FASB's New Lease Accounting and Revenue Recognition Standards:
What You Need to Know

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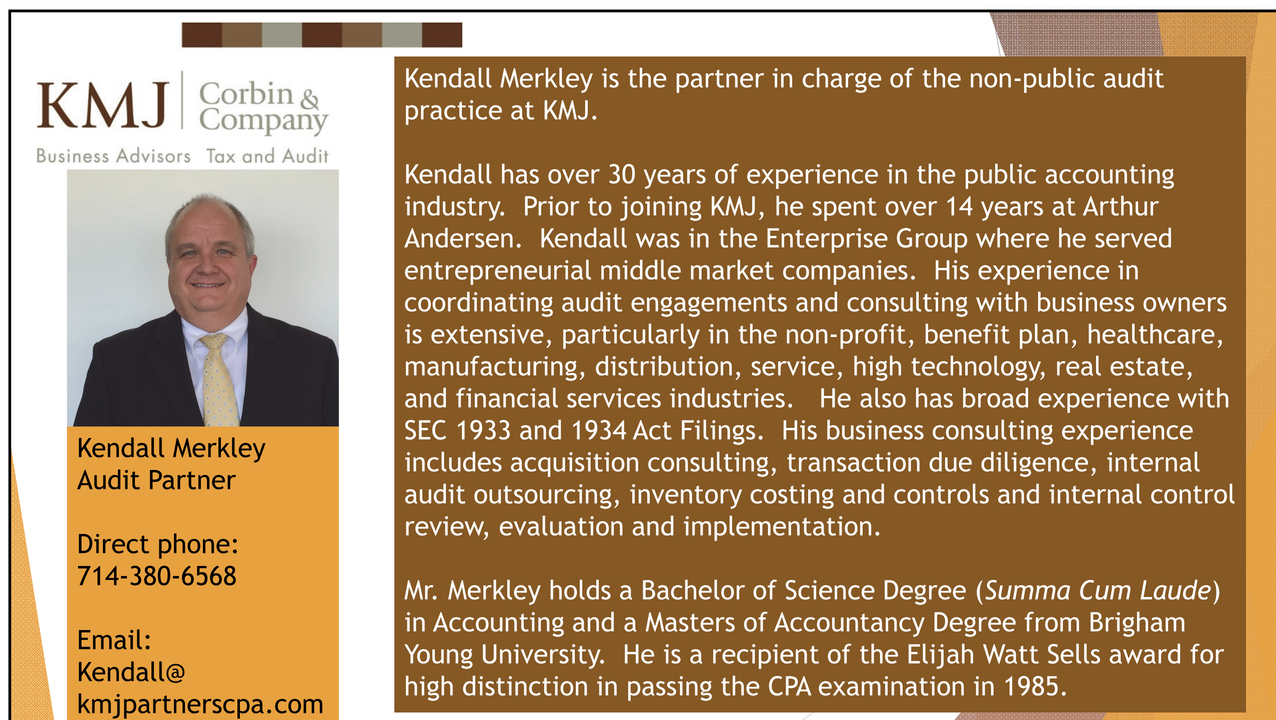

Today's Learning Objectives

- To help all in attendance to understand the "big picture" changes that are happening in accounting for revenue transactions and leasing transactions as a result of recent FASB rulemaking
- To discuss various implementation/transition issues

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Agenda

- Introductions/housekeeping matters – 10 minutes
- Revenue from Contracts with Customers – 80 minutes
- Lunch/Break – 20 minutes
- Leases – 60 minutes
- Q&A – 10 minutes

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Housekeeping Matters

- We will provide 1 hour of CPE credit for every 50 minutes you attend today's session
- Please sign in using the sheet provided
- Credit can only be given if you fill out a brief evaluation at the end of the session, which we will pass out at that time
- The 20-minute break in the middle of the training is for you to get a short convenience break and get some lunch, which we invite you to bring back to your seat to eat while we continue to learn together

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"This is a major project of utmost importance, but it has no budget, no guidelines, no support staff, and it's due in 15 minutes. At last, here's your chance to really impress everyone!"

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Revenue from Contracts with Customers

- Where are we?
  - ASU 2014-09 was issued on May 28, 2014 – the original pronouncement
  - ASU 2015-14 was issued on August 12, 2015 to defer the effective date of 2014-09 by one year
  - ASU 2016-08 was issued on March 17, 2016 to clarify implementation guidance on principal vs. agent considerations
  - ASU 2016-10 was issued on April 14, 2016 to clarify guidance relating to identifying performance obligations and licensing implementation guidance
  - ASU 2016-12 was issued on May 9, 2016 to address narrow-scope improvements to the guidance on collectibility, noncash consideration and completed contracts at transition

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Revenue from Contracts with Customers

- Where are we (continued)?
  - AICPA has formed sixteen (16!!) industry task forces to help develop a new Accounting Guide on Revenue Recognition to provide helpful hints and illustrative examples for application of the new standard
  - These 16 industry task forces have identified 154 implementation issues with the new standard that are being reviewed by the AICPA's Revenue Recognition Working Group, FASB's Transition Resource Group and the AICPA's Financial Reporting Executive Committee
  - The FASB has issued two additional exposure drafts with proposed technical corrections and improvements to the standard
- So, it's still a work in progress!!

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When do we have to adopt?

- For public companies, fiscal years beginning after **12/15/17** (2018 for calendar year-end public companies)
- For non-public companies, fiscal years beginning after **12/15/18** (2019 for calendar year-end non-public companies)
- Both publics and non-publics may early adopt one year before
- Depending on transition option, you are already in a year that will need to be re-cast under the new guidance

THE TIME TO UNDERSTAND THIS IS NOW!!

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Revenue Recognition Standard

- What is the overarching principle for this standard (606-10-05-3)?
  - To recognize revenue to depict the ***transfer*** of promised goods or services via ***contracts*** with ***customers*** in an amount that reflects the consideration to which the entity ***expects*** to be entitled in exchange for those goods or services
- Stated objectives:
  - Remove inconsistencies
  - Provide a more robust framework for addressing rev. rec. issues
  - Improve comparability of rev. rec. practices across entities, industries, jurisdictions and capital markets
  - Provide more useful information to users through disclosures
  - Simplify (??) the preparation of FS by reducing technical requirements

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Five Steps to Recognition (606-10-05-4)

1. Identify contract with customer
2. Identify separate performance obligations
3. Determine transaction price
4. Allocate transaction price to separate performance obligations
5. Recognize revenue when (as) each separate performance obligation is satisfied

Sounds easy, doesn't it?

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New Revenue Recognition Standard

- Creates ASC 606, a whole new section in the codification
- Is over 700 pages long!!
- New focus is on contractual performance obligations and satisfaction of performance obligations (more balance sheet focused)
- It eliminates certain industry accounting rules (software, construction, etc.)
- The devil is in the details – let's discuss

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Step 1: Identify the Contract with the Customer

Step 1	Step 2	Step 3	Step 4	Step 5
Identify the contract with the customer	Identify the separate performance obligations	Determine the transaction price	Allocate the transaction price	Recognize revenue when (as) each separate performance obligation is satisfied

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Step 1 – What is a contract (606-10-25-1)?

