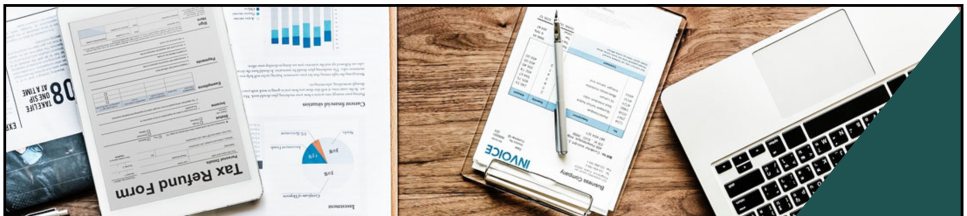


REVENUE RECOGNITION AND LEASES

Adam Kellerhals, CPA

SMITH•SCHAFER & ASSOCIATES, LTD.
Certified Public Accountants and Consultants

SMITH•SCHAFER & ASSOCIATES, LTD.
Certified Public Accountants and Consultants

WELCOME!

Thank you for taking the time to join us today!

Smith Schafer & Associates is an award-winning accounting and business consulting firm offering proactive services, deep expertise, innovative solutions and personal relationships.

We are local to Minnesota with offices in:

- Minneapolis
- Rochester
- Red Wing

Smith•Schafer & Associates, Ltd.
Certified Public Accountants and Consultants

ADAM J. KELLERHALS, CPA

- SENIOR AUDIT MANAGER
- **Expertise**
  – Audit & Attest Services
  – Financial Statement Presentation
  – Business Consultation
- **Background**
  – Bachelor of Arts degree in Accounting and Management from Luther College.
  – Joined the Twin Cities practice in June 2007.
- **Member**
  – AICPA & MNCPA
  – Nonprofit Financial Group - Twin Cities
  – Minnesota Construction Association

Smith Schafer & Associates, Ltd. 3

Smith•Schafer & Associates, Ltd.
Certified Public Accountants and Consultants

TODAY'S AGENDA

- Revenue Recognition
- Leases
- Q & A
- Wrap-up

Smith Schafer & Associates, Ltd. 4

TERMINOLOGY

- Accounting Standards Update (ASU) – Issued by the Financial Accounting Standards Board (FASB) to revise the Accounting Standard Codification (ASC) which is Generally Accepted Accounting Principals (GAAP).

REVENUE RECOGNITION FROM START TO CURRENT

- ASU 2014-09 – Original Pronouncement
- ASU 2015-14
- ASU 2016-08
- ASU 2016-10
- ASU 2016-11
- ASU 2016-12
- ASU 2016-20
- ASU 2017-13
- ASU 2017-14

SMITH•SCHAFER & ASSOCIATES, LTD.
Certified Public Accountants and Consultants

ASU 2014-09 REVENUE RECOGNITION

If you have the following accounts on your balance sheet, you may be affected by revenue recognition:

- Deferred revenue
- Customer deposits
- Customer rebates
- Billings in excess of costs
- Costs in excess of billings
- Work in process
- Or you should have any of these or similar accounts

Do you offer any of these services?

- Warranties
- Client loyalty programs
- Purchase discount programs
- Coupons
- Multiple Services/goods throughout a single sales process or within one contract

SMITH•SCHAFER & ASSOCIATES, LTD.
Certified Public Accountants and Consultants

ASU 2014-09 REVENUE RECOGNITION

- Removed virtually all current GAAP related to revenue recognition
- Introduced a new five step approach to recognize revenue
- Created new terminology
- Effective for years beginning after December 15, 2018

Smith•Schafer & Associates, Ltd.
Certified Public Accountants and Consultants

FIVE STEP PROCESS

- Step 1 • Identify the Contract with a 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

Smith•Schafer & Associates, Ltd.
Certified Public Accountants and Consultants

REVENUE RECOGNITION EXAMPLE

Appliances Are Great (AAG) sells a washing machine for $1,200 and related power cord for $550. Although the washing machine requires the power cord, the power cord can be purchase at AAG or many fine retailers.

