REVENUE RECOGNITION STANDARD

NOT-FOR-PROFIT ORGANIZATIONS

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09 - Revenue from Contracts with Customers (Topic 606), which attempts to clarify the principles for recognizing revenue. Although the ASU was issued in 2014, the FASB provided a long implementation period. For entities that are not considered public business entities (PBEs), the standard becomes effective for annual reporting periods beginning after December 15, 2018, which means January 1, 2019 for calendar year-ends.

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SO WHAT CHANGED?

The recognition of revenue under current accounting standards requires the consideration of two factors; being realized or realizable and being earned. FASB believes ASU 2014-09 will significantly enhance the comparability of revenue recognition practices while also providing a framework to ensure the guidance remains relevant. Specifically, the core principle of ASU 2014-09 is "that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services."

IS THERE ANY REVENUE THAT IS EXCLUDED FROM THE STANDARD?

Contributions and investment income are excluded, as they are nonreciprocal transactions. Most government and other grants will also be excluded as unconditional or conditional contributions due to the guidance that was issued in ASU 2018-08 Not-for-Profit Entities Clarifying the Scope and the Accounting Guidance for Contributions Received or Contributions. ASU 2018-08 specifically clarified that a "societal benefit" does not equal commensurate value. Therefore, in order for a government grant to be an exchange transaction under the new revenue recognition standard, the government agency would have to have received a direct benefit by the performance obligation of the contract.

What may be particularly challenging for Not-for-Profits will be distinguishing transactions that are part exchange transactions and part contributions. An example of this is purchasing a membership to the Organization. The Not-for-Profit would have to determine what part of the membership is a contribution to the Organization and what part of the membership price is a benefit that the member is entitled to. This is important because the exchange transactions will be considered a contract with a customer (and thus subject to the new revenue recognition standard) while the contribution component will be recognized upon receipt if it is an unconditional transfer of assets.

Sources of income that may fall within the scope of the new revenue standard include:

- Retail sales
- Membership fees
- Program service fees
- Tuition and fees
- Sponsorships
- Licenses and royalties
- Government grants that are determined to be an exchange transaction

To achieve the core principle, ASU 2014-09 provides a list of steps to be taken.

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

Each Organization will apply the five-step approach listed to determine when revenue and gains included within the scope of the standard should be recognized.

STEP ONE

For step one, you have to identify if there is a contract in place with a customer. According to the standard, a contract must be approved, create an enforceable right and obligation, have commercial substance, and collection must be probable. Approval can be written, oral, or as a matter of customary business practices which may not result in much change from current practices. One aspect of a contract that may need attention is enforceability. The standard identifies enforceability as a matter of law which may require legal analysis.

STEP TWO

For step two, you have to identify the performance obligations in the contract. A contract may have distinct separate performance obligations (goods or service or a bundle of goods or services) or it may have multiple obligations that have a similar pattern of transfer to the customer and can be grouped together and treated as one performance obligation. To be considered distinct, the goods or service has to provide the customer a benefit on its own or with other resources that are readily available to the customer and the promise to transfer the goods or service to the customer is identifiable separately from other promises in the contract. At contract inception, you will need to determine if the performance obligation(s) is satisfied at a point in time or over time.

STEP THREE

For step three, you have to determine the transaction price. The transaction price is the amount of consideration expected to be received for providing the goods or service. In most cases this will be obvious (because it is stated), but you also have to include non-cash and variable consideration in the transaction price. If variable consideration exists, you need to estimate the amount and include it only if it is probable a reversal of that revenue will not happen. Variable consideration can also decrease the transaction price. Examples of this include discounts, rebates, contractual adjustments, and penalties.

STEP FOUR

For step four, the total transaction price (from step 3) is allocated to each performance obligation (from step 2) on a standalone selling price basis (which is what you could sell that goods or service for separately in similar circumstances to similar customers). If you do not know what the performance obligation would be on a stand-alone basis, you will need to estimate it.

STEP FIVE

While steps 1- 4 take place at the contracts inception, step 5 takes place when performance obligations are satisfied. For step five, you will actually recognize revenue for each performance obligation either over time or at a point in time. You must recognize revenue over time if one of the following is true: customer simultaneously receives and consumes the benefit (for example, a 12-month gym contract), performance creates an asset the customer controls as it is created, or performance does not create an asset with an alternative use and you have the right to payment. If none of those things are true, you will recognize revenue at a point in time. That point is when control of the goods or service is transferred to the customer. Control does not necessarily mean physical possession; it means when the customer can direct the use of the goods or service.

At first glance, the new revenue recognition standard can appear complicated. While it is true there are many new aspects to recognizing revenue, it is certainly possible that the final timing and amount of revenue recognition will not be materially different. A good start for most Not-for Profit organizations would be to make a list of all current revenue sources and evaluate if a contract(s) exists within that revenue source and what performance obligations are associated with each contract. Then the Organization can begin to determine the effect the standard will have on the Organization.

If you have any questions regarding the revenue recognition standard (ASC 606) please contact us.

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