Lessons Learned with Revenue Recognition and Functional Expenses

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Additional Information

Learning Objective To provide an overview of revenue recognition, functional expenses and the impacts of Topic 606.	**Instructional Delivery Methods** Group Internet-based
Recommended CPE 1.0 CPE Credit	**Recommended Fields of Study** Specialized Knowledge
Prerequisites None required	**Advance Preparation** None
Program Level Basic	**Course Registration Requirements** None
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Presenters

Meet the Instructors

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Revenue from Contracts with Customers

Accounting Standards Update 2014-09 (Topic 606)

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Revenue from Contracts with Customers

Accounting Standards Update 2014-09 (Topic 606)

- Principals-based versus rules-based approach
- $ Amount of revenue = the consideration to which an entity expects to be entitled for those promised goods or services
- Exchange transactions are subject to the new ASU
    - "A reciprocal transfer between two entities that results in one of the entities acquiring assets or services or satisfying liabilities by surrendering other assets or services or incurring other obligations"

Revenue from Contracts with Customers

Implementation Dates

- Effective for year-ends beginning after December 15, 2018 UNLESS:
  - Financial statements have not yet been issued OR

    Financial statements have not been made available for issuance
- If you meet the one of two criteria above: Implementation date is extended one year, requiring implementation date for year-ends beginning after December 15, 2019.
  - On April 8, 2020, the Financial Accounting Standards Board (FASB) added a project to its technical agenda to propose delaying the effective dates of its standards on revenue recognition and lease accounting for certain entities due to challenges related to the COVID-19 pandemic.

Polling Question #1

Have you early adopted Topic 606, given the delay for one more year due to COVID-19?

A. *Yes*

B. *No*

C. *We're unsure yet if we will early adopt or not*

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Exchange Transactions/What is Included?

What is included (note this is not an all-inclusive list):

- Membership dues
- Sales of products and services
- Conferences and seminars
- Royalty agreements
- Tuition
- Advertising
- Naming rights
- Sponsorships
- Special events

Specifically excluded:

- Lease contracts
- Insurance contracts
- Financial instruments
- Other guarantees

Contributions and collaborative agreements are NOT included (these fall under ASU 2018-08)

Implementation

Revenue from Contracts with Customers

- Retrospective using either:
  - Full retrospective for all prior periods
  - Modified retrospective adoption
  - Note that if a change in accounting principle has a material effect on the financial statements, the auditor should include an emphasis of matter paragraph in the report that describes the change in accounting principle and provides a reference to the entity's disclosure.

- Three transition options:
  - Apply retrospectively to each prior reporting periods presented and may elect certain practical expedients
  - Allows an entity to adopt the new guidance retrospectively with the cumulative effect of initially applying in the opening balance of net assets the date of initial application.
  - Single-year financial statement versus comparative in the year of adoption

5 Step Model

Step 1.	Identify the contract with the customer.
Step 2.	Identify the performance obligations in the contract.
Step 3.	Determine the transaction price.
Step 4.	Allocate the transaction price to the performance obligations in the contract.
Step 5.	Recognize revenue when (or as) the entity satisfies a performance obligation.

Impact to your Organization

Revenue from Contracts with Customers

- May be required to make more estimates and use more judgment
- May need to work with lenders to revise debt covenants tied to accounts affected by the new guidance, such as revenues or liabilities
- May consider changes to its standard contract terms, including payment arrangements and distinct performance obligations, if current terms do not result in the desired accounting treatment
- May need to revise documented processes, internal controls, and accounting policies to capture the necessary information and ensure it meets the new requirements
- Technology updates and enhancements to current accounting and financial reporting software may be required to allow for the capture of the necessary inputs for proper revenue accounting

Bifurcating Contribution & Exchange Components

Background

- Contracts may have elements that are partially in the scope of Topic 606 and partially in the scope of other accounting guidance
- These transactions may include an inherent contribution, defined as "a contribution that results if an entity voluntarily transfers assets (or net assets) or performs services for another entity in exchange for either no assets, or for assets of substantially lower value and unstated rights or privileges of a commensurate value are not involved" by FASB
- Examples include:
  - Membership dues
  - Grants, awards and sponsorships
  - Naming opportunities
  - Donor status
  - Gifts in kind