If purchased together, the items are discounted to $800 and $500, respectively.

Also, all customers who spend over $1,000 receive a coupon for 10 percent off of their next purchase. AAG expect 60% of customers to use the coupon and spend on average $200.

A customer has agreed to purchase a washing machine and power cord and as a result will receive a coupon.

Step 1

• Identify the Contract with a Customer

Appliances Are Great is selling to a customer.

Step 2

• Identify the Performance Obligations in the Contract

What is the total number of Performance Obligations?

Would the answer change if the washing machine required a specialty power cord that only AAG sells?

Smith•Schafer & Associates, Ltd.
Certified Public Accountants and Consultants

Step 3

• Determine the Transaction Price

Variable Consideration

Assume our customer really needs this washing machine. If AAG can deliver the power cord within the next two weeks, the customer has agreed to pay an additional $10,000, if within 3-4 weeks, $5,000 and if more than a 4 weeks, $0. AAG believes their likelihood of delivery in those time frames are 50%, 25% and 25% respectively.

Smith•Schafer & Associates, Ltd.
Certified Public Accountants and Consultants

Step 3

• Determine the Transaction Price

- Expected Value
  - Weighted average of all outcomes
  - $6250
- Most Likely Amount
  - Single most likely amount
  - $10,000

SMITH•SCHAFER & ASSOCIATES, LTD.
Certified Public Accountants and Consultants

Step 4
- Allocate the Transaction Price to the Performance Obligations in the Contract

	Contract	Standalone	Allocation
Washing Machine	800	1,200	-
Coupon	-	12	-
Power Cord	500	550	-
	1,300	1,762	-

Savings through contract		462

SMITH•SCHAFER & ASSOCIATES, LTD.
Certified Public Accountants and Consultants

Step 4
- Allocate the Transaction Price to the Performance Obligations in the Contract

The coupon is a separate performance obligation and is valued below:

Average sale	$200	
Likelihood of use	60%	
Anticipated sale		$ 120
Discount		10%
Standalone price		$ 12.00

SMITH•SCHAFER & ASSOCIATES, LTD.
Certified Public Accountants and Consultants

Step 4
- Allocate the Transaction Price to the Performance Obligations in the Contract

	Contract	Standalone	Allocation
Washing Machine	800	1,200	885
Coupon	-	12	9
Power Cord	500	550	406
	1,300	1,762	1,300

Savings through contract		462	

SMITH•SCHAFER & ASSOCIATES, LTD.
Certified Public Accountants and Consultants

Step 5
- Recognize Revenue When (or as) the Entity Satisfies a Performance Obligation

Provide the Washing Machine

Account	Debit	Credit
Accounts receivable	800	
Contract asset	85	
Revenue		885

Provide the Power Cord

Account	Debit	Credit
Accounts receivable	500	
Revenue		406
Contract asset		85
Contract liability		9

Use or Expiration of Coupon

Account	Debit	Credit
Contract liability	9	
Revenue		9

SMITH SCHAFER & ASSOCIATES, LTD.
Certified Public Accountants and Consultants

STEP ONE – IDENTIFY THE CONTRACT WITH A CUSTOMER

- FASB Contract ≠ Legal Contract
- Agreement between two or more parties that creates enforceable rights and obligations
- 5 criteria that must be met including:
  - Collectability of substantially all of the consideration is probable

SMITH SCHAFER & ASSOCIATES, LTD.
Certified Public Accountants and Consultants

STEP TWO – IDENTIFY THE PERFORMANCE OBLIGATIONS IN THE CONTRACT

- Performance Obligation is a promise in a contract with a customer to transfer to the customer either:
  - A good or service (or a bundle of goods or services) 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
- A good or service is distinct if both of the following are met:
  - The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (that is, the good or service is capable of being distinct)
  - The entity's promise to transfer the good or service to the customer is separately identifiable from other promises.