- An approved agreement between two or more parties that creates enforceable rights and obligations
- Can be oral, written or implied by customary business practice
- Contract only covers the period before termination rights kick in (must evaluate whether any termination penalty effectively dissuades termination)

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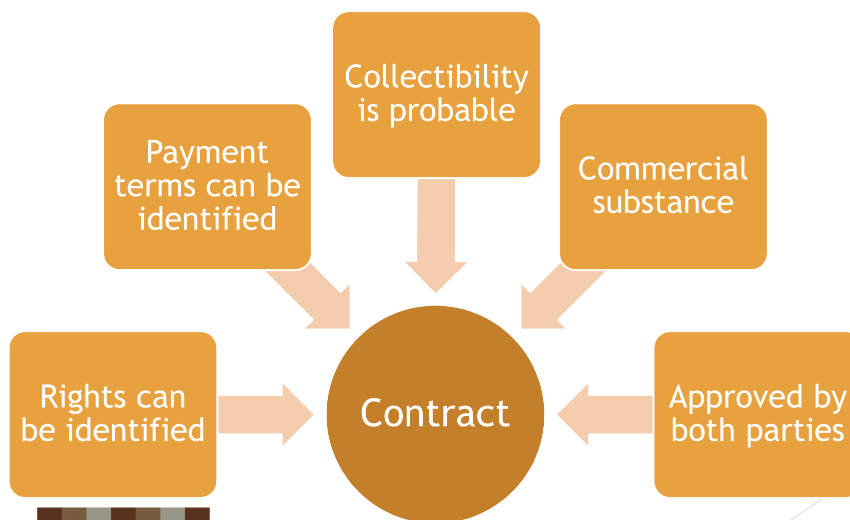
What are the components of a contract?



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Step 1 – Identify the contract (606-10-25-3)

- Identify the contract on a case-by-case basis
- Practical expedient – may apply contract guidance to a portfolio of contracts with similar characteristics rather than on a contract-by-contract basis

Step 1 – Approved Parties are Committed

- Contract must be enforceable by law
- Side agreements must be considered on a case-by-case basis
- Contract does not exist if either party may unilaterally terminate a wholly unperformed contract without compensating the other party

Step 1 – Collectibility criterion

- Collectibility assessed at beginning of contract; not reassessed unless ability to pay deteriorates
- Clarifications issued in ASU 2016-12:
  - Only need to assess collectibility of amounts related to goods or services that will be transferred before payment
  - Ability to stop delivering also manages risk; if services/goods would be cut off in the event of non-payment, only need to assess probability of collection of amounts for services/goods to be provided before cut off

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Step 1 – if all criteria are not met…

- Continue to reassess until all criteria are met
- If no contract exists, seller recognizes revenue when **either** of the following has occurred:
  - There are no remaining obligations to transfer goods/services and all consideration has been received and is nonrefundable; or
  - Contract has been terminated, and all consideration received from customer is nonrefundable
- Seller recognizes consideration received as a contract liability until the above criteria are met or contract criteria are met

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Combining Contracts (606-10-25-9)

- Required if contracts are with the same (or related) customer, AND
  - Negotiated as a package with one objective, OR
  - Goods/services are interrelated, OR
  - Fee in one contract is affected by price/performance in another contract
- If contracts are combined, evaluate combined contract as one
  - Irrelevant which particular contract a performance obligation or payment is located

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Contract Modification (606-10-25-10 through 13)

- If modification simply adds goods or services at a reasonable additional fee, treat as a separate contract
- If not, consider remaining performance obligations in a modified contract
  - If what remains is **distinct**, treat as a new contract
  - If not, redo past allocation taking into account modified contract and recognize cumulative catch-up

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Example 1 – Unpriced Change Order

Facts:

- Contractor has a single performance obligation – a house
- History of executing unpriced change orders with developer
- Contractor commences work related to change order
- Contractor expects the price to be approved based on past experience

Accounting?

- Unpriced change order = variable consideration (to discuss later)
- Cumulative catch-up adjustment (no distinct goods/services provided in change order)

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Step 1 – Take aways

- Do not need to have two signatures to have a contract
- **Legally enforceable** is the standard
- May require legal assistance to determine the point of legal enforceability
- Non-standard contracts = bigger challenge
- Consider more standardization of basic revenue agreements and better documentation of legal enforceability

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Step 2: Identify the Separate Performance Obligations

Step 1	Step 2	Step 3	Step 4	Step 5
Identify the contract with the customer	Identify the separate performance obligations	Determine the transaction price	Allocate the transaction price	Recognize revenue when (as) each separate performance obligation is satisfied

Step 2 – Promises (606-10-25-16 through 18)

- A promise to transfer a good or service to the customer
  - Can be explicit or implicit (due to marketing, published policies, business practices, etc.)
- Excludes activities that don't transfer goods or services
- Promises "immaterial in the context of the contract" may be disregarded (ASU 2016-10)
- Promise to ship or deliver a good to a customer may be treated either as a promise or as a fulfillment activity and excluded from this analysis (ASU 2016-10)

Step 2: "Distinct" (606-10-25-19 through 22)

- A distinct promised item is a "performance obligation"
  - If not distinct, bundle with other items until bundle is distinct
- A good or service is distinct if:
  - It is "capable of being distinct", i.e., customer can benefit from it alone or with readily available resources; AND
  - It is separately identifiable and therefore "distinct within the context of the contract"

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Step 2: "Distinct" indicators

- Indicators that promises are not separately identifiable, but are instead used as an input to the item being sold:
  - Seller integrates goods/services into a combined output (in a contract to build a house, the painting, wood, HVAC, electrical, plumbing, etc. are **not distinct**)
  - One good or service significantly modifies another (in a contract for customized software, the base software and the customization services are **not distinct**)
  - Goods or services are highly interrelated (individual activities at a hotel such as reservations, check in, housekeeping, baggage, concierge, etc. are usually **not distinct**)

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Example 2 – Sale of Software and Implementation Services

Facts:

- A vendor licenses ERP software
- The vendor also agrees to provide implementation services (set-up activities only)
- Customer could buy implementation from somewhere else or do it themselves
- Promise to deliver implementation is separate from promise to deliver software

Accounting:

- Performance obligations are distinct; treat separately

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Warranties (606-10-55-30 through 35)

- Standard warranties are **not considered** performance obligations
- Evaluate if warranty provides services in addition to assurance that product works as promised
  - Ongoing service (maintenance) is a performance obligation
  - Long warranty period might imply a separate performance obligation
- If warranty sold separately, treat as a separate performance obligation

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Post-Contract Support (PCS)

- Existing GAAP:
  - Record as a separate deliverable if VSOE of FV exists
  - VSOE of PCS evidenced by selling price when sold separately
  - If no VSOE, PCS combined with any license fees and recognized on straight-line basis over lease term

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PCS, continued

- New standard:
  - PCS is typically a separate performance obligation
  - Evaluate each PCS service to determine if it is distinct
  - Estimate the standalone selling price if the seller does not sell separately
  - Subscriptions likely to have two performance obligations:
    - Software available today
    - Right to receive when-and-if available software in the future

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Example 3 – Sale of License and PCS

Facts:

- Vendor sells a perpetual software license and PCS for five years
- None of the goods and services are sold by vendor on standalone basis

Accounting:

