New Rule Will Change the Way You Report Your Contracts

Take these steps to comply with the new accounting standard.

By Kevin O'Connell

A new accounting rule will change the way you fill out your financial statements when you report contracts you've entered into with your customers. Accounting Standards Codification (ASC) 606, "Revenue from Contracts with Customers," developed by the Financial Accounting Standards Board (FASB), will take effect for annual reporting periods beginning after December 15, 2018. (Some nonprofit organizations that are considered public entities will need to adopt the new standard for annual reporting periods beginning after December 15, 2017.)

Starting the process for implementation in the near future is imperative. Delay could cause your financial statements to fall out of compliance with generally accepted accounting principles (GAAP), create loan covenant violations, and cause you to incur extra costs on your annual audit.

Get ready for the new rule by taking a look at your different revenue streams and contracts. Decide which ones you'll need to recognize on your financial statements. Use the following as a guide:

WHICH REVENUE STREAMS ARE INCLUDED IN THE NEW STANDARD?

Revenue streams that are subject to revenue recognition under the new standard include: (1) government contracts, (2) licensing, (3) membership, (4) products and services, (5) royalty agreements, (6) sponsorships, (7) subscriptions, and (8) tuition.

WHICH REVENUE STREAMS AREN'T INCLUDED?

Revenue streams that *don't* fall under the scope of the new standard include: (1) debt and equity securities, (2) derivatives, (3) financial instruments, (4) guarantees, (5) insurance contracts, (6) leases, (7) nonmonetary exchanges, (8) transfer and servicing rights, (9) receivables, and (10) contributions from donors.

Some contracts, such as those for products and services and for tuition are straightforward. But some of the other revenue streams could be more complex. One example of how the new standard could affect nonprofits relates to memberships. Associations or clubs are nonprofit organizations that offer numerous benefits to their members. Such benefits could include use of facilities, newsletters, and discounted or free apparel. The new standard would require an association to determine whether the membership dues are part of a donation, an exchange transaction, or both. If the membership dues are determined to be both a donation and an exchange transaction, the portion of the membership dues related to the donation and exchange transaction should be identified and split out to be reported separately. The amounts must be reported separately because the portion related to donations isn't part of the new standard, while the portion related to the exchange transaction is subject to the new standard.

Government grants also create a set of issues under the new standard. As the standard only covers contracts with customers, there has been debate within the industry on

> "Delay could cause your financial statements to fall out of compliance."

whether the government is considered a customer. In many cases, the customers would be considered the constituents who benefit from the grant, rather than the government itself. This issue has been raised with the FASB, and we anticipate the FASB providing more guidance and clarifications around government grants and their relation to the new standard in the near future.

A Five-Step Model to Comply with the New Standard

To be sure you're compliant with the new regulations, you'll need to follow these steps:

1. **Identify the contract** with a customer.
2. **Identify the performance obligations** in the contract. A performance obligation is your promise to transfer a good or service to the customer.
3. **Determine the transaction price.** The transaction price is the amount of consideration (for example, payment) you expect in exchange for transferring the goods or services to the customer.
4. **Allocate the transaction price to the performance obligations** in the contract. To allocate an appropriate amount to each performance obligation, you must determine the stand-alone selling price of the goods or services for each performance obligation. If a stand-alone selling price isn't observable, you must estimate it.
5. **Recognize revenue** at the time that you satisfy each performance obligation (in other words, at the time that you provide the promised good or service to your customer).

Examples of How the New Model Will Impact Organizations

Here are examples of how the five-step model can be used for various revenue streams.

EXAMPLE 1: MEMBERSHIP DUES

Members pay annual dues of $500. The only benefit that members receive is a monthly news e-mail alert with a value of $200.

- Step 1 (Identify the contract): The $200 paid for the e-mail alerts is considered a contract with a customer. The remaining $300 is considered a *contribution,* since no specific performance obligations relate to this amount. Therefore, the $300 would *not* fall under the new standard.
- Step 2 (Identify the performance obligations in the contract): The nonprofit organization has an obligation to provide the e-mail alerts in return for payment.
- Step 3 (Determine the transaction price): The transaction price of the e-mail alerts is $200 per year.
- Step 4 (Allocate the transaction price to the performance obligations in the contract): The $200 would be allocated to the obligation to provide the e-mail alerts.
- Step 5 (Recognize revenue at the time that you satisfy each performance obligation): The $200 would be recognized as revenue over 12 months as each alert is provided to members. The $300 would be recognized as contribution revenue, which isn't subject to the new standard.

EXAMPLE 2: QUARTERLY NEWSLETTER

A nonprofit has annual dues of $1,000. Members receive benefits such as exclusive use of facilities and a quarterly newsletter. The newsletter has a fair value of $50 per year and is sold separately to outside parties.

- Step 1 (Identify the contract): There is a contract between the nonprofit and its members related to the dues and the subscription to the newsletter.
- Step 2 (Identify the performance obligations in the contract): There are two performance obligations that must be satisfied: (1) membership services, (2) subscription services for the newsletter.
- Step 3 (Determine the transaction price): The transaction price of the total bundle for both membership services and subscription services is $1,000.
- Step 4 (Allocate the transaction price to the performance obligations in the contract): Since the nonprofit sells subscription services to nonmembers for $50, a stand-alone selling price for the subscription has been established. Therefore, $50 would be allocated to the subscription services, and $950 would be allocated to membership services.
- Step 5 (Recognize revenue at the time that you satisfy each performance obligation): The nonprofit would need to determine if the revenue from each of the two performance obligations should be recognized over time or at a specific point in time. In this case, the membership services should be recognized over a 12-month period, and the subscription services should be recognized each quarter over 12 months.

EXAMPLE 3: EVENT SPONSORSHIP

An association gives service providers the opportunity to sponsor an event for its members. Sponsorship provides logo placements in all publications or advertisements connected with the event.

- Step 1 (Identify the contract): When the accompanying rights and privileges result in nominal value to the service provider, the nonprofit has received a contribution. Thus, this situation wouldn't meet the definition of a contract and wouldn't be subject to the provisions of the new standard. (However, nonprofits should consider the specific facts and circumstances of a naming opportunity and accompanying rights and privileges. Length of time, control over name and logo use, and other contract stipulations may create a transaction that would be recognized under the new standard.)

How to Prepare for the Changes to Come

Due to the extensive amount of work and time that the FASB believes it will take organizations to implement the new standard, they delayed the effective date by one year from their original proposal. Given the effective dates, you should use the following implementation timeline in order to stay in compliance with the new standard:

2017, FIRST HALF:

- **Review your contracts,** and analyze the impact of the new rule on your financial reporting.
- **Consult with your auditors** or other accounting professionals. Many accounting firms are offering services related to implementing the new standard and are willing to help nonprofits with implementation.

2017, SECOND HALF:

- **Amend your accounting policies** to reflect the new rule.
- **Rewrite your contracts** to comply with the new standard.
- **Communicate with your bankers,** funders, and other users of your financial statements about the changes that you will be making.

2018, FIRST HALF:

- **Test your readiness** for full implementation of the new standard.

2018, SECOND HALF:

- **Implement** the new standard.

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