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Firm Position Paper - Implementation of ASC 606 for Common Interest Realty Associations ©

In 2014, the Financial Accounting Standards Board issued what is now known as Topic 606, Revenue from Contracts with Customers, which governs the manner in which entities recognize revenue. Beginning with the financial statements for the year ended December 31, 2019 and thereafter all entities are required to consider the guidance incorporated in ASC 606 with regards to the recognition of revenue.

The changes to the financial statements recommended by PPC (a practice aid widely used by CPA's in the CIRA industry) are pervasive and, in our opinion, render the financial statements unusable to the average user of the reports. Following extensive research and consideration of this issue, Luft & Company, P.C. has concluded the PPC guidance is one of several alternatives and not authoritative guidance on the matter. This position was affirmed in a meeting Todd Luft attended with the PICPA Accounting and Auditing Committee on January 21, 2020, and conversations directly with the Financial Accounting Standards Board, the American Institute of Certified Public Accountants, our own Peer Review Captain and the Chair of the PICPA Peer Review Committee.

After careful consideration, Luft & Company, P.C. is recommending that our CIRA clients are not required to adopt the complex revenue recognition model promulgated by PPC. We base this conclusion on the many arguments against it that we believe have significant and credible merit, a few of which we will discuss below:

GUIDANCE ANALYSIS

In our discussion with the FASB Supervisor of Revenue Recognition Implementation were told there is no industry guidance related to ASC 606 and we should refer back to the "five steps" in §1.19 of ASU No. 2014-09 (aka ASC 606) to determine whether ASC 606 applies and how it should be implemented. Therein, Step 1 is Identify the Contract with the Customer. Logically the first step in this process would be to identify the customer.

Lack of Customer Relationship

- ASC 606-10-15-3 states that an entity shall apply the guidance in this Topic to a contract only if the counterparty to the contract is a customer. 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.

We have a difficult time envisioning an example of a relationship where the risks and benefits are shared more than a homeowner and his homeowners association.

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- The CIRA is a captive association consisting only of owners and includes all owners:
  - The Association cannot exist without the property owners and is not permitted to seek other members if they are not owners in the community. The Association's sole source of revenue is from these owner/members.
  - Owners cannot elect to surrender their membership. As property owners in the community they are required to be a member of the CIRA. Similarly, the Association cannot deny any unit owner membership.

- The owners' interests are exactly the same as the Association both in terms of benefits and risks as defined above:
  - The Association's principal benefit is to provide owners quiet enjoyment of the common elements and preserve property values in the community. Clearly the owner/members would share equally in successful delivery of this benefit.
  - If the Association requires additional funds to achieve this goal the Association has unilateral authority to increase assessments or levy a special assessment. Clearly owner/members share greatly in the failure of the Association to achieve its goals or any cost overruns experienced by the Association.

- Membership is not voluntary and assessments, by law, become an immediate lien on the members property.

- Members receive a right to vote for Board member and have ultimate authority over the Association's budget and spending.

- Members cannot shop for services such a lawn maintenance like a customer. It is doubtful anyone could successfully argue a unit owner is a customer when there is only one alternative for providing services.

Luft & Company, P.C. has adopted the position that the points noted above support there is no customer relationship and therefore no contract with a customer. As such, ASC 606 does not apply to Common Interest Realty Associations.

<u>Lack of a Contract</u>

CIRA's present their financial results in a hybrid fund accounting format. For the most part the financial statements reflect standard accounting found in a for-profit entity except CIRA's segregate accumulated funds in two categories:

<u>Operating Fund</u> – transactions associated with ongoing maintenance on a daily basis

<u>Replacement Fund</u> – transactions that are more periodic in nature representing major repairs and replacements of the common elements.

Together these funds represent fulfilling the purpose of the association.

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PPC's interpretation of this relationship is that the money that is appropriated to the Operating Fund has no deferred performance component and money appropriated to the Replacement Fund is entirely related to deferred, separate performance obligations.

We do not agree with this interpretation and the disagreement centers on the question of the contract obligation. At what point has the unit owner paid the Association for a service and the Association has performed that service?

The unit owner is required to remit payments to the Association on a periodic basis – generally monthly. In exchange for that payment obligation it could be argued the unit owner only receives a release of the lien on his property. But in truth the unit owner has the expectation to receive ongoing management and maintenance of the common elements in the community. It has long been industry best practice and underlying assumption that monthly assessments are in exchange for monthly services and the unit owner pays a single assessment for this service which is not bifurcated for a particular purpose. There has never been a proposal in the CIRA industry to consider Replacement Fund Appropriations as Deferred Revenue. There is no action that could be identified as fulfilling a contract and no right afforded unit owners to get a refund if a particular replacement expenditure is not performed.

