ACCOUNTING FOR COMMON INTEREST REALTY ASSOCIATION MEMBER ASSESSMENTS AFTER ASU 2014-09

Accounting Standards Have Changed but Accounting Policies Should Remain the Same

Abstract

Previous accounting standards for recognizing revenue from member assessments were removed under ASU 2014-09 and newly published editorial guidance has confused many about the proper accounting for member assessments. This article reviews how ASU 2014-09 affects member assessments and analyzes the newly published editorial guidance. Finally, a call to action is made for practitioners to petition the FASB for specific guidance for these transactions.

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Executive Summary

The issuance of a new accounting standard for revenue recognition, Accounting Standards Update (ASU) No. 2014-09 Revenue from Contracts with Customers (Topic 606) was not expected to change the accounting for member assessments in a common interest realty association (CIRA); however, in July 2019, a respected CIRA industry accounting guide published a new chapter on assessments revenue, advising CIRAs to apply Topic 606 to the accounting for assessments. The application of Topic 606 to member assessments, as proposed in the published guide, results in radical changes to the accounting policies historically followed by CIRAs and has created significant confusion and debate among the CIRA industry regarding the proper accounting for assessments, particularly assessments designated for future major repairs and replacements of common property.

There are nearly three hundred and fifty thousand community associations, representing seventy million residents, and collecting ninety billion dollars of assessments revenue annually in the United States according to the 2017 National and State Statistical Review published by the Community Associations Institute (CAI). Leaders of the accounting profession who serve the interests of the CIRA industry now need to organize efforts to ensure preservation of the accounting principles that have proven to produce quality accounting information for the users of CIRA financial statements.

The new ASU 2014-09 created a single common revenue standard for contracts with customers and removed most industry specific revenue standards. Among the industry specific revenue standards removed was the longstanding guidance that had previously applied to CIRA assessments. Since there is no longer any official specific guidance in the Accounting Standards Codification (ASC or the Codification) for CIRA assessments revenue, practitioners and CIRA industry experts are left to interpret the new revenue standard to determine if and how it applies to the accounting for CIRA assessments revenue.

By thoroughly analyzing the rights and obligations of CIRA owners stated in the governing documents of the CIRA, it becomes clear that assessments transactions are between a CIRA and its members in their capacity as owners and not as customers. Assessments to owners in a CIRA fail to meet the definition of a transaction with a customer as expressed in Topic 606, since the owners lack the characteristics of a customer, the CIRA lacks the characteristics of a supplier and the owners bear all the risks and benefits of the CIRA activity.

The most egregious change recommended in the published guidance is to reflect unused assessments for future major repairs and replacements of common property as contract liabilities until the funds are used, at which time a revenue event would be reported by the CIRA. Historically, replacements reserve assessments are recognized as revenue when the assessment is made, and accumulated replacement funds are reflected as members' equity in the CIRA's balance sheet.

The classification of accumulated funds designated for future major repairs as a "contract liability" is inconsistent with the financial statement concepts that serve as a framework for developing generally accepted accounting principles. Funds accumulated from the success of the central operations of the CIRA embody the characteristics of equity. Deferring revenue from replacements reserve assessments until the funds are used does not seem sensible because the owners benefit immediately from the assessment through control of the accumulated replacement funds and the ability to direct the use of the assets or obtain substantially all of the remaining benefits from the assets. Clearly, owners first receive benefits from the replacement reserve assessments immediately when the assessment is made to the owners, as opposed to when the replacement reserve assessments are spent. Accordingly, even if Topic 606 were to apply to member assessments, revenue should continue to be recognized at the point of assessment because the owners receive control of the replacement reserve assessments immediately, satisfying the performance obligation stated in Topic 606.

Other financial reporting issues arise when replacement reserve assessment revenue is deferred until the funds are used. One such issue involves investment earnings on replacement funds. The financial statement effect of different methods for allocating disbursements of investment earnings can dramatically change a CIRA's reported equity balances and net income.

The following discussion is intended to illustrate how Topic 606 affects assessments revenue, to explain what accounting policy CIRAs should follow for assessments revenue, and to rally industry leaders to take action by submitting an agenda request to the Financial Accounting Standards Board (FASB) in hopes that the FASB will issue authoritative guidance on revenue recognition for CIRA assessments.

Please visit www.desrochescpas.com/revenuerecognition to add your name or organization to the list of industry leaders who believe the FASB should address this topic.