- License and PCS are capable of being distinct
- License and PCS are separate performance obligations
- Will need to estimate standalone selling prices (no method prescribed, but **VSOE is not necessary**)

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Principal vs. Agent Considerations (ASU 2016-08)

Principal:

- Entity is a principal if it **controls** a promised good or service before it is transferred (not necessarily dependent on legal title)
- May satisfy performance by itself or subcontract
- Recognize revenue on a gross basis

Agent:

- If entity's performance obligation is to **arrange** for provision of good or service for another party
- Recognize fee or commission (net basis)

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Agent Indicators

- Another party primarily responsible for fulfillment
- Entity does not have inventory risk before or after the goods are ordered by a customer, during shipping, or on return
- Entity has no discretion in establishing sales price
- Consideration is structured in the form of a commission
- Entity has no exposure to credit risk for the account receivable from the customer in exchange for the good or service

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Step 2: Take aways

- There is a potential increase in the number of separate performance obligations vs. current GAAP
- It is important to identify an entity's policies and practices, representations made during contract negotiations, marketing materials, and business strategies when identifying the promises in an arrangement
- Performance obligations may be identified using a portfolio approach, but entities need to have processes in place to identify and account for any outliers
- If non-standard contracts are used, entity will have to identify distinct goods and services on an individual contract basis

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Step 3: Determine the Transaction Price

Step 1	Step 2	Step 3	Step 4	Step 5
Identify the contract with the customer	Identify the separate performance obligations	Determine the transaction price	Allocate the transaction price	Recognize revenue when (as) each separate performance obligation is satisfied

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Transaction Price (606-10-32-2)

- The amount of consideration to which a seller expects to be entitled in exchange for transferring promised goods or services to a customer
- Nature, timing and amount of consideration promised are affected by:
  - **Variable consideration**
  - **Constraining estimates** of variable consideration
  - The existence of a **significant financing component**
  - Noncash consideration
  - Consideration payable to the customer
- Transaction price can be fixed, variable, or a combination thereof
- Only consider credit risk if there is a significant financing component
- Collections on behalf of 3rd parties (i.e., sales taxes) are not part of price

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Variable Consideration (606-10-32-5 through 14)

- Estimate the effects of variable consideration (volume discounts, rebates, penalties, performance bonuses, usage-based fees, etc.)
- Choose the method that best predicts the actual fee
  - Probability-weighted (expected value) for large population
  - Most likely amount for individual contracts
- Limit estimates to amounts that are "probable"
- Update each period (cumulative catch-up) as estimates of "probable" consideration change

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Variable Consideration, continued

- May be explicit or implicit
  - Implicit if customer has a valid expectation arising from seller's customary business practices, published policies, or specific statements, or
  - Other facts and circumstances indicate that the seller's <u>intention at the outset is to offer a price concession</u>
- Excludes estimations of future options for additional goods and services and future change orders

Big change from "fixed and determinable"

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Common Types of Variable Consideration

-Bonuses -Refunds -Rights of return -Credits -Liquidated damages	-Incentive payments -Money-back guarantees -Price concessions -Performance bonuses -Penalties	-Awards -Volume discounts -Volume Rebates -Claims

Estimating Variable Consideration

Expected Value

- Sum of the probability-weighted amounts in a range of possible outcomes
- Most predictive when the transactions have a large number of possible outcomes
- Can be based on a limited number of discrete outcomes and probabilities

Most Likely Amount

- The single most likely amount is a range of possible outcomes
- Most predictive when the transaction will produce only two possible outcomes

Constraint on Amount of Variable Consideration

- An entity may only include variable consideration in the transaction price to the extent it is probable that a **significant revenue reversal** will not occur
- Likelihood of revenue reversal factors:
  - Susceptibility to factors outside the control of the seller
  - Seller has limited experience with similar types of performance obligations
  - Uncertainty is not expected to resolved for a long time
  - Contract allows for a broad range of possible consideration amounts

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Example 4 - Award

Facts:

- Expansion of highway from two to three lanes
- Contact price is $65 million plus a $5 million award fee if completed by holiday season
- Contract expected to take one year
- Contractor has a long history of this type of work
- Contractor believes it is 95% likely it will finish by the holiday season

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Example 4, continued

Accounting:

- Variable consideration needs to be estimated
- Most likely amount approach is appropriate because award is binary
- Significant revenue reversal considered unlikely
  - Long history of doing this kind of work
  - Largely within the contractor's control
  - Uncertainty will be resolved in a relatively short period
  - Only two possible final consideration amounts
- Conclusion: total contract price should include the amount of the award

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Rights of Return (606-10-55-22 through 29)

- Recognize:
  - Revenue for the transferred products in the amount not expected to be returned
  - Refund liability for the expected amount to be returned
  - Asset for estimated cost/FV of recovered product (if applicable)
- Update at the end of each accounting period (change in estimate)
- Promise to stand ready to accept returns should not be considered a separate performance obligation in addition to an obligation to provide a refund
- May use portfolio approach for similar products/markets/customers

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Example 5 – Right of Return

Facts:

- 100 contracts to sell a unit at $100 ($10,000 total consideration)
- Customary practice is to allow returns for 30 days
- Cost of product is $60 each

Accounting:

- Variable consideration – portfolio approach – 3% historical return rate
- Most likely return amount - $300
- Remaining amount is not constrained – record $9,700 of revenue

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Significant Financing Component (606-10-32-15 through 18)

- Objective is to adjust the promised amount to the amount that reflects the price the customer **would have paid in cash**
- Consider:
  - Difference between promised consideration and the normal cash selling price
  - Combine effect of expected length of time between transfer of good/service and payment and the prevailing market interest rates

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Significant Financing Component, continued

- Customer advance payment = interest expense and more revenue to seller
- Customer delayed payment = interest income and less revenue to seller
- Likely to exist if the promised consideration varies from cash price and there is more than one year between payment and the transfer of goods/services
- May not exist if advance payment with delivery is at customer discretion or there is a delay to allow future event to occur in order to resolve variable fee

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Other elements of transaction price

- Noncash consideration – record at FV, measure at contract inception (ASU 2010-12)
- Amounts paid to customers reduce transaction price unless seller:
  - Receives distinct goods/services from customer AND
  - Can reasonably estimate the FV of goods/services received

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Step 3: Take aways

- Recording estimated variable consideration might accelerate some revenue as compared to today
- Significant judgment will be required to estimate the amount of variable consideration that should be included in the transaction price
- Entities may use the portfolio approach by class of customer, products or services, distribution channel, etc. when it is expected to provide the same result; however, controls need to exist to identify and separately assess outliers
- Variable consideration is more challenging if there are few standard practices
- Entities must **identify and document** customary business practices, published policies, specific statements and/or intent to offer a price concession

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Step 4: Allocate the Transaction Price

Step 1	Step 2	Step 3	Step 4	Step 5
Identify the contract with the customer	Identify the separate performance obligations	Determine the transaction price	Allocate the transaction price	Recognize revenue when (as) each separate performance obligation is satisfied

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Allocate the Transaction Price (606-10-32-31 through 43)

