Ready or Not Here They Come – What to Expect From Upcoming Accounting Changes

Your Speakers Today:

John Daum, CPA
Partner at Condon O’Meara McGinty & Donnelly, LLP.

- Past President and Treasurer of the Long Island Chapter
- Member of various HFTP councils
- Member of the New York Society of Association Executives
- American Institute of Certified Public Accountants
- New York State Society of Certified Public Accountants.
- Over 25 years experience with not-for-profit organizations
Your Speakers Today:

Christopher Garland, CHAE
Principal Consultant at
Mission Hospitality Solutions

- HFTP Global Director
- Chair of Hotel Advisory Council
- AH&LA Finance Committee
- Retired Senior Vice President Operations Finance
- Author of various AH&LA publications on accounting issues facing industry
- On the AH&LA USALI Committee

Your Speakers Today:

Arlene Ramirez, MBA, CHE, CHIA, CHE
HFTP Immediate Global Past President

- Professor, Conrad N. Hilton College of Hotel & Restaurant Management, University of Houston
- Principal, ADR Hospitality Consulting
- Over 25 years of industry experience
Our Time Today

- What, Why and When?
- Leases
- Ten Minute Break 1:30 - 1:40
- Revenue Recognition
- Final Questions/Discussion

What is Changing?

Lease Accounting

Revenue Recognition
LEASES

"These new accounting requirements bring lease accounting into the 21st century, ending the guesswork involved when calculating a company’s often-substantial lease obligations. The new Standard will provide much-needed transparency on companies’ lease assets and liabilities, meaning that off-balance sheet lease financing is no longer lurking in the shadows. It will also improve comparability between companies that lease and those that borrow to buy.”

Hans Hoogervorst
International Accounting Standards Board Chairman
Overview

• Future payment obligations of operating leases were never recorded on the balance sheet
• Users not fully informed of the true obligations of the entity.

New Rule

• Entity will recognize the present value of future lease payments as:
  – Right of Use asset and
  – Lease Liability
New Rule

• Right of Use and Lease Liability will be amortized over the term of the lease based on the PV of the remaining lease payments at the end of each period.
• Rent expense recorded on straight-line basis
• Variances at end of term will be adjustment to Right of Use Asset

New Rule

• For leases with a term of 12 months or less, a lessee is permitted to make an accounting policy election not to recognize lease assets and lease liabilities
• If a lessee makes this election, it should recognize lease expense for such leases generally on a straight-line basis over the lease term
• Election needs to be consistently applied for similar leases
What is a Lease?

Previous GAAP:
- An agreement conveying the right to use property, plant or equipment (land and/or depreciable assets) usually for a stated period of time

New FASB ASC 842:
- 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.

IS THERE A LEASE?

IDENTIFIABLE ASSET
- That is explicitly or implicitly specified

CUSTOMER CONTROL
- Supplier has no practical ability to substitute and would not economically benefit from substituting an asset
- Decision-making authority over the use of the asset
- The ability to obtain substantially all economic benefits from the use of the asset
Lease or No Lease

Example:
- The Hotel contracts with Tech Co. for server space
- Tech Co. owns hundreds of servers and has right to select which server (or portion of server) they will use to host The Hotel’s data
- If necessary they can relocate The Hotel’s data to a different server or part of sever any time during the term of the contract

Lease or No Lease

There is no lease of server equipment in that contract.
- No specific asset is the subject of the contract
- Vendors right of substitution is substantive
Lease or No Lease

Example:
• Golf Country Club rents mowers from Cutting Inc.
• Contract specifies:
  – Make
  – Model
  – Serial number of every mower provided
  – Specified period of time

Lease or No Lease

– No substitutions are allowed unless a mower breaks down, if so it must be replaced with a like-kind mower within 2 business days
– Customer has control on use of the mowers
Lease or No Lease

There is a lease of the mowers.