Background

Common Interest Realty Associations

The purpose of a CIRA is to provide a legal structure for property owners who share a common goal to organize their efforts to care for common property that serves their collective individual properties and to provide other services that enhance the ownership of their collective individual properties. Membership in a CIRA is automatic and cannot be separated from the ownership of the underlying real estate. The CIRA and the members who comprise the CIRA are one and the same. Even though they are legally separate entities, the owners' common ownership and common control of the CIRA makes the CIRA and the owners indivisible. Assessments charged to owners of a CIRA are generally authorized under the Declaration, which is the legal document that creates the CIRA, defines the CIRA property and establishes most of the rights and obligations of the owners who purchase property subject to the Declaration. The Declaration is similar to an operating agreement used in a commercial enterprise to define the rights and responsibilities of owners in operating the enterprise. Owners who purchase property subject to the Declaration are granted voting rights to direct the operations and activities of the CIRA either directly or through the election of a board of directors consisting of CIRA owners who should represent the interests of all owners. Usually the board of directors oversees the CIRA activities and delegates the daily administration to an employee or authorized agent. The board of directors of the CIRA, or an authorized agent thereof, is responsible for establishing and maintaining the accounting policies of the CIRA. Although the board of directors and the manager routinely exercise control over the CIRA, the owners collectively have the highest level of power to direct the affairs of the CIRA.

As owners in a CIRA, there is an unlimited responsibility to provide funds for the operation, maintenance, repair and replacement of the common property through assessments. Owners will often vote annually on a budget prepared by the board of directors, which also establishes the assessment for the following fiscal year. Once authorized, assessments are enforceable against an owner and are typically secured by a lien against the owner's property subject to the Declaration. Property liens serve to protect the CIRA's interests in the event of non-payment.

Common property is property that collectively serves the owners' individual properties and may either be titled to the owners in common or titled to the CIRA and controlled by the owners through their powers to direct CIRA actions. Due to the long-term useful lives of many common property components, it is ordinary that annual assessments will include an amount to be set aside for future major repairs and replacements of the common property. The amounts set aside for future major repairs and replacements are generally held in a separate savings account and accounted for as a separate fund. Prudent management would require using these funds for their designated purpose, however, there is no legal restriction on the use of the replacement funds that distinguishes them from operating funds. If operating funds are insufficient to meet current needs, associations too often use funds designated for future major repairs and replacements to cover the shortfall. If funds are insufficient to perform necessary major repairs and replacements, the owners typically must make up the difference through a special assessment or in some cases may obtain third party financing to make up the deficit. Owners have the power to direct the use of CIRA funds for any CIRA purpose and may also return the funds to themselves.

Accounting Standards

The sources for GAAP are defined by the FASB in ASC Topic 105 – Generally Accepted Accounting Principles, which establishes the Codification as the sole source of authoritative GAAP and also addresses how an entity must determine GAAP when treatment for a transaction is not specified in the Codification. According to ASC 105, if the guidance for a transaction is not specified within authoritative GAAP, then an entity shall first consider accounting principles for similar transactions within authoritative GAAP and then consider non-authoritative guidance from other sources. Sources of non-authoritative GAAP include practices that are widely recognized and prevalent in the industry, FASB Concept Statements, American Institute of Certified Public Accountants (AICPA) Issues Papers, IFRS issued by the IASB, pronouncements of professional associations or regulatory agencies, Technical Information Service Inquiries and Replies included in AICPA Technical Practice Aids, accounting textbooks, handbooks, and articles. The appropriateness of other sources of accounting guidance depends on its relevance to the particular circumstances, the specificity of the guidance, the general recognition of the issuer or author as an authority, and the extent of its use in practice.

Historically, CIRAs have recognized revenue from assessments in accordance with ASC 972-605. However, in May 2014, the FASB issued ASU 2014-09, which was organized in two sections. The first section created a new Topic 606, and the second section consisted of amendments to conform guidance throughout the Codification as a result of the FASB's decisions to remove most industry specific revenue standards in favor of a common revenue standard. The amendments in the update are effective for annual periods beginning after December 15, 2018. The previous standard for recognizing revenue from assessments, ASC 972-605, was removed from the Codification under the conforming amendments of ASU 2014-09.

ASU 2014-09 was part of a joint project between the FASB and the International Accounting Standards Board (IASB) to clarify the principles for recognizing revenue and to develop a common revenue standard for U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS). The common revenue standard was intended to remove inconsistencies and weaknesses in revenue requirements, provide a more robust framework for addressing revenue issues, improve comparability of revenue recognition across entities, industries, jurisdictions and capital markets, provide more useful information to users of financial statements through improved disclosure requirements, and simplify the preparation of financial statements by reducing the number of requirements to which an entity must refer.