Bifurcating Contr ibution & Exchange Components

Accounting Treatment

- NFP should bifurcate the transaction
  - Determine the fair value of the transaction's exchange portion
  - Residual is reported as contributions
- FASB guidance in ASC 958 provides indicators that may be helpful in determining whether certain transactions (such as memberships) are contributions, exchange transactions or a combination of both

Practical Expedient: Right to Invoice

Accounting Treatment

- Allows an entity to bypass Steps 3, 4, and 5
- Entity may recognize revenue equal to the invoice amount if it has a contractual right to invoice its customer in an amount equal to the value provided to the customer for the entity's performance completed to date
  - Example: management services it provides to its affiliates
    - Right to revenue corresponds directly with the value delivered to the affiliates
    - Revenue is recognized commensurate with the amount to which it has the right to invoice the affiliate, which is based on contractually identified percentages. Payment is received monthly in arrears

Practical Expedient: Right to Invoice

Disclosures

- Aggregate transaction price allocated to unsatisfied or partially satisfied performance obligations at the end of the reporting period
  - Does not need to be disclosed if either condition is met:
    - Performance obligation is part of a contract with an original expected duration of one year or less
    - Entity recognizes the revenue in the amount to which the entity has a right to invoice

Input Measure: Recognition over Time

Accounting Treatment

- An entity transfers control **over time** if any of the following criteria are met:
  - The customer receives and consumes the benefits of the entity's performance as the entity performs.
  - The customer controls the asset as it is created or enhanced by the entity's performance (could be tangible or intangible).
  - The entity's performance does not create an asset with an alternative use to the entity and the customer does not have control over the asset created, but the entity has an enforceable right to payment for performance completed to date and expects to fulfill the contract as promised.

Example: Membership Dues

Accounting Treatment

- A performance obligation is defined in ASC 606-10-25-14 as a promise in a contract with a customer to transfer to the customer either:
  - A good or service that is distinct
  - A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer
- Membership contract states the NFP will provide the following:
  - discounted tickets during the one year term
  - early access to tickets during the one year term
  - a subscription to provide two semi-annual magazines

****For the purpose of this example, the promises to deliver all of these goods and services are <u>distinct</u>. However, the promise to deliver discounted tickets and access to tickets are <u>delivered concurrently</u> and have the same measure of progress and may be accounted for as if they were a single performance obligation referred to as "membership benefits."**

Example: Membership Dues (cont'd)

Accounting Treatment

- The performance obligation for each semi-annual magazine subscription is satisfied at a **point in time**
  - Revenue should then be recognized when control of the magazine has been transferred to the customer (e.g. shipped or delivered electronically)
- The member simultaneously receives and consumes the benefits of membership and the membership performance obligation is satisfied over time
  - Measurement over time is best and will recognize revenue **ratably** over the one year membership

Immaterial Items

Revenue from Contracts with Customers

- Subsequent amendments to the original Codification
- Relates to promises / performance obligations deemed immaterial in the context of a customer contract
- Do not have to be aggregated
- Do not have to be assessed for materiality at the entity level for auditing purposes
- **Example 1**: online publication (valued at $10 for the year) with membership dues (for a total contract price of $500 for the year) – commensurate value of the online publication is deemed immaterial (subjective) to the entire membership dues price / contract

Immaterial Items (cont'd)

Revenue from Contracts with Customers

- **Example 2**: museum membership that includes a one-time free admission
- Use caution!