The reality of the relationship is the Association is required to stand-ready to assure the members have use of the common elements.

- The eventual expenditure of funds for major repairs and replacements is not a contract. While it is anticipated the Association is putting money aside for this eventuality, there is no contract that would be consummated by any particular activity and no member would be entitled to a refund of assessments if an anticipated major repair and replacement was not completed.

Luft & Company, P.C. has adopted the position that the points noted above support there is no contract requiring a separate performance obligation and therefore no aspect of assessment revenue is required to be deferred as a Contract Liability under Topic 606.

Stand-Ready Contracts

On January 26, 2015 IFRS and GASB issued a joint paper covering "Stand-Ready Performance Obligations" wherein they acknowledged there are arrangements where a company (i.e. CIRA) is obligated to Stand-Ready to provide a service over a period of time and without the ability to predict with any precision when doing so would require an action or expenditure on the part of the service provider. They use as examples –

> *Type A* - Obligations in which the delivery of the good(s), service(s), or intellectual property underlying the obligation is within the control of the entity, but for which the entity must still further develop its good(s), service(s), or intellectual property. For example, a software vendor might promise to transfer unspecified software upgrades at the vendor's discretion . . .;

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Type B - Obligations in which the delivery of the underlying good(s) or service(s) is outside the control of the entity and the customer. For example, an entity promises to remove snow from an airport's runways in exchange for a fixed fee for the year;

Type C - Obligations in which the delivery of the underlying good(s) or service(s) is within the control of the customer. For example, an entity might agree to provide periodic maintenance, when-and-if needed, on a customer's equipment after a pre-established amount of usage by the customer;

Type D - Making a good or service available to the customer continuously, such as in the health club example set forth in Example 18 (paragraphs 606-10-55-184 [IE92] through 55-186 [IE94]) of the new revenue standard.

All of these examples bear a strong resemblance to a CIRA which performs the underlying service to Stand-Ready to keep the common elements available to the members and in good working condition. Segregating funds for major replacements in the future is simply a budgeting technique to level the membership's anticipated contributions towards the eventuality that in some years there will be more expenditures than other years. Similarly, a health club's membership fees include a portion to be dedicated towards replacing the equipment, but all efforts are supporting the underlying contract obligation to Stand-Ready with properly maintained facilities. The position paper suggests that Stand-Ready contracts should be amortized on straight-line basis, which in CIRA's would approximate monthly revenues as they become due.

We believe PPC did not take this Position Paper into account in determining Replacement Fund accumulations represent a deferred Performance Obligation.

Luft & Company, P.C. concludes that if a contractual relationship exists, it is a contract for the Association to Stand-Ready to manage and maintain the common elements and consistent with the joint memo should be amortized on a straight-line basis, which in a CIRA would be to expense the obligation as assessments become due, with no Separate Obligation representing a Contract Liability under Topic 606.

CIRA FUND ACCOUNTING

It is difficult to understand why PPC considers the Operating Fund differently than the Replacement Fund. There are inconsistencies in this position and valid arguments to the contrary.

Operating Fund

Citing some of the inconsistencies in this argument:

- If an Association budgets and collects assessments based on a snow removal budget of $150,000 and it doesn't snow that year, why wouldn't the $150,000 surplus that year be considered a Contract Liability pending future snow removal.
- Most CIRA By-Laws require any Operating Fund Surplus to be immediately refunded to the Unit Owners or immediately credited to the unit owner's next assessment due date. In most GAAP

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considerations anything that was required to be immediately refunded would be considered a liability – not equity.

- Pennsylvania CIRA laws require any Operating Fund Surplus to be similarly refunded or credited
- Federal Tax Law requires the same treatment
- The CIRA is established as a not-for-profit entity so it could be argued any Operating Fund Equity is temporary and relies on future performance obligations to be satisfied or the money refunded to the unit owner.

  Yet PPC's argument is simply Topic 606 does not alter revenue recognition in the Operating Fund.

Replacement Fund

The CIRA typically accumulates funds for future major repairs and replacements based on a Replacement Reserve Study performed by an independent engineering firm. This study provides a schedule of the common elements in the community, their current condition, and projected major repair or replacements in terms of estimated time frame and costs. The Board of Directors of the Association establishes an annual budget that includes an appropriation to the Replacement Fund based on this estimate. This appropriation is always budgeted as a current expense to the CIRA and placed in a Replacement Fund. Monies in that fund cannot be moved to the Operating Fund without a Board of Directors resolution and in many cases requires an affirmative vote of the membership.

