

Real Estate Price Declines and The Need for Contingent Liability Disclosure Vigilance: An Illustrative Example

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ABSTRACT

The current real estate price decline has caused property tax revenue in the US to decline substantially as well. Property taxes are an important source of revenue for many non-profit entities. Tax revenue declines threaten many non-profit entities, particularly schools in the U.S. The effects of these declines in revenue may not be properly disclosed. This paper reports on an example of contingent liability disclosure that fails to report contingent liabilities that materially reduce school and other non-profit revenue. Accountants and auditors need to be wary of the financial statement effect of falling tax revenues. They must carefully and completely disclose the contingent liability effects resulting from real estate price collapses.

INTRODUCTION

There are many ill effects emanating from the current downturn in real estate prices. Many homeowners in the US have defaulted on 'underwater' mortgages where the current value of the property is less than the balance due on the home mortgage. Building construction is slowing and the construction industry is suffering from the lack of demand for new housing and commercial property. In circumstances such as these, accountants and auditors need to be wary of the financial statement effects related to declining real estate values. There have been many articles in the popular press about the resulting global, financial crisis and its implications for reporting, markets, and employment. One effect that has not been discussed in the popular press involves the emergence of material contingent liabilities related to falling real estate prices. Accountants must carefully and completely disclose the contingent liability effects resulting from such price collapses. This is particularly true in the US for nonprofit organizations such as county organizations and school districts that rely greatly on revenues based on property values.

According to the Wall Street Journal (2008) "Prices [housing] nationwide have fallen nearly 20% since their 2006 peak, and many economists foresee a further decline of 10% or more in the next year." The effect of these price declines could have a dramatic effect on organizations that depend upon property tax revenues. For instance, in Los Angeles (2008), of the total property tax revenue, schools receive the largest portion, 41.1% or \$4.1 billion. The county and city areas of Los Angeles receive \$3.9 billion, special districts (e.g., libraries, water and utility districts) \$740 million, and redevelopment agencies \$1.2 billion from property taxes. In 2008 Cook County Illinois (2008) raised \$333 million in property tax revenues, New York City (2008) raised \$13 billion.

ACCOUNTING PROMULGATIONS

In 1980, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Concepts No. 4 *Objectives of Financial Reporting by Nonbusiness Organizations* in which the board concluded that financial reporting for government-sponsored entities should be the same as that provided by for-profit entities. Specifically, the FASB stated that: "Financial reporting should provide information to help present and potential resource providers and other users in assessing the services that a nonbusiness organization provides and its ability to continue to provide those services...Financial reporting should provide information about the economic resources, obligations, and net resources of an organization and the effects of transactions, events, and circumstances that change resources and interests in those

resources. “ (pp. 21-22) In assessing the level of services that an entity will provide, it is important to be cognizant of the obligations and potential obligations that could adversely impact the current level of services.

The US Government Accounting Standards Board (GASB) posed similar objectives. In 1987 Concept Statement No. 1 *Objectives of Financial Reporting* of the GASB stated that the objectives of governmental financial reporting include providing information about sources of financial resources as well as disclosing the risk of potential loss of resources.

In March 1975, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 5, *Accounting for Contingencies* which superseded Accounting Research Bulletin (ARB) No. 50, *Contingencies*. In it, the FASB defined contingencies as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. While contingencies are transactions that have not yet occurred, they may occur in the future and are thus very important to the financial statement reader. In recognition of the importance of information about contingent liabilities, accounting regulating bodies, like the FASB and GASB, have consistently required their disclosure.

Included in the FASB's list of possible sources of contingencies were pending or threatened litigation, and actual or possible claims and assessments. In order for an entity to record a loss and set up a contingency on their books, two criteria need to be met. One, the loss must be probable because the required future event will likely occur and two, the amount of the loss can be easily estimated. In the circumstance that one or both of these criteria are not met, footnote disclosure is required for possible losses when there is at least a reasonable possibility of a loss. In that case the FASB required that the disclosure indicate the nature of the contingency and give an estimate of the possible loss or range of loss or state that such an estimate cannot be made.

However, recently the FASB has found inadequacies with SFAS 5. In June 2008 the FASB (2008) proposed an exposure draft entitled, “Disclosure of Certain Loss Contingencies - an amendment of FASB Statements No. 5 and 141(R). The basis for this exposure draft is that The FASB does not believe current guidance provides “adequate information to assist users of financial statements in assessing the likelihood, timing, and amount of future cash flows associated with loss contingencies.” The FASB is proposing to increase the scope of SFAS 5. In any event, the disclosure of loss contingencies are in the process of review.

Governmental units in the US are required to follow GAAP established by the FASB unless the Governmental Accounting Standards Board (GASB) issues a pronouncement superceding a FASB pronouncement. Gauthier (2005) states quite clearly that contingent liabilities should be handled by governmental units in the same way that for-profit entities report contingencies. Specifically, unbooked contingencies should be disclosed in the notes to the financial statements. The California State Administrative Manual (1998) also states that contingent liabilities will be reported.

The International Accounting Standards Board (IASB) issued International Accounting Standard number 37 which also requires the disclosure of contingent liabilities: “An entity should disclose a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote.” The current IASB requirement is consistent with the FASB requirements related to contingent liabilities although a proposed revision to IAS 37 would change some of the terminology and increase the probability that contingent liabilities would be reported on the balance sheet instead of in the notes to the financial statements.