- Objective: Allocate to each performance obligation the amount of consideration which the entity expects to be entitled in exchange for satisfying each performance obligation
- Allocation based on relative **standalone selling price** (the price at which an entity would sell a promised good or service separately to a customer), determined at contract inception
- Best evidence: observable transactions if similar; otherwise, whatever is best:
  - Expected cost plus margin or market assessment
  - Residual approach is ok (if highly variable or uncertain)
- Applies to all industries, including software (big change from VSOE)

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Allocation Methodologies

Adjusted Market Assessment Approach
- (Competitors' prices, adjusted to reflect seller's costs and margins)

Estimated Cost Plus Margin Approach
- (Forecasted expected cost plus appropriate margin)

Residual Approach
- (Total transaction price minus sum of observable standalone prices)

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Allocating Discounts (606-10-32-36 through 38)

- Usually allocated proportionally to all performance obligations
- Unless objective evidence from observable transactions supports allocations to individual performance obligations
- If residual method is being used, allocate discount first

Same as existing GAAP, except the ability to target discount with observable evidence

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Allocation of variable consideration (606-10-31-39 through 41)

- Generally, allocate proportionally to all performance obligations
- Allocate to one performance obligation if:
  - Terms of variable payment relate specifically to it, AND
  - Results in a reasonable allocation to other performance obligations
- Allocate changes in transaction price on same basis as initial allocation (cumulative catch-up adjustment)

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Example 6 – Allocating Transaction Price

Facts:

- Contractor to build road and bridge; base price is $140 million
- Contractor receives base award of $10 million if project finished 30 days early; award increases or decreases by 10% daily for each day before or after the 30 days
- Contractor believes based on past experience that it will complete the project 31 days ahead of schedule and will be entitled to $11 million bonus

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Example 6 – Allocating Transaction Price, continued

Accounting:

- Contractor determined elements are distinct and therefore two separate performance obligations
- Contract price is determined to be $151 million
- Contractor builds roads/bridges on standalone basis; standalone estimated prices are $140 million road, $30 million bridge
- Conclusion: Allocate $124.4 million to road ($140/$170), $26.6 million to the bridge ($30/$170)

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Step 4: Take Aways

- Estimating standalone selling price may require considerable management judgment and estimation
- If performance obligations are non-standard, estimates will need to be non-standard on a contract-by-contract basis
- Allocating based on relative selling prices, especially with variable consideration, could necessitate significant modifications to IT systems currently used to record revenues
- Estimation of standalone selling price requires documentation of processes/conclusions

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Step 5: Recognize Revenue When (or As) Each Separate Performance Obligation is Satisfied

Step 1	Step 2	Step 3	Step 4	Step 5
Identify the contract with the customer	Identify the separate performance obligations	Determine the transaction price	Allocate the transaction price	Recognize revenue when (as) each separate performance obligation is satisfied

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Satisfying a Performance Obligation

- Objective
  - Obligation is satisfied when **control** over the goods or services is transferred
    - Control = customer directs the use and obtains substantially all the remaining **benefits** of the asset
    - Control includes the ability to prevent other entities from directing the use of, and obtaining benefits from, an asset
  - Control may pass at **point in time** or **over time**
    - "Over time" results in generally earlier recognition for goods and services, as delivery or completion is not necessary
    - "Point in time" results in generally earlier recognition for IP licenses, as revenue would be recognize at beginning of license rather than over the term of the license

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Benefits

- Include potential cash flows (inflows or savings in outflows), either directly or indirectly; for example:
  - Using the asset to produce goods or provide services
  - Using the asset to enhance the value of other assets
  - Using the asset to settle liabilities or reduce expenses
  - Selling or exchanging the asset
  - Pledging the asset to secure a loan
  - Holding the asset for future appreciation in value

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Timing of transfer of control (606-10-25-17)

- Occurs over time if:
  - The customer benefits as performance occurs (e.g., replacement provider would not have to start over)
  - The customer controls the asset that the vendor's performance is creating or enhancing
  - Work performed by vendor does not create an asset with alternative use to vendor AND vendor has right to payment for work to date if customer cancels
    - Contract and practical considerations affect "alternative use"
    - Legal remedies affect "right to payment"

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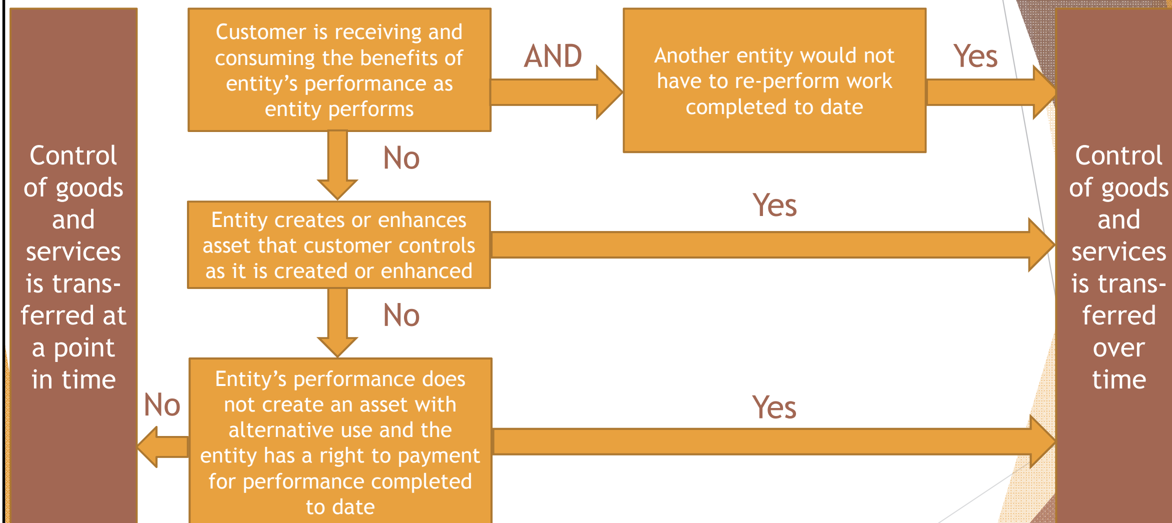
Decision Tree



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Over Time or Point in Time?

- Transfer of control for goods
  - Non-custom goods, generally at delivery
  - Custom goods, perhaps during production (if no alternative use)
- Transfer of control for services
  - Generally, over time
  - However, if no value received by customer until completion (e.g., a final report), wait until completion

Likely to be more recognition before delivery than there is today

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Indicators of Transfer of Control

- Seller has the right to payment
- Customer has legal title
- Customer has physical possession
- Seller has right to non-refundable payment
- Customer has significant risks and rewards of ownership
- Customer has accepted the asset if vendor can objectively determine that terms have been met (trial period – wait until end of trial period to record)

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Performance Obligations Satisfied Over Time (606-10-25-31 through 37)

- Revenue recognized based on a single measure of progress
  - Input methods (cost, labor hours, time) – ignore costs that don't relate to performance and adjust cost if pattern does not reflect performance
  - Output methods (hourly billings, milestones)
  - "Passage of time" is ok if performance is even
- If progress cannot be measured, no revenue until completion

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Example 7 – Control Transferred Over Time

Facts:

- Contract manufacturer (CM) enters into a fixed price contract to manufacture highly customized equipment
- Customer does not control equipment until title transfers at the end of the contract, estimated to be six months
- Customer must pay CM a non-refundable payment of $20,000 per month for the first five months with final payment due upon delivery and acceptance by customer

