P&L Serving the Community Association Industry

Porter & Lasiewicz CPAs
3355 Cochran Street, Suite 101
Simi Valley, California 93063
(805) 433-6022 Fax (805) 426-8177
www.PL-CPAS.com

Discussion paper on applicability of ASC 606 to community associations

Gary Porter CPA
Cheryl Lasiewicz CPA

This memo is intended to provide information about the applicability of ASC 606 to the community association industry. We do not promote any specific point of view in this memo, but rather discuss the various interpretations as have been discussed with many CPA practitioners.

In 2014 the Financial Accounting Standards Board (FASB) which sets Generally Accepted Accounting Principles (GAAP) for the USA issued new standards for revenue recognition for all US entities. The core principle of the new guidance is 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 goods or services. This new guidance affects any entity that either enters into contracts with customers. Those standards took effect for Associations with fiscal years beginning after December 15, 2018. The new standards are located in FASB's Accounting Standards Codification (ASC) section 606, which are normally referred to simply as ASC 606. These new standards replaced ASC 605 which had been in effect since 2009. Preceding ASC 605 general industry practice for revenue recognition was directed by the AICPA Accounting and Audit Guide for Common Interest Realty Associations issued in 1991.

The net impact of ASC 606 on the community association industry is problematic because the old ASC 605 "rules based" standards provided specific guidance for community associations. The new ASC 606 "principles based" standards establish broad standards which do not include specific guidance for community associations, meaning CPA practitioners must interpret how the standards should be applied. The problem arises because ASC 606 effectively assumes that there is a single reporting entity (vendor or organization) and a single customer. Because community associations don't fit into that mold the issue of trying to fit a square peg (the association) in a round hole (ASC 606) arises.

The AICPA formed several different industry committees in order to create revenue recognition implementation guidance based upon the principles of ASC 606. One such committee was created for the timeshare industry. However, this committee was mainly focused on the developer aspect of the timeshare industry rather than on how the new guidance would be implemented by common interest realty associations. Unfortunately, no guidance for CIRAs was created as a result of this committee, however, a draft paper interpreting the revenue recognition standards as they might be implemented was created. A conclusion was reached that operating revenues (assessments) would continue to be reported in the same manner but that reserve revenues (assessments) would be subjected to a radically new treatment based on that committee's interpretation of the standards. These interpretations were effectively adopted and recommended in the primary set of practice aids used by virtually all CPAs that practice in the community association industry. Included in the set of practice aids was a paragraph stating that some practitioners disagreed with the committee's interpretations and were interpreting ASC 606 in an alternate manner.

In order to appreciate the major differences of opinion on interpretation of the standards it is necessary to understand the major concepts involved. ASC 606 established the following five steps that must be applied in order to implement the revenue recognition guidance:

Step 1: Identify the contract(s) with a customer.
Step 2: Identify the performance obligations in the contract.
Step 3: Determine the transaction price.
Step 4: Allocate the transaction price to the performance obligations in the contract.
Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation.

The AICPA committee appears to have interpreted these steps as follows for the community association industry:
Step 1 – The Association is the reporting entity and "vendor" of goods and services and the member is the customer and the transactions involved represent commercial activities under the contract defined in the governing documents.
Step 2 – The performance obligations were determined to be "operating activities" versus "reserve activities" primarily based on the significant differences in timing of expenditures.
Step 3 – The transaction price is determined by the assessments designated in the annual budget and/or user fees charged.
Step 4 – Allocation of transaction price is primarily determined by the budget, meaning reserve assessments versus operating assessments, and presumably also by expenditures in the case where no specific reserve assessments are budgeted or assessed.
Step 5 – Operating revenues are recognized monthly as assessed. Reserve revenues are recorded on the balance sheet as "Contract Liabilities" as assessed or received and recognized as revenue only when reserve expenditures are made. **(This is the radical departure from prior industry guidance and general practice for the last forty years.)**

The financial statement presentations resulting from the above interpretation of ASC 606 are clearly not in accordance with prior GAAP and many CPA practitioners believe that such financial statements are both difficult to comprehend and misleading to readers of the financial statements. These practitioners have interpreted ASC 606 in a much different manner than the views expressed above by the AICPA committee. Further there is considerable resistance expressed to the fact that such a small group of individuals interpreted ASC 606 in such a radically different manner without exposing their conclusions to industry practitioners for comment and failing to consider any opposing points of view.

