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NOT-FOR-PROFIT ESSENTIALS: THE NEW REVENUE RECOGNITION STANDARD

Key Information to Prepare for Implementation

In the ever-changing world of not-for-profit accounting, preparation is critical for any standard that will impact financial statements, information systems, controls and processes. Such is the case with Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers*. Issued in May 2014 by the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB), the standard will require substantial effort from entities with customer contracts.

Despite the standard's significance, most organizations are lagging behind in their preparation. In fact, while recent American Institute of Certified Public Accountants (AICPA) guidance recommends that preparation already be in progress, nearly 71 percent of organizations still do not have a clear implementation plan, according to a recent survey of corporate financial preparers. Further, more than 88 percent have not completed an assessment of the effects of the new revenue recognition standard.

Therefore, in this white paper, we are kick-starting your organization's efforts by addressing the areas most critical to preparing for implementation, most notably:

- Development and intentions of the new standard
- Revenue streams potentially impacted
- Implementation timing and methods
- Five-step recognition process
- Other considerations and implementation resources
- Seven key preparation steps

DEVELOPMENT AND INTENTIONS

The new standard attempts to eliminate many of the inconsistencies between U.S. generally accepted accounting principles (GAAP) and International Financial Reporting Standards (IFRS).

For instance, GAAP previously focused on industry- and transactional-specific revenue guidance, whereas IFRS was principle-based and lacked guidance specific to many complex revenue issues. The new standard somewhat converges the two by providing a more principle-based framework for addressing revenue recognition issues—thereby reducing complexity and the volume of guidance to which financial statement preparers must refer.

Also, revenue recognition practices across different entities and industries should now be more comparable, and financial statement users should gain a better understanding of the nature, amount, timing, and certainty of revenue through enhanced and expanded disclosures.

REVENUE STREAMS POTENTIALLY IMPACTED

Many not-for-profit revenue streams are within the new standard's scope and could be impacted, such as:

- Membership dues
- Subscriptions
- Products and services
- Royalty agreements
- Sponsorships
- Conference and seminars
- Tuition, boarding, and meal plans
- Special events
- Advertising
- Licensing
- Federal and state grants and contracts

While this list may seem fairly inclusive, not all revenue sources are impacted. For example, investment income is not impacted, and although contribution revenue is not specifically excluded from the scope, it is a non-reciprocal exchange and therefore does not meet the new standard's definition of revenue. That said, for transactions that contain both contribution and exchange components, the components should continue to be bifurcated and accounted for separately under the new standard.

Additionally, depending on how your organization accounts for the above-listed revenue sources, the new standard may not impact them. For example, if performance obligations regarding tuition, boarding, and meal plan revenues are all satisfied within the same fiscal period, you do not need to allocate the transaction price between the performance obligations. Instead, all such revenues should continue to be recognized in the period earned, which generally coincides with the organization's fiscal year.

IMPLEMENTATION TIMING AND METHODS

Implementation Timing

Public entities are required to adopt the new standard for annual and interim reporting periods beginning after December 15, 2017 (December 31, 2016 for early application).

Meanwhile, nonpublic entities are required to adopt the new standard for annual reporting periods beginning after December 15, 2018, and for interim reporting periods beginning after December 15, 2019. Nonpublic entities may adopt early for annual reporting periods beginning after December 31, 2016, and for interim reporting periods reporting within that period or one year after the annual reporting period in which the standard is first applied.

Implementation Methods

The standard can be applied in two ways: 1) retrospectively to each prior reporting period, or 2) retrospectively with the cumulative effect of applying the standard at the date of initial application. In deciding which option is best for you, consider the transition approaches most commonly used in your industry. Also, note that a historical analysis of contracts is needed, and a transition plan may include parallel tracking of contracts (i.e., simultaneously tracking under the old and new standards).

Following are details regarding each application method.

1. Retrospectively to Each Prior Reporting Period

For completed contracts, an entity does not need to restate contracts that begin and end within the same annual reporting period. Further, for completed contracts that have variable consideration, an entity may use the transaction price at the date the contract was completed rather than estimating variable consideration amounts in the comparative reporting periods.