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Example 7, continued

Accounting:

- CM's performance does not create an asset with alternative future use to CM
- CM has the right to non-refundable payments for performance to date
- Therefore, CM should recognize revenue over time as it manufactures the equipment

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Intellectual Property Licenses (606-10-55-54 through 64; amended by ASU 2016-10)

- First need to determine if license is distinct
- If distinct, need to determine whether license is transferred:
  - At a point in time (right to use)
  - Over time (right to access)
- Royalties from contracts where value is largely from the IP license itself are recognized only when the sale or usage occurs (exception to variable consideration rules discussed earlier)

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Types of Intellectual Property Licenses

- "Symbolic" IP is valuable largely because of its association with licensor (e.g., brand, logo, copyrighted character)
  - Symbolic IP's value is affected by licensor activity
  - Revenue therefore recognized over term (significant change)
- "Functional" IP is valuable largely because of something it does (e.g., software, film, music)
  - Licensor doesn't usually affect usefulness; therefore revenue is usually recognized up-front
  - However, if it is clear that ongoing activities will affect the licensed IP, revenue is recognized over term

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IP Licenses: Other (606-10-55-64 and 65)

- No revenue from IP lease until both:
  - License (or renewal, if applicable) period has begun
  - Necessary information to benefit form the license has been transferred

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Example 8 – License to IP with Sales-Based Royalty and Guaranteed Minimum

Facts:

- Vendor licenses patented technology in a handheld device for no upfront fee and 1% of future product sales
- The license term is for the remaining patent term of three years
- Possible consideration from sales ranges from $0 to $50 million, depending on whether new technology is developed
- Vendor is entitled to at least $5 million at the end of each year regardless of actual sales
- Management concluded that license transfers at a point in time
- Management has concluded that they will collect all amounts owed to them and there are no further obligations under this contract

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Example 8, continued

Accounting:

- Vendor will recognize future royalty revenue when the future product sales occur
- However, since the vendor is entitled to $5 million annually, that portion of the consideration is not variable
- Vendor should recognize at license inception the present value of the future minimum payments as revenue; any annual consideration in excess of $5 million will be recognized as those applicable sales occur

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Breakage (606-10-55-46 through 49)

- Breakage = customers might not exercise all their rights (unused gift cards, etc.)
- If breakage is probable and estimable, take into account when evaluating performance obligations
- If not estimable, recognize breakage when likelihood of use is remote

Similar to practice today

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Customer Options (606-10-55-41 through 45)

- Allocate revenue to options for additional goods and services if at a discount not otherwise available to customers
  - Estimate price of option based on terms of offer, likelihood of exercise and discount available to others
  - If option is for additional quantity or time period for same goods or services, entity may just estimate total goods/services to be provided, and allocate accordingly
- Judgment required to distinguish variable consideration from customer option

Similar to current practice

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Sell-Through Accounting

- Old:
  - Recognize revenue when product sold by distributor to end customer where distributor has the following rights:
    - Price protection
    - Right to return unsold inventory
    - Collection is uncertain
    - Ongoing sales involvement by seller
  - New:
    - Recognize revenue when control transfers to customer
    - Right of return and price protection are variable consideration elements that need to be estimated upon transfer of control

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Example 9 – Sale of Product to a Distributor with Ongoing Involvement

Facts:

- Vendor uses distributor network
- Distributor may return unused product at end of contract term
- Vendor supports distributor with technical sales support

Accounting:

- Record revenue upon transfer of control to distributor, subject to returns, if collectibility is probable
- Sales support is a separate performance obligation – recognize when support is provided

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Non Refundable Upfront Fees

- Examples: health club initiation fees, activation fees in phone contracts, etc.
- Assess whether fee relates to transfer of a promised good or service
  - If yes, is it a separate performance obligation?
  - If no, it is an advance payment and should be recognized as goods or services are provided
- May extend beyond initial contract period if renewal provides a material right

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Other Revenue Topics

- Consignment sales – focus on whether customer has "control" and "unconditional obligation to pay" – result is very similar to existing GAAP
- Bill and Hold Sales – guidance is similar to current GAAP but less explicit
  - May require separation of promise to hold goods (custodial service)

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Step 5: Take aways

- The concept of transfer of control may require more judgment than the concept of delivery
- The control concept may change revenue timing
- Control transfer may involve legal considerations that vary across jurisdictions
- Sell-through accounting is greatly affected

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Contract Costs (340-40)

- No new onerous "loss contract" requirements
- Cost guidance is all new – should increase consistency
- Incremental costs of obtaining a contract are an asset
  - OK to expense as incurred if amortization period is one year or less
- Direct costs to fulfill contract are an asset if they enhance resources to satisfy performance obligations in the future
- Costs that would have been incurred regardless of whether the contract was obtained or not should be expensed (e.g., legal costs to draft up contract)

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Disclosures (606-10-50)

- Objective: Allow users to understand nature, amount, timing and uncertainty of revenues and cash flows from customer contracts.
- Two broad categories:
  - Qualitative
  - Quantitative
- Some specific disclosures required for interim periods

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Disclosures

- Describe performance obligations, payment terms, refund, return, warranty and similar provisions
- Amount of transaction price allocated to remaining performance obligations at end of period, including when amounts will be recognized, and variable consideration not yet included in transaction price
- Revenues disaggregated into categories (by segment)
- Rollforward of contract assets and liabilities
- Methods used to recognize revenue for obligations satisfied over time and why methods are appropriate
- Judgments made in determining when control passes for obligations satisfied at a point in time

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Disclosures, continued

- How estimates are determined for variable consideration, with separate discussion of each significant type and how potential for reversal is evaluated, and standalone selling prices
- Practical expedients related to time value of money adjustments

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Disclosures – Take aways

- Disclosures are extensive – don't leave this for the last minute
- Significant management judgment involved
- Information disclosed will need to be well supported and documented

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Transition

- Options:
  - Retrospectively to all periods
  - Retrospectively with practical expedients (e.g., use transaction price at completion rather than estimating variable consideration in comparative periods)
  - Cumulative effect on contracts not completed at date of adoption
- SAB 74 disclosures in footnotes (public companies)
  - Disclose what you've done and what you know so far
- Changes to systems, policies and procedures, etc.
  - Discuss with audit committee if you haven't started process yet

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What could go wrong?

- Might run out of time and not do a thorough job of preparing
- New internal controls need to be tested, tried and determined to be working effectively before 404 assessment
- May not have time to implement IT system changes
- May not have considered impact on new product lines/services
- May not involve cross-functional team, creating organizational issues and other unintended consequences

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Start Now!!

