

Auditing the Complex: Revenue and Leases

ARL4/26/V1

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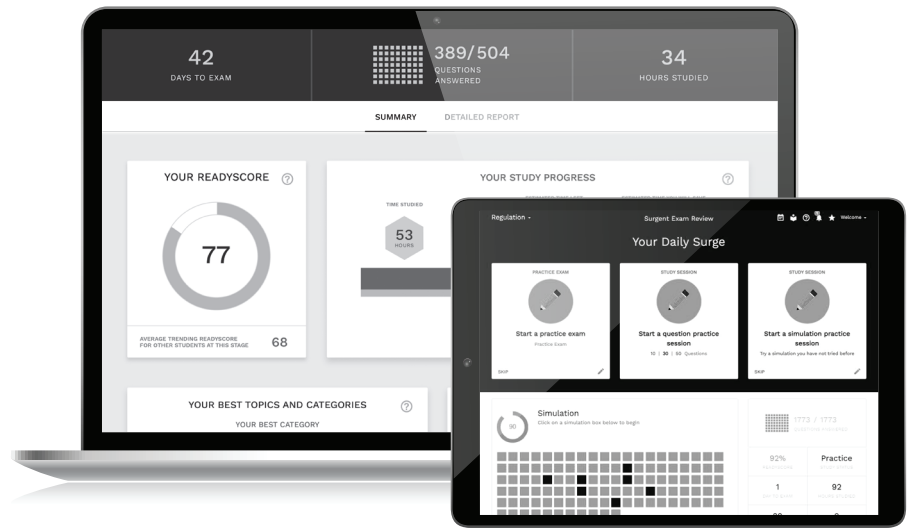
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Table of Contents

Accounting and Auditing Revenue 1

Accounting for and Auditing Leases 2

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NOTES

Accounting and Auditing Revenue

Learning objectives	1
I. Introduction	1
A. Overview of ASC 606	1
B. Revenue recognition guidance	2
C. ASC 606 objectives	3
1. <i>SAB No. 101 and related industry-specific revenue recognition guidance</i>	3
2. <i>Transfer of control</i>	3
3. <i>Unit of account</i>	3
4. <i>Enhanced disclosures</i>	3
5. <i>Key terms addressed by ASC 606</i>	4
D. Test yourself #1	5
II. The five-step revenue recognition model	5
A. Step 1 – Identify the contract(s) with a customer	5
1. <i>Collectability</i>	6
2. <i>Portfolio approach</i>	8
3. <i>Combining contracts</i>	9
4. <i>Contract modifications</i>	10
B. Step 2 – Identify the performance obligations in the contract	12
1. <i>Implicit promises in contracts with customers</i>	12
2. <i>Distinct goods and services</i>	13
3. <i>A series of distinct goods or services</i>	14
4. <i>Licenses</i>	16
5. <i>Options that grant a material right</i>	17
C. Step 3 – Determine the transaction price	19
1. <i>Variable consideration</i>	19
2. <i>Refund liability</i>	20
3. <i>Constraining estimates of variable consideration</i>	20
4. <i>The existence of a significant financing component in the contract</i>	21
5. <i>Noncash consideration</i>	22
6. <i>Consideration payable to a customer</i>	23
D. Step 4 – Allocate transaction price to performance obligations in the contract	23
1. <i>Standalone selling price is the key</i>	23
2. <i>Discounts</i>	24
3. <i>Allocation of variable consideration</i>	24
4. <i>Changes in the transaction price</i>	25
E. Step 5 – Recognize revenue when the entity satisfies a performance obligation	25
1. <i>Performance obligations satisfied over time</i>	26
2. <i>Performance obligations satisfied at a point in time</i>	26
3. <i>Measuring progress toward complete satisfaction of a performance obligation</i>	27
4. <i>Reasonable measures of progress</i>	28
5. <i>Gross vs. net presentation</i>	28
6. <i>Loss contracts</i>	29
F. Test yourself #2	29
III. Contract costs	29
A. Incremental costs of obtaining a contract with a customer	29
B. Costs incurred in fulfilling a contract with a customer	30
C. Amortization and impairment	30
IV. Disclosures	32
A. Applying the ASC 606 required disclosures	32
B. Test yourself #3	36
V. Auditing revenue	36
A. Material misstatements in the financial statements	36
B. Risk assessment procedures related to revenue	37
1. <i>Assessing risk for revenue and receivables</i>	38
2. <i>Preliminary analytical procedures</i>	39
3. <i>Reading and understanding revenue contracts</i>	40

4. <i>Control risk assessment</i>	41
5. <i>Common control activities over the revenue recognition process</i>	42
6. <i>Using the audit risk model to determine audit evidence required</i>	45
C. Test yourself #4	46
D. Substantive procedures related to revenue	47
E. Other considerations related to substantive procedures over revenue	52

Accounting and Auditing Revenue

Learning objectives

After completing this chapter, the reader should be able to:

- Navigate the FASB's comprehensive revenue recognition guidance in ASC 606, *Revenue from Contracts with Customers*;
- Explain audit risks associated with revenue;
- Discuss how to tailor the audit plan to assessed risks of material misstatement in revenue recognition; and
- Recall common substantive procedures related to revenue.

I. Introduction

Revenue is frequently the most critical income statement line item for most companies and is often the largest line item in their financial statements. However, many entities' revenue recognition processes can be quite complex, consisting of many estimates and other significant judgments which can have a significant impact on both the amount of and the timing of revenue recognized by such entities. Further, given its significance, revenue is often a significant source of financial statement fraud, with recent surveys indicating that over 60 percent of financial statement frauds involve revenue. As such, there is a rebuttable presumption in the auditing literature that revenue has a heightened fraud risk and thereby is a significant risk area when performing a financial statement audit. Under AU-C §315, you have a significant risk if your inherent risk is, "close to the upper end of the spectrum of inherent risk due to the degree to which inherent risk factors affect the combination of the likelihood of a misstatement occurring and the magnitude of the potential misstatement should that misstatement occur." Lastly, Accounting Standards Codification (ASC) 606, *Revenue from Contracts with Customers*, significantly impacts the revenue recognition approach for many entities and also requires significant financial statement disclosures related to revenue.

So, as auditors, it is critical not only that we understand the accounting model for recognizing revenue but also are able to design appropriate audit procedures that address the heightened risk of misstatement that is often present with revenue.

Let's start our discussion with a review of ASC 606's model for recognizing revenue.

A. Overview of ASC 606

ASC 606 supersedes the revenue recognition requirements in ASC 605, *Revenue Recognition*, most of the industry-specific guidance throughout the industry topics of the ASC, and some of the cost guidance included in ASC 605-35, *Revenue Recognition – Construction-Type and Production-Type Contracts*, and affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards, for example, lease contracts and insurance contracts. So, the standard pretty much impacts everyone.

In this section of the module, we will review the five-step model in ASC 606 for entities to follow when recognizing revenue.

B. Revenue recognition guidance

The core principle of the revenue recognition standard 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 (that is, payment) to which the entity expects to be entitled in exchange for those goods or services.

To achieve this, an entity will apply the following five-step principles-based approach to recognizing revenue:

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.

The standard includes disclosure requirements intended to provide financial statement users with comprehensive information about the nature, amount, timing, and uncertainty of revenue and cash flows arising from a reporting entity's contracts with customers. In addition, a reporting entity is also required to provide quantitative and/or qualitative information about assets recognized from the costs to obtain or fulfill a contract with a customer.

ASC 606 applies to all contracts with customers (including the transfer of nonfinancial assets) except for the following:

- a. Lease contracts within the scope of ASC 842, *Leases*;
- b. All contracts within the scope of ASC 944, *Financial Services – Insurance*;
- c. Financial instruments and other contractual rights or obligations within the scope of other ASC topics (e.g., ASC 310, *Receivables*);
- d. Guarantees (other than product or service warranties) within the scope of ASC 460, *Guarantees* (entities should see ASC 815, *Derivatives and Hedging*, for guarantees accounted for as derivatives); and
- e. Nonmonetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers. (For example, ASC 606 would not apply to a contract between two oil companies that agree to an exchange of oil to fulfill demand from their customers in different specified locations on a timely basis.)

For a contract with a customer which falls partially within the scope of ASC 606 and partially within the scope of other ASC topics, for example, a lease with a service contract, if the other topics specify how to separate and/or initially measure parts of a contract, an entity should first apply those topics. In other words, the more specific topic would take precedence in accounting for a part of a contract, and any residual consideration should be allocated to the part(s) of the contract within the scope of that topic.

C. ASC 606 objectives

1. SAB No. 101 and related industry-specific revenue recognition guidance

SEC Staff Accounting Bulletin No. 101 (SAB No. 101) was the primary guidance for entities to follow with regard to recognizing revenue from its original release in 1999. SAB No. 101 established the following four criteria to be met in order for entities to recognize revenue:

- a. Persuasive evidence of an arrangement exists;
- b. Delivery has occurred, or services have been rendered;
- c. The seller's price to the buyer is fixed or determinable; and
- d. Collectability is reasonably assured.

While the spirit of these four requirements has been retained in ASC 606's five-step model, there are nonetheless some significant changes in ASC 606 from SAB No. 101. For instance, the requirement for the selling price to be fixed and determinable has been modified to allow for the consideration of variable consideration, thus allowing a potential acceleration in the recognition of revenue in some instances. Further, consideration of collectability is now considered in determining whether an entity has entered into a valid contract or not.

Further, ASC 606 replaced the various industry-specific accounting guidance with one model. While incorporating many features of the industry-specific guidance into its principle-based model, ASC 606 eliminated such guidance as AICPA Statements of Positions (SOP) Nos. 81-1 and 97-2, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*, and *Software Revenue Recognition*, respectively.

2. Transfer of control

ASC 606 uses the concept of transfer of control as its criteria to determine the time when revenue should be recognized. ASC 606 details several indicators of passage of control, including the transfer of the risks and rewards of ownership to the customer. However, these are indicators and not specific steps to be achieved, with an entity not needing to achieve all of the indicators in order to determine that control has passed. In assessing these principles-based criteria, entities may determine that they meet this passage of control threshold at a time that is different than under their current assessment.

3. Unit of account

Under ASC 606, revenue is recognized at the unit of account level, which the guidance defines as a performance obligation. The determination of a performance obligation is based on the concept of distinctiveness. We will explore this definition a bit later in the chapter.

Related to the unit of account topic is the question of allocation of transaction price. Ultimately, the transaction price needs to be allocated to each unit of account or performance obligation. If an entity's unit of account changes, then its allocation of the transaction price to that unit of account will likely change as well, resulting in potential changes to both the amount and timing of revenue recognition as an entity performs on a contract.

4. Enhanced disclosures

ASC 606 requires entities to disclose significantly more information concerning their revenue transactions than under legacy accounting guidance. While there are many disclosures entities must make, with certain variations for nonpublic entities, one of the most significant deals with the disclosure of revenue on

a disaggregated basis. ASC 606 provides no specific format for this disclosure, so it is at the entity's discretion as to how they will comply with this requirement. Given the sensitivity of revenue information, as well as the impact that this information may have on readers of financial statements, entities should take appropriate time and effort in determining the nature of this disclosure. Though nonpublic entities do not need to disclose this information in a quantitative format, they should nonetheless give similar consideration to how they will be disclosing this qualitative information.

ASC 606 has significant required quantitative and qualitative disclosures related to revenue. The following are required disclosures under ASC 606:

- a. Revenue recognized from contracts with customers, separately from other sources of revenue;
- b. Impairment losses recognized on receivables or contract assets arising from contracts with customers, separately from impairment losses from other contracts;
- c. Disaggregation of revenue (may be qualitative for nonpublic entities);
- d. Contract balances (nonpublic entities may omit);
- e. Performance obligations; and
- f. Transaction price allocated to remaining performance obligations (nonpublic entities may omit).

ASC 606 provides additional guidance on some of these disclosures as well as some optionality related to the disclosure of variable transaction price related to remaining performance obligations. However, when such optionality or practical expediciencies exist, they require the user to make other related qualitative disclosures.

5. Key terms addressed by ASC 606

The FASB added the following terms to the ASC master glossary as a result of the addition of ASC 606:

- a. **Contract** – An agreement between two or more parties that creates enforceable rights and obligations.
- b. **Contract asset** – An entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time (for example, the entity's future performance).
- c. **Contract liability** – An entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or the amount is due) from the customer.
- d. **Customer** – A party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.
- e. **Receivable** – The right to receive payment.
- f. **Performance obligation** – 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 or a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.
- g. **Revenue** – Inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.
- h. **Standalone selling price** – The price at which an entity would sell a promised good or service separately to a customer.