For reporting periods presented before the date of initial application, an entity does not need to disclose the amount of the transaction price allocated to remaining performance obligations or an explanation of when the entity expects to recognize that amount as revenue.

2. Retrospectively with the Cumulative Effect of Applying the Standard at the Date of Initial Application

The cumulative effect adjustment is made to the opening balance of net assets in the period of adoption. If this is elected, it should provide additional disclosures in reporting periods that include the date of initial application. For example, it should provide the amount by which each financial statement line item is affected by the new standard, as well as an explanation of the reasons for significant changes.

FIVE-STEP RECOGNITION PROCESS

The new standard has a five-step recognition process that follows one core principle: that an entity should recognize revenue to depict the transfer of 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 or services.

Following are descriptions of each step in the recognition process.

1. Identify the Contract(s) with a Customer

A contract exists if four conditions are met:

1. Collection is probable
2. Payment terms and rights to goods and services can be identified
3. The contract has commercial substance (i.e., the risk, timing, or amount of the entity's future cash flow is expected to change as a result of the contract)
4. The contract is approved and parties are committed to their obligations

A potential change from previous recognition policies is that your organization must conclude that it will likely collect from your customer. This requirement may not be met due to a customer's inability to pay, thus potentially causing delays in revenue recognition. Consider taking a closer look at your contracts to ensure that all requirements are met, and developing a process to assess credit risk.

2. Identify Performance Obligations in the Contract

A performance obligation is the promise to transfer a good or service to the customer. Your organization should account for each promised good or service in a contract as a separate performance obligation only if it is distinct or a series of distinct goods or services that are substantially the same and have the same pattern of transfer.

A good or service is distinct if it is separately identifiable from other promises in the contract, and if the customer can benefit from it on its own or with other readily available resources. If a good or service is not distinct, it should be combined with other promised goods or services until a distinct bundle is identified. Your organization may want to develop indicators, such as degrees of customization or inter-relatedness, to evaluate what constitutes a distinct performance obligation.

3. Determine the Transaction Price

Consider contracts with variable consideration. You should determine the best method to estimate the consideration, such as a probability-weighted expected value or the most likely amount, though existing systems and processes may not be able to identify components and calculate adjustments.

In addition, consider constraining estimates of variable consideration, only recording variable revenue to the extent it is probable that a significant reversal in cumulative revenue recognized will not occur. Also, consider if there are significant financing components, such as if the period between payment by the customer and transfer of the promised goods or services is over one year, and adjust the consideration amount for the effects of the time value of money.

If a customer promises noncash consideration, measure it at fair value. If unable to do so, use the standalone selling price of the goods or services being promised to the customer.

If consideration is paid/payable to the customer by the entity, either in cash or items that can be applied to amounts owed to the entity (credit, coupon, voucher), your organization should account for the payment as a reduction of the transaction price or as a payment for a distinct good or service (or both). Reassess the transaction price at each reporting period (e.g., variable consideration estimate, if constrained, etc.).

4. Allocate the Transaction Price to the Contract Performance Obligations

Evaluate existing contracts to determine if there is an observable standalone selling price for the goods or services. If not, consider how an observable standalone selling price could be estimated by gathering market and cost data.

The transaction price is allocated to various performance obligations according to the standalone selling prices. If there is a discount or variable consideration that relates to one performance obligation, the standard specifies when to allocate to one or all performance obligations. Subsequent changes to the transaction price should be recorded as a revenue adjustment in the period of change, allocated to various performance obligations in the same proportion as was determined at contract inception.

5. Recognize Revenue when or as the Entity Satisfies a Performance Obligation

For each performance obligation, consider whether revenue will be recognized over time or at a point in time, based on the new standard and the specific guidance for licenses. If the timing of revenue recognition will be different under the new standard, your organization may need to implement changes to systems, processes, and controls. Reporting systems may need to change, or you could consider the need for period-end adjustments.

Your organization satisfies a performance obligation over time if one of the following is met:

- The customer simultaneously receives and consumes the benefits provided by your organization during performance.
- Your organization's performance creates or enhances an asset that the customer controls as the asset is created or enhanced.
- Your organization's performance does not create an asset with an alternative use, and it has an enforceable right to payment for performance completed to date.