The importance of contingent liabilities is well documented and supported by the many accounting regulatory bodies in their various pronouncements and guidelines. The reader of financial statements needs information about contingent liabilities to aid in the process of predicting or anticipating future cash flows.

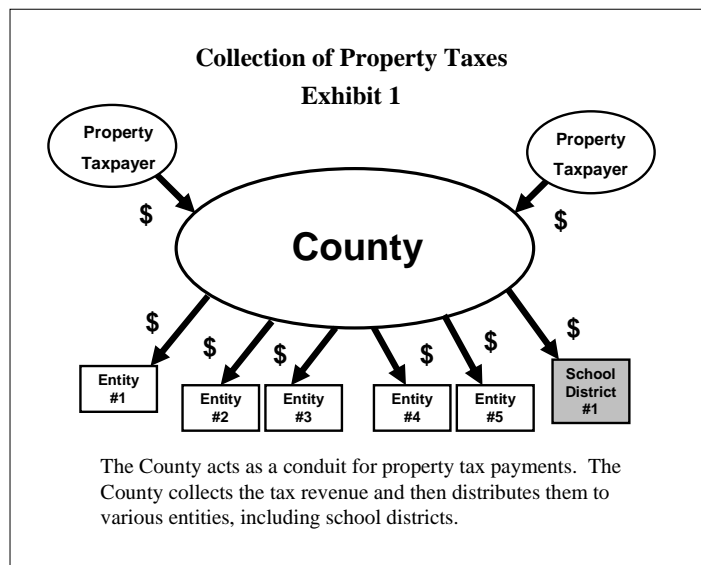
The complexities of loss contingencies can be magnified during periods of downward valuation such as the current real estate price collapse. Taxing authorities reassess property values and therefore property taxes move downward. Property holders seek lower property tax assessments frequently through the court system. This in turn reduces revenue for schools and other non-profit entities. Lawsuits filed in the court system for refunds of prior property taxes create contingent liabilities that can materially affect future cash flow and thus the operations of various entities that depend on property tax revenue.

ILLUSTRATIVE EXAMPLE

There are over 1,000 school districts in California. School districts in California, like many states in the US, receive funding from a variety of sources including local property taxes. This is true in California where each county acts as a conduit for property tax payments. As is depicted in Exhibit 1, the county collects the tax revenue from property holders and then distributes the revenue to various entities, including school districts.

When a property taxpayer challenges their property tax assessment in court, the County is defended by the County Counsel, District Attorney or an equivalent county official. If the taxpayer is successful in court, the amounts that they had previously overpaid as taxes are refunded to the property taxpayer. This rebate affects those school districts and all other entities that rely on the property tax revenue such that projected revenue amounts that had been budgeted would be revised downward. Thus, the entity receives less revenue from the County. A revenue revision resulting from a property tax rebate can occur at any time throughout the year.

A study conducted by Danko et. al. (2008) focused on one such significant property tax rebate; one that prompted a midyear county budget adjustment and resulted in the laying off of school district employees. All of the county's school district financial statements for periods preceding significant property tax rebates were reviewed. Although significant property tax appeals may take years to complete, there was no mention of the possibility of any major property tax rebates in the notes to the financial statements for any of the school districts in the county, specifically the contingent liabilities section. In each case the financial statements received unqualified audit opinions.



Details of the study indicated that although the county, as well as all other entities relying on the property taxes, had material revisions in their 2006 revenue stream as a result of significant rebates, the prior years financial statements indicated no potential downward revision to the revenue stream, in other words, there was no disclosure of a loss contingency.

In addition, the authors examined the financial statements of several school districts where pending property tax rebates were material and found that there was no disclosure of contingent liabilities related to litigation. The authors set out to find out why these material contingent liabilities were not disclosed.

Auditing standards require an assessment of outstanding lawsuits to determine the extent to which contingent liabilities should be reported. The case of school districts is unique in that the county is the entity that collects property taxes and acts as a conduit for the funds to the school districts. Thus, property owners would naturally file suits against the county for property tax rebates and, depending upon the size and complexity of the litigation, the lawsuits could take many months, even years to resolve. The fact that the selected school districts employed several different audit firms, each providing a clean opinion, suggests that too little emphasis may have been placed on the disclosure of such loss contingencies, those that occur at the county level but affect many other entities, such as school districts. In short, the

school districts themselves were not being sued by property owners, thus they didn't have direct awareness of the potential effect of the lawsuits on their own revenue.

IMPLICATIONS

Contingent liabilities can occur through litigation emanating at other conduit entities, such as, in this case, the County, and this litigation, because it has or could have a material effect on the school districts' financial operations must nonetheless be included in contingent liability disclosure by the affected secondary entity, in this case, the school district. This means that attorneys for the conduit entity (i.e. County Counsel) must also be consulted by the school district's management for contingent liability disclosure information. Additionally, external auditors for school districts must confirm these legal matters with the attorneys for the conduit entity.

CONCLUSION

Accountants and auditors must be mindful of the implications of the financial statement impact that accompanies economic circumstances such as those we experience today. With property values declining, many sources of revenue for government entities will experience a decrease. The impact of potential losses of revenue should be disclosed no matter where their source. Property tax declines will probably be one such source that will require estimation and disclosure.

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