- PPC recommends the entire Replacement Fund be considered a Contract Liability.

Citing some of the inconsistencies in this argument:

- There is no performance obligation related to these funds. There is no action that could be taken that would fulfill a "contract". The monies have been put aside as an estimate of future needs and not any particular expenditure. This is essentially "retained earnings" with an explanation of the reason the earnings are retained in an otherwise not-for-profit entity.
- No unit owner has any right to refund if a replacement expenditure does not occur. Monies associated with assessments are deemed earned in finality upon their due date.
- Some believe Replacement Fund contributions should be treated similar to the technical treatment under Federal Tax Law, which is the appropriations are considered Capital Contributions and should not be included in the P&L at all.

Unit Owners have an anticipated consideration for their monthly assessments. They have remitted a monthly payment for a monthly service. They have an expectation that the CIRA has considered the long-term maintenance and provided funding for that maintenance in the budget, but they are not making that remittance with an expectation of a specific future performance obligation that could be considered the fulfillment of a Separate Performance Obligation (Step 2 of ASC 606).

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Luft & Company, P.C. Position – Revenue Recognition

Luft & Company, P.C. is adopting the position that clients that submit financial information to our firm and have not already adopted the complex implementation promulgated by PPC are permitted to issue GAAP financial statements based on that information. If the client presents financial information consistent with the PPC recommendation we will accept those as also permissible GAAP presentations.

As a firm, we do not endorse PPC's interpretation and we note there is no consensus of opinion at this time among industry leaders or the CPA firms that serve the CIRA industry. It is entirely possible that Associations that make the pervasive changes recommended by PPC will need to change back in another year or two when there is a consensus of opinion and that consensus requires PPC to change their recommendation. The significant confusion, dialog and increased costs for our clients that would ensue from the change is simply not justified when there is no consensus the change is required or correct.

To properly identify that ASC 606 has been appropriately considered in our audit procedures, we are encouraging our clients to include the following note to the financial statement:

> Revenue Recognition
>
> Assessment revenue is recognized when assessments are due. Any amounts received in advance of the due date are deferred until due. The Financial Accounting Standards Board issued Accounting Standards Code 606 requiring the deferral of the recognition of income until the services are rendered. The Association has determined ASC 606 does not apply to the Association as no customer relationship exists as it is defined by the Code. The Association does not defer the recognition of any portion of revenue as a Contract Liability.

Luft & Company, P.C. Position - Bad Debts Recognition

Topic 606 prescribes that the Association calculates probable Bad Debts based on an analytical review of expected revenue using probability factors. If based on that analysis it is determined there is a probable reduction in revenue, Topic 606 directs the Association to record this adjustment as reduced revenue (Variable Consideration).

As discussed earlier, our firm does not agree Topic 606 applies to CIRA's. Consistent with this, if an Association's accounting records have not adopted ASC 606 for Bad Debts recognition and continue to record Bad Debts as an expense we will not suggest an entry to consider this as Variable Consideration and a reduction in revenue. Additionally, we anticipate CIRA clients will continue to follow industry practice of specific identification of this exposure, recognizing Owner Assessments are by law a lien on the owner's property and analytical generalizations are unlikely to yield a materially correct result. We will not suggest an adjustment to this accepted industry practice.

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ADDENDUM 1 - PROBLEMS WITH PPC'S RECOMMENDED ASC 606 ADOPTION

The recommended adoption of ASC 606 falls short of addressing many inherent issues that are lingering with this presentation. While not an all-inclusive list, some areas the industry would be left to resolve include:

1. In Appendix 4A-2 it is recommended that Replacement Fund assessments are recognized only to the extent expenditures exceed interest income. What if there are no expenditures in a year? How would interest income be recognized if there is no Replacement Fund Equity? Are they promulgating that interest income isn't earned until the funds provided by that income is expended, so interest income earned is not income but an additional liability?

2. The existing Replacement Fund Equity would be reclassified as a liability, but that equity includes interest income earned over a period of years which has not been bifurcated, so are they suggesting all prior interest income be reclassified as a liability?

3. To our knowledge no management company maintains accounting records consistent with the PPC recommendation. How is the auditor to make such dramatic changes to the client's accounting and still maintain independence to perform the audit?