Topic 606 is based on the principle that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. According to ASC 606-10-15-2, an entity shall apply the guidance of Topic 606 to all contracts with customers, except for contracts involving leases, insurance, financial instruments, guarantees, and non-monetary exchanges. Furthermore, regarding the applicability of Topic 606 to contracts, ASC 606-10-15-3 states that, "An entity shall apply the guidance in this Topic to a contract (other than a contract listed in paragraph 606-10-15-2) only if the counterparty to the contract is a customer. A customer is a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration. A counterparty to the contract would not be a customer if, for example, the counterparty has contracted with the entity to participate in an activity or process in which the parties to the contract share in the risks and benefits that result from the activity or process (such as developing an asset in a collaboration arrangement) rather than to obtain the output of the entity's ordinary activities."

Recently Published Guidance

In July 2019, Thomson Reuters published the thirtieth edition of PPC's Guide to Homeowners' Associations and other Common Interest Realty Associations ("the PPC Guide"). The PPC Guide is a highly respected publication that is relied upon by accounting professionals for accurate and comprehensive analysis of GAAP for CIRAs. The PPC Guide is not authoritative, however, it is the most frequently updated and thoroughly developed publication on the topic of CIRA accounting and auditing practices. Among the substantive updates to thirtieth edition of the PPC Guide was the addition of a discussion on new authoritative guidance, FASB ASC 606, for revenue recognition.

Chapter 312 Revenue from Contracts with Customers (FASB ASC 606) of the PPC Guide states that "The authors believe that CIRAs are required to implement the guidance from ASU 2014-09. Additionally, the services provided by the CIRAs and their relationship with the members appear to meet the definitions of contracts and customers, respectively, as defined in FASB ASC 606." The PPC Guide instructs that member assessments are consideration paid by members to the CIRA in exchange for goods and services and should be accounted for under ASC 606. The authors believe that the member assessments for operations should be recognized as revenue throughout period when the assessment is made, similar to existing practice because the CIRA is providing for the operations of the entity over the period.

Regarding replacements reserve assessments, the authors acknowledge that there is diversity of thought on how CIRA's should recognize revenue from replacements reserve assessments, depending on the determination of the CIRA's performance obligation with regard to replacements reserve assessments. Although there is diversity of thought, the authors advise that it is generally believed that replacements reserve assessments should be recorded as a contract liability on the balance sheet and not recognized as revenue until the funds are spent. With the adoption of this method of accounting for replacements reserve assessments, any equity fund balance arising from member assessments that was previously accumulated for replacements reserves must be reclassified as a contract liability while the investment earnings from accumulated funds would remain as equity.

Analysis

CIRA Owners as Customers

Some have reasoned that a CIRA is like other membership organizations that are subject to the guidance of Topic 606; however, there are fundamental characteristics that distinguish a CIRA from other membership organizations. According to ASC 606-10-10-3, "An entity shall consider the terms of the contract and all relevant facts and circumstances when applying this guidance." In reviewing the terms of the contract that is written by and between the owners, the Declaration, one learns that unlike other membership organizations, CIRA membership is exclusive to and mandatory for all property owners subject to the Declaration, the CIRA is directed and controlled by an elected board of owners, the purpose of the CIRA is to maintain, repair and replace the common property that serves the properties of the owner-members, the owners/board have the power to set assessments, direct the use of funds for CIRA activities, return accumulated funds to the owners and owners also have the unlimited responsibility to provide funds for the CIRA's activities. By thoroughly analyzing the rights and obligations of the owners under an association Declaration, it becomes clear that transactions between an association and its members in their capacity as owners (i.e. member assessments) are fundamentally different from transactions with an association and its members in their capacity as a customer. In addition, the Declaration is a contract between the Association and its owners. It is not a contract with a customer.

In order to understand the key characteristics that differentiate a CIRA and its owners from the relationship between customers and suppliers, it may be helpful to compare and contrast the differences between these relationships more comprehensively. Below is a table of characteristics found in relationships between owners and the CIRA as well as those of typical customer-supplier relationships. In the below table, the owner is assumed to be the customer and the CIRA is assumed to be the supplier. Although there are many differences and some similarities when comparing these two relationships, the quality of certain key characteristics should be considered more heavily than others.

Upon reviewing the table below, it becomes apparent that association assessment transactions don't possess the characteristics of a customer / supplier transaction. Because the owners are responsible to fund and direct the CIRA activities, they bear all the risks and benefits of the CIRA. The risks and benefits of a contract activity that has normal commercial substance are borne separately by customers and suppliers.