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Break time – be back at 12:20

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Leases – ASU 2016-02

- Topic of discussion since at least 2001
- Convergence project with IASB
- New standard does not converge GAAP and IAS
- Objective: to increase transparency and comparability among entities by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements

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Leases

- Affects any entity that enters into a lease
- Did not substantively change accounting applied by a lessor, but focuses on lessee accounting
- Effective for fiscal years beginning after December 15, 2018 for public companies; one year later for non-public companies
- Early adoption is permitted

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New Leasing Standard – the "Big Picture"

Most leases on the balance sheet for lessees

- Classification will drive expense profile

Lessor model largely unchanged

- Most changes result from alignment with ASC 606

FASB tried to make things easy

- Classification, reassessment, transition

Effective 2019 but don't wait to assess impact

- Process and systems changes may be required
- Potential impact on banking/debt covenants

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Scope of ASU

- What's in?
  - Leases of property, plant, or equipment
- What's out?
  - Leases of intangible assets
  - Leases to explore for or use nonregenerative resources
  - Leases of biological assets
  - Leases of inventory
  - Leases of certain assets under construction

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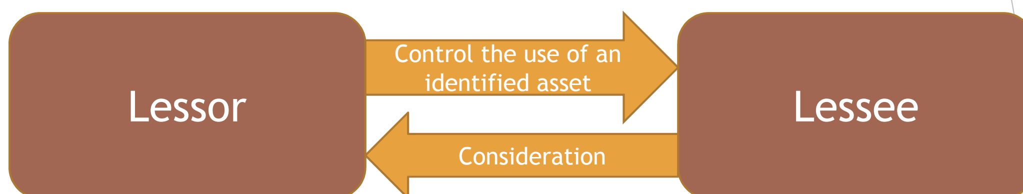
Definition of Lease

- A contract, or part of a contract, that conveys the right to control the use of identified property, plant or equipment for a period of time in exchange for consideration.



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What is a lease?

- Assess whether:
  - Fulfillment depends on the use of an **identified asset** (explicit or implicit)
  - The contract conveys the **right to control the use** of the identified asset
- There is no lease if lessor has a **substantive right to substitute another asset**; a substantive right includes:
  - If the supplier can substitute alternative assets without the consent of the customer
  - There are no barriers (economic or otherwise) that would prevent the supplier from substituting alternative assets

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Right to Control the Use

- Right to control the use = right to obtain substantially all of the **economic benefits** from use
- Economic benefits are obtained directly or indirectly in many ways
  - Including the asset's primary output and by-products
  - Including potential cash flows derived from these items
- Benefits related to **ownership of an asset** should not be included in the assessment of whether an arrangement contains a lease

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Right to Control the Use, continued

- Right to direct "how and for what purpose" asset is used throughout the period of use
- Relevant decisions about "how and for what purpose" asset is used are predetermined before the period of use, AND
  - Customer has the right to operate the asset without the supplier having the right to change operating instructions; or
  - Customer designed the asset in a way that predetermines the most relevant decisions about how and for what purpose
- Protective rights do not necessarily prevent the customer from being able to direct the use of the asset

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Warranty or Upgrade Considerations

- Supplier's right or obligation to substitute an alternative asset due to operational failure does not mean the asset is not an identified asset
- Supplier's right or obligation to upgrade the asset similarly does not mean the asset is not an identified asset

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Example 1: Shipping

Facts:

- Customer enters in a five-year contract with supplier for the charter of a specific ship
- Customers determines whether and what cargo will be transported and the timing and location of delivery throughout the entire contract period
- Supplier operates and maintains the ship and is responsible for the cargo; customer may not hire another operator

Accounting:

- Customer has ability to direct the use of the ship by making the decisions that most significantly affect the cash flows to be derived from use
- Therefore, this is a lease

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Example 2: Shipping (again)

Facts:

- Customer enters into a contract with a ship owner for the transport of cargo from Rotterdam to Sydney on a specified ship (no substitution rights)
- Contract specifies the cargo to be transported and the dates of pickup and delivery; cargo will occupy substantially all the capacity of the ship
- Supplier operates and maintains the ship and is responsible for the safe passage of the cargo; Customer may not hire another operator

Accounting:

- There is an identified asset
- Customer has the right to obtain substantially all the benefits from the use of the ship over the period of use
- However, customer **does not have the right to control** the use of the ship (it cannot direct how and for what purpose the ship is used; this is specified in the contract)
- Therefore, this is **not a lease**

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Multiple Element Arrangements – Breaking Up is Hard to Do

Contracts with multiple lease components for different underlying assets

- An asset will be considered a separate lease component if:
  - Licensee can benefit from the use of the underlying asset either on its own or using other resources that are readily available
  - The underlying asset is not highly dependent on or highly interrelated with other assets in the arrangement
- Note: Land and other elements evaluated separately unless the accounting for the land element would not be significantly different

Contracts with lease and nonlease components (i.e., separate services)

- An activity is a nonlease component if it transfers a good or service to the lessee:
  - CAM and utilities would likely be nonlease components
  - Property taxes and insurance would likely be combined with the lease component(s)

Multiple Element Arrangements

- Lessors would allocate revenue to separate performance obligations in accordance with new revenue recognition standard
- Lessees would use relative standalone prices (if available); if not:
  - Use estimates of the standalone price for lease and nonlease components

Practical Expedient

- Lessees can make an accounting policy election to treat both lease and nonlease elements as a single lease component (elect by class of underlying asset)
- Would simplify accounting, but increase the asset/liability recorded on balance sheet

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Lease Classification - overview

- Lease would be classified as a finance lease (lessee) or a sales-type lease (lessor) when any of the following are true:
  - Lease transfers ownership of the underlying asset to lessee by the end of the lease term
  - Lease grants the lessee an option to purchase the underlying asset that the lessee is reasonable certain to exercise
  - **Lease term** is for a **major part** of the remaining economic life of the underlying asset
  - Present value of the **lease payments** and any residual value guaranteed by the lessee equals or exceeds **substantially all** of the fair value of the underlying asset
  - Leased asset is so specialized in nature that it is expected to have no alternative future use to the lessor at the end of the lease term
- Standard states that old bright-line thresholds under ASC 840 could be a “reasonable approach” to evaluate leases

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Lease Term

- Noncancelable period, plus …
  - Renewal options that are reasonably certain to be exercised by the lessee
- Termination options that are reasonably certain not to exercised by the lessee
  - Options to extend (or not terminate) that are controlled by the lessor

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Lease Term, continued

- Re-assess lease term when:
  - A significant event or change in circumstances occurs within the control of the lessee
  - A contract term obliges the lessee to exercise (or not exercise) a renewal or termination option
  - Lessee elects to exercise or not exercise a renewal or termination option that was not previously deemed reasonably certain of being or not being exercised
  - There is a lease modification that does not result in a separate contract
- Lessors would not be required to reassess lease term unless there is a modification that does not result in a separate contract

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Lease Payments

What amounts are included in lease payments?