4. If the Association spends money from the Replacement Fund in excess of previously collected assessments, the Contract Liability will be a debit balance. Does the Association then book a "Contract Receivable"?

5. Many Associations simply do not have a Replacement Fund but instead build-up an Operating Fund equity balance knowing they will either use this balance to pay for long-term replacements or have a special assessment if the Operating Fund Equity is insufficient. In those situations, would the Operating Fund be treated differently and bifurcated based on a somewhat arbitrary basis?

6. If the Association funds the Replacement Fund project with a bank loan, and the bank loan is funded with a multi-year Special Assessment, when and how are the proceeds of the Special Assessment recognized?

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ADDENDUM 2 - PRACTICAL MATTERS

The industry has Standard Practices which are proposed to be overridden with the PPC recommendation. The result overlooks the reasons for these practices and could cause unintended ramifications:

1. For an Association which previously had a $3 million Replacement Fund Equity the financial statement would now show a $3 million liability –
    a. Perspective buyers who may not get the benefit of an explanation would be scared away from investing in a unit that shares the burden of paying this $3 million liability
    b. Unit owners would be "fooled" into thinking this is a factual representation of future needs of the community which are fully funded with the offsetting cash balance. This is fundamentally untrue and without support. Even with a $3 million balance the future needs of a community could be severely underfunded.

2. Boards of Directors and auditors may be called upon to defend a balance sheet liability that is based on an engineering estimate and has no factual basis upon which to defend it. Industry practice is to iterate time and again in the financial statements, supplemental schedules and other communications the Replacement Fund accumulations and their adequacy is just an estimate. Nothing that eludes to this liability should be in the Balance Sheet alluding any degree of certainty.

3. Bank covenants include maintaining certain equity based on GAAP basis financial statements. This treatment would put most in violation of their covenants. While this would be ultimately resolved it would create issues and projects for many associations requesting exceptions and incurred costs obtaining revised loan documents.

4. Condominium Associations need to get approved by the FHA in order to qualify for FHA lending. The proposed financial statement format would put all associations in deficiency of the requirement for Replacement Fund Equity.

5. Associations are not-for-profit which means in some years there is a profit and in other years losses. If the Operating Fund has a negative balance in any given year and the Replacement Fund Equity is no longer Equity, the Association will be showing Negative Equity, harming the potential sales and the ability for purchasers to get obtain mortgages.

6. CIRA revenue is pretty predictable – a monthly fee times the number of units times twelve months (e.g. $300/month x 100 homes x 12 months = $360,000). Unit owners and other vested parties have a reasonable expectation to see $360,000 of assessment revenue, but that will rarely, if ever, happen again requiring explanations and reconciliations for management companies, Boards of Directors and the multitude of unit owners – especially when there is an Operating Fund deficit and total revenue recognized is less than the $360,000 they know they paid.

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7. We know of one Association in Philadelphia that has a Special Assessment of $1 million annually as they save for a major HVAC project. Their annual financial statement would not show any assessment revenue but instead a $1 million increase in the Contract Liability. They will certainly scratch their head wondering how paying $1 million dollars increased liabilities.

8. The suggested financial statement Note (see Appendix 4A-2, Note F) is overly complicated for the users of the Financial Statement in the CIRA industry. From a practical matter, any financial statement that requires this suggested explanation has lost its usefulness to the typical homeowner unfamiliar with these matters.

9. It is not unusual for the Board of Directors to solicit a Replacement Reserve Funding Study and discover the Association has underfunded the anticipated expenditures for the Replacement Fund. In those cases, the Note to the Financial Statement would disclose this matter. By representing a Contract Liability on the Balance Sheet while at the same time including a Note documenting the Replacement Fund is underfunded, the reader of the financial statement will likely be confused.

10. Similarly, how does the Association represent that the Association in underfunded if there is no fund accumulation on the Balance Sheet. The only way to refer to this would be for the Note to say the liability is understated or the true liability is not included in the Balance Sheet. Either way would be very confusing to the reader.

11. If the Board of Directors resolves to transfer Operating Equity to the Replacement Fund, PPC would have this reflected as Equity converted to a Liability – clearly nonsense to the any reader of the financial statement not expert in accounting matters.

12. Given the previous point, it won't be long until Associations realize that the Operating Fund is Equity and Replacement Fund is a Liability and will start resisting funding the Replacement Fund in favor of a bloated Operating Fund Equity. Would the auditors then be forced to make the management decision that this is not an acceptable presentation and force the Association to transfer? If not, would this management decision rise to the level of Emphasis of Matter in the Auditor's Opinion Letter?

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