TABLE 1
COMPARISON OF CUSTOMER-SUPPLIER RELATIONSHIPS TO OWNERS AND CIRAs

CHARACTERISTIC	**CUSTOMER AND SUPPLIER**	**OWNER AND CIRA**
Relevant legal statute governing contract.	Uniform Commercial Code or Equivalent	State Property Owners Act or Condominium Act
Common ownership between contracting parties	NONE	100%
Common control between contracting parties	NONE	100%
Term of contract performance.	Finite	Perpetual
Availability of alternative parties to contract with.	YES	NO
Operating in competitive market.	YES	NO
Customer (Member) and supplier (CIRA) take part in a process of bidding, sales, and vetting each other prior to contracting with each other.	YES	NO
Customer (Member) and supplier (CIRA) have a meeting of the minds through negotiation prior to contracting.	YES	NO
Customer (Owner) has bargain motive in contracting with supplier (CIRA).	YES	YES
Mandatory requirement for customer (owner) to contract with specific supplier (CIRA).	NO	YES
Customer (Owner) purchases are concentrated with a single supplier (CIRA).	NO	YES
Customer (Owner) able to choose supplier (CIRA) based on customer's wants / needs.	YES	NO

Customer (Owner) can increase / decrease volume of business with the supplier (CIRA).	YES	NO
Customer (Owner) is able to withhold or discontinue payment for poor performance or no performance by supplier (CIRA).	YES	NO
Supplier (CIRA) has profit motive in contracting with customer (owner).	YES	NO
Supplier (CIRA) sales are concentrated with a single customer (owner)/group of common customers (owners).	NO	YES
Supplier (CIRA) able to choose customer (owner) based on supplier's (CIRA's) wants / needs.	YES	NO
Supplier (CIRA) can increase / decrease volume of business with customer (owner).	YES	NO
Supplier (CIRA) is able to withhold or discontinue delivery of goods or service for non-payment by customer (owner).	YES	NO (not generally)
Customer (Owner) obtains benefits of contract through receipt / control over goods or services upon delivery by supplier (CIRA).	Full possession by customer upon delivery.	Only exclusive right of enjoyment granted and control over assets of CIRA.
Party who bears supplier non-performance risks.	Customer	Owners
Party who bears risk of supplier price increases.	Customer	Owners
Party who controls contract pricing for goods or services.	Supplier	Owners
Party who controls payment terms for goods or services.	Supplier	Owners
Party who controls selection and management of upstream supply chain providers.	Supplier	Owners
Party who bears upstream supply chain price risks / benefits.	Supplier	Owners
Party who bears upstream supply chain disruption risks.	Supplier	Owners
Party who bears customer credit risks.	Supplier	Owners

As the table illustrates, owners lack nearly all of the traits of a customer and bear all the risks and benefits of the CIRA activity. The primary trait that differentiates owners from customers would be common control and ownership of the CIRA entity which grants the owners discretion over the contract pricing (assessments), activities, performance, risks and benefits. The owners provide funds for whatever CIRA activities the owners agree to perform and the owners have the right to alter previously determined directives of the CIRA. This is not reflective of a customer and supplier relationship.

Through analysis of the unique structure of a CIRA, and the legal rights and obligations defined in the relationship between a CIRA and its owners, and considering all the relevant facts and circumstances of the Declaration, it becomes clear that assessment transactions between a CIRA and its members are transactions with a CIRA and its owners not a CIRA and its customers. For member assessments, the owners are not customers even though they provide funds for and receive benefits from the CIRA activities. To account for assessment transactions with the owners as if they were customers would omit key information about the relevant facts and circumstances regarding the rights and obligations of the owners in the contract known as the Declaration. Assessments to owners in a CIRA fail to meet the definition of a transaction between a customer and supplier as contemplated in Topic 606.

Members' Equity as Contract Liabilities

Barring the fact that assessments are borne of a contract with owners and not customers, if Topic 606 is applied to assessments as suggested by the PPC Guide, then ASC 606-10-45-2 requires any amounts due from a customer or paid by a customer be presented as a contract liability until the entity transfers the goods or services to the customer. Assuming that the replacements reserve assessment represents consideration paid in exchange for future major repairs and replacements of common property, then any replacements reserve assessments due or previously paid would be reflected as a contract liability until they are spent. Per Statement of Financial Accounting Concepts No. 6 Elements of Financial Statements (CON6), paragraph 36, "a liability has three essential characteristics: (a) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand, (b) the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice, and (c) the transaction or other event obligating the entity has already happened."

