



# The New Revenue Recognition Standard, Lease Standard and an Accounting Alternative

# Revenue Recognition: What's Really Changed?

- » The new standard eliminates transaction and industry specific guidance that we have in current US GAAP
- » The new standard is a more principles-based approach rather than a defined rules based approach
- » Requires a lot of JUDGMENT
- » Adds a new Topic, FASB ASC 606, Revenue from Contracts with Customers, to the Codification replacing ASC 605
- » Non-public companies – effective for annual reporting periods beginning after December 15, 2018

# Revenue Recognition Transition

- » Retrospective method of adoption presents all periods on the new standard and recognizes a cumulative effect to the opening retained earnings of the earliest period presented
- » Cumulative effect method of adoption shows the cumulative effect to the opening balance of retained earnings at the date of initial application

# Revenue from Contracts with Customers

- » The scope of the standard only applies to revenue from contracts with customers
- » Customer defined as: 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
- » Contracts can be written, oral or implied by an entity's customary business practices but must be enforceable

# Revenue Recognition in 5 Steps

- » Identify the contract with the customer
- » Identify the performance obligations in the contract
- » Determine the transaction price
- » Allocate the transaction price to performance obligations
- » Recognize revenue when (or as) the entity satisfies a performance obligation

# Identify the Contract

- » Must meet certain criteria:
  - Contract has commercial substance
  - Must be an agreement between two parties that creates enforceable rights and obligations
  - The entity can identify each party's rights regarding the goods or services to be transferred
  - Payment terms can be identified
  - Collectability is probable

# Examples of Contracts

- » A customer orders a cup of coffee
- » Delta orders an aircraft from Boeing
- » A software company enters into a contract to develop and install software
- » A company provides asset management services to a customer

# Revenue Recognition in 5 Steps

## » Is there a valid contract?

1. The contract has commercial substance, you gave money for the coffee
2. The parties approved the contract, Starbucks agreed to sell you agreed to buy
3. Rights in the contract are identifiable. You have a right to coffee and Starbucks has a right to \$2.95.
4. Payment terms are identified – you agree to pay for the coffee
5. It is probable that consideration will be collected. Starbucks received 2.95 before delivering the coffee.



# Revenue Recognition in 5 Steps

- » Identify the performance obligations in the contract – in this case there is only one, to deliver the coffee
- » Determine the transaction price – the price is \$2.95 and no discounts or other adjustments are available, so this is the transaction price
- » Allocate the transaction price to performance obligations – one performance obligation for \$2.95
- » Recognize revenue when (or as) the entity satisfies a performance obligation - in this case when the coffee is delivered
- » Simple, right??

# Revenue Recognition in 5 Steps – Coffee and Bagel

- » Let's expand this example and say that you walk into a Starbucks and there is a special. If you order a cup of coffee and a bagel you get \$2 off of a pound of ground coffee. You decide to take advantage of the deal. The coffee is \$2.95, the bagel \$1.50 and the ground coffee that normally sells for \$15 is \$13 because of the special.
- » Identify the performance obligations in the contract – in this case there are three performance obligations, to deliver the coffee, the bagel and the ground coffee. Each of these is separately identifiable and could be sold on its own. None of these items are dependent on the others.
- » Determine the transaction price – the price is  $\$2.95 + \$1.50 + \$13 = \$17.45$

# Revenue Recognition in 5 Steps – Coffee and Bagel

- » Allocate the transaction price to performance obligations
- » The transaction price will be allocated based on standalone selling prices of  $2.95 + 1.50 + 15.00 = 19.45$
- »  $2.95 / 19.45 \times 17.45 = 2.65$
- »  $1.50 / 19.45 \times 17.45 = 1.35$
- »  $15.00 / 19.45 \times 17.45 = 13.45$
- » Recognize revenue when (or as) the entity satisfies a performance obligation. In this case when the coffee, bagel and ground coffee is delivered.

# Example – Cellular Phone

- » A cellular phone company (the Company) is offering a free phone to new customers who sign a two year agreement. There is a one time activation fee of \$25 and a monthly fee of \$30 for the two year contract. The two year fee is the same with or without the free phone. The phone costs the Company \$100, and they can sell it separately for \$120. None of the fees paid by a customer are refundable for any reason. What are the separate performance obligations, what is the transaction price, and how is it allocated?

# Revenue Recognition in 5 Steps

- » Is there a valid contract? Yes
- » Identify the performance obligations in the contract – in this case there is more than one, phone and service. What about activation?
- » Determine the transaction price – the price is \$25 activation fee and \$30 monthly for 24 months, or \$745
- » Allocate the transaction price to performance obligations using the standalone selling prices of the phone and the service
- » Recognize revenue when (or as) the entity satisfies a performance obligation. In this case when the phone is delivered and then the service is recognized over time.

