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WEBINAR

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Part II, Planning for the Future:
Revenue Recognition and Lease Accounting

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Today’s Presenters

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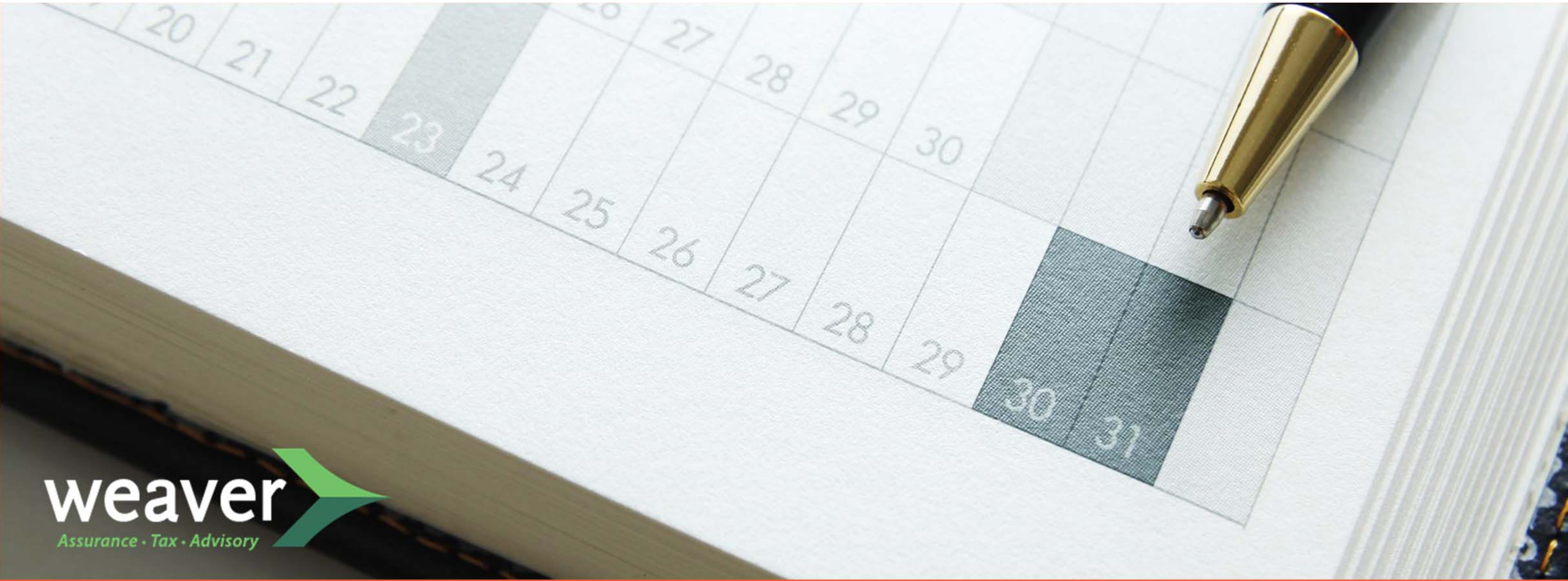
Today's Topics

- Overview: Changes and Timelines
- Changes to Revenue Recognition
- Changes to Lease Accounting
- Operational Considerations
- Audit Considerations



Overview: Changes and Timelines

Summary of Upcoming Changes

ASU 2014-09
Revenue from Contracts with Customers

Summary:
An update to clarify the principles for recognizing revenue, remove inconsistencies, improve comparability and usefulness and to simplify financial statement preparation.

ASU 2018-08
Clarifying the Scope & Guidance for Contributions Received & Made

Summary:
An update to improve the scope and accounting guidance for
- Contributions vs exchange transactions
- Determining if a contribution is conditional

Effective Date:
Fiscal years beginning **after December 15, 2018** (calendar YE '19 and fiscal YE '20)

Transition Method:
Retrospective application is required however a modified retrospective approach available

Summary of Upcoming Changes

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ASU 2016-02
Leases

Summary:
An update to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities and disclosing key information about leasing arrangements.

ASU 2018-10
Codification Improvements to Topic 842, Leases

Summary:
The amendments in this update affect narrow aspects of the guidance issued in the amendments in update 2016-02.