- i. **Transaction price** – The amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties.

D. Test yourself #1

How would you describe your clients' understanding of ASC 606?

- A. They know how to report revenue in the financial statements and understand the financial disclosure reporting requirements.
- B. They only understand how to report revenue in the financial statements.
- C. They only understand the disclosure requirements.
- D. They require significant adjusting entries and significant help describing the revenue recognition process for purposes of financial statement disclosure.

There is no correct answer to this question.

II. The five-step revenue recognition model

ASC 606 outlines a five-step revenue recognition model:

- Step 1: Identify the contract(s) 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.

With this as a background, let us begin our review of the five-step revenue recognition model found in ASC 606.

A. Step 1 – Identify the contract(s) with a customer

The FASB's definition of a contract is based on the common legal definitions of a contract in the United States and emphasizes that a contract exists when an agreement between two or more parties creates enforceable rights and obligations between those parties. Enforceability of the rights and obligations in a contract is a matter of law, and it is important to note that an agreement does not have to be in writing to be a contract. Whether the agreed-upon terms are written, oral, or evidenced otherwise (for example, by electronic assent), a contract exists if the agreement creates rights and obligations that are enforceable against the parties.

Conversely, a contract does not exist if each party to the contract has the unilateral enforceable right to terminate a wholly unperformed contract without compensating the other party (or parties) or the collectability threshold discussed below is not met. A contract is wholly unperformed if the entity has not yet transferred any promised goods or services to the customer and the entity has not yet received, and is not yet entitled to receive, any consideration in exchange for promised goods or services.

Legalese aside, in accordance with ASC 606, an entity can only apply the revenue recognition model to a contract if all of the following criteria are met:

- a. The parties have approved the contract (in writing, orally, or in accordance with other customary business practices) and are committed to fulfilling their respective obligations.
- b. The entity can identify each party's rights regarding the goods/services to be transferred.
- c. The entity can identify the payment terms for the goods/services to be transferred.
- d. The contract has commercial substance (that is, the risk, timing, or amount of the entity's future cash flows is expected to change as a result of the contract).
- e. It is probable that the entity will collect the consideration to which it will be entitled in exchange for the goods/services that will be transferred to the customer.

If an agreement with a customer meets the above criteria at inception, an entity should not reassess the criteria unless there is an indication of a significant change in facts and circumstances, for example, if a customer's ability to pay the consideration deteriorates significantly. If that were the case, the entity would reassess whether it is probable that it will collect the consideration to which it will be entitled in exchange for the remaining goods or services that will be transferred to the customer. The word *remaining* here is important because it indicates that a reassessment of the criteria would only be applied to those rights and obligations that have not yet transferred. That is, an entity would not include in the reassessment (and therefore would not reverse) any receivables, revenue or contract assets already recognized. If an agreement with a customer does **not** meet the above criteria, an entity should continue to assess the agreement to determine whether the criteria are subsequently met. If an agreement with a customer does not meet the above criteria and an entity receives consideration from the customer, the entity should recognize the consideration received as revenue only when the entity has no remaining obligations to transfer goods or services to the customer, and all, or substantially all, of the consideration promised by the customer has been received by the entity and is nonrefundable; or the agreement has been terminated, and the consideration received from the customer is nonrefundable.

An entity should recognize the consideration received from a customer as a liability until either of the above events occurs or until the above criteria are subsequently met. Depending on the facts and circumstances relating to the agreement, the liability recognized represents the entity's obligation to either transfer goods or services in the future or refund the consideration received. In either case, the liability should be measured at the amount of consideration received from the customer.

1. Collectability

As entities digested this guidance in ASC 606, the probability of collectability threshold generated many requests for clarification from stakeholders. These requests resulted in the FASB providing further guidance on this concept in ASC 606. We will explore this additional guidance in this section. Here is a comparison of the guidance in ASC 606 to current guidance:

- a. Under old U.S. GAAP, the collectability of consideration must be reasonably assured for revenue to be recognized.
- b. Under ASC 606, collectability is not considered in the transaction price, but it is a factor when determining whether a valid contract exists.

The ASC's master glossary defines probable as a future event or events that are likely to occur. So, using this definition, to have a contract, it must be likely to occur that substantially all of the consideration will be collected. Under ASC 606, no revenue could be recognized if there is not a valid contract.

Some stakeholders narrowly interpreted the guidance related to collectability in a manner that would result in more contracts than the board intended not meeting the collectability criterion. In response to this feedback, the FASB clarified the objective of the collectability criterion in Step 1. This Update states that the objective of the collectability assessment is to determine whether the contract is valid and represents a substantive transaction on the basis of whether a customer has the ability and intention to pay the promised consideration in exchange for the goods or services that will be transferred to the customer. The FASB also added additional guidance to ASC 606 via this Update that stated that the assessment **does not** need to consider the customer's ability and intent to pay the **entire** amount of the consideration for entire duration of the contract, only that which related to the goods or services expected to be transferred.

The entity should look to the contractual terms and its customary business practices to see if its credit risk is less than the entire amount of consideration promised in the contract. For example, the payment terms of the contract may require the customer to pay for the good or service before its delivery; or the entity may have the ability to stop transferring the promised goods or services in the event that the customer fails to pay. Accordingly, in each of these situations, the entity's credit risk would be less than the entire amount of promised consideration in the contract. In the instance of the latter, the entity should assess the collectability of the consideration to which it is entitled only for the goods or services that the customer has the right to receive or that the customer would receive under the entity's customary business practices.

With this clarified guidance, it is clear that the goal of the FASB is to only prevent revenue from being recognized on contracts that lack true substance.

Further, if a contract fails to meet the collectability criterion at contract inception, an entity should continue to assess the contract to determine whether that criterion is subsequently met. If the criterion is not subsequently met, an entity only recognizes any consideration it received as revenue when one of the criteria in paragraph 606-10-25-7 has been met. The two criteria in the original standard are:

- a. When the entity has no remaining obligations to transfer goods or services to the customer, and all, or substantially all, of the consideration promised by the customer has been received by the entity and is nonrefundable; or
- b. The agreement has been terminated, and the consideration received from the customer is nonrefundable.

Additionally, some stakeholders expressed the view that it is unclear when these two criteria would be met for certain arrangements.

To help clarify the criteria for recognizing revenue when the collectability threshold is not met at contract inception, the FASB added a third criteria to the two presented above that allows an entity to recognize revenue in the amount of consideration received. When the entity has transferred control of the goods or services to which the consideration that it has received relates, it can recognize that consideration as revenue if all of the following conditions are met:

- a. It has stopped transferring goods or services (if applicable);
- b. It has no obligation under the contract to transfer additional goods or services; and
- c. The consideration received from the customer is nonrefundable.

Essentially, an entity can record revenue on amounts received for already transferred goods if the amount is nonrefundable and it has stopped transferring the good or service and is not required to transfer additional goods or services.

Example: Collectability of the consideration

In this example, an entity, a service provider, enters into a three-year service contract with a new customer of low credit quality at the beginning of a calendar month. The transaction price of the contract is \$720, and \$20 is due at the end of each month. The standalone selling price of the monthly service is \$20. Both parties are subject to termination penalties if the contract is canceled.

The entity's history with this class of customer indicates that while the entity cannot conclude it is probable the customer will pay the transaction price of \$720, the customer is expected to make the payments required under the contract for at least nine months. However, if, during the contract term, the customer stops making the required payments, the entity's customary business practice is to limit its credit risk by not transferring further services to the customer and pursuing collection for the unpaid services.

In assessing whether the contract meets the collectability criteria for determining whether a valid contract exists, the entity would assess whether it is probable that the entity will collect substantially all of the consideration to which it will be entitled in exchange for the services that will be transferred to the customer. This includes assessing the entity's history with this class of customer and its business practice of stopping service in response to customer nonpayment. Consequently, as part of this analysis, the entity does not consider the likelihood of payment for services that would not be provided in the event of the customer's nonpayment because the entity is not exposed to credit risk for those services.

It is not probable that the entity will collect the entire transaction price (\$720) because of the customer's low credit rating. However, the entity's exposure to credit risk is mitigated because the entity has the ability and intention (as evidenced by its customary business practice) to stop providing services if the customer does not pay the promised consideration for services provided when it is due. Therefore, the entity concludes that the contract meets the collectability criterion of Step 1 of the model because it is probable that the customer will pay substantially all of the consideration to which the entity is entitled for the services that the entity will transfer to the customer (that is, for the services the entity will provide for as long as the customer continues to pay for the services provided).

Consequently, assuming the other four criteria for a valid contract are met, the entity would apply the remaining guidance in this topic to recognize revenue and only reassess those criteria if there is an indication of a significant change in facts or circumstances such as the customer not making its required payments.

ASC 606 contains other examples that help to clarify this guidance.

2. Portfolio approach

Although ASC 606 specifies the accounting required for an individual contract, it does include the following practical expedient that allows an entity to use a portfolio approach to apply the guidance:

As a practical expedient, an entity may apply this guidance to a portfolio of contracts (or performance obligations) with similar characteristics if the entity reasonably expects that the effects on the financial statements of applying this guidance to the portfolio would not differ materially from applying this guidance to the individual contracts (or performance obligations) within that portfolio. When accounting for a portfolio, an entity should use estimates and assumptions that reflect the size and composition of the portfolio.

Of course, an entity will need to apply judgment in selecting the size and composition of the portfolio in such a way that the entity reasonably expects that application of the revenue recognition model to the portfolio would not differ materially from the application of the revenue recognition model to the individual contracts or performance obligations in that portfolio.

However, this is not to say that an entity has to quantitatively evaluate each outcome; that is not the FASB's intention, rather, the entity should take a reasonable approach to determine the portfolios that would be appropriate for its types of contracts.

The portfolio approach may be particularly useful in some industries where entities have a large number of similar contracts and applying revenue recognition model under ASC 606 separately for each contract might be impractical. For example, entities in the telecommunications and cable TV industries are characterized as having a high volume of contracts with various potential configurations; providing multiple goods and services in those contracts; including a discount in the contracts; and providing the goods or services at different times. Because of this, implementing an accounting system to determine the standalone selling price for the promised goods or services in each contract and, in turn, allocating the transaction price to the performance obligations identified in that contract would certainly be quite complex and costly.

Example: Portfolio approach

ABC Inc. enters into 100 contracts with local homeowners to provide seasoned oak firewood for the upcoming winter.

Each contract includes the sale of one chord of firewood for \$150 (100 total chords × \$150 = \$15,000 total consideration). Cash is received when control of the firewood transfers.

ABC Inc.'s customary business practice is to not allow a customer to return any unused firewood.

ABC Inc. applies ASC 606 to the portfolio of 100 contracts because it reasonably expects that the effects on the financial statements from applying the guidance to the portfolio would not differ materially from applying the guidance to the individual contracts within the portfolio.

3. Combining contracts

In accordance with ASC 606, an entity should combine two or more contracts entered into at or near the same time with the same customer (or related parties of the customer) and account for the contracts as a single contract if one or more of the following criteria are met:

- a. The contracts are negotiated as a package with a single commercial objective.
- b. The amount of consideration to be paid in one contract depends on the price or performance of the other contract.
- c. The goods or services promised in the contracts (or some of the goods or services promised in each of the contracts) are a single performance obligation.

In determining whether contracts have been entered into at or near the same time, an entity should apply judgment, keeping in mind that the longer the period between the commitments of the parties to the contracts, the more likely it is that the economic circumstances affecting the negotiations have changed.

4. Contract modifications

A contract modification is a change in the scope or price (or both) of a contract that is approved by the parties to the contract (often described as a change order, variation, or amendment to the contract).

A contract modification exists when the parties to a contract approve a modification that either creates new or changes existing enforceable rights and obligations of the parties to the contract, and can be approved in writing, by oral agreement, or implied by customary business practices.

If the parties to the contract have **not** approved a contract modification, an entity should continue to apply the guidance in ASC 606 to the existing contract until the contract modification is approved.

It is important to note that a contract modification may exist even though the parties to the contract have a dispute about the scope or price (or both) of the modification or the parties have approved a change in the scope of the contract but have not yet determined the corresponding change in price. In determining whether the rights and obligations that are created or changed by a modification are enforceable, an entity should consider all relevant facts and circumstances including the terms of the contract and other evidence.

If the parties to a contract have approved a change in the scope of the contract but have not yet determined the corresponding change in price, an entity should estimate the change to the transaction price arising from the modification in accordance with the guidance on estimating variable consideration and on constraining estimates of variable consideration.