Assessments set aside for future major repairs and replacements may be directed by a CIRA board of directors for alternative uses. In other words, the replacements reserve assessments are not legally restricted by the contract or Declaration. For example, a board of directors may decide, to use funds to improve their liquidity and transfer funds from an account designated for future major repairs and replacements to an operating account. Clearly, a CIRA has discretion on how replacement funds may be used and so the accumulated replacement funds do not possess the second essential characteristic of liabilities stated in CON6 paragraph 36 above. Since the CIRA has discretion on how the funds may be used, classification as a liability does not seem appropriate.

Accumulated funds held for the owners' benefit have historically been accounted for as "members' equity" on the CIRA financial statement as that classification best represents the nature of the funds and the character of the relationship between the CIRA and the owners from which the funds originate. Per CON6, paragraph 54, "In contrast (to assets and liabilities), equity is a residual interest - what remains after liabilities are deducted from assets - and depends significantly on the profitability of a business enterprise or on fundraising or other major or central operations of a not-for-profit organization…An enterprise's liabilities and equity are mutually exclusive claims to or interests in the enterprise's assets by entities other than the enterprise, and liabilities take precedence over ownership interests."

In a CIRA, the major or central operations are to collect funds from the owners and provide for the maintenance, repair and replacement of common property. The amount of accumulated funds in the CIRA depends significantly on the major or central operations of the CIRA: collecting assessments and paying expenses. Moreover, the owners' claims to receive the funds from the CIRA are subordinate to the claims against the CIRA from other entities who provide services or deliver goods to the CIRA. Both of these facts would indicate that the accumulated funds of a CIRA embody the traits of owners' equity as described in CON6, paragraph 54 above.

Other relevant guidance regarding the characteristics of equity provided in CON6 are found in paragraphs 51 and 60, which state that "A major distinguishing characteristic of the equity of a business enterprise is that it may be increased through investments of assets by owners who also may, from time to time, receive distributions of assets from the entity….Owners benefit if the enterprise is profitable but bear the risk that it may be unprofitable." (CON6 paragraph 51). Additionally, "In a business enterprise, the equity is the ownership interest. It stems from ownership rights (or the equivalent) and involves a relation between an enterprise and its owners as owners rather than as employees, suppliers, customers, lenders, or in some other nonowner role." (CON6 paragraph 60).

Membership in the CIRA is a consequence of property ownership. Assessments due to the CIRA from each owner are determined according to their ownership interest, and not according the amount of benefits expected to be received from the CIRA. In a CIRA, no member has the right to receive a refund of unearned consideration as a customer would, however, the owners may return to themselves any funds that remain in the CIRA, after expenses. A return of funds must be made to all owners in proportion to their interests in the CIRA. No individual owner has the right to demand that the CIRA deliver goods or services to satisfy a contract between them, but rather the CIRA funds must be spent according to the desires of all the owners. It seems that assessments arise from the duty of the owners to provide for the expenses associated with commonly owned property, not from a customer type transaction wherein a member expects to receive benefits in exchange for consideration. The risks and benefits of the CIRA are borne by the owners and the results of operations have a direct bearing on the amount of assessments required to fund the CIRA activities. Any return of funds to the owners depends on the past performance of the CIRA and is based on the owners' interests as opposed to the amount of consideration paid over the value of benefits received by a member.

The transaction for assessments is made between the CIRA and the owners in their capacity as owners and not as customers. The resulting accumulated funds from the central operations of the CIRA embody the characteristics of equity and lack the essential criteria of a liability as stated in CON6. Characterizing assessments charged to owners as a transaction with a customer and not an owner, as well as changing the balance sheet classification of accumulated funds designated for future major repairs and replacements from equity to a liability is inconsistent with the financial statement concepts established by the FASB.

Accumulated Replacement Reserves Benefit Owners Immediately

Assuming that the replacements reserve assessment is made under a contract with a customer and that Topic 606 applies, the PPC Guide's interpretation of the performance obligation with regard to replacements reserve assessments indicates that the "customer" receives the benefits of replacements reserve assessments (consideration paid) when the CIRA spends the funds on related expenses (performance obligation). In determining the performance obligation, FASB ASC 606-10-25-20 states that, "A customer can benefit from a good or service in accordance with paragraph 606-10-25-19(a) if the good or service could be used, consumed, sold for an amount that is greater than scrap value, or otherwise held in a way that generates economic benefits." In applying this guidance, there is serious doubt that the PPC Guide's determination of the performance obligation is correct since owners first receive benefits from the replacement reserve assessments immediately when the assessment is made to the owners, as opposed to when the replacement reserve assessments are spent.