– Right of substitution is not substantive
– Substitution does not provide supplier with an economic benefit
– Supplier actually incurs expense in replacing the asset

Classification of Lease

- Lease transfers ownership of asset to lessee
- Lease grants lessee a purchase option reasonably certain of being exercised
- Lease term is for major part of asset’s remaining economic life
- PV of lease payments (incl. lessee RVG) is substantially all the asset’s fair value
- Asset is so specialized it is expected to have no alternative use to lessor

- If Yes to all then financing
- If No to all then operating
One Reasonable Approach

A finance lease if:

• Lease term is equal to 75% or more of the remaining life of leased asset
• PV of lease payments (plus any guaranteed residual value) equals or exceeds 90% of the fair value of the lease asset

If Unclear

If lease specifics still unclear

• If lease represents installment purchase where lessee acquires substantially all the economic benefits of an asset, even if the lease is less than 75% of the remaining life or less than 90% of PV of lease payment, it would be finance lease
Dates

LEASE INCEPTION DATE is the date the principal terms of the lease are agreed to.

LEASE COMMENCEMENT DATE is the date the lessor makes an underlying asset available for use by the lessee.

What to Record For All Leases

<table>
<thead>
<tr>
<th>Lease Liability</th>
<th>Right-of-Use Asset</th>
</tr>
</thead>
<tbody>
<tr>
<td>• PV of lease payments</td>
<td>• Equal to lease liability</td>
</tr>
<tr>
<td>• Use rate implicit in lease or lessee's</td>
<td>• Adjusted for:</td>
</tr>
<tr>
<td>incremental borrowing</td>
<td>– Prepaid/accrued rent</td>
</tr>
<tr>
<td>rate</td>
<td>– Lease incentives received</td>
</tr>
<tr>
<td></td>
<td>– Initial direct costs</td>
</tr>
<tr>
<td></td>
<td>– Impairment</td>
</tr>
<tr>
<td></td>
<td>– Exit or disposal cost obligations</td>
</tr>
</tbody>
</table>
Example

The Hotel leases a car from Super Auto Inc.

<table>
<thead>
<tr>
<th>Term</th>
<th>4 years (No renewal option)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economic Life</td>
<td>6 years</td>
</tr>
<tr>
<td>Purchase Option</td>
<td>None</td>
</tr>
<tr>
<td>Payments</td>
<td>$100 in arrears/Increase $4 annual</td>
</tr>
<tr>
<td>Rate</td>
<td>8%</td>
</tr>
<tr>
<td>Fair Value of Asset</td>
<td>$600</td>
</tr>
<tr>
<td>Residual Value</td>
<td>None</td>
</tr>
</tbody>
</table>

Let’s Use The Chart

- Lease transfers ownership of asset to lessee: No
- Lease grants lessee a purchase option reasonably certain of being exercised: No
- Lease term is for major part of asset’s remaining economic life: No
- PV of lease payments (incl. lessee RVG) is substantially all the asset's fair value: No
- Asset is so specialized it is expected to have no alternative use to lessor: No

If Yes to all then financing
If No to all then operating
So For An Operating Lease

That is greater than 12 months...

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
<th>E</th>
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<tbody>
<tr>
<td>1</td>
<td>106</td>
<td>100</td>
<td>28</td>
<td>72</td>
<td>78</td>
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<td>2</td>
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<td>90</td>
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<tr>
<td>4</td>
<td>106</td>
<td>112</td>
<td>8</td>
<td>104</td>
<td>98</td>
</tr>
<tr>
<td>Total</td>
<td>424</td>
<td>424</td>
<td>74</td>
<td>350</td>
<td>350</td>
</tr>
</tbody>
</table>

Expense is calculated by taking total of cash payments / 4 years. (Straight line)

**Journal Entry**

**Journal Entry at Commencement of Lease**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Right-of-Use Asset</td>
<td>350</td>
</tr>
<tr>
<td>Lease Liability</td>
<td>350</td>
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<tr>
<td>NPV of Lease Payments</td>
<td></td>
</tr>
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</table>

**Journal Entry Year 1**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease Expense</td>
<td>106</td>
</tr>
<tr>
<td>Lease Liability</td>
<td>72</td>
</tr>
<tr>
<td>Cash</td>
<td>100</td>
</tr>
<tr>
<td>Accumulated Amort.</td>
<td>78</td>
</tr>
<tr>
<td>Record Annual Lease</td>
<td></td>
</tr>
</tbody>
</table>
Assume...