Fixed lease payments	• Payments specified in the contract • In-substance fixed payments
Variable payments	• Payments that depend on an index or a rate • Excludes payments based on usage or performance • Reassessment required under certain circumstances
Residual value guarantees	• Lessee – amount that it is probable will be owed under the guarantee at the end of the lease term • Lessor – the full amount at which the residual asset is guaranteed by the lessee
Purchase and termination options	• Treated in a manner consistent with the accounting for renewal options • Include options that a lessee is reasonably certain to exercise

Discount Rate

- **Lessee** must use the rate the lessor charges (if readily determinable), or, alternatively, its incremental borrowing rate
- **Lessor** would use the rate it charges the lessee, which is known as the rate implicit in the lease
- Reassessment:
  - Lessee would update it when there is a remeasurement of the lease obligation
  - Lessee/lessor would reassess when there is a modification that does not result in a separate contract
  - Non-public companies are permitted to make an accounting policy election to use the risk-free rate from measuring their lease obligations

Lessee Accounting Model

- Most leases are recorded on the balance sheet using a right-of-use ("ROU") asset approach
- Initial measurement:
  - Lease obligation = PV of lease payments not yet paid
  - ROU asset = lease obligation + initial direct costs – lease incentives + prepaid lease payments
- Subsequent measurement:
  - Lease obligation – amortized using the effective interest method
  - ROU asset – depends on lease classification
  - Expense recognition pattern:
    - Finance lease – front-loaded
    - Operating lease – generally straight-line

Short-term Leases

- A lessee can elect, by asset class, not to record on its balance sheet a lease with a lease term of 12 months or less and which does not include a purchase option that the lessee is reasonably certain to exercise

Lessor Accounting Model

Existing model retained with minimal changes

Sales-type	Direct financing	Operating
• Lessee gains control of the underlying asset • Underlying asset is derecognized; net investment in lease is recognized • Selling profit or loss is recognized at lease commencement • Initial direct costs recognized at commencement unless no selling profit or loss	• Lessee does not obtain control, but lessor relinquishes control of asset • Underlying asset is derecognized; net investment in lease is recognized • Profit deferred and amortized into income over the lease term • Initial direct costs deferred and amortized into income over the lease term	• Lessor retains control of the underlying asset • Underlying asset remains on the lessor's balance sheet • Income recognized on a straight-line basis unless a more systematic basis is more appropriate • Initial direct costs deferred/expensed over the lease term consistent with income

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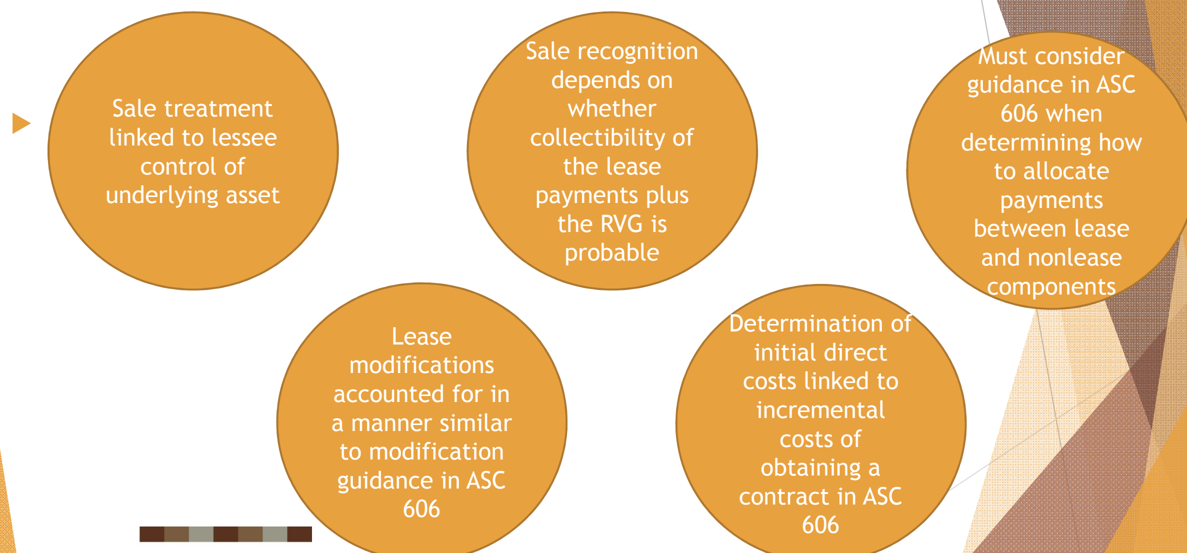

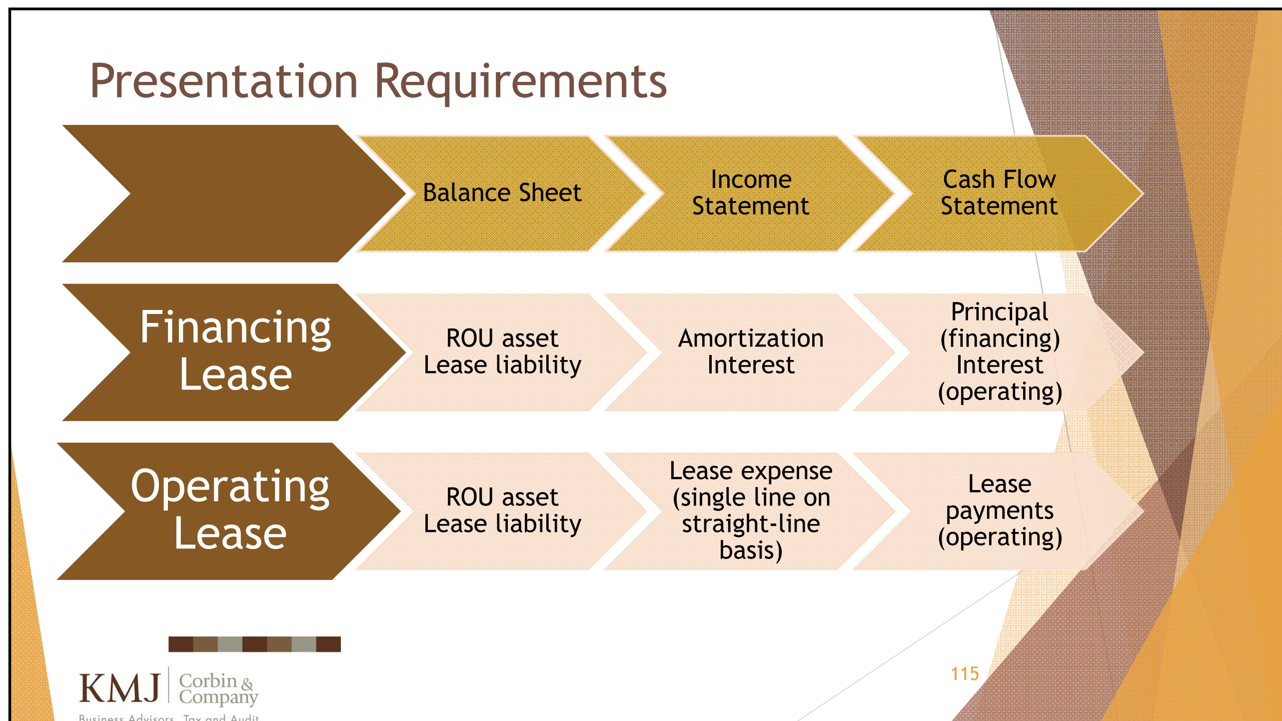
Presentation Requirements
Balance Sheet
Income Statement
Cash Flow Statement
Financing Lease
ROU asset Lease liability
Amortization Interest
Principal (financing) Interest (operating)
Operating Lease
ROU asset Lease liability
Lease expense (single line on straight-line basis)
Lease payments (operating)
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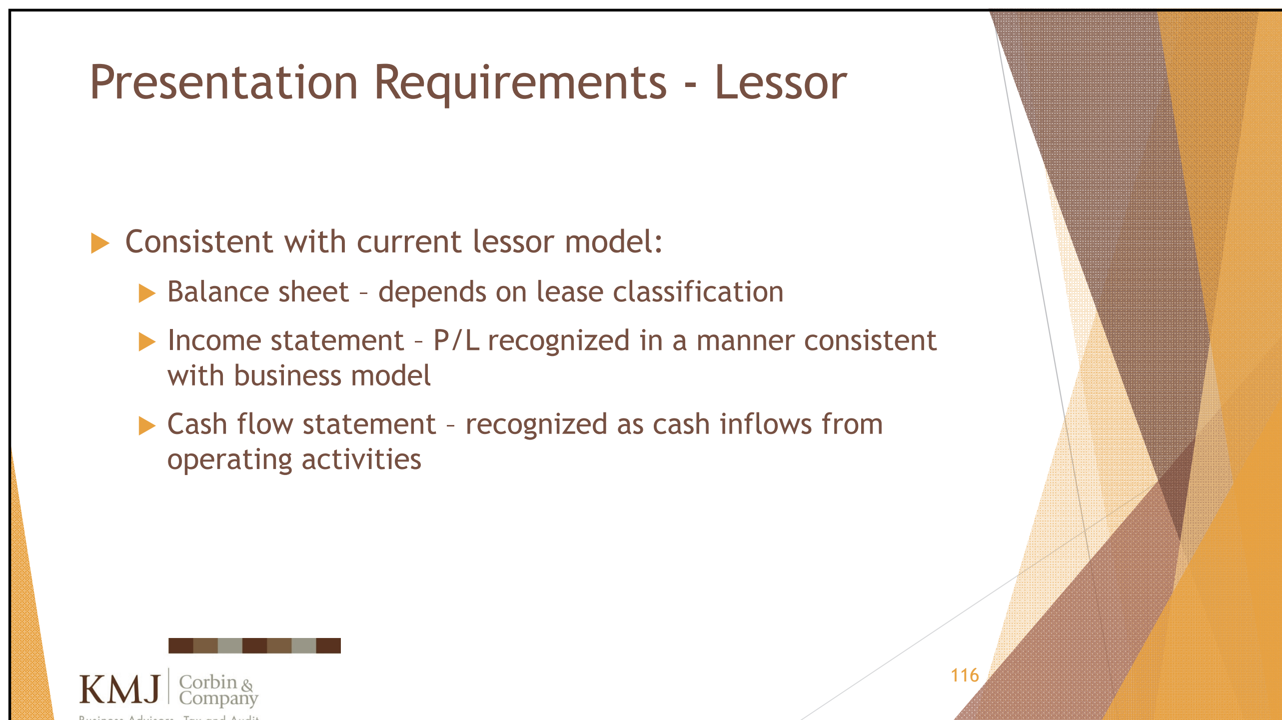
Presentation Requirements - Lessor
Consistent with current lessor model:
Balance sheet – depends on lease classification
Income statement – P/L recognized in a manner consistent with business model
Cash flow statement – recognized as cash inflows from operating activities
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Disclosure Requirements - lessee