# Example Cellular Phone

- » Consideration: \$25 activation fee plus \$30/month for 24 months
- » Total amount of consideration of \$745
- » Allocation of consideration based on standalone selling price:

$$\text{Phone } 120/840 = .14 \times 745 = 104.30$$

$$\text{Service } 720/840 = .86 \times 745 = \underline{640.70}$$

$$\text{Total} \qquad \qquad \qquad 745.00$$

Recognize revenue for phone on delivery, service over time

# Trouble Spots in Revenue Recognition

- » Identifying all of the performance obligations in a contract may take time
- » Determining the transaction price
- » Determining the standalone selling price to allocate the transaction price

# Determining the Transaction Price

- » Transaction price is the amount of consideration that a company expects to receive from a customer determined by the terms of the contract and customary business practices
- » The standard includes specific guidance related to:
  - Variable consideration including incentives and penalties
  - Refund liabilities
  - Financing components
  - Non-cash consideration
  - Consideration payable to a customer



# Variable Consideration - Probability Weighted

- » A construction company enters into a contract to build an office building for \$500,000 with a performance bonus of \$50,000 that will be paid based on timing of completion. The bonus decreases by 10% per week for each week beyond the agreed upon completion date. Based on history there is a 50% chance of completion on the agreed to date, 30% one week late, and 20% two weeks late.
  - » On time:  $50\% \text{ of } 550,000 (500,000 + (50,000 * 1)) = 275,000$
  - » One week late:  $30\% \text{ of } 545,000 (500,000 + (50,000 * .9)) = 163,500$
  - » Two weeks late:  $20\% \text{ of } 540,000 (500,000 + (50,000 * .8)) = \underline{108,000}$
- 546,500

# Extended Payment Terms

- » On July 1, 2017 Company A sold goods to Company B for \$900,000 in exchange for a four-year, zero interest bearing note with a face amount of \$1,416,163. The goods have an inventory cost of \$590,000 on Company A's books.
  - Record revenue on July 1 of \$900,000 for the FV of inventory
  - A is financing the transaction and should also record interest revenue over the four year period. The imputed rate is 12%. Interest revenue July - December is \$54,000 ( $12\% \times \frac{1}{2} \times 900,000$ )

# Volume Discount

- » Consideration is paid to the customer in the form of a discount, coupon, volume rebate or free services. Under this standard these types of arrangements reduce the consideration received and the revenue to be recognized.
- » Company A offers a 2% volume discount if they purchase \$1,000,000+ of product during a calendar year. Customer B always orders in excess of \$1,000,000 and receives the discount. During March, A sold \$400,000 of product to B. Because history suggests that B will order more than \$1 million, the following entry is made at March 31 to record revenue:

Accounts receivable	392,000
---------------------	---------

Sales revenue	392,000
---------------	---------

If the discount is later forfeited due to criteria not being met

Cash	400,000
------	---------

Accounts receivable	392,000
---------------------	---------

Sales discount forfeited	8,000
--------------------------	-------

# Allocating Transaction Price

- » Allocate transaction price based on relative fair values
  - Easiest measure is standalone selling price
  - When not readily available must estimate
- » Estimation methods:
  - Adjusted market assessment approach – evaluate the market and estimate the price that customers are willing to pay
  - Expected cost plus a margin approach – forecast expected costs of satisfying a performance obligation and then add an appropriate margin
  - Residual approach – total transaction price less any observable standalone selling prices of other promises in the contract

# Recognizing Revenue at a Point in Time or Over Time

- » Revenue is recognized when performance obligation is complete
- » Concept of change in control is the deciding factor. Indicators are:
  - Company has right to payment
  - Legal title has transferred
  - Physical possession has transferred
  - Customer has risks and rewards of ownership
  - Customer has accepted the asset
- » Note that these are not “requirements” just indicators

# Recognize Revenue Over Life of Contract

- » Not a policy election
- » Must recognize over a period of time if one of three criteria are met:
  - Customer receives and consumes benefits as seller performs
  - Customer controls the asset as it is created or enhanced
  - Company does not have an alternative use for the product
- » Recognition over time must be consistent with completion of performance
  - Output method – milestone, surveys
  - Input method – costs, time, labor/machine hours, material used

# Other Revenue Recognition Issues

- » Sales Returns and Allowances – recognize revenue in the amount expected to be received taking in consideration the products that may be returned
- » Repurchase Agreements
- » Bill and Hold – revenue can only be recognized if certain criteria are met for a change in control
- » Principal-agent relationships
- » Consignments
- » Warranties – Warranties that provide additional service beyond the assurance type warranty are recorded as a separate performance obligation
- » Non-refundable upfront fees – similar to activation fee in the cell phone example

# New Guidance on Leases - Overview

- » FASB ASU 2016-02 codifies ASC 842 – Leases which will replace the guidance in ASC 840
- » Issued in February 2016
- » Effective for public business entities in fiscal years beginning after December 15, 2018. The effective date for private entities is deferred for one year.