A member's interest in a CIRA appreciates, generating economic benefits to the owner when the CIRA assesses the owners. Similarly, the value of the owner's individually owned property appreciates when the CIRA assesses the owners. For example, Owner 1 owns Unit 1 which is located in CIRA 1. CIRA 1 is composed of 10 identical units and has accumulated reserves for future major repairs and replacements totaling $1,000,000. Owner 2 has an identical Unit 2 in an identical CIRA 2, which has not accumulated any reserves for future major repairs and replacements. If an owner were to sell real property in a CIRA, their respective ownership in the CIRA also transfers to the new owner along with the economic benefits of the CIRA ownership interest. An informed and educated buyer would be willing to pay a premium for Unit 1 that transfers with an ownership interest in CIRA 1, while Unit 2 will likely be sold at a significant discount because ownership in CIRA 2 does not carry the same economic benefits. Clearly, Owner 1 has received a benefit from the stronger financial position of CIRA 1 and Owner 1 will transfer more economic benefits to the purchaser of Unit 1. Owner 1's interest in CIRA 1 confers economic benefits that are part of the sale of Owner 1's unit. If the performance obligation for replacement reserve assessments is to spend the replacement funds, then the financial position reported in the balance sheet for the owners of CIRA 1 would indicate that they have the same amount of economic benefits as the owners of CIRA 2.

The resulting financial position of owners is strengthened because of the accumulation of replacement funds. These benefits are realized immediately upon the assessment of the owners. Accumulated funds provide future economic benefits because of the ability of the owners to use them toward future costs or return the funds to themselves. If the contract between the CIRA and the owner was a contract between a customer and supplier, then the customer (owner) would benefit from the assessment of the owners as it strengthens their financial position and increases the value of their assets. The subsequent disbursing of those funds would also increase the value of their assets through improvement of common property; however, it would result in a decrease of the owners' cash assets in the CIRA. The benefit of replacement reserve assessments is first realized by the owners when the assessment is made and the financial position of the CIRA is improved.

Control of Replacement Reserves Satisfies Performance Obligation to Owners

Again, assuming that the replacement reserve assessment is made under a contract with a customer and that Topic 606 applies, the PPC Guide's interpretation of the performance obligation with regard to replacement reserve assessments also falls short in the application of Topic 606 because it delays the recognition of revenue to the time when the replacement funds are spent. In determining when an entity should recognize revenue, FASB ASC 606-10-25-23 states, "An entity shall recognize revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (that is, an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset." In addition, concerning control, FASB ASC 606-10-25-25 states, "Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset."

Since the owners of a CIRA control how funds may be used, the members obtain control of the assets resulting from replacement reserve assessments immediately when the CIRA assesses its owners. For example, CIRA 1 assesses the owners $240,000 annually for the operations of the CIRA, including an amount to set aside for future major repairs and replacements of the common property. The assessment is supported by an annual budget which is approved by the board of directors and by vote of the owners. The budget includes $200,000 for normal operating expenses including insurance, maintenance and utilities and $40,000 to be reserved for future major repairs and replacements of the common property. In accordance with best industry practices, CIRA 1 separates funds designated for future major repairs and replacements into a designated savings account. If CIRA 1 runs an operating deficit or encounters a large unplanned expenditure, then the board of directors may decide to use funds designated for future major repairs and replacements to fund the operating deficit or pay for the large unplanned expenditure. Since the board of directors representing the owners and/or the owners themselves have the ability to direct the use of the assets, the performance obligation is satisfied when the funds are assessed. Reflecting accumulated funds for future major repairs and replacements as a "contract liability" on a CIRA's financial statement until the funds are spent does not seem sensible since the owners control the accumulated replacement funds through the ability to direct the use of the asset or obtain substantially all of the remaining benefits from the asset by spending the funds on replacements of common property, using the funds for operating expenses, improving their working capital by transferring the funds to the operating account, or returning the funds to themselves.

Replacement Reserve Assessments Revenue Recognition

Again, assuming that the replacement reserve assessment is made under a contract with a customer and that Topic 606 applies, the PPC Guide's revenue recognition policy for replacements reserve assessments fails to represent the definition of revenue and distorts the net income of the CIRA, diminishing the usefulness of the financial statements because it defers revenue recognition until the replacement funds are spend. Revenue is defined by the FASB in CON6, paragraph 78 as "inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations." In the case of a CIRA, the major or central operations are to collect assessments and pay for common expenses.