- Objective: enable users to assess the amount, timing, and uncertainty of cash flows arising from leases
- Nature of leases
- Not yet commenced lease information
- Related-party lease transactions
- Election regarding short-term leases
- Finance and operating lease costs
- Short-term and variable lease costs
- Sublease income
- Gain/loss on sale/leaseback
- **Weighted average remaining lease terms** and maturity analysis
- **Weighted average discount rate**

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Disclosure Requirements - Lessor

- Nature of its leases
- Significant assumptions and judgments used
- Related-party lease transactions
- Tabular disclosure of lease-related income
- Components of net investment in leases
- Information on the management of risk associated with residual asset
- Maturity of operating lease payments and lease receivable

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Foreign Currency Issues

- ROU asset is nonmonetary while lease liability is monetary
- Lease liability is remeasured using current exchange rate, while ROU asset is remeasured using historical exchange rate
- Could introduce new level of volatility for entities with significant leased assets in foreign currencies with significant currency fluctuations

Other provisions

- Sale/leaseback transactions
  - Arrangement in which leaseback is classified as a financing lease would preclude sale accounting
  - Substantive repurchase options would preclude sale accounting
  - Seller-lessor should evaluate the transfer of the underlying asset under the requirements of ASC 606
  - “Failed sale” will be accounted for as a financing arrangement by both parties

Other provisions, continued

- Lessee involvement in asset construction
  - New accounting depends on whether the lessee controls the underlying asset during the construction period (standard provides indicators to consider)
  - Control – asset is effectively owned by the lessee during the construction period; arrangement would be subject to sale/leaseback accounting upon completion of construction
  - No control – costs related to construction would be accounted for under GAAP topics

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Lessee Transition

- Recognize and measure leases at the beginning of the earliest period presented using a modified retrospective approach
- Unless practical expedients are adopted:
  - Determine whether contracts are or contain a lease
  - Reclassify leases as finance or operating leases
  - Derecognize capital lease assets and obligations
  - Recognize liabilities at the present value of minimum payments plus probable residual value guarantees

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Lessee Transition, continued

- Recognize ROU asset at the amount of the liability
  - Plus deferred rent credits
  - Plus/minus any prepaid or accrued rent
  - Plus amortized incentives
  - Minus any exit activities liabilities
  - Minus any impairments
  - Plus allowable initial direct costs
  - Plus/minus assets/liabilities from business combinations
- Write off any excess initial direct costs that do not meet the new definition as an adjustment to equity

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Lessee practical expedients

- Optional relief to forgo reassessing:
  - Whether expired or existing contracts are or contain leases
  - Classification of expired or existing or existing leases
  - Whether initial direct costs capitalized for existing leases quality for capitalization
- Must elect as a package and apply to all leases
- In essence, an entity that elects to apply the practical expedients will continue to account for leases that commence before the effective date in accordance with old GAAP unless the lease is modified, except that lessees are required to recognize a ROU asset and lease liability for all operating leases

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Lessee Transition, continued

- If an "old" lease is modified after effective date, the lessee is required to remeasure the lease liability and follow the requirements of the new standard from the effective date of the modification

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Lessor Transition

- Major impacts:
  - Capitalization of initial direct costs
  - Business models that rely on third party residual value guarantees to achieve sales recognition
  - Business models that feature sale/leaseback of equipment to a financing party and sublease to the ultimate customer
  - Business models that feature sale of assets subject to operating leases

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Lessor transition

- Operating leases –straight line recognition
- Rent holidays and other variations – continue to recognize on a straight-line basis
- Variable lease payments based on usage, etc. would be recognized as earned (different from variable consideration under ASC 606)
- Other details – refer to standard

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Action Steps

- Gather information about every existing lease (complete inventory of every document)
- Look at any contract that might contain a lease component
- Design and implement controls for:
  - Contract evaluation
  - Lease modifications
  - Asset impairment
  - Foreign currency

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Action Steps, continued

- Preliminary determination to apply practical expedients
- Consider ROU asset impairment evaluation
- Foreign operations – consider impact on materiality assessments as some foreign operations might now have significantly more assets and liabilities
- Talk to bank and look at covenants

Conclusion

- Leasing standard is potentially the most important change in a generation
- Study it and discuss ramifications with senior management
- Get detailed information and work to get the accounting right now so you can relax later!!

▶Q & A

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Thank you for your attendance and participation today!!

"Here's where you give me non-comprehending nods of approval."

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