An entity should account for a contract modification as a separate contract if:

- a. The scope of the contract increases because of the addition of promised goods or services that are distinct; and
- b. The price of the contract increases by an amount of consideration that reflects the entity's standalone selling prices of the additional promised goods or services and appropriate adjustments to that price to reflect the circumstances of the particular contract. For example, an entity adjusts the standalone selling price of an additional good or service for a discount the customer receives because the entity does not incur the selling-related costs that it would incur when selling a similar good or service to a new customer.

If a contract modification is **not** accounted for as a separate contract, an entity should account for the promised goods or services not yet transferred at the date of the contract modification (that is, the remaining promised goods or services) in whichever of the following ways is applicable.

If the remaining goods or services are distinct from the goods or services transferred on or before the date of the contract modification, the entity should account for the contract modification as if it were a termination of the existing contract, and the creation of a new contract. The amount of consideration to be allocated to the remaining performance obligations (or to the remaining distinct goods or services in a single performance obligation) is the sum of:

- a. The consideration promised by the customer (including amounts already received from the customer) that was included in the estimate of the transaction price and that had not been recognized as revenue; and
- b. The consideration promised as part of the contract modification.

If the remaining goods or services are not distinct and, therefore, form part of a single performance obligation that is partially satisfied at the date of the contract modification, the entity should account for the contract modification as if it were a part of the existing contract. The effect that the contract modification has on the transaction price, and on the entity's measure of progress toward complete satisfaction of the performance obligation, is recognized as an adjustment to revenue either as an increase in or a reduction of revenue at the date of the contract modification, that is, the adjustment to revenue is made on a cumulative catch-up basis.

If the remaining goods or services are a combination of the above two items, the entity should account for the effects of the modification on the unsatisfied (including partially unsatisfied) performance obligations in the modified contract in a manner that is consistent with the objectives of the contract modifications guidance discussed above.

Example: *Modification of a contract for goods – Price reflects standalone selling price*

An entity promises to sell 120 products to a customer for \$12,000 (\$100 per product). The products are transferred to the customer over a six-month period. The entity transfers control of each product at a point in time.

After the entity has transferred control of 60 products to the customer, the contract is modified to require delivery of an additional 30 products (a total of 150 identical products) to the customer. The additional 30 products were not included in the initial contract.

When the contract is modified, the price of the contract modification for the additional 30 products is an additional \$2,850, or \$95 per product. The pricing for the additional products reflects the standalone selling price of the products at the time of the contract modification, and the additional products are distinct from the original products. Therefore, the contract modification for the additional 30 products is, in effect, a new and separate contract for future products that does not affect the accounting for the existing contract. The entity recognizes revenue of \$100 per product for the 120 products in the original contract and \$95 per product for the 30 products in the new contract.

Example: *Modification of a contract for goods – Price does not reflect standalone selling price*

Assume the same facts as the example above except during the process of negotiating the purchase of an additional 30 products, the parties initially agreed on a price of \$80 per product. However, the customer discovers that the initial 60 products transferred to the customer contained minor defects that were unique to those delivered products. The entity promises a partial credit of \$15 per product to compensate the customer for the poor quality of those products.

The entity and the customer agree to incorporate the credit of \$900 (\$15 credit × 60 products) into the price that the entity charges for the additional 30 products. Consequently, the contract modification specifies that the price of the additional 30 products is \$1,500 or \$50 per product. That price comprises the agreed-upon price for the additional 30 products of \$2,400, or \$80 per product, less the credit of \$900.

At the time of modification, the entity recognizes the \$900 as a reduction of the transaction price and, therefore, as a reduction of revenue for the initial 60 products transferred.

In accounting for the sale of the additional 30 products, the entity determines that the negotiated price of \$80 per product does not reflect the standalone selling price of the additional products.

Therefore, the contract modification does not meet the conditions to be accounted for as a separate contract because the remaining products to be delivered are distinct from those already transferred, and so the entity accounts for the modification as a termination of the original contract and the creation of a new contract.

As such, the amount recognized as revenue for each of the remaining products is a blended price of \$93.33 [(\$100 × 60 products not yet transferred under the original contract) + (\$80 × 30 products to be transferred under the contract modification)] ÷ 90 remaining products}.

B. Step 2 – Identify the performance obligations in the contract

Entities face many different types of obligations in their day-to-day business activities. As such, the FASB decided to specifically define a performance obligation in the new revenue recognition guidance as a promise in a contract with a customer to transfer to the customer either:

- a. A good or service (or a bundle of goods or services) that is **distinct**; or
- b. A **series of distinct goods** or services that are substantially the same and that have the same pattern of transfer to the customer.

1. Implicit promises in contracts with customers

Contracts with customers typically state the goods or services an entity promises to transfer to a customer.

However, performance obligations identified in a contract with a customer may not always be limited to the goods or services explicitly stated in that contract.

Promises implied by an entity's customary business practices, published policies, or specific statements at the time of entering into the contract can also create a valid expectation by the customer that the entity will transfer goods or services to the customer.

Example: ***Implicit promise of providing a “free” service***

An entity has historically provided maintenance services for no additional consideration (that is, “free”) to end customers that purchase the entity's product from the distributor.

The entity does not explicitly promise maintenance services during negotiations with the distributor, and the final contract between the entity and the distributor does not specify terms or conditions for those services. However, on the basis of its customary business practice, the entity determines at contract inception that it has made an implicit promise to provide maintenance services as part of the negotiated exchange with the distributor. That is, the entity's past practices of providing these services create valid expectations of the entity's customers (the distributor and end customers).

As such, the entity identifies the promise of maintenance services as a performance obligation to which it allocates a portion of the transaction price.

2. Distinct goods and services

A good or service that is promised to a customer is distinct if both of the following criteria are met:

- a. 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). For example, if an entity transferred a machine to the customer but the machine is only capable of providing a benefit to the customer after an installation process that only the entity can provide, the machine would not be distinct; and
- b. The entity's promise to transfer the goods or service to the customer is separately identifiable from other promises in the contract (that is, the good or service is distinct within the context of the contract).

In some cases, even though the individual goods or services promised as a bundle of goods or services might be capable of being distinct, those goods or services should not be accounted for separately because it would not result in a faithful depiction of the entity's performance in that contract. For example, many construction- and production-type contracts involve transferring to the customer various goods and services that are capable of being distinct, such as building materials, labor, and project management services.

However, identifying all of those individual goods and services as separate performance obligations would be impractical and, more importantly, it would neither faithfully represent the nature of the entity's promise to the customer nor result in a useful depiction of the entity's performance.

This is because it would result in an entity recognizing and measuring revenue when the materials and other inputs to the construction or production process are provided, instead of recognizing and measuring revenue when the entity performs (and uses those inputs) in the construction or production of the item (or items) for which the customer has contracted. So, when identifying whether goods or services are distinct, an entity should not only consider the characteristics of an individual good or service but should also consider whether the promise to transfer the good or service is separately identifiable, that is, distinct within the context of the contract.

ASC 606 provides further guidance on the objective of the concept of distinctiveness. Specifically, the guidance now reads that the objective is to determine whether the nature of the promise, within the context of the contract, is to transfer each of those goods or services individually or, instead, to transfer a combined item or items to which the promised goods or services are inputs.

ASC 606 also revised the related factors and examples to align with the improved articulation of the separately identifiable principle. The updated guidance now lists the following factors to aid in this assessment:

- a. The entity provides a significant service of integrating the goods or services with other goods or services promised in the contract into a bundle of goods or services that represent the combined output or outputs for which the customer has contracted. In other words, the entity is using the goods or services as inputs to produce or deliver the combined output or outputs specified by the customer. A combined output or outputs might include more than one phase, element, or unit.
- b. One or more of the goods or services significantly modifies or customizes, or are significantly modified or customized by, one or more of the other goods or services promised in the contract.

- c. The goods or services are highly interdependent or highly interrelated. In other words, each of the goods or services is significantly affected by one or more of the other goods or services in the contract. For example, in some cases, two or more goods or services are significantly affected by each other because the entity would not be able to fulfill its promise by transferring each of the goods or services independently.

If a promised good or service is not distinct, an entity should combine that good or service with other promised goods or services until it identifies a bundle of goods or services that is distinct. In some cases, that would result in the entity accounting for all the goods or services promised in a contract as a single performance obligation.

3. A series of distinct goods or services

A promise to transfer a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer would be a single performance obligation if both of the following criteria are met:

- a. Each distinct good or service in the series that the entity promises to transfer to the customer meets any of the following criteria and thus considered to be a performance obligation satisfied over time:
 - (i) The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs (for example, cleaning service).
 - (ii) The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced (for example, work in process).
 - (iii) The entity's performance does not create an asset with an alternative use to the entity (For example, an asset with design specifications that are unique to a customer), and the entity has an enforceable right to payment for performance completed to date (for example, recovery of the costs incurred by an entity in satisfying the performance obligation plus a reasonable profit margin).
- b. The same method would be used to measure the entity's progress toward complete satisfaction of the performance obligation to transfer each distinct good or service in the series to the customer.

Examples of such arrangements would represent subscription-based services, where each good or service offered is essentially identical, as well as services frequently offered by software as a service (SaaS) providers and outsourced service providers, such as transaction processors.

Entities must use judgment in determining whether offered goods or services represent an identical good or service, such as a help desk or R&D arrangement, where the promise to the customer is access that is provided daily, or a promise which is distinct. In the former, the above criteria would apply, whereby in the latter, each offering of the good or service would be a distinct promise and a separate performance obligation.

Example: Goods and services are not distinct

An entity, a contractor, enters into a contract to build a hospital for a customer. The entity is responsible for the overall management of the project and identifies various goods and services to be provided, including engineering, site clearance, foundation, procurement, construction of the structure, piping and wiring, installation of equipment, and finishing.

The promised goods and services are **capable of being distinct**; that is, the customer can benefit from the goods and services either on their own or together with other readily available resources. This is evidenced by the fact that the entity, or competitors of the entity, regularly sells many of these goods and services separately to other customers. In addition, the customer could generate economic benefit from the individual goods and services by using, consuming, selling, or holding those goods or services.

However, the goods and services are **not distinct within the context of the contract**; that is, the entity's promise to transfer individual goods and services in the contract are not separately identifiable from other promises in the contract. This is evidenced by the fact that the entity provides a significant service of integrating the goods and services (the inputs) into the hospital (the combined output) for which the customer has contracted. As such, the entity accounts for all of the goods and services in the contract as a single performance obligation.

Example: *Determining whether goods or services are distinct*

An entity, a software developer, enters into a contract with a customer to transfer a software license, perform an installation service, and provide unspecified software updates and technical support (online and telephone) for a two-year period. The entity sells the license, installation service, and technical support separately.

The installation service includes changing the web screen for each type of user (for example, marketing, inventory management, and information technology). The installation service is routinely performed by other entities and does not significantly modify the software. The software remains functional without the updates and the technical support.

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct. The entity notes that the software is delivered before the other goods and services and remains functional without the updates and the technical support. Thus, the entity concludes that the customer can benefit from each of the goods and services either on their own or together with the other goods and services that are readily available.

The entity also considers additional factors and determines that the promise to transfer each good and service to the customer is separately identifiable from each of the other promises. In particular, the entity notes that the installation service does not significantly modify or customize the software itself, and, as such, the software and the installation service are separate outputs promised by the entity instead of inputs used to produce a combined output.

On the basis of this assessment, the entity identifies four performance obligations in the contract for the following goods or services:

- a. The software license;
- b. An installation service;
- c. Software updates; and
- d. Technical support.

Next, the entity would determine whether each of the performance obligations for the installation service, software updates, and technical support are satisfied at a point in time or over time, and also assesses the nature of the entity's promise to transfer the software license in accordance with ASC 606.

Example: Determining whether goods or services are distinct – Substantial customization

Assume that the promised goods and services are the same as above, but the contract specifies that, as part of the installation service, the **software is to be substantially customized** to add significant new functionality to enable the software to interface with other customized software applications used by the customer. Also assume that the customized installation service can be provided by other entities.

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct. The entity notes that the terms of the contract result in a promise to provide a significant service of integrating the licensed software into the existing software system by performing a customized installation service as specified in the contract. In other words, the entity is using the license and the customized installation service as inputs to produce the combined output (that is, a functional and integrated software system) specified in the contract. In addition, the software is significantly modified and customized by the service.

Although the customized installation service can be provided by other entities, the entity determines that within the context of the contract, the promise to transfer the license is not separately identifiable from the customized installation service. Therefore, the software license and the customized installation service are not distinct. As above, the entity concludes that the software updates and technical support are distinct from the other promises in the contract.

This is because the customer can benefit from the updates and technical support either on their own or together with the other goods and services that are readily available and because the promise to transfer the software updates and the technical support to the customer are separately identifiable from each of the other promises.