By applying the PPC Guide's suggested policy for revenue recognition to replacement reserve assessments, an association running an operating deficit and using funds designated for future major repairs and replacements to help pay for excess operating expenses, will simply recognize more revenue since the reserve funds have been spent. Thus, revenues will equal expenses and no deficit will be reflected on the statement of revenues and expenses.

If applying the PPC Guide's method of accounting to replacement reserve assessments to the example provided above, the reality of the association's poor financial condition is masked by the recognition of revenue from using replacement funds. The creation of revenue by spending replacement funds or re-designating them for operating is arbitrary and produces financial information about revenues and net income that is irrelevant and of little use in evaluating the financial performance of a CIRA. There are several other scenarios when applying the PPC Guide's proposed method where replacement funds are spent, re-designated, or returned to members, and a revenue recognition event is reported that bears little resemblance to the actual inflows of resources to the CIRA or the settlement of its liabilities. Examples of these situations include transferring replacement funds to operating, using replacement funds for a capital improvement, using replacement funds for operating expenses, dissolution of an association and a return of funds to members.

Considering the definition of revenue stated in CON6 and applying the PPC Guide's policy for accounting for replacement reserve assessments will indicate to financial statement users that the use of replacement funds is equivalent to the inflows of assets to the CIRA or settlement of its liabilities that constitute the CIRA's ongoing central operations. One may argue that under Topic 606, the contract liability is reduced when replacement funds are used and so satisfies the definition of revenue in CON6. However, as previously discussed, it does not seem appropriate to reflect unspent replacement reserve assessments as a contract liability because the nature of the owners' claims to the replacement funds is best described as equity and does not satisfy the definition of a liability in CON6. Also, the performance obligation for replacement reserve assessments is satisfied at the point of assessment because the owners realize benefits when the CIRA assesses the owners. Finally, revenue should be recognized at the point of assessment because the owners receive control of the replacement reserve assessments immediately. Accordingly, the more accurate reflection of revenue from replacement reserve assessments is the inflow of assets to the CIRA that occurs at the point of assessment when the CIRA recognizes a receivable from the owners, not when the replacement funds are spent.

Investment Earnings of Replacement Reserve Funds

One of the many financial reporting problems that arise in applying Topic 606 to replacement reserve assessments as the PPC Guide proposed is the accounting for receipts and disbursements of investment earnings on replacement funds. Investment earnings are appropriately reflected as revenue of the replacement fund when they are earned and are reflected as equity in the association's balance sheet. In applying the PPC Guide's proposed method of accounting for replacement reserve assessments, a CIRA must determine the amount of investment earnings (equity) that are spent versus the amount of assessments for replacement reserves (contract liabilities) that are spent from the CIRA's total accumulated replacement funds when the funds are used. Any amounts determined to be used from replacement reserve assessments would be released to revenue as it is used, however, the amount of investment earnings used would reduce equity and be reflected as a net operating loss in the current period.

A simple and highly accurate solution to determining the amount of investment earnings that are used would be to deposit all investment earnings into a separate bank or investment account and reflect any use of the accumulated investment earnings specifically as those funds are used. The practice of this method would prove extremely difficult, however. More commonly, investment earnings are deposited to the bank or investment account where the replacement funds are held, and the earnings are comingled with the assessments that are invested. The CIRA might take a reasonable approach and assume that the investment earnings are spent in proportion to the value of total accumulated earnings over the value of total accumulated funds (weighted average method). Although this calculation would be cumbersome and inefficient, it produces a practical solution to the problem when earnings are comingled with the assessments. Another approach that may be simpler to administer, but that produces rather arbitrary results is to adopt a FIFO or LIFO policy to dictate that investment earnings are spent first or last when disbursements are made from replacement funds or when replacement funds are re-designated for operating.

In practice, the financial statement effect of these different methods for allocating disbursements of investment earnings can dramatically change a CIRA's reported equity balances and net income. Large associations may have invested replacement funds that generate a material amount of earnings annually. The application of a weighted average, FIFO or LIFO method to calculate the amount of replacement fund earnings that are spent can result in equity balances that vary widely, depending on the adopted calculation method and a report of net income that bears little resemblance to the actual results of operations. The results of applying Topic 606 as proposed in the PPC Guide appear to be arbitrary and obscure rather than relevant and useful; consequently, the CIRA's financial position would be difficult to evaluate because of the subjectivity involved in accounting for replacement fund investment earnings as they are used.