The net impact for those promoting an alternate interpretation of ASC 606 would effectively result in no change in financial reporting of reserve revenues from previous GAAP existing for the last forty years under the AICPA Audit Guide and ASC 605. For this reason, and because there clearly is no consensus on this matter, we simply refer herein to the two opposing positions as the "radical change" position and the "leave it be" position.

The interpretation of ASC 606 by the "leave it be" group appears to rely on a number of different points.

Perhaps the most powerful and persuasive of these positions is that according to ASC 606-10-15-3, the entity should apply the guidance to a contract only if the counterparty to the contract is customer. Therefore, in the absence of a counterparty, there is no customer-vendor relationship between the members and the Association and therefore Topic 606 should not apply at all. Since the members (who are considered "customers" by the radical change group) control the governance of the association (the reporting entity) it is not possible to separate the members from the association. The plain language of this section states that " . . . 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 . . ."

In addition, if you ignore ASC 606-10-15-3 and take the position that ASC 606 DOES apply to CIRAs, various individuals in this "leave it be" group have challenged each of the five steps in the revenue recognition process to further document that no matter how you try to spin it, ASC 606 is simply a case of trying to shove a square peg in a round hole, it doesn't fit. Various positions stated to us include the following.

<u>Step 1: Identify the contract(s) with a customer</u>. Because ASC 606-10-15-3 essentially proves that there is no customer this first step fails and ASC 606 cannot apply. ASC 606 defines a contract as "an agreement between two or more parties that creates enforceable rights and obligations". The governing documents identified by the "radical change" group as the contract are not in fact a contract but are more similar to a law (covenant). That covenant protects only the reporting entity and the member has virtually no rights and cannot enforce the obligations of the reporting entity. Therefore, based upon ASC 606-10 and in the case of a CIRA, a valid contract does not exist. Therefore ASC 606 does not apply to CIRAs.

Step 2: Identify the performance obligations in the contract. The "radical change" position that there is a minimum of two performance obligations with reserve expenditures representing the completion of the reserve performance obligation fails on several fronts. 1) If the governing documents are believed to be the contract, that contract only states that the obligation of the association is to maintain the common areas for the benefit of the members. It does not state that the Association will replace or repair a specific reserve item, for example to replace the roof. Therefore, only a single performance obligation is expressed in the governing documents. 2) Because of the ever-changing membership base, a very high percentage of former members may not even be current members at the time reserve expenditures are made for the assessments they may have paid years earlier. Therefore, the performance obligation may not ever be met for the reserve assessments paid by the former members. 3) FASB has effectively already fully addressed this issue in their "Stand Ready Performance Obligations" report in January 2015. While not written specifically with CIRAs in mind, that report describes performance obligations virtually identical to those of reserve activities in the CIRA setting and has reached the conclusion that recognizing revenue as received is appropriate.

ASC 606-10-25-4 states "that for the purpose of applying the guidance in this Topic, a contract does not exist if each party to the contract has the unilateral enforceable right to terminate a wholly unperformed contract without compensating the other party (or parties). A contract is wholly unperformed if both the entity has not yet transferred any promised goods or services to the customer, or the entity has not yet received, and is not yet entitled to receive, any consideration in exchange for promise goods or services." Members are not entitled to a refund or any consideration or compensation from the Association, should the Association decide not to complete a major repair or replacement in any given time period. If, in the case of a CIRA entity, the performance obligation is considered to be to provide common area maintenance services to the members of the Association, and if we assume that the assessments paid by the members to the association are the consideration for the common area maintenance services; then if the assessments paid (i.e. consideration) by members for the purpose of major repairs and replacements were assessed in any time period other than when the major repair or replacement designated by the governing body of the Association occurs, the contract between the Association and its members for common area maintenance is wholly unperformed as described in the guidance above. In other words, if the assessments designated for reserves are not assessed in the same time period as when the major repairs and replacements are completed, the contract between the Association and the membership is wholly unperformed as defined above. Again, for the purposes of this new guidance there is no "contract with a customer." Therefore, the new guidance could not be applied to the assessment revenues.

Step 3: Determine the transaction price. How is this applied to associations that do not specifically budget for reserves and may or may not transfer excess operating funds to reserves at year end but clearly have reserve expenditures? If you accept the position that the member is a customer and that reserves are a separate performance obligation under the "contract" of the governing documents, what is the transaction price in this situation?