On the basis of this assessment, the entity identifies three performance obligations in the contract for the following goods or services:

- a. Customized installation service (that includes the software license);
- b. Software updates; and
- c. Technical support.

Next, the entity would determine whether each performance obligation is satisfied at a point in time or over time.

4. Licenses

Given the number of complex arrangements which entities enter into, it may be challenging to identify all performance obligations in a contract, as well as determine when control passes to the customer. One such area relates to licenses.

While providing guidance on accounting for license arrangements in ASC 606, stakeholders nonetheless requested further information in applying this guidance.

In response, the FASB further defined license arrangements in ASC 606 as follows:

- a. **Functional intellectual property** – Intellectual property that has significant standalone functionality (for example, the ability to process a transaction, perform a function or task, or be played or aired). Functional intellectual property derives a substantial portion of its utility (that is, its ability to provide benefit or value) from its significant standalone functionality. Revenue for licenses of functional intellectual property would be recognized when access to the license is granted.
- b. **Symbolic intellectual property** – Intellectual property that is not functional intellectual property (that is, intellectual property that does not have significant standalone functionality). Because symbolic intellectual property does not have significant standalone functionality, substantially all of the utility of symbolic intellectual property is derived from its association with the entity's past or ongoing activities, including its ordinary business activities. Revenue for licenses of symbolic intellectual property would be recognized over the period of the license.

Lastly, some licenses contain sale and usage royalty payment provisions. In such instances, the revenue on such licenses would be recognized as the royalty earned, even if the underlying license is one for functional intellectual property.

5. Options that grant a material right

Entities generally would not account for options until they are exercised. However, certain options that grant a material right to a customer should be considered as separate performance obligations, with a portion of the transaction price allocated to them and recognized when the option is exercised.

ASC 606 defines a material right as an option which provides a material right to the customer that it would not have received without entering into the contract. For example, offering a discount on future purchases over and above one offered to all customers would be considered a material right. Additionally, offering a free item when a customer purchases other products would be another example of an option granting a material right.

Key to accounting for such options is to determine the standalone selling price of the option. This may be relatively easy in some instances or more difficult in others, depending on the amount of objective evidence of standalone selling price that exists for the good or service. As with all such allocations, you should start with any observable evidence of standalone selling price. However, the standalone selling price will often need to be estimated. The estimate should reflect both the discount that the customer would obtain when exercising the option, adjusted for any discount that the customer could have received without exercising the option and the likelihood that the option will be exercised.

Example: Following a sale of \$1,000, a retailer offers customers a 50 percent discount on its next purchase from the retailer that occurs over the next 60 days. The retailer offers all consumers a 10 percent discount for all purchases. The retailer assumes that 75 percent of the recipients of the 50 percent discount coupon will use it, with their expected purchase subject to the discount being \$200.

In this instance, the incremental discount would be 40 percent, the 50 percent discount offered less than the 10 percent offered to the general public.

The estimated discount per coupon holder would be \$60, determined as follows:

Purchases subject to 50 percent discount	\$200
Incremental discount of 40 percent	\$80
Estimated percent of customers utilizing discount	75%
Estimated discount per customer	\$60

Accordingly, the standalone selling price of the option would be \$60. The original \$1,000 selling price, would need to be allocated between the original purchase of \$1,000 and standalone selling price of the option of \$60, as follows:

Revenue allocated toward original purchase	$\$1,000 \times 1000 \div (1,000 + 60) = \943
Revenue allocated toward option	$\$1,000 \times 60 \div (1,000 + 60) = \57

The amount of \$57 allocated to the option would be deferred as it is allocated toward the performance obligation of the expected future purchase. This amount would be recognized when the 50 percent coupon is exercised or when the coupon expires.

A similar methodology would be followed when a free product is offered to the customer as well.

Example:

A member enters into a contract with a trade association and receives a benefit that is considered a material right along with other bundled benefits. The fair value of the bundled benefits is \$200, which is the contract price.

The member gets a 30 percent discount on continuing education purchases during the membership period. Nonmembers do not get the discount. The controller estimated the average amount of additional purchase members make during the year at \$150 and the probability of using the discount at 45 percent.

The material benefit is worth \$20.25 over and above the contract price.

The material benefit portion is recognized as the member takes the CPE. If the member does not take the CPE, then revenue is recognized when the obligation expires (at the end of the contract). The revenue related to the bundled benefits is recognized over the period of the contract.

Value of incremental purchase	\$150.00
Likelihood	0.45
Discount	<u>0.30</u>
Value of discount	20.25

Contract price	91%	\$200.00
Value of discount	9%	<u>\$ 20.25</u>
		\$220.25

Proportion of discount	0.091941
Contract price	200
Value of discount	<u>\$ 18.39</u>
Value of other services	181.61

C. Step 3 – Determine the transaction price

The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, sales taxes). An entity should consider the terms of the contract and its customary business practices to determine the transaction price and should assume that the goods or services will be transferred to the customer as promised in accordance with the existing contract and that the contract will not be canceled, renewed, or modified.

The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or both.

It is important to note here that the transaction price should only include amounts to which the entity has rights under the current contract; which is to say, the transaction price does not include estimates of consideration from the future exercise of options for additional goods or services or from future change orders. Until the customer exercises the option or agrees to the change order, the entity does not have a right to consideration. In addition, the amounts to which the entity has rights under the current contract can be paid by any party (that is, not only by the customer). For example, in the healthcare industry, an entity may determine the transaction price based on amounts to which it will be entitled to payment from the patient, insurance companies, and/or governmental organizations. This can also occur in other industries in which an entity receives a payment from a manufacturer as a result of the manufacturer issuing coupons or rebates directly to the entity's customer.

At the end of each reporting period, an entity should update the transaction price, including its assessment of whether an estimate of variable consideration is constrained (discussed below), to faithfully represent the circumstances present at the end of the reporting period and the changes in circumstances during the reporting period. The entity should account for changes in the transaction price by allocating the change to the performance obligations in the contract on the same basis as at contract inception. Amounts allocated to a satisfied performance obligation should be recognized as revenue or as a reduction of revenue in the period in which the transaction price changes.

When determining the transaction price, an entity should consider the effects of all of the following:

- a. Variable consideration;
- b. Constraining estimates of variable consideration;
- c. The existence of a significant financing component in the contract;
- d. Noncash consideration; and
- e. Consideration payable to a customer.

1. Variable consideration

Oftentimes, an amount of consideration in a contract will vary because of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties, or other similar items. The promised consideration can also vary if an entity's entitlement to the consideration is contingent on the occurrence (or nonoccurrence) of a future event. For example, an amount of consideration would be variable if a product were sold with either a right of return or a fixed amount is promised as a performance bonus on achievement of a specified milestone. Variable consideration promised by a customer may be explicitly stated in the contract.

Notwithstanding the terms of a contract, promised consideration is variable if either of the following conditions is true:

- a. The customer has a valid expectation arising from an entity's customary business practices, published policies, or specific statements that the entity will accept an amount of consideration that is less than the price stated in the contract. That is, it is expected that the entity will offer a price concession. Depending on the jurisdiction, industry, or customer this offer may be referred to as a discount, rebate, refund, or credit; or
- b. Other facts and circumstances indicate that the entity's intention, when entering into the contract with the customer, is to offer a price concession to the customer.

An entity should estimate an amount of variable consideration in a contract by using either of the following methods, depending on which method the entity expects to better predict the amount of consideration to which it will be entitled:

- a. **Expected value method** – The expected value is the sum of probability-weighted amounts in a range of possible consideration amounts. An expected value may be an appropriate estimate of the amount of variable consideration if an entity has a large number of contracts with similar characteristics.
- b. **Most likely amount method** – The most likely amount is the single most likely amount in a range of possible consideration amounts, that is, the single most likely outcome of the contract. The most likely amount may be an appropriate estimate of the amount of variable consideration if the contract has only two possible outcomes; for example, an entity either achieves a performance bonus or does not.

An entity should apply either the expected value method or the most likely amount method consistently throughout the contract, and should consider all of the historical, current, and forecasted information that is reasonably available to identify a reasonable number of possible consideration amounts. The information that an entity uses to estimate the amount of variable consideration would typically be similar to the information that the entity's management would use during a bid and proposal process or in establishing prices for promised goods or services.

2. Refund liability

An entity should recognize a refund liability if it receives consideration from a customer and expects to refund some or all of that consideration to the customer. A refund liability is measured at the amount of consideration received or receivable for which the entity does not expect to be entitled, that is, amounts not included in the transaction price.

The refund liability and corresponding change in the transaction price, and therefore the contract liability, should be updated at the end of each reporting period for changes in circumstances.

ASC 606 includes application guidance covering the accounting for a refund liability relating to a sale with a right of return.

3. Constraining estimates of variable consideration

The FASB decided that in order to provide useful information to financial statement users, some estimates of variable consideration should **not** be included in the transaction price. This would be the case if the estimate is too uncertain and therefore may not faithfully depict the consideration to which the entity will be entitled in exchange for the goods or services transferred to the customer.

What this means is that an entity should only include in the transaction price an amount of variable consideration estimated to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

4. The existence of a significant financing component in the contract

In determining the transaction price, an entity should adjust the promised amount of consideration for the effects of the time value of money if the timing of payments agreed to by the parties to the contract (either explicitly or implicitly) provides the customer or the entity with a significant benefit of financing the transfer of goods or services to the customer. Note that the period of time for consideration is not the term of the contract but rather the time between delivery of the good or service and the customer's payment for the good or service.

Notice that the focus here is on whether the payment terms provide the customer or the entity with a significant benefit of financing. That is, an entity should only adjust for financing if the timing of payments specified in the contract provides the customer or the entity with a significant benefit of financing.

This is because although there may be a significant period of time between the transfer of the goods or services and the payment, the reason for that timing difference may not be related to a financing arrangement between the entity and the customer.

An entity should consider all relevant facts and circumstances in assessing whether a contract contains a financing component and whether that financing component is significant to the contract, including:

- a. The difference, if any, between the amount of promised consideration and the cash selling price of the promised goods or services; and
- b. The combined effect of both of the following:
 - (i) The expected length of time between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services; and
 - (ii) The prevailing interest rates in the relevant market.

Example: Significant financing component

A three-year gym membership is \$3,000 upfront (or \$110 per month). Membership is a single obligation satisfied ratably over a three-year period

The difference between the cash selling price and the monthly payment plan is a significant financing component. The discount rate reflected in a separate financing transaction is 5 percent.

Monthly revenue is \$89.91, calculated as follows:

PMT			
Rate	5% / 12	↑	= 0.004166667
Nper	36	↑	= 36
Pv	3000	↑	= 3000
Fv		↑	= number
Type		↑	= number
			= -89.91269131

On the other hand, a contract with a customer would not have a significant financing component if:

- a. The customer paid for the goods or services in advance, and the timing of the transfer of those goods or services is at the discretion of the customer;
- b. A substantial amount of the consideration promised by the customer is variable, and the amount or timing of that consideration varies on the basis of the occurrence or nonoccurrence of a future event that is not substantially within the control of the customer or the entity (for example, if the consideration is a sales-based royalty); or
- c. The difference between the promised consideration and the cash selling price of the good or service arises for reasons other than the provision of finance to either the customer or the entity, and the difference between those amounts is proportional to the reason for the difference (for example, “protective” payment terms).

In addition, an entity need not adjust the promised amount of consideration for the effects of a significant financing component if the entity expects, at contract inception, that the period between when the entity transfers a promised good or service to a customer and when the customer pays for that good or service will be one year or less.

If a contract does include a significant financing component, an entity should use the discount rate that would be reflected in a separate financing transaction between the entity and its customer at contract inception. That rate would reflect the credit characteristics of the party receiving financing in the contract, as well as any collateral or security provided by the customer or the entity, including assets transferred in the contract. An entity may be able to determine that rate by identifying the rate that discounts the nominal amount of the promised consideration to the price that the customer would pay in cash for the goods or services when (or as) they transfer to the customer. After contract inception, an entity should not update the discount rate for changes in interest rates or other circumstances (such as a change in the assessment of the customer’s credit risk).

Interest income or interest expense should be presented separately from revenue from contracts with customers in the statement of comprehensive income and is recognized only to the extent that a contract asset (or receivable) or a contract liability is recognized in accounting for a contract with a customer.

5. *Noncash consideration*

To determine the transaction price for contracts in which the customer promises consideration in a form other than cash, an entity should measure the noncash consideration, or promise of noncash consideration, at fair value, determined at the date of the contract. If the entity cannot reasonably estimate the fair value of the noncash consideration, it should measure the consideration indirectly by reference to the standalone selling price of the goods or services promised to the customer in exchange for the consideration.

