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INSIDE THE ISSUE

Revenue Recognition is Finally Here!

By Cindy Buttress, Senior Manager

The new revenue recognition standard, Accounting Standards Update (ASU) No. 2014-09 (Revenue from Contracts with Customers – Topic 606), became effective for all non-public business entities for annual reporting periods beginning after December 15, 2018. This ASU affects financial institutions directly, with respect to their revenue recognition practices, but also indirectly, with respect to borrower financial statements submitted for underwriting and credit monitoring purposes.

The underlying principle in ASU 2014-09 is that revenue should be recognized when goods or services are transferred to the customer for an amount the entity can expect to receive. Financial institutions need to identify which revenue areas on their income statement are going to be included and which are excluded. The following are examples of account that are excluded from the new standard:

- "Core" interest income (including loan and investment interest income),
- Lease contracts,
- Mortgage servicing income,
- Late fees on loan commitment fees,
- Loan prepayment fees,
- Loan origination fees, and
- Premium or discount amortization.

This underlying principle will have the greatest potential impact for financial institutions in reporting non-interest income, including:

- Gains or losses on Other Real Estate Owned (OREO),
- Deposit related fees,
- Safe deposit box fees, and
- Trust income.

Once all revenue accounts included in the ASU are identified, financial institutions need to determine whether these revenue accounts are considered material to the total revenue for the entity. If the revenue accounts are not material, entities may not have to implement the new standard.

When implementing this ASU, entities must follow a five step process:

1. Identify the contract with the customer which meets all of the following five criteria,
   a) Approved agreement between two or more parties that creates enforceable rights and obligations,
   b) Each party's rights regarding goods/services to be transferred can be identified.
   c) Payment terms can be identified,
   d) Has commercial substance and
   e) Probable the consideration entitled will be collected.
2. Identify the separate performance obligations,
3. Determine the transaction price,
4. Allocate the transaction price to performance obligations and
5. Recognize revenue when (or as) the performance obligation is satisfied.

What happens when a contract does not meet the five criteria above and consideration has been received? Revenue for consideration received would be recognized when at least one of the following has occurred:

- Entity has no remaining obligations to transfer goods/services and all consideration promised has been received and is nonrefundable.
- Contract has been terminated and consideration is nonrefundable.
- Entity has transferred control of the goods/services, entity has transferred goods/services to the customer and has no obligation to transfer additional goods/services, and all consideration received is nonrefundable.

If one of the above is not met, any consideration received should be recorded as a liability until the above is met or the contract meets the criteria for being a contract according to the ASU.

When OREO property is sold, financial institutions will need to determine if the sales contract meets the criteria according to the ASU, including ensuring the collectability of substantially all funds to which the entity is entitled in exchange for the OREO when financing the transaction. If the sale meets the criteria of the ASU and control of the asset is transferred to the borrower, gains/losses as a result of the sale should be recognized. If the transaction does not meet all criteria, gains/losses are deferred and recognized when the sales contract meets the definition according to the ASU.

While deposit fees fall into the scope of the ASU, day-to-day contracts should not be a significant concern if the customer can cancel the deposit (close their account) without a significant penalty. Wire fees, overdraft fees, etc. do appear to be contracts but do not extend beyond the period which the services were performed, and as such, do not appear to cause concern from the revenue recognition perspective.

The ASU also affects financial statements submitted by borrowers of financial institutions. If a borrower submits audited, reviewed or compiled financial statements prepared in accordance with Generally Accepted Accounting Principles (GAAP), significant changes in the manner in which revenue is recognized may be evident, depending on the nature of contracts entered into by the borrower. It is important for loan officers, credit analysts and underwriters to understand their borrowers' revenue recognition practices from a comparative perspective.

Non-public business entities were given additional time to adopt ASU 2014-09, but the time has come to implement. Financial institutions should take a close look at their revenue accounts to determine what categories would be impacted by the ASU and develop a plan for analyzing the revenue to ensure accurate implementation of this ASU.

Transfer of control can include:

- *Legal title,*
- *Vendor has right to nonrefundable payment,*
- *Physical possession,*
- *Significant risk/rewards of ownership*
- *Acceptance of asset or*
- *No repurchase agreement.*

Cindy Buttress, CPA
Senior Manager

ASU 2014-09 has a lot of factors to consider during the implementation process. Varney can help you navigate the ASU. Contact Cindy at cbuttress@varney.com or 1-800-240-5004 to get more information.

To Lease or Not to Lease - How Do You Record It?

By Amanda McKeeman, Senior Accountant

The updated lease accounting standard, ASU 2016-02, goes into effect for non-public business entities with fiscal years beginning after December 15, 2019, with early adoption permitted. Under current GAAP, leases are classified as an asset and liability, when meeting the criteria of a capital lease. Otherwise, there is no balance sheet effect as operating leases are 'off-balance sheet' transactions. When implementing ASU 2016-02, an asset and liability will be recorded, regardless of the classification.