ASU 2018-11
Leases (Topic 842), Targeted Improvements

Summary:
The amendments in this update relate to:

- Transition relief on comparative reporting at adoption.
- Separating components of contracts for lessors whose lease contracts qualify for the practical expedient.

Effective Date:
Fiscal years beginning **after December 15, 2019** (calendar YE '20 and fiscal YE '21)

Transition Method:
Retrospective application is required however a modified retrospective approach available

Changes to Revenue Recognition

ASU 2014- 09
ASU 2018-08

ASU 2014-09: Revenue from Contracts with Customers

Objectives:

- To remove inconsistencies
- Improve comparability
- Increase usefulness to the users of the financial statements
- To simplify financial statement preparation
- 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 and services

ASU 2014-09: Revenue from Contracts with Customers

Excluded from the scope of the Statement

- Lease contracts
- Insurance contracts
- Guarantees
- Financial instruments
- Contributions (most significant to Not-for-Profit entities)

What is a "customer"?

- Customer - 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.
- The most controversial issue whether or not government grants and contracts fell within the scope this standard. The issue is further addressed in ASU 2018-08.

ASU 2014-09: Revenue from Contracts with Customers

Five-Step Model:

Identify contract(s) with customer

Identify the performance obligation(s) in the contract

Determine the transaction price

Must allocate the transaction price to the performance obligation(s) in the contract

Recognize revenue as the Organization satisfies the obligation(s)

Five Step Model - Example

1. Identify contract(s) with customer:
    - **Customer:** Members
    - **Contract:** Annual membership dues contract
    - **Duration of contract:** One year
2. Identify the performance obligation(s) in the contract:
    - **Dues**
    - **Discounts on gift shop purchases**
    - **Free admission for a guest**
3. Determine the transaction price: **$100**

Five Step Model - Example

4. Must allocate the transaction price to the performance obligation(s) in the contract

This may involve a significant amount of estimation.

Membership		
Dues	Discount on Purchases	Free Admission
Allocate		
60%	25%	15%

Five Step Model - Example

Determine if contracts meet the revenue recognition criteria:

1. The first criteria is that an entity must have an arrangement with a customer that meets the definition of a contract under the standard. Contract must create enforceable rights and obligations. Enforceability of the rights and obligations in a contract is a matter of law. Contracts can be written, oral, or implied by an entity's customary business practices.

5. Recognize revenue as the Organization satisfies the obligation(s)

Five Step Model - Example

5. Recognize revenue as the Organization satisfies the obligation(s)

Determine if contracts meet the revenue recognition requirements - continued

2. The second criteria is to determine the following:

a. Have the parties to the contract approved the contract (in writing, orally, or in accordance with other customary business practices) and are committed to perform their respective obligations?
b. Can the entity identify each party's rights regarding the goods or services to be transferred?
c. Can the entity identify the payment terms for the goods or services to be transferred?
d. Does the contract has commercial substance (that is, the risk, timing, or amount of the entity's future cash flows is expected to change as a result of the contract)?
e. Is it probable that the entity will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer?

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Five Step Model - Example

5. Recognize revenue as the Organization satisfies the obligation(s)

Consider timing of recognition:

Membership to Organization YE 12/31

Dues:	Discount on Purchases:	Free Admission:
4/1/19 – 3/31/20	12/15/19	1/5/20

Five Step Model - Example

5. Recognize revenue as the Organization satisfies the obligation(s)

Consider components of the transaction/contract:

Transactions may be part contribution (non-reciprocal), part exchange (reciprocal) and will need to be bifurcated and each element accounted for separately. This, too, may involve a significant amount of estimation.

Examples:

- Sponsorships at special events
- Naming opportunities
- Memberships

Effects on Financial Statement and Disclosures

1. Properly disaggregate revenue streams in the Statement of Activities
2. In the year of implementation, determine whether to use the full retrospective approach or the modified retrospective approach
   a. modified retrospective approach (electing available practical expedients) - entities can elect to apply the standard only to contracts not completed at the adoption date or all contracts at that date
   b. full retrospective approach - entities apply as if the standard had been in effect since the inception of all contracts with customers presented in the financial statements in the year of adoption
3. Disclose
   a. Terms and description of contracts
   b. Performance obligations – when satisfied and remaining
   c. Practical expedients utilized and difference in accounting as a result

Audience Poll

Participate in the audience poll to provide insight.