What if the car that was being leased had a modification that it made it unique so that it would only be used at The Hotel.

Then this would render it a financing lease.

So For A Financing Lease

<table>
<thead>
<tr>
<th>Year</th>
<th>Amortization</th>
<th>Cash Payment</th>
<th>Interest</th>
<th>Principal Reduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>88</td>
<td>100</td>
<td>28</td>
<td>72</td>
</tr>
<tr>
<td>2</td>
<td>87</td>
<td>104</td>
<td>22</td>
<td>82</td>
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<td>3</td>
<td>88</td>
<td>108</td>
<td>16</td>
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<tr>
<td>4</td>
<td>87</td>
<td>112</td>
<td>8</td>
<td>104</td>
</tr>
<tr>
<td>Total</td>
<td>350</td>
<td>424</td>
<td>74</td>
<td>350</td>
</tr>
</tbody>
</table>
**Journal Entry**

### Journal Entry at Commencement of Lease

- **Right-of-Use Asset** 350
- **Lease Liability** 350
- **NPV of Lease Payments**

### Journal Entry Year 1

- **Interest Expense** 28
- **Amortization Expense** 88
- **Lease Liability** 72
- **Cash** 100
- **Accumulated Amort.** 88

Record Annual Lease Payment

---

**Affect on Statements**

<table>
<thead>
<tr>
<th></th>
<th>Operating</th>
<th>Finance</th>
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<tbody>
<tr>
<td><strong>Commencement</strong></td>
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<td></td>
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<tr>
<td>Balance Sheet</td>
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<td></td>
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<tr>
<td>Right-of-Use Asset</td>
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<td>350</td>
</tr>
<tr>
<td>Lease Liability</td>
<td>(350)</td>
<td>(350)</td>
</tr>
<tr>
<td><strong>YEAR 1</strong></td>
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<td></td>
</tr>
<tr>
<td>Income Statement</td>
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<td></td>
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<tr>
<td>Lease Expense</td>
<td>106</td>
<td>0</td>
</tr>
<tr>
<td>Amortization Expense</td>
<td>0</td>
<td>88</td>
</tr>
<tr>
<td>Interest Expense</td>
<td>0</td>
<td>28</td>
</tr>
<tr>
<td>Total Impact on Net Income</td>
<td>(106)</td>
<td>(116)</td>
</tr>
<tr>
<td><strong>Statement of Cash Flows</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Operating</td>
<td>(100)</td>
<td>(28)</td>
</tr>
<tr>
<td>Investing</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Financing</td>
<td>0</td>
<td>(28)</td>
</tr>
<tr>
<td><strong>Balance Sheet</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Right-of-Use Asset</td>
<td>272</td>
<td>262</td>
</tr>
<tr>
<td>Lease Liability</td>
<td>(278)</td>
<td>(278)</td>
</tr>
</tbody>
</table>
Getting Ready

Things to Consider

- Find all leases and create abstracts
- Do you have a system to handle?
- Communicate with your auditors
- Estimate impact on Balance Sheet, ratios and debt covenants

Getting Ready

- Database of Leases
- Lease administration
- Analysis and Strategy
- Tax Implications
REVENUE RECOGNITION

Why Change?

- Address difference in global standards
- Improve comparability across industries through standardization
- Address weaknesses in revenue recognition practices
- Provide the user of statements with more useful information
ASC 606 Summarized

The core principle of the model is to recognize revenue when control of the goods or services transfers to the customer, as opposed to recognizing revenue when the risks and rewards transfer to the customer under the existing revenue guidance.