# New Guidance on Leases - Overview

- » Two Types of leases similar to previous lease guidance
- » Finance lease – effectively a purchase of the underlying asset, control of the asset is transferred to the lessee
- » Operating lease – all other leases, lessee obtains control of only the use of the underlying asset not the asset itself
- » The core principle of ASC 842 which is different than previous guidance is that a lessee should recognize the assets and liabilities that arise from all leases whether a finance lease or an operating lease. This will put a right-of use asset and a liability on the books for virtually all leases.

# New Guidance on Leases - Overview

- » Discounted future minimum lease payments are used to record the lease liability. The following types of payments are included:
  - Fixed payments less any lease incentives
  - Variable lease payments that depend on a rate or index
  - Exercise price of an option to purchase the underlying asset if the lessee is reasonable certain to exercise the option
  - Payments for penalties for terminating the lease if expected to be exercised
  - Amounts probable of being owed under residual value guarantees

# New Guidance on Leases - Overview

- » The right of use asset is measured as:
  - Amount of the initial measurement of the lease liability
  - Any lease payments made to the lessor at or before the commencement date of the lease less any incentives received
  - Any initial direct costs incurred by the lessee
- » The subsequent reporting for the lease depends on its classification as operating or finance

# Operating Lease Accounting Example

- » Lessee has entered into a lease for equipment that is non-specialized with lessor
  - Lease term - Three years
  - No renewal option
  - Asset life - Five years
  - Purchase option – None
  - Rent payments - \$120 escalating \$5 annually
  - Fair value of asset - \$900
  - Residual value guarantee - None

# Operating Lease Accounting

- » Does the lease transfer ownership? No
- » Option to purchase that is reasonably certain? No
- » Lease term is major part of economic life? No (3/5 or 60%)
- » Present value of lease payments is substantially all of the fair value? No (\$346)
- » Specialized nature? No
  
- » The lease is an operating lease

# Operating Lease Accounting - Lessee

- » Initial recognition
- » Dr. Right of use asset 346
- » Cr. Lease liability 346
  
- » Year One Entry to record lease payment
- » Dr. Lease expense 125
- » Dr. Lease liability 106
- » Cr. Cash 120
- » Cr. Accumulated Amortization 111

# Finance Lease Accounting - Lessee

- » If there were a residual guarantee for any unrecovered residual value of the asset and payments are not probably under the residual guarantee this would be a finance lease.
- » Initial recognition
- » Dr. Right of use asset 346
- » Cr. Lease liability 346
  
- » Year One Entry to record lease payment
- » Dr. Interest expense 14
- » Dr. Amortization expense 111
- » Dr. Lease liability 106
- » Cr. Cash 120
- » Cr. Accumulated Amortization 111

# Challenges and Opportunities

- » Changes to the leasing standard may require business process changes
  - How property and equipment is requisitioned
  - Lease or buy decisions
  - Lease maintenance including termination and implementation
  - Financial reporting
  - Financial indicators and analytics
  - How to capture and store data required by the standard



# Preparation is Critical

- » Assign an individual or committee of individuals to become technical experts through training, reading, etc.
- » Evaluate existing revenue streams at a contract level for revenue recognition and work to capture lease data for each lease throughout the company for the lease standard. Determine what the impacts will be keeping in mind impacts on operational and performance metrics, company contracts, compensation arrangements, accounting policies, internal controls, debt covenants and tax matters
- » Identify any changes needed in your IT systems or software in order to capture the data needed for the new standards
- » Educate key stakeholders – investors, bankers will need to understand specific impacts to your financial statements

# AICPA FRF for SMEs

- » **AICPA Financial Reporting Framework for Small and Medium-sized Entities (FRF for SMEs)**
  - Designed for closely held or owner-managed for profit businesses
  - Entities that do not have regulatory reporting requirements (broker dealers, insurance companies or banks)
  - Not planning to go public
  - The FRF for SME will continue to use traditional revenue recognition and lease accounting methods eliminating the cost and effort to implement these new standards that may not be relevant to your business

# More on the FRF for SMEs

- » The accounting principles composing the FRF for SMEs are intended to be the most appropriate for the preparation of a smaller business financial statements based on the needs of bankers and other users
- » Only relevant principles are included and accounting is simplified:
  - No Other Comprehensive Income
  - No VIE's
  - No complicated accounting for stock compensation and derivatives
  - No hedge accounting
  - Uses historical cost basis, steering away from complicated fair value measurements

# More on the FRF for SMEs

- » Disclosures are targeted and not excessive
- » Accounting for long-lived assets follows and amortized/depreciated cost approach. No impairment testing required
- » Goodwill is amortized the same as for federal tax purposes
- » Stable accounting framework that is not intended to change frequently. Only updates that are relative to the target SMEs will be made



Julie B. Killian, CPA, CGMA | Principal

[info@claytonmckervey.com](mailto:info@claytonmckervey.com) | 248.208.8860

As the point person for the firm's Revenue Recognition practice, Julie work closely with owners, controllers and bookkeepers of companies with operations in the United States, as well as international companies in Europe and South America. She is focused on the technical and compliance aspects of financial reporting which drives her work in assurance, including audits and reviews of traditional financial statements in various industries, employee benefit plans, and other regulatory audits.