If a customer contributes goods or services, for example, materials, equipment, or labor, to facilitate an entity’s fulfillment of a contract, the entity should assess whether it obtains control of those contributed goods or services. If it does, the entity should account for the contributed goods or services as noncash consideration received from the customer.

6. Consideration payable to a customer

Consideration payable to a customer includes amounts that an entity pays, or expects to pay, to a customer, or to other parties that purchase the entity's goods or services from the customer, in the form of cash, credit, or other items that the customer can apply against amounts owed to the entity.

An entity should account for consideration payable to a customer as a reduction of the transaction price and, therefore, of revenue unless the payment to the customer is in exchange for a distinct good or service that the customer transfers to the entity, in which case the entity should account for the purchase of the good or service in the same way that it accounts for other purchases from suppliers. An example of such an arrangement would be in a cooperative advertisement arrangement where the entity contributes to the cost of an advertisement through a reduction of amounts due to it from its customer. An amount equal to the fair value of comparable advertisement if the entity had separately purchased it would be considered advertising expense and not accounted for as a reduction of revenue.

If consideration payable to a customer is a reduction of the transaction price, an entity should recognize the reduction of revenue when (or as) the later of the entity recognizing revenue for the transfer of the related goods or services to the customer, or the entity paying or promising to pay the consideration (even if the payment is conditional on a future event).

D. Step 4 – Allocate transaction price to performance obligations in the contract

Recall the core principle in revenue recognition guidance under ASC 606 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. What this really means in essence is that an entity should allocate the transaction price to each performance obligation in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for satisfying each performance obligation. (Practical application examples provided below.)

1. Standalone selling price is the key

The standalone selling price at contract inception of the goods or services underlying each performance obligation should be used to allocate the transaction price to each of those performance obligations. The standalone selling price is the price at which the entity would sell the promised goods or services separately to a customer.

Akin to a level 1 input in the fair value hierarchy, the best evidence of a standalone selling price is the observable price of goods or services when the entity sells those goods or services separately in similar circumstances and to similar customers. For example, a contractually stated price or a list price for goods or services may be (but not always) the standalone selling price of those goods or services.

If a standalone selling price is not directly observable, an entity should estimate it by considering all reasonably available information, for example, current market conditions, entity-specific factors, and information about the customer.

Examples of suitable estimation methods (which should be applied consistently for similar circumstances) include:

- a. The adjusted market assessment approach, which uses competitors' prices for similar goods or services and adjusts those prices to reflect the entity's costs and margins;
- b. The expected cost plus a margin approach, which forecasts expected costs of satisfying a performance obligation and adds an appropriate margin for those goods or services; and
- c. The residual approach, which estimates a standalone selling price by reference to the total transaction price less the sum of the observable standalone selling prices of other goods or services promised in the contract.

2. Discounts

If the sum of the standalone selling prices of the promised goods or services in the contract exceeds the transaction price, that is, the customer receives a discount for purchasing a bundle of goods or services, an entity should allocate the discount to all of the performance obligations on a relative standalone selling price basis. However, an entity should allocate a discount entirely to one or more, but not all, performance obligations in the contract if all of the following criteria are met:

- a. The entity regularly sells each distinct good or service (or each bundle of distinct goods or services) in the contract on a standalone basis;
- b. The entity also regularly sells on a standalone basis a bundle (or bundles) of some of those distinct goods or services at a discount to the standalone selling prices of the goods or services in each bundle; and
- c. The discount attributable to each bundle of goods or services described in (b) is substantially the same as the discount in the contract, and an analysis of the goods or services in each bundle provides observable evidence of the performance obligation (or performance obligations) to which the entire discount in the contract belongs.

If a discount is allocated entirely to one or more performance obligations in the contract in accordance with the above, an entity should allocate the discount before using the residual approach to estimate the standalone selling price of a good or service.

3. Allocation of variable consideration

It may not always be appropriate for an entity to allocate the variable consideration in a transaction price to all of the performance obligations in a contract. For example, an entity may contract to provide two products at different times with a bonus that is contingent on the timely delivery of only the second product. In that case, it might be inappropriate to attribute variable consideration included in the transaction price to both products. Similarly, an entity may contract to provide two products at different times with a fixed amount for the first product that represents that product's standalone selling price and a variable amount that is contingent on the delivery of the second product. That variable amount might be excluded from the estimate of the transaction price because of the requirements for constraining estimates of the transaction price (discussed above). In that case, it might be inappropriate to attribute the fixed consideration included in the transaction price to both products.

As such, an entity should allocate a variable amount (and subsequent changes to that amount) entirely to a performance obligation or to a distinct good or service that forms part of a single performance obligation if both the following criteria are met:

- a. The terms of a variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct good or service (or to a specific outcome from satisfying the performance obligation or transferring the distinct good or service) and
- b. Allocating the variable amount of consideration entirely to the performance obligation or the distinct good or service is consistent with the allocation objective to depict the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer when considering all of the performance obligations and payment terms in the contract.

4. Changes in the transaction price

After contract inception, the transaction price can change for a variety of reasons, for example, the resolution of uncertain events. When this happens, the entity should allocate the change to the performance obligations in the contract on the same basis as at contract inception. This ensures that changes in the estimate of variable consideration that are included in (or excluded from) the transaction price are allocated to the performance obligation(s) to which the variable consideration relates.

An entity should allocate a change in the transaction price entirely to one or more distinct goods or services if the above criteria are met.

Amounts allocated to a satisfied performance obligation should be recognized as revenue or as a reduction of revenue in the period in which the transaction price changes; and an entity should not reallocate the transaction price to reflect changes in standalone selling prices after contract inception.

E. Step 5 – Recognize revenue when the entity satisfies a performance obligation

Under the revenue recognition guidance in ASC 606, an entity will recognize revenue when or as it satisfies a performance obligation by transferring promised goods or services to a customer. Transfer occurs when or as the customer obtains control of the goods or services, either at a point in time or over time, as applicable.

Control in this context is defined as the ability to direct the use of and obtain substantially all of the remaining benefits from an asset. Control also includes the ability to prevent other entities from directing the use of and obtaining the benefits from an asset (“defensive control”).

When evaluating whether a customer obtains control of an asset, an entity should consider any agreement to repurchase the asset. An entity would need to assess if such an agreement would negate the passage of control necessary for the recognition of revenue.

Lastly, under ASC 606, an entity should consider if revenue should be recognized over time first and, if not, then assess the point in time when control passes. This consideration may result in a change in the timing of revenue recognition for certain entities if their contracts contain certain provisions which require them to recognize revenue over time under ASC 606. An example would be contract manufacturers that manufacture to customer specifications, which could lead to recognizing revenue over time under ASC 606.

1. Performance obligations satisfied over time

An entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognizes revenue over time, if any of the following criteria are met:

- a. The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs;
- b. The entity's performance creates or enhances an asset (for example, work in process) that the customer controls as the asset is created or enhanced; or
- c. The entity's performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date. The right to payment must include some element of profit, though it does not need to be the negotiated profit percentage in the contract.

An asset created by an entity's performance does not have an alternative use to an entity if the entity is either restricted contractually from readily directing the asset for another use during the creation or enhancement of that asset or limited practically from readily directing the asset in its completed state for another use.

The assessment of whether an asset has an alternative use to the entity is made at contract inception.

After contract inception, an entity should not update the assessment of the alternative use of an asset unless the parties to the contract approve a contract modification that substantively changes the performance obligation.

2. Performance obligations satisfied at a point in time

Performance obligations are satisfied at a point in time when a customer obtains control of a promised asset at a point in time (that is, not over time as discussed below).

To determine the point in time when a customer obtains control of a promised asset and, therefore, the entity satisfies a performance obligation, the entity should consider the definition of control noted above.

In addition, an entity should also consider the following indicators of the transfer of control:

- a. **The entity has a present right to payment for the asset** – If a customer presently is obliged to pay for an asset, then that may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset in exchange.
- b. **The customer has legal title to the asset** – Legal title may indicate which party to a contract has the ability to direct the use of, and obtain substantially all of the remaining benefits from, an asset or to restrict the access of other entities to those benefits. Therefore, the transfer of legal title of an asset may indicate that the customer has obtained control of the asset. If an entity retains legal title solely as protection against the customer's failure to pay, those rights of the entity would not preclude the customer from obtaining control of an asset.

- c. **The entity has transferred physical possession of the asset** – The customer’s physical possession of an asset may indicate that the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset or to restrict the access of other entities to those benefits. However, physical possession may not coincide with control of an asset. For example, in some repurchase agreements and in some consignment arrangements, a customer or consignee may have physical possession of an asset that the entity controls. Conversely, in some bill-and-hold arrangements, the entity may have physical possession of an asset that the customer controls.
- d. **The customer has the significant risks and rewards of ownership of the asset** – The transfer of the significant risks and rewards of ownership of an asset to the customer may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. However, when evaluating the risks and rewards of ownership of a promised asset, an entity should exclude any risks that give rise to a separate performance obligation in addition to the performance obligation to transfer the asset. For example, an entity may have transferred control of an asset to a customer but not yet satisfied an additional performance obligation to provide maintenance services related to the transferred asset.
- e. **The customer has accepted the asset** – The customer’s acceptance of an asset may indicate that it has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset.

3. Measuring progress toward complete satisfaction of a performance obligation

For each performance obligation that an entity satisfies over time, the entity should recognize revenue over time by measuring the progress toward complete satisfaction of that performance obligation.

The objective when measuring progress is to depict the transfer of control of goods or services to the customer, that is, to depict an entity’s performance. In this respect, an entity should include in a measure of progress any goods or services for which the entity transfers control to the customer and exclude any goods or services for which the entity does not transfer control to the customer.

As circumstances change over time, an entity should update its measure of progress to depict the entity’s performance completed to date. Such changes should be accounted for as a change in accounting estimate in accordance with ASC 250, *Accounting Changes and Error Corrections*.

For each performance obligation satisfied over time, an entity should apply a single method of measuring progress that is consistent with the above objective and should apply that method consistently to similar performance obligations and in similar circumstances.

Appropriate methods of measuring progress include output methods and input methods:

- a. **Output methods** recognize revenue on the basis of direct measurements of the value to the customer of the goods or services transferred to date relative to the remaining goods or services promised under the contract and include methods such as surveys of performance completed to date, appraisals of results achieved, milestones reached, time elapsed, and units produced, or units delivered. If an entity has a right to invoice a customer in an amount that corresponds directly with the value to the customer of the entity's performance completed to date, the entity should recognize revenue in the amount that the entity has a right to invoice. Such an arrangement may occur in professional services, where a customer is billed on a time and material basis, based on agreed-upon rates. An entity could recognize revenue based on the amount it bills even if the amounts billed increased, as long as the amounts represented the value of the services provided to a customer. However, a lump-sum billing, even if meant to approximate the value provided to date to a customer would not qualify for this right to invoice exemption.
- b. **Input methods** recognize revenue on the basis of the entity's efforts or inputs in satisfying a performance obligation, for example, costs incurred, relative to the total expected inputs to satisfy that performance obligation. If the entity's efforts or inputs are expended evenly throughout the performance period, it may be appropriate for an entity to recognize revenue on a straight-line basis. Entities that currently record revenue based on achievement of milestones should assure that such milestones represent actual performance on the contract. If not, the entity would need to change to another input or output method.

4. Reasonable measures of progress

An entity should only recognize revenue for a performance obligation satisfied over time if it can reasonably measure its progress toward complete satisfaction of the performance obligation, which requires the entity to have the reliable information required to apply an appropriate method of measuring progress. In some cases, for example, in the early stages of a contract, an entity may not be able to reasonably measure the outcome of a performance obligation but does expect to recover the costs incurred in satisfying the performance obligation. In those circumstances, the entity should recognize revenue only to the extent of the costs incurred until such time that it can reasonably measure the outcome of the performance obligation.

5. Gross vs. net presentation

For each performance obligation within each contract, the entity must determine whether it is a principal in the transaction or whether it is the agent. As a principal, the entity takes control of the good or service it sells and would record revenue gross, along with related costs of sales. However, if the entity does not take control of the underlying good or service, it is essentially acting as an agent in the transaction. As such, it would record only its agent fee as revenue in the transaction.

Example: An entity processes claims for others. It receives a fee for the processing. However, the transactions flow through the entity. This is not the entity's revenue and expenses since the entity is an agent for the other party. Thus, it would recognize fee revenue.

ASC 606 contains numerous examples that illustrate characteristics of both principal and agent relationships, along with examples of characteristics which would indicate control of the good or service.