- Depending on the facts and circumstances, this **could be viewed as a material right** because it represents an option to buy additional goods and services at a price lower than normally charged

Disclosures

- Any income streams not in ASC 606's scope must be separately identified on the income statement **OR**
- Make disclosure in the notes to the financial statements, if not presented separately on the face of the financial

Disclosures

- FASB provided significant relief to entities that do not meet the definition of a public entity
- Early adopters of the standard have found this area to be more challenging than initially anticipated
- NFPs should ensure they have systems, internal controls and procedures in place to accumulate the information required to satisfy these new presentation and disclosure requirements
- Objective of the disclosure requirements is to enable financial statement users to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers

Disclosures

- Disaggregation
  - At a minimum, revenue must be disaggregated according to the timing of transfer of goods or services (point-in-time versus over-time revenue recognition)
  - should include qualitative information about how economic factors affect the nature, timing and uncertainty of revenue and cash flows
- Contract Balances
  - NFPs must report contract assets separately from accounts receivable on the balance sheet and they should not include amounts that are expected to be refunded and include opening and close balances of receivables, contract assets and liabilities on the balance sheet or in the notes to the financial statements

Disclosures

- Performance Obligations
  - must disclose how performance obligations are satisfied
  - must describe the nature of goods or services provided, highlighting if an entity is acting as an agent
- Significant Judgments
  - required to disclose judgments and changes in judgments that significantly affect the amount and timing of revenue from customer contracts
  - must disclose the methods, inputs and assumptions made in assessing whether an estimate of variable consideration is constrained
  - for performance obligations satisfied over time, all entities should disclose the methods used to recognize revenue

Polling Question #2

Does your organization require outside assistance with the implementation process?

A. *Yes*

B. *No*

C. *Unsure*

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Implementation Tips

- Don't wait!!!!
- First, review accounting policies and procedures
- Consult with outside help
- Establish adoption method (full or modified retrospective method) that will be the least burdensome for the organization
- Review relevant disclosure requirements and determine how amounts will be accumulated

Functional Expense Reporting

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Functional Expense Reporting under ASU 2016-14

Introduction

- Effective Dates
  - Fiscal years beginning after December 15, 2017
- Reporting of expenses by functional and natural classification
  - The relationship between functional classification and natural classification for all expenses shall be presented in an analysis that disaggregates functional expense classifications, such as major classes of program services and supporting activities by their natural expense classifications, such as salaries, rent, electricity, supplies, interest expense, depreciation, awards and grants to others, and professional fees. The information must be presented in one location:
    - On the face of the statement activities
    - As a schedule in the footnotes
    - In a separate financial statement (statement of functional expenses)

Functional Expense Reporting under ASU 2016-14

Introduction (continued)

- Preparation of the analysis
  - Expenses reported by other than their natural classification must be reported by their natural classification in the functional expense analysis
  - Investment expenses netted with investment income
  - Gains and losses not included
- Investment expenses netted with investment income
- Gains and losses not included

Polling Question #3

Has your organization's methodology of preparing the statement of functional expenses changed due to the implementation of ASU 2016-14?

A. Yes

B. No

C. Unsure

Functional Expense Reporting under ASU 2016-14

Program and Supporting Services

- Program services
  - Activities that result in goods and services being distributed to beneficiaries, customers or members that fulfill the purpose or mission of the Not-for-Profit Organization
  - Major purpose for and major output of the Not-for-Profit
  - Costs of activities that represent the direct conduct or direct supervision of programs
  - Allocation of costs that benefit more than one function within the organization
- Supporting Services
  - All activities of a Not-for-Profit Organization other than program services
    - Management and General
    - Fundraising
    - Membership Development

Functional Expense Reporting under ASU 2016-14

Management and General Expenditures

- The following types of expenditures are considered purely management and general costs:
  - Oversight
  - Business management
  - General recordkeeping and payroll
  - Budgeting
  - Financing, including unallocated interest costs
  - Soliciting funds other than contributions and membership dues

Functional Expense Reporting under ASU 2016-14

Management and General Expenditures

- The following types of expenditures are considered purely management and general costs:
  - Costs associated with customer-sponsored contracts
  - Disseminating information to inform the public of the NFP's use of contributed funds
  - Making announcements concerning appointments
  - Producing and disseminating the annual report
  - Employee benefits management and oversight (human resources)
  - All other management and administration except for direct conduct of program services, fundraising, or membership development

Functional Expense Reporting under ASU 2016-14

Example 1 – CEO Salary

- A CEO spends a portion of time directly overseeing a research program. Additionally, a portion of time is spent with current and potential donors on fundraising cultivation activities. The CEO's remaining time is spent indirectly supervisor other areas of the organization, including administrative areas
  - A portion of CEO compensation and benefits is allocated to research program and to the fundraising function
  - Remaining time spent on indirect supervision of other areas does not qualify as direct conduct or direct supervision of a program activity
    - The proportional amount of CEO compensation and benefits remains in management and general