Let's start with the basics. **Lessor** accounting has not changed significantly under the new standard, but should be aware of enhanced financial statement disclosure requirements. For **lessee's**, this is not the case. There are significant accounting and presentation changes when implementing this new ASU, if the lease term is for greater than 12 months. The definition of a "lease" has been updated in order to work alongside the updated revenue recognition standard. A lease will now be defined as 'a contract, or part of a contract, that conveys the right to control the use of identified property, plant or equipment (an identified asset) for a period of time in exchange for consideration'. A key element in the definition is 'right to control the use of identified property…'. If there is a right of substitution of the property, then generally, the lessee does not have right to an underlying asset and thus, a contract does not exist. As well, if there is not a specified, identified asset, then a contract does not exist. Something else to keep in mind relates to "embedded leases" – a lease that might be buried in a service contract (think of your copy machines, phone systems, etc.). Make sure to review service contracts to properly identify and evaluate these embedded leases for consideration relating to ASU 2016-02.

The term of the lease is the noncancellable period of the lease along with:

a) Periods covered by an option to extend the lease if the lessee is reasonably certain the option will be exercised;

b) Periods covered by an option to terminate the lease if the lessee is reasonably not certain to exercise the option and

c) Periods covered to extend (or not to terminate) the lease when the option to exercise is controlled by the lessor.

But, leases with a lease term of 12 months or less are excluded from the new leasing standard.

So, how are leases now classified under the new standard? The two classifications are finance leases and operating leases. While the terms are pretty consistent with current GAAP, the definitions are certainly different. Finance leases are generally for other than property leases (e.g. equipment, cars, trucks, etc.). Specifically, a non-property lease is considered a finance lease unless the lease term is for an insignificant part of the total economic life of the underlying asset or the present value (PV) of the lease payments is insignificant relative to the fair value of the underlying asset at the time of commencement. If these conditions are met, the lease is considered an operating lease. More simply put, if the lease meets one or more of the following at inception, the lease is a finance lease:

a) The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.

b) The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.

If a lease is modified, the lease is considered a new lease when both of the following are present:

1. *Modification grants lessee an additional right of use not included in the original lease (right to use an additional asset) and*
2. *Lease payments increase commensurate with the standalone price for the additional right of use*

Lessee's, at the end of the lease or when there is no remaining lease liability or right of use asset (ROU), should record the difference between the carrying amounts of the ROU and lease liability on the income statement as a gain/loss, including any termination penalties.

c) The lease term is for the major part of the remaining economic life of the underlying asset. However, if the commencement date falls at or near the end of the economic life of the underlying asset (the last 25% of the economic life), this criterion should not be used.

d) The PV of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments equals or exceeds substantially all (90% or more) of the fair value of the underlying asset.

e) The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

Now that we have defined the types of leases, how do they get recorded by a lessee? At the commencement of the lease, the lessee is to record all leases by recognizing a Right of Use (ROU) asset and a lease liability for future rental payments. The ROU asset and the lease liability are measured at the PV of the lease payments based on both the lease term and rentals, discount at lessee's incremental borrowing rate, and includes recoverable initial direct costs in the ROU asset.

- Financing Lease: After the commencement date, the ROU asset will be amortized generally over the straight line basis (unless another basis is more representative) for the shorter of the estimated lease term or the underlying asset's estimated life. There is a separate income statement effect due to the amortization of the ROU asset, accretion of the lease liability interest and variable lease payments incurred after commencement.
- Operating Lease: After commencement, the ROU asset amortization is similar to the finance lease, however the income statement effect is different as the single lease cost is recorded; interest on the lease liability is displayed together with the amortization of the ROU asset.

The ROU assets, under both types of leases, must be reviewed for impairment and the lease liability should be reassessed for any significant changes in lease payments, term or discount rate each period.

In terms of overall transition to the new standard, companies have two options. Option one is to adjust comparative periods. Under this option, you would apply the lease standard to each lease that existed at the beginning of the earliest comparative period presented in the financial statements, as well as leases that commenced after this date. For leases that commenced prior to the beginning of the earliest comparative period a cumulative effect adjustment is recognized at that date. Option two is to *not* adjust comparative periods. Under this option, the new standard would be applied to each lease that had commenced as of the beginning of the reporting period in which the entity first applies the lease standard, with a cumulative-effect adjustment as of that date. Keep in mind that an entity that applies the second option must abide by both ASC 840 (prior standard) and ASC 842 (new standard) disclosure requirements. Regardless of how you report, finance leases cannot be combined with operating leases for financial reporting on the balance sheet.

Amanda McKeeman
Senior Accountant

If implementing the new lease standard sounds like a cumbersome task for your entity, don't hesitate to give Amanda, or any one of the banking team members, a call at 1-800-240-5004. We have a helpful template available for identifying and recording leases. We will gladly walk through the accounting and disclosure requirements with you.

In Other News...

- ASU 2016-01, Recognition and Measurement of Financial Assets and Financial Liabilities goes into effect for fiscal years beginning after December 15, 2018, with early adoption permitted. While Federal Reserve Bank and Federal Home Loan Bank stocks are specifically excluded from this ASU, all other equity investments are to be reported at fair value. This ASU provides guidance for how to report equity investments without readily determinable fair values.
- ASU 2018-15: Intangibles – Goodwill and Other – Internal Use Software ~ are you a customer in a hosting arrangement, including a cloud computing arrangement that is a service contract? This ASU provides guidance on accounting for costs of implementing activities. Implementation of this ASU is effective for non-public entities with annual reporting periods after December 15, 2020. Contact us for details.