If a performance obligation is satisfied at a point in time, several factors can help determine the point:

- Your organization has a present right to payment for the asset.
- The customer has legal title to the asset.
- Your organization has transferred physical possession of the asset.
- The customer has the significant risks and rewards of ownership of the asset.
- The customer has accepted the asset.

THE NEW STANDARD IN ACTION: A CASE STUDY

Suppose an organization charges $250 in annual dues to members. In exchange, members receive:

- A quarterly newsletter ($100 cost for non-members)
- Certain educational opportunities
- Information about industry trends

The two performance obligations would be the newsletter and membership services. Since the standalone cost of the newsletter is $100, the remaining $150 is allocated to membership services. Both are recognized as they are satisfied: the newsletter revenue is recognized each quarter and the membership services revenue is recognized each month over the 12-month reporting period.

If the $250 in annual dues only entitled members to the quarterly newsletter, the organization would need to bifurcate the exchange between the newsletter component ($100 recognized quarterly over 12 months) and the contribution component ($150 contribution revenue).

ADDITIONAL CONSIDERATIONS

Capitalizing Contract Costs

Instead of expensing the cost of obtaining a contract, recognize it as an asset if the cost is incremental and expected to be recovered (e.g., selling commissions). Capitalization is unnecessary if the amortization period is one year or less.

In addition, recognize the cost to fulfill a contract as an asset if it relates directly to a contract, is expected to be recovered, and generates or enhances resources of the entity that will be used to satisfy performance obligations (e.g., pre-contract or setup costs).

To account for the costs of fulfilling a contract with a customer, your organization should also apply the applicable requirements of other standards, such as:

- Topic 330, Inventory
- Subtopic 350-40, Internal-Use Software
- Topic 360, Property, Plant, and Equipment
- Subtopic 985-20, Costs of Software to Be Sold, Leased, or Marketed

Disclosures

As previously noted, your organization should disclose sufficient information to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. Qualitative and quantitative information is required about:

- *Contracts with customers*, including revenue and impairments recognized, disaggregation of revenue, and information about contract balances and performance obligations (including the transaction price allocated to the remaining performance obligations)
- *Significant judgments and changes in judgments*, determining the timing of satisfaction of performance obligations (over time or at a point in time) and the transaction price and amounts allocated to performance obligations
- *Assets recognized from the costs to obtain or fulfill a contract*

Determining Scope

Often there may be customer contracts that fall under a codification topic not updated under the new standard. Examples may include leases (e.g., equipment and/or maintenance of an asset), insurance, financial instruments, and guarantees.

If a customer contract is fully within the scope of other accounting guidance, apply the other guidance. If a customer contract is partially within the scope of other accounting guidance, apply the other guidance to that which it specifically applies, then the new standard to the remainder.

ADDITIONAL IMPLEMENTATION RESOURCES

With such a significant new standard, not-for-profit organizations will likely have numerous questions throughout the implementation process. Fortunately, there are many available resources.

For instance, the FASB's Not-for-Profit Advisory Committee communicates perspectives from the not-for-profit sector to the FASB. Also, the AICPA's Not-for-Profit Entities Revenue Recognition Task Force identifies implementation issues and provides helpful examples and tips for applying the new standard. Both groups have identified potential issues or areas in which clarification is needed, such as:

- Tuition discounts
- Government grants (when a grant-making entity would qualify as a customer)
- Subscription and membership dues
- Bifurcation of transactions that involve a contribution component
- Sponsorships
- Contribution revenue (recommending that FASB excludes contributions from the scope)
- Royalties

While it may seem like a daunting task, it is critical to evaluate the new standard's potential impact on your revenue recognition, financial statement disclosures, information systems, processes, and controls. Start to familiarize yourself with the new standard, and discuss it with your accounting advisors. With their help, you can determine the impact in your organization and be fully prepared for implementation.

To learn more about how your organization can keep pace with demands for transparency, accountability, and governance, click here for more insights from SC&H Group's Non-Profit Services team.

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