Results will be featured after the poll closes.

Ready. Set. Poll.

ASU 2018-08: Contributions

ASU 2018-08 was issued to clarify and improve the scope and the accounting guidance for contributions received and contributions made. The amendments in the update should assist entities in:

1. Evaluating whether transactions should be accounted for as contributions (nonreciprocal transactions) or as exchange (reciprocal) transactions subject to other guidance and
2. Determining whether a contribution is conditional.

ASU 2018-08: Contributions

Contribution:

An **unconditional** transfer of cash or other assets, as well as unconditional promises to give, to an entity or a reduction, settlement, or cancellation of its liabilities in a voluntary nonreciprocal transfer by another entity acting other than as an owner.

The resource provider often receives value **indirectly** by providing a societal benefit although that benefit is not considered to be of commensurate value.

Resource provider has full discretion over the amount transferred.

Exchange Transaction

A reciprocal transfer in which each party receives and sacrifices approximately commensurate value.

In an exchange transaction, the potential public benefits are secondary to the potential proprietary direct benefits to the resource provider.

ASU 2018-08: Contributions

Conditional Contribution

Must have both:

1. One or more barriers that must be overcome before a recipient is entitled to the assets transferred or promised.

2. A right of return to the contributor for assets transferred (or for a reduction, settlement, or cancellation of liabilities) or a right of release of the promisor from its obligation to transfer assets (or to reduce, settle, or cancel liabilities).

- An agreement does not need to include the specific phrase "right of return" but should be sufficiently clear to support a conclusion

- In cases of ambiguous donor stipulations, a contribution containing stipulations that are not clearly unconditional shall be presumed to be a conditional contribution

ASU 2018-08: Contributions

Indicates a Barrier

Measurable Performance-Related Barrier or Other Measurable Barrier

- A specified level of service
- An identified number of units of output
- A specific outcome
- A specific event
- Matching requirement

Limited Discretion by the Recipient on the Conduct of an Activity

The recipient has limited discretion over the manner in which an activity can be conducted.

- A requirement to follow specific guidelines about incurring qualifying expenses,
- A requirement to hire specific individuals as part of the workforce conducting the activity

Stipulations That Are Related to the Purpose of the Agreement

- A homeless shelter to provide a specified # of meals to the homeless
- An animal shelter to expand its facility to accommodate a specified # of add'l animals,
- A research report that summarizes the findings from a grant on gluten-related allergies.

If unrelated or trivial - not considered barriers

ASU 2018-08: Contributions

After a contribution has been deemed not to have a donor imposed condition, an entity shall consider whether the contribution includes a donor imposed restriction.

A donor imposed restriction specifies a use for a contributed asset that is more specific than the following:

a. The nature of the entity
b. The environment in which it operates
c. The purposes specified in its articles of incorporation or bylaws

May also be restricted for time.

- As a result of 2018-08, which clarified the definition of an exchange transaction NFPs will account for most federal grants as donor-restricted conditional contributions, rather than as exchange transactions and as such grants will be excluded from consideration within the scope of ASU 2014-09.

Changes to Lease Accounting

ASU 2016-02
ASU 2018-10
ASU 2018-11

ASU 2016-02: Leases

Lessees are now required to recognize a **lease liability** and a **right-of-use asset** for all leases (except short-term leases with a duration of **less than 12 months**) as of the commencement date (i.e. the date on which the lessor makes the underlying asset available to the lessee).

ASU 2016-02: Leases

Lease Liability

The lessee's obligation to make lease payments arising from a lease, measured on a discounted basis.

Right-of-Use Asset

An asset that represents the lessee's right to use (or control the use of) a specified asset during the lease term.

ASU 2016-02: Leases

What's in scope?

In Scope

- Leases of property, plant, and equipment

Out of Scope

- Leases of intangible assets
- Leases of biological assets
- Leases of inventory
- Leases of assets under construction

ASU 2016-02: Leases

Transition Method:

Retrospective application is required however, a modified option is available.