What is your organization’s planned method of adoption?

- Adopt the standard and apply to each past period presented.
- Apply to existing and future contracts as of the effective date.
- Additional disclosures notes required.

Source: 2016 PwC/IFRS revenue recognition survey
Five Step Review For Revenue Recognition

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 obligation
5. Recognize revenue when the entity satisfies a performance obligation

Identify Contract With Customer

Consider if the contract meets each of the five criteria to pass Step 1:

Have the parties approved the contract? (Section 3.1.1)

Can the entity identify each party's rights regarding the goods/services to be transferred? (Section 3.1.2)

Can the entity identify the payment terms for the goods/services to be transferred? (Section 3.1.3)

Does the contract have commercial substance? (Section 3.1.4)

Is it probable that the entity will collect substantially all of the consideration to which it is entitled in exchange for the goods/services that will be transferred to the customer? (Section 3.1.5)

Proceed to Step 2 and only reassess the Step 1 criteria if there is an indication of a significant change in facts and circumstances. (Section 3.2.1)

Continue to assess the contract to determine if the Step 1 criteria are met.

Recognize consideration received as a liability until each of the five criteria in Step 1 are met or the consideration received is nonrefundable and one of the following occurs:

1. The entity's performance is complete and substantially all of the consideration has been collected.
2. The contract has been terminated.
3. The entity has transferred control of the goods/services to which the consideration received relates, has stopped transferring goods/services to the customer, and has no obligation to transfer additional goods/services. (Section 3.2)

Source: GT-ASC-606-and-340-40-guide.ash
Performance Obligations

A 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.

Transaction Price

The transaction price is the amount which an entity expects in exchange for promised goods or services, excluding amounts collected on behalf of third parties (i.e. sales tax, occupancy tax). The promise included in the contract may also have fixed amounts, variable amounts, or both.
Components For Determining The Transaction Price

Variable consideration and the constraint (Section 5.1)

Consideration payable to customer (Section 5.4)

Transaction price

Significant financing components (Section 5.2)

Noncash consideration (Section 5.3)

Components For Determining The Transaction Price

Estimate variable consideration (Section 5.1)

Expected value  Most likely amount

Apply the constraint guidance (Section 5.1.1)

Limit to the amount at which it is probable that there will not be a significant revenue reversal.
Allocate The Transaction Price To The Performance Obligations

- Adjusted Market Assessment Approach
- Expected Cost Plus Margin Approach
- Residual Approach

Recognize Revenue

- Does the customer receive and consume the benefits as the entity performs? [Y/N]
- Does the customer control the asset as it is created or enhanced? [Y/N]
- Does the asset have an alternative use to the entity? [Y/N]

- Control transfers over time (Section 7.1).
- Does the entity have an enforceable right to receive payment for work to date? [Y/N]

- Control transfers at a point in time (Section 7.2).
Principal Versus Agency

When another party is involved in providing goods or services to a customer

PRINCIPAL

The nature of the promise is a performance obligation to provide the specified goods or services itself.

AGENCY

The nature of the promise is to arrange for those goods or services to be provided by the other party.

Principal Or Agent

Is a third party involved in providing the promised good or service to the customer? N The principal/agent guidance in ASC 606 does not apply.

Y Identify the specified good or service to be provided to the customer.

Does the entity control the specified good or service before it transfers the good or service to the customer? Y The entity is acting as principal in the transaction. Recognize revenue gross.

N The entity's performance obligation is to arrange for another party to provide the specified goods or services to the customer.

The entity is acting as agent in the transaction. Recognize revenue net.
FASB Wording

FASB used the term "specified good or service" instead of "performance obligation" to avoid confusion when an entity is acting as an agent. An Agent’s performance obligation is to find or arrange another (third) party to provide the goods or services.