6. Loss contracts

ASC 606 retains the guidance from previous revenue recognition GAAP in ASC 605 related to loss contracts that requires an entity to recognize the entire anticipated loss on a contract as soon as the loss becomes evident. A determination that a loss contract exists occurs when the anticipated transaction price of the contract, as determined under ASC 606, is less than the contract costs.

Unless contracts are combined under the guidance in ASC 606, the loss is determined at the contract level. However, according to ASC 606, an entity may make an accounting policy election to determine the need for a loss provision on a contract at the performance obligation level. If electing this option, the entity should apply this policy in the same manner for similar types of contracts.

F. Test yourself #2

Which step of the ASC 606 five-step revenue recognition process has caused your clients the greatest challenges in properly recognizing revenue?

- A. Step 1: Identify the contract.
- B. Step 2: Identify performance obligations.
- C. Step 3: Identify the transaction price.
- D. Step 4: Allocate consideration.
- E. Step 5: Recognize revenue.

There is no correct answer to this question.

III. Contract costs

The guidance relating to contract costs can be found in subtopic, ASC 340-40, *Other Assets and Deferred Costs – Contracts with Customers*.

ASC 340-40 provides accounting guidance for the following costs related to a contract with a customer within the scope of ASC 606:

- a. Incremental costs of obtaining a contract with a customer; and
- b. Costs incurred in fulfilling a contract with a customer that are not within the scope of another ASC topic.

A. Incremental costs of obtaining a contract with a customer

Incremental costs of obtaining a contract with a customer are costs an entity incurs that would not have been incurred if the contract had not been obtained, for example, a sales commission.

Incremental costs of obtaining a contract with a customer should be recognized as an asset if the entity expects to recover those costs. However, as a practical expedient, such costs may be expensed as incurred if the amortization period of the asset that the entity otherwise would have recognized is one year or less.

B. Costs incurred in fulfilling a contract with a customer

An entity should recognize an asset for the costs incurred to fulfill a contract only if those costs meet all of the following criteria:

- a. The costs relate directly to a contract or to an anticipated contract that the entity can specifically identify – for example, costs relating to services to be provided under renewal of an existing contract or costs of designing an asset to be transferred under a specific contract that has not yet been approved;
- b. The costs generate or enhance resources of the entity that will be used in satisfying or in continuing to satisfy performance obligations in the future; and
- c. The costs are expected to be recovered.

For costs incurred in fulfilling a contract with a customer that are within the scope of another ASC topic, for example, ASC 330, *Inventory*, an entity should account for those costs in accordance with those other topics (or subtopics, as the case may be).

Costs that relate directly to a contract or a specific anticipated contract include any of the following:

- a. Direct materials, such as supplies used in providing the promised services to a customer;
- b. Direct labor, such as salaries and wages of employees who provide the promised services directly to the customer;
- c. Allocations of costs that relate directly to the contract or to contract activities, such as costs of contract management and supervision, insurance, and depreciation of tools and equipment used in fulfilling the contract (overhead);
- d. Costs that are explicitly chargeable to the customer under the contract; and
- e. Other costs incurred only because an entity entered into the contract (for example, payments to subcontractors).

On the other hand, an entity should recognize the following costs as expenses when incurred:

- a. General and administrative costs (unless those costs are explicitly chargeable to the customer under the contract, in which case an entity should evaluate those costs in accordance with the above);
- b. Costs of wasted materials, labor, or other resources to fulfill the contracts that were not reflected in the price of the contract;
- c. Costs that relate to satisfied performance obligations or partially satisfied performance obligations in the contract, that is, costs that relate to past performance; and
- d. Costs for which an entity cannot distinguish whether the costs relate to unsatisfied performance obligations or to satisfied performance obligations or partially satisfied performance obligations.

C. Amortization and impairment

An asset capitalized in accordance with the above guidance should be amortized on a basis consistent with the transfer to the customer of the goods or services to which the asset relates. The asset may relate to goods or services to be transferred under a specific anticipated contract as well, for example, services to be provided under renewal of an existing contract or costs of designing an asset to be transferred under a specific contract that has not yet been approved.

An entity should update the amortization to reflect a significant change in the entity's expected timing of transfer to the customer of the goods or services to which the asset relates and should account for the change as a change in accounting estimate in accordance with ASC 250, *Accounting Changes and Error Corrections*.

An entity should recognize an impairment loss in profit or loss to the extent that the carrying amount of an asset recognized exceeds:

- a. The remaining amount of consideration that the entity expects to receive in exchange for the goods or services to which the asset relates; less
- b. The costs that relate directly to providing those goods or services and that have not been recognized as expenses.

To determine the amount of consideration that an entity expects to receive, an entity should use the principles for determining the transaction price (except for the guidance on constraining estimates of variable consideration) and adjust that amount to reflect the effects of the customer's credit risk. ASC 606 clarifies that the entity should also consider expected contract renewals and extensions and include both the amount of consideration it has already received but has not recognized as revenue and the amount it expects to receive in the future.

Before an entity recognizes an impairment loss for an asset recognized, the entity should recognize any impairment loss for assets related to the contract that are recognized in accordance with another ASC topic (for example, ASC 330, *Inventory*). ASC 606 clarifies the sequence for impairment testing to be, first, assets not within the scope of ASC 340, ASC 350 (*Goodwill and Other*), or ASC 360 (PP&E), such as inventory; then assets within the scope of ASC 340; and, lastly, asset groups and reporting units within the scope of ASC 360 and ASC 350.

After applying the impairment test above, an entity should include the resulting carrying amount of the asset recognized in the carrying amount of the asset group or reporting unit to which it belongs for the purpose of applying the guidance in ASC 350, *Intangibles – Goodwill and Other*, and ASC 360, *Property, Plant, and Equipment*, to that asset group or reporting unit.

An entity should not recognize a reversal of an impairment loss previously recognized.

IV. Disclosures

A. Applying the ASC 606 required disclosures

ASC 606 required disclosures include the following:

Disclosure Topic	Required Disclosure
Disaggregation of revenue	Disaggregation of revenue into categories that show how economic factors affect the nature, amount, timing, and uncertainty of revenue and cash flows.
Reconciliation of contract balances	<p>Opening and closing balances and revenue recognized during the period from changes in contract balances and quantitative and qualitative information about the significant changes in contract balances.</p> <p>The amount of revenue recognized that was included in the contract liability balance at the beginning of the period.</p> <p>The amount of revenue recognized in the current period relating to performance obligations satisfied in a prior period (such as from contracts with variable consideration).</p> <p>How the timing of the satisfaction of a performance obligation relates to the timing of payments. Discussion of the effect on the contract asset and liability balances related to any timing differences.</p>
Performance obligations	<p>When performance obligations are typically satisfied.</p> <p>Significant payment terms.</p> <p>Nature of the goods or services promised to be transferred.</p> <p>Obligations for returns, refunds, or other similar obligations.</p> <p>Types of warranties and related obligations.</p>
Remaining performance obligations	<p>The amount of the transaction price allocated to any remaining performance obligations not subject to significant revenue reversal.</p> <p>When the entity expects to recognize revenue associated with the transaction price allocated to the remaining performance obligations.</p> <p>Qualitative description of any significant contract renewal and variable consideration not included within the transaction price.</p>
Costs to obtain or fulfill contracts	<p>The closing balances, by main category of asset, of capitalized costs to obtain and fulfill a contract and the amount of amortization in the period.</p> <p>The method used to determine the amount of costs incurred and the amortization for each reporting period.</p>
Other qualitative disclosures	<p>Significant judgments and changes in judgments that affect the amount and timing of revenue, including the timing of satisfaction of performance obligations and the transaction price and amount allocated to performance obligations.</p> <p>For performance obligations satisfied over time, disclose the method used to recognize revenue (output or input method used and how applied) and why method used faithfully depicts the transfer of goods or services.</p>

Disclosure Topic	Required Disclosure
	<p>For performance obligations satisfied at a point in time, disclose significant judgments made in evaluating when customer obtains control.</p> <p>Information about the input, methods, and assumptions used to determine the transaction price. Assess whether variable consideration is constrained, allocate transaction price, and determine the standalone selling price.</p> <p>How management determines the minimum amount of revenue not subject to the variable consideration constraint.</p> <p>Description of the practical expedients, including those for transition, used in an entity's revenue accounting policies.</p>
Interim disclosures	<p>Disaggregation of revenue disclosure.</p> <p>Contract balances disclosure.</p> <p>Revenue recognized in the reporting period that was included in the contract liability balance at the beginning of the period.</p> <p>Remaining performance obligation disclosures.</p> <p>Information about the entity's remaining performance obligations as of the end of the reporting period.</p>

The above disclosure requirements are for public companies. Private companies have either reduced or modified disclosures, as follows:

Disclosure Topic	Required Disclosure
Disaggregation of revenue	Nonpublic entities may elect to not apply the quantitative disaggregation or revenue disclosure guidance discussed above. If this election is made, an entity still must disclose revenue disaggregated according to the timing of transfer of goods or services (at a point in time or over time) and qualitative information about how economic factors (i.e., type of customer, geographical location, and type of contract) affect the amount, nature, timing, and uncertainty of revenue and cash flows.
Reconciliation of contract balances	Nonpublic entities can elect to disclose only the opening and closing balances of contract assets, contract liabilities, and receivables from contracts with their customers. The other disclosures described above are optional.
Performance obligations	Descriptive disclosures of an entity's performance obligations are required. However, disclosures regarding remaining unsatisfied or partially satisfied performance obligations are optional.
Significant judgments	<p>For performance obligations satisfied over time, disclose the method used to recognize revenue (output or input method used and how applied).</p> <p>Information about the input, methods, and assumptions used to determine the transaction price. Assess whether variable consideration is constrained.</p> <p>All other above disclosures under other qualitative disclosures are optional.</p>
Practical expedients	Above noted disclosures are optional.
Interim disclosures	Above noted disclosures are optional.

Even these reduced disclosures are a handful to comply with.

Let us explore the content of some of these disclosures in a bit more detail, realizing that they will be tailored to the facts and circumstances of each entity's revenue recognition policies and customer base. No two sets of disclosures will be alike. If an entity elects to use the practical expedient in either paragraph 18 of ASC 606-10-32, about the existence of a significant financing component or paragraph 4 of ASC 340-40-25, about the incremental costs of obtaining a contract, the entity should disclose that fact. Private companies may elect not to provide this disclosure.

Let's look at an example of applying the above guidance for several hypothetical companies.

Example: InstallCo is a retailer and installer of cabinetry products ("the Company"). InstallCo purchases its inventory from its suppliers and sells its inventory, as is, to both contractors and individual customers. Most of the Company's sales are paid for at the time of sale, but the Company does offer 30-day credit terms to certain contractors with whom it engages in a large volume of sales. The credit terms essentially allow for the contractor to get paid by the residential customer before needing to remit payment to the Company. The Company will ship its product via common carrier, for a shipping and handling fee. Per the terms of its shipping contracts, title passes when the goods are placed on the common carrier, who assumes all responsibilities for any damaged goods.

InstallCo will also install the cabinetry which its customers purchase from it. It employs three teams of installers and schedules the installation as close to the purchase of the cabinetry as possible. The Company bills on a time-and-materials basis for installation services. The following is a representative footnote for InstallCo, describing its revenue recognition policies under ASC 606.

Revenue Recognition Policy

The Company derives its revenue primarily from the sale and installation of cabinetry products to both contractors and individual customers. Revenues are recognized when control of these products or services is transferred to its customers in an amount that reflects the consideration the Company expects to be entitled to in exchange for those products and services. Sales and other taxes the Company collects concurrent with revenue-producing activities are excluded from revenue. Shipping and handling fees charged to customers are reported within revenue. The Company does not have any significant financing components as payment is received at or shortly after the point of sale.

Revenue from performance obligations satisfied at a point in time consists of sales of cabinetry products from the Company's inventory. These goods are sold to homeowners and commercial designers and builders.

Revenue from performance obligations satisfied over time consists of the sale of installation services of the Company's cabinetry products. These services are generally provided to homeowners.

Disaggregation of Revenue From Contracts With Customers

The following table disaggregates the Company's revenue based on the satisfaction of its performance obligations for the years ended December 31:

	20X0	20X9
Performance obligations satisfied at a point in time	\$1,950,000	\$1,790,000
Performance obligations satisfied over time	1,050,000	925,000
Total net sales	\$3,000,000	\$2,715,000

Performance Obligations

For performance obligations related to the sale of cabinetry, control transfers to the customer at a point in time. The Company's principal terms of sale are FOB shipping point. The Company transfers control and records revenue for product sales either at the point of sale, when the customer takes possession of the goods, the title passes, and the Company has a right to payment, or upon placement of the goods on a common carrier, which assumes responsibility for shipment and delivery to the customer.