“Modified retrospective” brings into scope all leases existing at, or entered into after, the beginning of earliest comparative period presented in the financial statements.

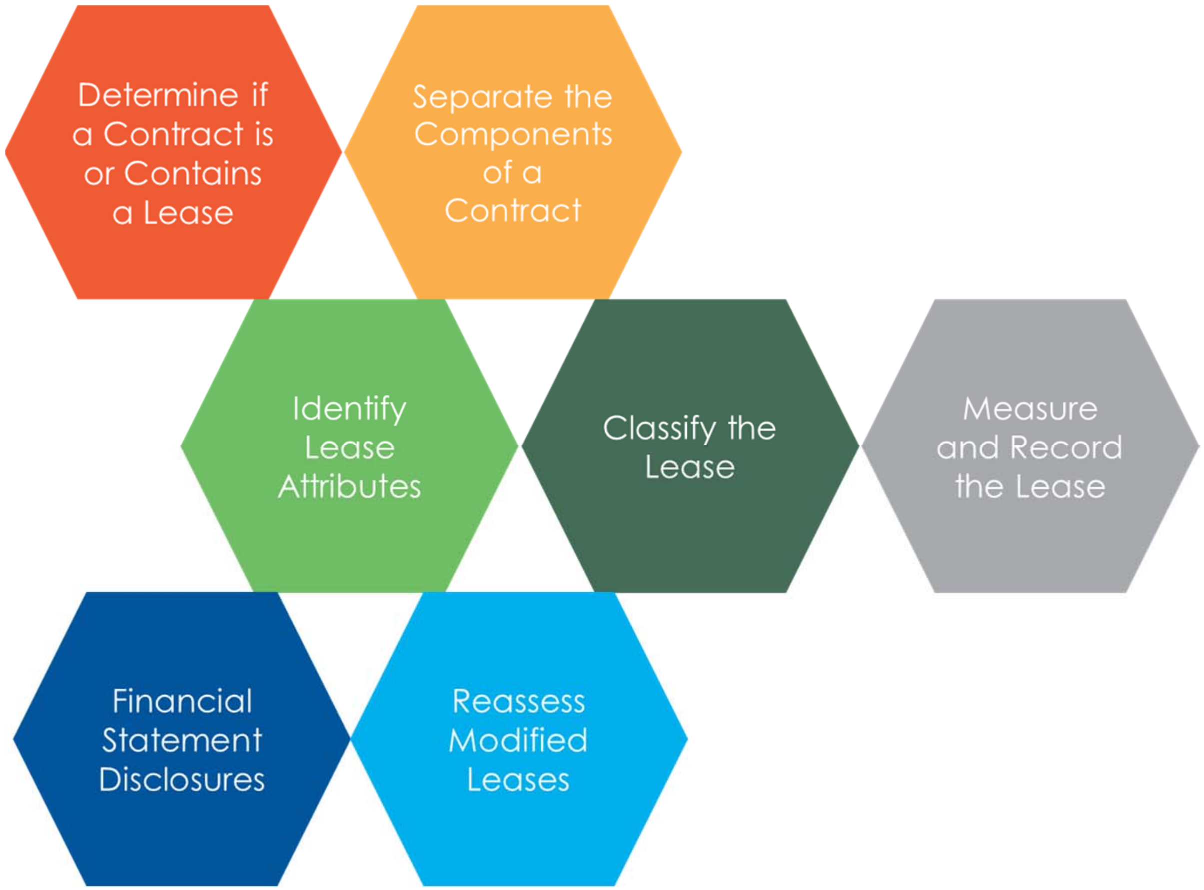
Transition Guidance:

An entity must apply the guidance at the beginning of the earliest period presented in a set of financial statements for substantially all leases outstanding at initial application.

For example, 2019 (or earlier) data is needed for adoption in 2020 for calendar-year-end entities.

Note: Practical expedients are provided.

ASU 2016-02: Leases



ASU 2016-02: Leases

Lease Classification

The terms of a lease determine

- Classification
- Income statement recognition

Financing Lease

- Lease effectively transfers control of the underlying asset
- Lease represents an in substance financed purchase (sale) of an asset
- Lease does not effectively transfer control of the underlying asset to the lessee, but the lessor obtains a guarantee for the value of the asset from a third party

All other leases are classified as **operating leases**.