Step 4: Allocate the transaction price to the performance obligations in the contract. See number three above

Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation. See number 2 above. This standard explains that the performance obligation is satisfied when the reporting entity "transfers control" to the customer. Again, that is only relevant when there is a single vendor and a single customer. In the case of a CIRA, the service related to reserves is the repairing or replacing of common area property for the benefit of multiple members. There is no effective transfer of control.

As stated above, there are two groups in opinion regarding the applicability of ASC 606 to CIRAs, the "leave it be" group and the "radical change" group. Perhaps the "leave it be" camp has a stronger case based upon the amount of effort put into the research of this issue and the resulting logic to the conclusions listed above.

Many practitioners have asked us what our position is on the applicability of ASC 606 to CIRAs. However, our interpretation of ASC 606 in relation to CIRAs doesn't matter to anyone else and is irrelevant to the overall conversation. We recognize there are CPA firms who are passionately defending their interpretation of ASC 606 as being the ONLY acceptable position, and that effectively there are only two positions with respect to recognition of reserve assessment revenues – the "radical

change" position and the "leave it be" position. Both groups are citing relevant authority within ASC 606. Our position is that each group has interpreted this principle-based standard and reached a conclusion and that until a consensus is reached, either position is acceptable. While we all have our own opinions, CPAs should not be attempting to influence other practitioners in order to agree on a particular point of view since we are all capable of making our own interpretation. Since there is not consensus and there are only opinions on how the new guidance should be applied to CIRAs, there is also no right or wrong answer. We know this may be contrary to what you have heard.

A further point is that it is not up to the practitioner to make decisions for the Association. Auditing standards require that practitioners are to be independent of the audit client in order to perform an audit or review. Due to this requirement, our clients must possess the necessary Skills, Knowledge, and Experience (SKE) to understand the financial statements. Accordingly, we are providing the information to our clients including the two widely divergent positions taken by practitioners, and we encourage them to adopt whichever position they believe is correct. We've explained that the differing positions are simply opinions based upon interpretations, and because there are numerous experienced individuals in both groups and no consensus in opinion, we will accept either position as being in accordance with GAAP. If clients ask our opinion as to which method we prefer, we will provide it.

If practitioners were to accept the fact that there is no consensus in opinion (despite what some individuals are stating) and are not so heavily invested themselves in being right in whichever position they prefer, it also solves another significant problem for practitioners. If you take on a new association client next year that took a position to either adopt "radical change" or "leave it be" you can accept that your new client has adopted a position that is in accordance with GAAP. You do NOT have to force them to adopt a different position, and we posit that it is not appropriate to do so. If an association does decide to change their interpretation of ASC 606 at a later date, they are simply changing from one acceptable method to another acceptable method. In other words, this change would not represent a change from an unacceptable method to an acceptable method. That may change if the profession is ever to reach consensus on this issue, but right now that consensus does not exist.

A last comment is that, for those individuals who think that FASB and AICPA always get it right, you need look no further than the old AICPA CIRA audit guide, ASC 972 and the topics of fixed asset capitalization of real estate assets for associations as well as the reserve disclosures in order to realize the weakness of that position. The concept that fixed assets should be capitalized based upon whether the association receives revenue from that asset has no basis in professional standards, professional literature, or common sense and flies in the face of other standards. Disclosures for reserves based on a component funding model when virtually nobody outside the state of Florida uses and was long ago debunked as an appropriate funding method again demonstrates that careful thought was not applied in reaching conclusions that have plagued the CIRA industry for decades.

Authors:
Gary Porter is a partner in the firm Porter & Lasiewicz, CPAs and has been serving associations since 1976. Gary is also well recognized as an industry leader. Gary served as the 1998-1999 CAI National President and has chaired a number of committees for CAI and the California Society of CPAs. Gary has also served on the AICPA Task Force to re-write the Homeowners Association Industry Audit Guide.

Cheryl Lasiewicz is a partner in the firm Porter & Lasiewicz, CPAs and has been a CPA for over 20 years including seven years serving associations. Cheryl is a member of the AICPA and the California Society of CPAs.

Both Gary Porter and Cheryl Lasiewicz are contributing authors to the Practitioners Publishing Company's *Guide to Homeowners Associations and other Common Interest Realty Associations.*