For performance obligations related to cabinetry installation services, control transfers to the customer over time. These services are sold under time-and-materials contracts. Revenue under time-and-materials contracts is recognized on the basis of actual time incurred multiplied by the billable hourly rate stated in the contract, plus materials expense incurred and billed when installation is complete.

Variable Consideration and Product Warranties

The nature of the Company's business gives rise to variable consideration, typically including just returns that generally decrease the transaction price, which reduces revenue. These variable amounts are generally credited to the customer based on the product returns or price concessions. Variable consideration is estimated at the most likely amount that is expected to be earned.

Estimated amounts are included in the transaction price to the extent it is probable that a significant reversal of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is resolved. Estimates of variable consideration are estimated based upon historical experience and known trends.

The Company offers its customers the standard manufacturer's warranty on the performance of the cabinets. Under these warranty provisions, the customer may make a claim against the cabinet manufacturer, who is responsible for any repair to the products. The Company has no responsibility in such instances.

The Company does offer a one-year warranty of its installation services. The Company accrues the cost of the warranty claims which it expects to receive on its installation services as a component of its cost of sales. The cost is estimated based upon historical experience and known trends.

Contract Balances

Contract assets include unbilled amounts typically resulting from sales under contracts when installation has begun but has not yet been completed and thereby billed. Contract assets were as follows for the years ended December 31:

	20X0	20X9	20X8
Contract assets	\$45,000	\$39,000	\$27,000

The Company had no contract liabilities at those dates.

B. Test yourself #3

Which ASC 606 disclosures are most challenging for your clients?

- A. Quantitative information about revenue (point in time vs. over time).
- B. Qualitative information about revenue.
- C. Information about performance obligations.
- D. Information on significant estimates in the revenue recognition process.
- E. Information on contract assets and liabilities.

There is no correct answer to this question.

V. Auditing revenue

A. Material misstatements in the financial statements

The potential for misstatement or fraud exists in each step of ASC 606's five-step model for recognizing revenue. Heightened risk can exist across all of the financial statement assertions. The following are a few examples of where material misstatements can enter the financial statements.

Assertion	Audit Risk
Occurrence or existence	An entity may not meet all of the criteria for having a valid contract, thereby preventing the recognition of revenue. As many entity incentives are tied to revenue and related profitability, an entity may attempt to overstate revenue through nonexistent or fictitious contracts
Rights and obligations	An entity may fail to identify all performance obligations within a contract (or identify all compensation to which it is entitled under the contract), thereby resulting in the inappropriate timing of revenue recognition.
Completeness	Due to error or fraud, the amount of revenue recorded in an accounting period may be incomplete, thereby understating revenue. This may be done to manage earnings or to avoid current year taxation
Accuracy, valuation, and allocation	ASC 606 has significant estimates related to the revenue recognition process, particularly with regard to variable consideration. Either through error or fraud, management can manipulate these estimates, resulting in an inaccurate amount of revenue being recognized in a particular accounting period. Determination of standalone selling price can have a significant impact on the timing and amount of revenue recognized for bundled products
Cutoff	Management can manipulate the amount of revenue recognized by recording it in an improper accounting period. For contracts with multiple performance obligations, it may be more challenging to record revenue in the proper period with a more detailed unit of account, as is the case under ASC 606.
Presentation and disclosure	Disclosure requirements under ASC 606, even though less voluminous for private companies, can be challenging to comply with.

As mentioned, under AU-C §240, there is a rebuttable presumption that there is heightened fraud risk related to revenue, and, as such, revenue is a significant risk. If this presumption is not rebutted, the auditor must perform appropriate procedures, as detailed in AU-C §§315, 330, and 240, related to financial statement assertions to which the key risk relates. Specifically, under AU-C §315, if an auditor has determined that a significant risk exists, the auditor should obtain an understanding of the entity's controls, including control activities, relevant to that risk and, based on that understanding, evaluate whether such controls have been suitably designed and implemented to mitigate such risks.

Further, per AU-C §330, if the auditor has determined that an assessed risk of material misstatement at the relevant assertion level is a significant risk, the auditor should perform substantive procedures that are specifically responsive to that risk. Similar guidance related to fraud risk exists under AU-C §240. As a result, an auditor must test relevant controls over the financial statement assertion (s) to which the fraud risk relates and, accordingly, substantive analytical procedures alone are not sufficient audit evidence for the assertion to which the fraud risk relates.

B. Risk assessment procedures related to revenue

Effective auditing of revenue begins with an effective risk assessment. Further, auditing procedures over revenue should also address any risks, as well as assurance obtained, from the audit of other areas related to revenue. For example, the receipt and posting of cash receipts related to revenue transactions may be audited as part of procedures performed on cash and accounts receivable. Procedures related to auditing revenue should also consider the procedures performed over accounts receivable. Procedures performed when auditing transactions recorded in the financial reporting process should be leveraged if they apply to auditing revenue as well. Examples of such transactions would be adjustments made to various forms of variable consideration, bad debt expense and allowance for credit losses under ASC 326 *Measurement of Credit Losses on Financial Instruments – Expected Credit Loss (ECL)* and sales returns and allowances. Communication is vital among engagement team members to both assure that all relevant risks related to revenue recognition have been addressed and also that steps have not been duplicated.

A key step in auditing revenue is to perform a robust risk assessment. Revenue often contains considerable risks of misstatement and fraud, and it generally receives significant audit attention.

Relevant financial statement assertions are:

- a. Existence;
- b. Completeness;
- c. Valuation;
- d. Cutoff;
- e. Rights and obligations; and
- f. Presentation and disclosure.

Given this and the rebuttable presumption of heightened fraud risk, auditors need to have a comprehensive understanding of the entity's, as well as the industry's business practices in order to properly assess risk.

The auditor must obtain an understanding of the entity and its environment, including its system of internal control. AU-C §315 requires separate assessment of inherent and control risk as part of that process.

As part of this understanding, the auditor should obtain an understanding of the following:

- a. Industry, regulatory or other external factors;
- b. The nature of the entity;
- c. Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements;
- d. Measurement and review of the entity's financial performance;
- e. Selection and application of accounting policies;
- f. Existence of unique or challenging revenue recognition issues, such as licenses and/or principal vs. agent considerations; and
- g. Understanding of what IT is utilized in the revenue recognition process along with what general IT controls have been implemented.

ASC 606 is a complex standard, with many nuances which can significantly impact the recognition of revenue. As part of the risk assessment process, it is key for auditors to identify the existence of types of products or services, or contractual provisions, which would increase the risk of material misstatement.

Factors to consider include the following:

- a. The nature and extent of performance obligations;
- b. Existence of and key provisions of licensing agreements;
- c. Types of contracts and the use of standardized or customized contracts;
- d. Seasonal or cyclical variations in sales;
- e. Sales policies which are customary for entities in the industry;
- f. Policies regarding pricing, price concessions, sales returns, discounts, credit terms, contingencies, and delivery and payment terms;
- g. People involved in the processes impacting revenue;
- h. Compensation arrangements related to revenue targets;
- i. Classes and categories of customers, including distributors, which may result in unique contractual provisions; and
- j. The nature and frequency of contract modifications.

This understanding can be obtained in many ways, including through inquiry of those involved in the revenue recognition process and reviewing the client's documentation of its revenue recognition process. These inquiries should extend beyond the accounting and controller's department to include all those involved in the revenue recognition process, including sales personnel, credit and cash collections, warehousing, and legal personnel.

1. Assessing risk for revenue and receivables

The most challenging assertions to test for revenue are occurrence and valuation. With some entities, completeness may be an important assertion. To identify the risk of material misstatement, the auditor should also consider that the entity is likely to have more than one revenue stream. Some streams may have more risk for material misstatement than others, whereas some may not be significant at all.

Remember that a significant account balance is a balance with one or more relevant assertions, and an assertion is relevant if the risk of material misstatement is higher than remote. If there is a minor product that is ancillary to the core business, this requirement may be met. Also recall that not all assertions are likely to be relevant. For example, rights and obligations may be relevant to an entity that is an agent, but if the entity is selling a product, then rights and obligations may not be relevant.

There are five important characteristics in understanding inherent risk:

- a. **Complexity** – Arises either from the nature of the information or from the way that the required information is prepared, including when such preparation processes are inherently more difficult to apply. For example, there is complexity in the calculation of rebate provisions because of the number of different commercial terms with many different suppliers and many interrelated commercial terms used in calculating rebates due. In addition, there are many potential data sources with different characteristics used in making an accounting estimate, and the processing of that data involves many interrelated steps. Therefore, the data is inherently more difficult to identify, capture, access, understand, or process.
- b. **Subjectivity** – Arises from inherent limitations in the ability to prepare required information in an objective manner due to limitations in the availability of knowledge or information. In these cases, management may need to make an election or subjective judgment about the appropriate approach to take and about the resulting information to include in the financial statements.
- c. **Change** – Results from events or conditions that, over time, affect the entity’s business or the economic, accounting, regulatory, industry, or other environment in which it operates when the effects of those events or conditions are reflected in the required information.
- d. **Uncertainty** – Arises when the required information cannot be prepared based only on sufficiently precise and comprehensive data that is verifiable through direct observation. Management applies the available knowledge to prepare the information using sufficiently precise and comprehensive observable data when it is available, and reasonable assumptions supported by the most appropriate available data when it is not.
- e. **Risk of fraud (susceptibility to misstatement due to management bias or other fraud risk factors)** – Results from conditions where there is an intentional or unintentional failure by management to maintain neutrality in preparing the information. Factors relevant to the susceptibility to misstatement due to fraud in the form of fraudulent financial reporting or misappropriation of assets are described in AU-C §240.

A significant risk is a risk that is at the upper end of the inherent risk spectrum. Inherent risk factors affect inherent risk to varying degrees individually or in combination, and inherent risk will be higher for some assertions than for others.

No risk	Low	Moderate	High	Significant
Remote	Reasonably possible	Probable		

2. Preliminary analytical procedures

Another integral part of the information gathering process is performing preliminary analytics, which are required on all audits. As revenue is recorded over the entire course of the accounting period, auditors should be able to develop fairly precise predictable relationships to support both preliminary and substantive analytics. We will discuss common substantive analytics performed on revenue later in this section. Further, as appropriate, the auditor should perform these preliminary analytics on a disaggregated basis, whether by time, product line, distribution channel, or other applicable method of disaggregation.

Common preliminary analytical procedures performed on revenue account balances are:

- a. Year over year or trend analysis of revenue, ideally on a disaggregated basis;
- b. Comparison of budget to actual sales, at an appropriately detailed level;
- c. Gross profit analysis, at an appropriately disaggregated level; and
- d. Comparisons of sales to operational data, such as headcount, square-footage, or existing stores.

As client management often scrutinizes revenue, the auditor should request any internal revenue analyses that are prepared for senior management and/or those charged with governance, along with relevant analysis, as such information may also provide insights into the business.

AU-C §240 states that revenue analytics must be performed. This is to inform the risk of fraud.

3. Reading and understanding revenue contracts

Another integral activity in assessing inherent risk related to revenue is the need for the auditor to read and understand the key terms of the sales contracts. Identifying and assessing key contractual terms is essential to the application of each step of ASC 606's five-step revenue recognition model. For example, obtaining an understanding of key contractual terms is vital in assessing whether the five criteria for a valid contract are met. The contract should identify ways to assess the following:

- a. The process for approving the contract, including any modifications;
- b. Each party's rights and obligations;
- c. Payment amount and terms, including financing terms and other elements of variable consideration;
- d. Whether the contract has commercial substance; and
- e. In conjunction with understanding client credit policies and procedures, how the entity addresses the issue of collectability, including the entity's policy on contract performance when the customer does not pay the agreed-upon transaction price.

Further, this understanding obtained from reading and understanding the key contractual terms will assist the auditor in assuring that the client appropriately applied the guidance in ASC 606 in the following areas:

- a. Process for and determination of performance obligations, including the existence of implicit promises;
- b. Identifying elements of variable consideration, including the key metrics and measures for calculating it, such as volume or prompt pay discount targets, rebate levels, sales return provisions, bonuses, incentives, and penalties, including liquidated damages or warranty provisions;
- c. Existence of product bundling arrangements, and how the client prices both the bundle as well as the items in the bundle on a standalone basis; and
- d. Nature of the satisfaction of contractual promises, either over time or at a point in time, including the rationale for each. Such understanding should include a determination of whether the entity met one of the three criteria for recognizing revenue over time and, if not, the relevant indicators of control which support the point of time at which revenue is recognized.