ASU 2016-02: Leases

Measure the Initial Lease Liability

Initial Lease Liability = Present Value of Unpaid Future Lease Payments + Present Value of amount probable of being owed under RVG

Measure the Initial Right of Use Asset

Initial Right of Use Asset = Initial Lease Liability + Initial Direct Costs + Prepaid Lease Payments - Lease Incentives Received

*** RVG = Residual Value Guarantee**

ASU 2016-02: Leases

Operating Lease (lease costs is determined on a straight-line basis)

Lease Cost = Sum of Undiscounted Lease Payments for Lease Term + Initial Direct Costs - Incentives Received / # of Periods in Lease Term

Finance Lease (Assuming straight-line amortization method)

Amortization Expense = Initial Right of Use Asset / # of Periods in Lease Term

&

Interest Expense = Initial Lease Liability * Interest Rate

ASU 2016-02: Leases

A lessee enters into a 3-year lease and agrees to make the following annual payments at the end of each year:

- Year 1: $10,000
- Year 2: $15,000
- Year 3: $20,000

	Both Methods	Finance lease				Operating lease		
Year	Lease Liability	Interest Expense <X>	Amortization Expense <Y>	Total Lease Expense <X + Y>	Right-of-Use Asset	Lease Expense <Z>	Reduction in Right-of-Use Asset <Z – X>	Right-of-Use Asset
0	$ 38,000				$ 38,000			$ 38,000
1	31,038	$ 3,038	$ 12,666	$ 15,704	25,334	$ 15,000	$ 11,962	26,038
2	18,520	2,481	12,667	15,148	12,667	15,000	12,519	13,519
3	–	1,481	12,667	14,148	–	15,000	13,519	–
Total		$ 7,000	$ 38,000	$ 45,000		$ 45,000	$ 38,000	

The initial measurement of the right-of-use asset and liability to make lease payments is $38,000, at a discount rate of 8%.

	BALANCE SHEET	INCOME STATEMENT	CASH FLOW STATEMENT
FINANCING LEASE	ROU Asset Lease Liability	Amortization expense Interest expense	Principal (financing) Interest (operating)
OPERATING LEASE	ROU Asset Lease Liability	Lease expense (single on straight-line basis)	Lease payment (operating)

LESSEE DISCLOSURES

- Nature of its leases
- Information about leases that have not yet commenced
- Related-party lease transactions
- Accounting policy election regarding short-term leases
- Finance and operating lease costs
- Short-term and variable lease costs
- Sublease income
- Gain or loss from sale-and-leaseback
- Maturity analysis for lease obligations
- Weighted-average remaining lease term
- Weighted-average discount rate

Audience Poll

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Operational Considerations

Operational Considerations

Revenue Recognition

- Review contracts and evaluate using the five step model
- Ensure estimates and allocation of transaction prices are reasonable
- Ensure contract are enforceable (executed documents)
- Re-evaluate contributions and grants to ensure restrictions have conditions have been properly recognized
- Evaluate impact on financial statements

Leases

- Obtain leases
- Verify that classification as operating vs capital is accurate
- Prepare journal entries to record Right of Use Asset and Lease Liability for operating leases
- Evaluate impact on financial statements (i.e. debt covenants)
- Review and modify accounting and operational policies, as needed (i.e. enter into more short term leases)

Audit Considerations

Audit Considerations

- Depending on the types and number of contracts with customers, the auditor may need to spend a significant amount of time:
  - ✓ Reviewing contracts
  - ✓ Re-assessing accounting and operational policies
  - ✓ Evaluating management’s estimates
  - ✓ Testing and recalculating to determine revenue has been properly recognized in each period presented.
  - ✓ Review disclosures

Audit Considerations

- Similar to contracts with customers, depending the number and types of leases the organization has, the auditor may need to spend a significant amount of time:

  ✓ Reviewing the leases for proper classification

  ✓ Evaluating the journal entries financial statement presentation, disclosures and debt covenants

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Your Questions

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Thank You!