Accounting Policies for Assessments

As discussed, the relevant facts and circumstances of the Declaration and the assessments transactions between owners and the CIRA indicate that the nature of the relationship is with the owner in their capacity as an owner and not as a customer or supplier, the best representation of revenue from assessments for operations or replacement reserves is to report revenue when the assessment is made and the assets of the entity are enhanced, and the traits of accumulated funds in the CIRA most closely resemble the traits of equity to owners as stated in CON6 and lack the essential characteristics of a liability. Accordingly, it seems that the application of Topic 606 to assessments transactions is not proper and the scope of Topic 606 would not include assessments between a CIRA and the owner-members.

The Association may have other transactions with members or nonmembers in which the guidance of Topic 606 should be followed. For example, fees charged to members for services such as resale packages, guest passes, maintenance services, special events, food and beverage vending, and laundromat vending, all exemplify a typical customer – supplier type transaction. Although Topic 606 applies to these transactions, the accounting results are the same as previously determined prior to issuance of Topic 606. In summary, the revenue is recognized when the promised goods or services are delivered to the member or nonmember.

In determining GAAP for regular assessments of a community association, there is no guidance provided in the Codification specific to these transactions and due to their uniqueness, there are no similar transactions for which guidance is provided in the Codification. Accordingly, we believe the historically established industry practice for recognizing revenue from regular assessments remains GAAP for community associations even though the former accounting standard for regular assessments, ASC 972-605, was removed by the FASB in an effort to remove almost all industry specific revenue standards. Current industry practice is to recognize revenue from regular assessments in the periods in which they are assessed, regardless of when they are collected or expended. This practice follows previously issued guidance from the AICPA Audit and Accounting Guide for Audits of Common Interest Realty Associations that was written specifically for regular assessments transactions of a community association. The AICPA guide was previously accepted by the FASB as GAAP for community associations and added to the Codification as ASC 972-605. It is the most widely recognized and prevalent industry practice in the United States of America, has been in practice for nearly thirty years under the standard issued by the AICPA in 1991, and was followed generally for over thirty years prior to that.

The fact that this previously authoritative guidance issued by the AICPA and the FASB was removed from the category of authoritative GAAP as the FASB made comprehensive conforming amendments to revenue standards does not diminish the relevance of the guidance, specificity of the guidance, or the authority of the issuers. Neither the AICPA nor the FASB have issued statements that the previously issued revenue recognition guidance was flawed or in need of revision. The removal of the prior standard was a casualty of oversight and a lack of industry involvement when the FASB released the exposure draft of ASU 2014-09 for comment.

Conclusion

Industry leaders are needed now more than ever to provide clear guidance to CIRAs concerning generally accepted accounting principles for member assessments transactions. Never has such a debate occurred on the issue of proper accounting policies for member assessments. The debate is occurring due to a change in accounting standards that was not addressed to CIRAs. It is important to keep in perspective the intention and purpose of the FASB for issuing ASU 2014-09 and not apply accounting standards to transactions arbitrarily without considering their applicability and scope. The voice of the CIRA industry was not present in the standard setting process when the FASB proposed removing the assessments revenue standard along with most industry specific revenue standards. Because of the lack of involvement from CIRAs, the FASB could not appreciate the need for a revenue standard specific to CIRAs as it proposed broad conforming amendments under ASU 2014-09. The CIRA industry is little understood and largely overlooked by global accounting firms and academics that steer or establish the accounting standard setting process. This lack of attention is understandable since CIRAs are relatively small organizations with no profit motive, however, there are nearly three hundred and fifty thousand community associations, representing seventy million residents, and collecting ninety billion dollars of assessments revenue annually in the United States according to the 2017 National and State Statistical Review published by the Community Associations Institute (CAI). Leaders of the accounting profession who serve the interests of the CIRA industry now need to organize efforts to ensure preservation of the accounting principles that have proven to produce quality accounting information for the users of CIRA financial statements. Accounting professionals, CIRA managers, and board of directors members should work with the governmental affairs office of CAI to petition the FASB and request an agenda topic to provide confirmation of the appropriate accounting policy for recognizing revenue from regular member assessments in a common interest realty association under generally accepted accounting principles.

Please visit www.desrochescpas.com/revenuerecognition to add your name or organization to the list of industry leaders who believe the FASB should address this topic.

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DesRoches & Company, CPAs, P.C. specializes in providing accounting, auditing and income tax services to condominium and homeowners associations. Since the firm's inception in 1988, DesRoches & Company has performed thousands of financial statement audits of community associations throughout southeastern Virginia. The firm currently serves more than five hundred community association clients. DesRoches & Company has been actively involved in the education of community association property managers and boards of directors through its participation in the Southeastern Virginia Chapter of the Community Associations Institute ("SEVA CAI") and believes in empowering volunteer leaders and managers of community associations to make a positive impact in their communities through prudent financial management.

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