Functional Expense Reporting under ASU 2016-14

Example 2 – CFO Salary

- The CFO of a Not-for-Profit has primary responsibility for:
  - Accounting and reporting
  - Short-term budgeting and long-term financial planning
  - Cash management
  - Direct oversight of the organization's endowment
- The CFO's compensation and benefits for activities 1-3 would be allocated to management and general activities
- The portion of time spent on management of the investment strategy for the endowment would be allocated to investment expenses and netted against investment income
- Accounting for investments or other fiduciary oversight would be allocated to M&G

Functional Expense Reporting under ASU 2016-14

Example 3 – Human Resources Department

- The human resources department of a Non-for-Profit organization is generally involved in the benefits administration for all personnel of the organization
  - The human resources department's related costs would not be allocated to any specific program. Rather, those costs would remain a component of management and general activities because benefits administration is a supporting activity for the entire entity

Functional Expense Reporting under ASU 2016-14

Example 4 – Grant Accounting and Reporting Allocation

- A Not-for-Profit Entity receives federal grants and employs an accountant who is responsible for grant accounting and reporting. In some cases, under the terms of the grant agreements, a fiscal report is required to be filed that details expenses incurred and charged against the grant.
  - The fiscal report is not part of the direct conduct or direct supervision of the grant, but rather is an accounting function
  - The grant accountant's compensation and benefits would not be allocated to a programmatic area
- A principal investigator prepares a scientific research report to advance the purpose of a federal research grant
  - The investigator's compensation and benefits would be allocated to the grant because the activity represents direct conduct of the program activity

Functional Expense Reporting under ASU 2016-14

Grant Reporting vs. Functional Expense Reporting Under ASU 2016-14

- Functional expense reporting under GAAP disconnected from donor reporting
  - Expenditures which may be eligible for reimbursement under federal awards as indirect costs may not allocable to programs
    - Human resources department salaries, accounting, auditing, administrative and payroll processing fees
  - 2 CFR 200, Subpart A, Section 200.56 Definition of Indirect Costs
    - Costs incurred for a common or joint purpose benefitting more than one cost objective and not readily assignable to the cost objectives benefitted
    - Includes general expenses such as the director's office, accounting, personnel, and other costs
    - To the extent that costs are reasonable, allowable, and allocable, they are a legitimate cost of doing business payable under a U.S. Government contract or grant
  - Reconciliation of functional expense reporting to grant reporting
    - Separate supplemental schedule of functional expenses for indirect rate calculation
  - Presentation Issues
    - Allocable management and general costs should be spread across their respective natural expense group
    - Presentation of a single "Allocation of M&G" line is discouraged

Functional Expense Reporting under ASU 2016-14

Required Disclosures

- The financial statements of a not-for-profit entity must disclose the following information:
  - A description of the methods used to allocate costs among program and support functions
  - Example from the ASU
    - The financial statement report certain categories of expenses that are attributable to one or more program or supporting functions of the Organization. Those expenses include depreciation and amortization, the president's office, communication department, and information technology department. Depreciation is allocated based on square footage, the president's office is allocated based on estimates of time and effort, certain costs of the communications department are allocated based on estimate of time and effort, and the information technology department is allocated based on estimates of time and costs of specific technology utilized.

Functional Expense Reporting under ASU 2016-14

The Overhead Ratio and Strategies for Effective Functional Expense Presentation

- The overhead ratio is a commonly accepted measure of efficiency and effectiveness of not-for-profit organization
  - Higher spending on program services viewed to be more efficient
  - Assumption that low supporting services expense indicate more effective organizations
- The restrictions of ASU 2016-14 lead to increased supporting services expenses
  - Ensure that all expenditures that can be allocated to programs are allocated to programs
  - Utilize the footnotes to describe program accomplishments and tell the story
  - Expand the functional expense disclosure to describe the value of the supporting services to the organization

Questions?

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