SMITH•SCHAFER & ASSOCIATES, LTD.
Certified Public Accountants and Consultants

STEP THREE – DETERMINE THE TRANSACTION PRICE

- Considerations:
  - Constraining estimates
  - Financing component
  - Consideration payable to customers
  - Variable consideration

SMITH•SCHAFER & ASSOCIATES, LTD.
Certified Public Accountants and Consultants

STEP FOUR – ALLOCATION OF TRANSACTION PRICE

- Multiple performance obligations =
  - Determine standalone selling price of each obligation
  - Allocate any bundle savings across all obligations
  - Allocate any discounts to one or all obligations
- Change in contract price =
  - Change in allocation to the obligations on the same basis used at the contract inception

SMITH•SCHAFER & ASSOCIATES, LTD.
Certified Public Accountants and Consultants

STEP 5 – RECOGNIZE REVENUE

- An asset is transferred when (or as) the customer obtains control of the asset.
- At contract inception must determine if performance obligations will be satisfied over time or at a point in time.

SMITH•SCHAFER & ASSOCIATES, LTD.
Certified Public Accountants and Consultants

STEP 5 CONTINUED…OVER TIME

- To recognize revenue over time ONE of the following must be met:
  - The customer receives and consumes the benefits provided by the seller's performance as the seller performs
  - The seller's performance creates/enhances an asset that the customer controls as the asset is created/enhanced
  - The seller's performance does not create an asset with an alternative use to the seller, and the entity has an enforceable right to payment for the performance completed to date

SMITH•SCHAFER & ASSOCIATES, LTD.
Certified Public Accountants and Consultants

PRESENTATION

- Contract Asset or Liability
- Transition
- Disclosures

SMITH•SCHAFER & ASSOCIATES, LTD.
Certified Public Accountants and Consultants

FUTURE STEPS

1. Do you have these and how will you treat them:
   – Multiple performance obligations
   – Distinct goods
   – Variable consideration
2. Document your five steps.

LEASES FROM START TO CURRENT

- ASU 2016-02 – Original Pronouncement
- ASU 2017-13
- ASU 2018-01
- ASU 2018-10
- ASU 2018-11
- ASU 2018-20
- ASU 2019-01

ASU 2016-02 LEASES

- New presentation and disclosure requirements.
- Lease expense (rent expense) is recognized in a similar matter as today.
- Effective for years beginning after December 15, 2019. (FASB may delay for one year – until years beginning after December 15, 2020)

SMITH•SCHAFER & ASSOCIATES, LTD.
Certified Public Accountants and Consultants

LEASE TYPES

- Finance Lease
- Short Term Lease
- Operating Lease

SMITH•SCHAFER & ASSOCIATES, LTD.
Certified Public Accountants and Consultants

PRESENTATION - BALANCE SHEET

Finance Lease	Operating Lease	Short Term Lease
• Right of use asset • Lease liability	• Right of use asset • Lease Liability	• Not Applicable*

Smith•Schafer & Associates, Ltd.
Certified Public Accountants and Consultants

PRESENTATION – INCOME STATEMENT

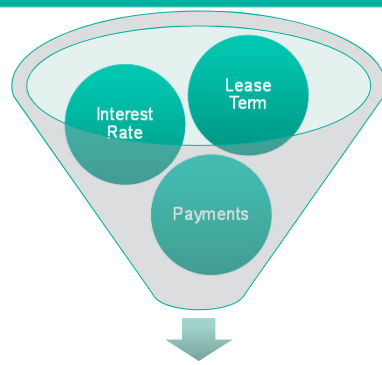
Finance Lease	Operating Lease	Short Term Lease
• Amortization Expense • Interest Expense	• Rent Expense	• Rent Expense

