchased Interest: Assume that an HOA ("Hummingbird") purchased a security in the secondary market on June 1, 2004. The security was originally issued January 1, 2004. The security has a $25,000 face value and pays 5% interest (it pays $625 twice a year – January 1 and July 1). When Hummingbird purchased the security on June 1, Hummingbird paid the seller for interest from the last interest payment date (which was January 1) through June 1. That's five months of purchased interest (5/6ths of $625 or $521). On July 1st the security pays interest of $625. The statement from the brokerage firm reflects this. However, the $625 was earned over the last six months and Hummingbird only owned the security for one month. Hummingbird's net share of the $625 received is only $104 ($625 less $521).

When the $625 interest is received, the accounting process needs to recognize that the entire $625 is not really interest income to the association - only the $104 is income to the association. (Also good to get this sorted out for tax purposes!) The mechanics of the process can be left to the accountants. However, Boards and managers might want to ask the accountants a couple of questions regarding investment accounts: Have we purchased any interest as part of our investment activity? Do we do what's necessary to properly account for that purchased interest?

Premium and Discount: Securities are, at times, acquired for amounts which include premiums or discounts – i.e., the amount paid for a security is more or less than the security's face value. Premiums are paid when the face interest rates on such securities are in excess of then-available market rates. The secondary market commands that a "premium" be paid for such higher-interest securities. That has been common recently. Discounts from face value occur when the security has a lower than market rate interest rate.

In concept, the premium paid or discount realized for each security should be amortized to interest income over the remaining term of that security (accountants create Excel spreadsheets to do this…). If the amortization is done properly, the book amount for the security will equal the face value of the security when it matures. In practice, monthly amortization of premium / discount is typically not done. One option is to expense the premiums (or accrete the discount) at the time of acquisition of the securities. If neither an amortization process nor an immediate write-off process is in place, the cumulative unamortized premium / discount should be reviewed periodically to determine if a write-off of a portion of the premium / discount is appropriate. If that is done, and if the amortizable / accretable amount is significant, an adjustment is made to write-off the amount that could have been amortized or accreted to-date.

As in the case of purchased interest, the mechanics of the amortization / accretion processes can be left to the accountants (using their Excel spreadsheets…). However, for associations that have investments in fixed income securities, the Boards and managers might want to ask the accountants a couple of questions: Does our investment activity result in any premiums or discounts when we acquire securities? If so, do we do what's necessary to properly account for the premiums and discounts?

When an association uses the secondary investment market, two incremental accounting challenges – purchased interest and premium/discount on investments – surface. These need to be handled correctly to ensure that the investment balance shown on your association's balance sheet is correct – and that interest income is properly stated for both book and income tax purposes.