Indicators of Control

- Primarily responsible for fulfilling the promise to provide the specified good or service.
- Inventory risk before the specified good or service has been transferred to a customer or after transfer of control to the customer.
- Discretion in establishing the price for the specified good or service.
Hospitality Examples

- OTA Revenue
- Initiation Fees
- Membership Dues
- Refundable Fees
- Management/Asset Management Fees
- Loyalty Programs

Membership Dues

Assume the following:
- Club has members which pay $60 a year annual dues and receive the following:
  - Parking
  - Newsletter
  - Access to Clubhouse

Under current GAAP the club recognizes $60 a year in revenue over the one year period or $5 per month.
Membership Dues

Assume the club is running a promotion to increase membership so for $60 you continue to receive same benefits but will have the following added:

- One free cart rental worth $15
- A $25 discount off a purchase of $100 or more in the pro shop

Under New Standard

- Viewed as two additional performance obligations (the cart and the merchandise discount)
- The $60 transaction price will need to be allocated among the performance obligations
How To Allocate

<table>
<thead>
<tr>
<th>Three Performance Obligations</th>
<th>Price</th>
<th>Proportion</th>
<th>$60 Allocated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dues</td>
<td>60</td>
<td>60%</td>
<td>36</td>
</tr>
<tr>
<td>Cart Rental</td>
<td>15</td>
<td>15%</td>
<td>9</td>
</tr>
<tr>
<td>Merchandise Discount</td>
<td>25</td>
<td>25%</td>
<td>15</td>
</tr>
<tr>
<td>TOTAL</td>
<td>100</td>
<td>100%</td>
<td>60</td>
</tr>
</tbody>
</table>

Assume The Following

- Member joins in October of 2021 and pays the $60 dues
- In January 2022 they use the free cart valued at $15
- In January 2022 they purchase $100 worth of merchandise and use the $25 discount
Recording Transactions

<table>
<thead>
<tr>
<th>CURRENT GAAP</th>
<th>NEW GAAP</th>
</tr>
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<tbody>
<tr>
<td><strong>October 2021</strong></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>60</td>
</tr>
<tr>
<td>Deferred Revenue--Dues</td>
<td>60</td>
</tr>
<tr>
<td><strong>Monthly</strong></td>
<td></td>
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<tr>
<td>Differed Revenue--Dues</td>
<td>5</td>
</tr>
<tr>
<td>Dues Revenue</td>
<td>5</td>
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<tr>
<td><strong>January 2022</strong></td>
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<tr>
<td>Promo Expense</td>
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<tr>
<td>Cart Rental Revenue</td>
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<tr>
<td>Cash</td>
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<td>Sales Discount</td>
<td>25</td>
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<td>Merchandise Revenue</td>
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FINANCIAL STATEMENT IMPACT

<table>
<thead>
<tr>
<th>CURRENT GAAP</th>
<th>NEW GAAP</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
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</tr>
<tr>
<td>Dues Revenue</td>
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</tr>
<tr>
<td>2021</td>
<td>15</td>
</tr>
<tr>
<td>2022</td>
<td>45</td>
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<tr>
<td><strong>TOTAL</strong></td>
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<tr>
<td>Cart Rental Revenue</td>
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</tr>
<tr>
<td>2021</td>
<td>0</td>
</tr>
<tr>
<td>2022</td>
<td>15</td>
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<tr>
<td><strong>TOTAL</strong></td>
<td>15</td>
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<tr>
<td>Net Merchandise Revenue</td>
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<tr>
<td>2021</td>
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<tr>
<td>2022</td>
<td>75</td>
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<tr>
<td><strong>TOTAL</strong></td>
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<td>TOTAL REVENUE</td>
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<td>2021</td>
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<td>NET INCOME</td>
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<tr>
<td><strong>TOTAL</strong></td>
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</table>
Preparing For Revenue Recognition

• Evaluate revenue streams and identify specific areas that will change with the new principle
• Evaluate any allocations or pricing issues
• Identify changes to systems and internal controls

Preparing For Revenue Recognition

• Look at month end processes and modify based on new requirements
• Train staff and all key stakeholders
QUESTIONS

Sources