Smith•Schafer & Associates, Ltd.
Certified Public Accountants and Consultants

EMBEDDED LEASE

Contract + Identified Asset = Embedded Lease

CALCULATION INPUTS



Right of Use Asset (ROU)

REAL ESTATE TAXES AND CAM

- Net Lease
  - Variable lease payment that is not dependent on an index or rate of change and excluded from ROU calculation
- Gross Lease
  - Standalone cost of the CAM is excluded in ROU calculation or use the practical expedient to include

Real estate taxes and insurance will not receive an allocation of the lease payment

SMITH•SCHAFER & ASSOCIATES, LTD.
Certified Public Accountants and Consultants

INTEREST RATE OPTIONS

- Rate implicit in the lease:
  - To determine the lessee must know the lessor's:
    - Initial cost of the asset
    - Upfront costs
    - Residual value of the asset
  - Example
    - A lessor pays a total of $60,000 for an asset with a five-year life and agrees to lease the asset $1,200 a month for five years. The implicit rate is 7.42%

SMITH•SCHAFER & ASSOCIATES, LTD.
Certified Public Accountants and Consultants

INTEREST RATE OPTIONS

- Incremental borrowing rate:
  - The rate of interest that a lessee would have to pay to borrow on a collateralized basis over a similar term an amount equal to the lease payments in a similar economic environment.
- Risk free rate:
  - Must be for the same term as the lease

SMITH•SCHAFER & ASSOCIATES, LTD.
Certified Public Accountants and Consultants

RELATED PARTY LEASES

Related party leases are required to be accounted for by their legally enforceable terms or conditions.

If the lease is reasonably certain to be renewed or extended

that is the term used in the calculation of the asset and liability.

SMITH•SCHAFER & ASSOCIATES, LTD.
Certified Public Accountants and Consultants

TRANSITION

- Adjust the earliest period presented (including retained earnings)
- Adjust only the year of adoption – however – more disclosure is required

SMITH•SCHAFER & ASSOCIATES, LTD.
Certified Public Accountants and Consultants

FUTURE STEPS

1. Find leases and service contracts.
2. Lease capitalization policy.
3. Renew or document related party leases.

SMITH•SCHAFER & ASSOCIATES, LTD.
Certified Public Accountants and Consultants

Q & A

Join our Facebook Group, Connect Us, where you can network after our events with peers, ask questions, get access to exclusive content, early registration to future events and much more!

www.facebook.com/groups/ConnectUs

Smith Schafer & Associates, Ltd. 41

SMITH•SCHAFER & ASSOCIATES, LTD.
Certified Public Accountants and Consultants

OUR UPCOMING LOCAL EVENTS

Our goal for Smith Schafer events is to bring together our communities to connect and share knowledge on industry topics and trends. We want to provide value and education to our clients and peers.

September 10 – How to Improve your Company's Profitability
October 1 – Nonprofit Revenue Recognition and Leases – LIVE Webinar
October 17 – Tax & Retirement Tips

Visit our website for more details!

www.smithschafer.com

Smith Schafer & Associates, Ltd. 42

Smith•Schafer & Associates, Ltd.
Certified Public Accountants and Consultants

CONNECT WITH SMITH SCHAFER

Twin Cities Office
7500 Highway 55, Suite 350
Minneapolis, MN 55427
952-920-6603

Adam J. Kellerhals, CPA
a.kellerhals@smithschafer.com
952-698-7192

FACEBOOK.COM/SMITHSCHAFERASSOCIATES

TWITTER.COM/SMITHSCHAFER

LINKEDIN.COM/COMPANY/SMITHSCHAFERCPAS

INSTAGRAM.COM/SMITHSCHAFERCPAS

WWW.SMITHSCHAFER.COM | INFO@SMITHSCHAFER.COM

Smith•Schafer & Associates, Ltd.
Certified Public Accountants and Consultants

DISCLAIMER