When obtaining this understanding, the auditor should note whether the client's revenue contracts are standardized or customized, as this will have a significant impact on the risk associated with auditing the contracts. If the client has a large number of customized contracts, the auditor will need to perform more work to obtain this understanding. This will also impact the assessment of inherent risk related to such contracts, as the existence of many unique terms across the portfolio of contracts increases the likelihood of the misapplication of ASC 606 and thereby the likelihood of a material misstatement being in the financial statements.

This understanding should be documented, and appropriately cross-referenced when auditing revenue and reviewing revenue contracts.

From the above information, the auditor must make an assessment of inherent risk, by financial statement assertion, for revenue. Further, auditors should assess if there are different classes of transactions which make up the revenue financial statement line item. If so, then this understanding should be obtained for each significant class of transactions as well. Accordingly, it is not uncommon for the auditor to have separate inherent risk assessment by assertion for different classes of transactions, as, for instance, the risk related to an internet-based revenue contract resulting in a credit card sale would be different than that of a sale through a "brick and mortar" channel for cash.

4. Control risk assessment

As part of the risk assessment process, the auditor must obtain an understanding the entity's system of internal controls in order to conclude on whether they have been designed to prevent or detect a material misstatement, due to error or fraud, and whether the controls have been implemented. The understanding of the design of the controls is primarily obtained through reviewing system documentation and inquiry of appropriate personnel involved in the revenue recognition process. Determining whether such controls have been implemented is primarily performed via a walkthrough. From this understanding, the auditor will assess the risk that the controls have been designed and implemented to prevent or detect such material misstatement. This assessment, performed at the relevant assertions level for the revenue account as a whole, or at the relevant class of transactions, is called control risk. If the auditor assesses control risk at anything other than high, meaning that there is a high risk that the controls, as implemented, will not prevent or detect material misstatement, then the auditor must test the operating effectiveness of these controls over the entire period of their operation, using sample sized for control testing developed by the AICPA and reviewed in other modules of this audit skills series. If such controls are not designed or implemented effectively, or if the auditor assesses that it would be more effective and efficient to obtain audit evidence substantively, the auditor will assess control risk as high. However, even if assessing control risk as high, the auditor must still document the understanding of the control's design and implementation as part of the risk assessment process.

That said, companies often have some relevant controls over aspects of the revenue recognition process and while they may not be robust or complete enough to support a low controls risk assessment over all of the financial statement assertions, such controls may still support a control risk assessment of less than high for certain assertions and thereby the potential to reduce the nature, timing, and extent of substantive procedures through testing these controls.

The following are common control activities over the revenue recognition process. Note that risk assessment procedures and testing of controls should be performed in conjunction with that related to accounts receivable, and the cash receipts process, as applicable. Further, these would be supplemented by controls that address the other COSO components, as follows:

- a. **Control environment** – Overall management philosophy related to controls and the existence of anti-fraud provisions, such as hotlines;
- b. **Risk assessment** – Rigor by which management and those charged with governance assess risks related to achieving the organization’s objectives, including those related to revenue recognition, and documentation of the risk assessment process and the response to identified risks;
- c. **Information and communication** – Quality of the information systems used to recognize revenue and receive cash, including the financial reporting process, and dissemination of information, including that related to the design and implementation of internal controls, to all impacted within the organization; and
- d. **Monitoring** – Periodic monitor of controls related to revenue, such as internal audit reviews, and ongoing monitoring of controls by both those involved in and external to the revenue recognition process.

5. Common control activities over the revenue recognition process

Control activities are generally those that occur at the transaction level. They are generally a combination of preventative and detective and can be manual, automated or a combination of both. Given the sensitivity of revenue to a company’s performance, as well as many companies’ heightened focus on cash and cash management, entities frequently have designed and implemented some controls at the transaction level related to the sales and cash receipts process. The following are examples of common controls over the processes that make up the revenue cycle. Some controls, such as management overall review of operations and appropriate segregation of duties, occur across various processes and are only including in the matrix one time.

Control	Financial Statement Assertion Addressed
Processing customer orders	
Management reviews the entity's financial statements on a periodic basis and investigates significant variances from budgets and expected results.	E/O, C, R/O, V, A/CO, CO
Delinquent accounts receivable are reviewed.	E/O, C, V, R/O, A/CL, CO
Revenue by product or service and/or customer are reviewed.	E/O, C, V, A/CL, CO
The sales order system prevents sales to customers on credit holds or in excess of credit limits.	V, R/O
Adequate segregation of duty of the following procedures: <ul style="list-style-type: none"> • Approving terms of contracts with customers; • Processing customer orders; • Recording customer orders; • Authorizing shipments; • Initiating shipping documents; • Invoicing customers; • Collecting accounts receivable; • Posting cash receipts; • Reviewing A/R aging; • Authorizing A/R write-offs; • Independently investigating A/R discrepancies; • Authorizing adjustments to accounts receivable balances; • Editing the A/R master file; • Processing customer service calls and complaints; and • Investigating issues related to revenue recognition. 	E/O, C, V, R/O, A/CL, CO
Customer orders, shipping documents, and invoices are prenumbered, and the sequence is accounted for.	E/O, C
Summary totals of billings (batch totals) are prepared daily and compared to the posting to the control account.	E/O, C, A/CL, CO
Invoices are agreed to the approved customer orders, shipping document, and approved price list before recording revenue.	E/O, C, A/CL
Access to the master pricing file is appropriately restricted.	E/O, C, A/CL
Product margins by product line are reviewed regularly by management.	C, V, A/CL, CO
Reconciliation of physical inventory counts to the perpetual records.	E/O, C, V, R/O, A/CL, CO

Control	Financial Statement Assertion Addressed
Shipping and invoicing customer orders and recording revenue	
Management has implemented policies and procedures to identify all material categories of contracts in accordance with ASC 606.	E/O, C, A/CL
All contracts and classes of contracts are analyzed and reviewed to identify performance obligations.	E/O, C, R/O, A/CL
Contracts are reviewed to verify the amount of consideration, fixed or variable, which an entity expects to receive.	E/O, C, V, R/O, A/CL
Contracts are reviewed to ensure proper allocation of the transaction price to separate performance obligations, as per their standalone selling price.	C, V, R/O, A/CL
Management has implemented policies and procedures to recognize revenue equal to the amount allocated to a satisfied performance obligation.	E/O, C, A/CL, CO
Contract balances and revenue recognized during the period from changes in contract balances for each significant class of contract are reviewed and reconciled to the general ledger.	E/O, C, A/CL, CO
Processing revenue adjustments and product returns	
All write-offs and credit memos are reviewed, as per policy.	E/O, V, R/O, A/CL
Appropriate segregation of duties over the revenue adjustment process are maintained.	E/O, V, A/CL
Processing cash receipts	
Cash receipts are reconciled to the general ledger postings daily.	E/O, C, V, R/O, CO
Lockbox receipts are compared to customer remittances.	E/O, C, R/O, A/CL, CO
A/R sub-ledger is reviewed and reconciled to the to the general ledger.	E/O, C, A/CL, CL
Appropriate segregation of duties over the cash receipts and posting process.	E/O, C, R/O, A/CL, CO
The entity uses a lockbox.	E/O
Cash receipts are deposited intact promptly or stored securely until deposited.	E/O, C, A/CL
Adjustments to cash accounts are approved and documented by the appropriate level of management or other appropriate person.	E/O, C, A/CL
Bank reconciliations are prepared and reviewed on a timely basis.	E/O, C, V, R/O, A/CL, CO
Estimating the allowance for doubtful accounts and bad debt expense	
Accounting policies and procedures document the process for estimating the allowance for credit losses, in accordance with GAAP.	V, A/CL
Supporting analysis for estimating the allowance for credit losses and bad debt expense is prepared and reviewed.	V, A/CL
Independent review of the significant judgments and estimates included in the financial records is performed at the end of each accounting period by an appropriately knowledgeable personnel.	E/O, C, V, R/O, A/CL, CO

Control	Financial Statement Assertion Addressed
Estimating the allowance for returns and other elements of variable consideration	
Accounting policies and procedures are developed to estimate the allowance and other elements of variable consideration, including those requiring management's estimates and judgments and such policies are in accordance with ASC 606.	V, A/CL
A supporting analysis is prepared for estimating the allowance for returns and other elements of variable consideration.	V, A/CL
An independent review of significant judgments and estimates is performed at the end of every accounting period by knowledgeable personnel.	E/O, C, V, R/O, A/CL, CO
Maintaining the customer master file	
Only authorized users can modify data in the customer master records.	E/O, R/O
Restricted access	
Access to financial systems used to process revenue are restricted to only those which require access and only to those modules that are necessary to process transactions.	E/O, R/O

Lastly, the entity should have robust review and approval processes for any journal entries recorded are part of the financial reporting process. Such transactions include:

- a. Adjustments made to revenue and contract liability accounts for transactions in which cash is received but for which there is not a valid contract;
- b. Adjustments related to contract modifications;
- c. Adjustments to contract assets and liabilities; and
- d. Adjustments to record changes to accounts related to variable consideration.

Also, the entity should have policies and procedures, and related controls, over the development of information necessary for the entity to meet the financial statement disclosure requirements of ASC 606.

Note that, if applicable, controls should also exist to ensure appropriate accounting for costs related to acquired contracts and performance of contracts which would be capitalized under ASC 340-40, including the development of amortization periods and, if necessary, impairment changes.

6. Using the audit risk model to determine audit evidence required

The outcome of the risk assessment process is to develop an assessment of the risk of material misstatement (RMM), at the relevant assertion level, for revenue as a whole, or at a class of transactions level, as appropriate. RMM drives the nature, timing, and extent of the auditor's substantive procedures, which are performed in relation to detection risk, or the risk that the auditor's procedures will not detect a material misstatement in the financial statements. The lower the risk of material misstatement, the higher the detection risk the auditor can accept. A higher detection risk results in less assurance needed from the substantive procedures performed.

The following summarizes the relationship between RMM and detection risk, as it relates to the nature, timing, and extent of substantive procedures the auditor needs to perform in order to reduce audit risk to an acceptable level.

$$\text{Detection risk} = \frac{\text{Audit risk}}{\text{Inherent risk} \times \text{control risk}}$$

Inherent Risk	Control Risk	RMM
High	High	High
High	Moderate	High
High	Low	Moderate
Moderate	High	Moderate
Low	High	Low
Moderate or Low	Moderate	Low/Moderate
Moderate or Low	Low	Low

It should be noted that AU-C §315 makes it clear that tests of the operating effectiveness of controls are required to support a control risk assessment below the maximum level. AU-C §315 also indicates that when control risk is assessed at the maximum, the risk of material misstatement is the same as inherent risk. In the model above this convention is followed except where inherent risk is low and control risk is maximum and the RMM is above inherent risk at moderate, such could be assessed at low. However, we should be reminded that anytime inherent risk is on the upper end of our scale there is a significant risk and our audit procedures must be responsive to that heightened level of risk.

When the auditor does not plan to test the operating effectiveness of identified controls, the auditor's evaluation of the design and determination of the implementation of controls may still assist in the design of substantive procedures. When identified controls are designed effectively and implemented, risk assessment procedures may influence the auditor's determination of the nature and timing of substantive procedures to be performed (for example, the auditor may determine to perform inspection, rather than external confirmation, or to perform procedures at an interim date, rather than at period end).

C. Test yourself #4

How would you assess your client's controls over revenue recognition?

- A. The client's controls are generally strong over most or all aspects of the revenue recognition process.
- B. The client has some effective controls over many aspects of the revenue recognition process.
- C. The client has some effective controls over some of the aspects of the revenue recognition process.
- D. The client's controls are poor or nonexistent over many aspects of the revenue recognition process.

There is no correct answer to this question.

D. Substantive procedures related to revenue

Substantive procedures related to revenue should be considered in light of other procedures which have been performed on other accounts related to the revenue cycle, such as accounts receivable, cash and inventory, as well as the assessed RMM, performed at the assertion level.

Also, note that there is often a significant or fraud risk relate to revenue for one or multiple financial statement assertions. For assertions for which significant or fraud risks exist, the auditor must perform substantive procedures, and that substantive analytical procedures alone are not sufficient. For assertions for which significant or fraud risks do not apply, the auditor can use judgment to determine the appropriate nature, timing and extent of procedures which will provide sufficient audit comfort over the relevant assertion. The following is a summary of the appropriate procedures to perform related to a financial statement assertion when both a significant or fraud risk exists and when one does not:

When...	The auditor may...
There is a significant risk	Use tests of details alone, use SAP and tests of details, use tests of controls and SAP, or use tests of controls and tests of details. Note that analytical procedures alone will not provide sufficient audit evidence where there are significant risks.
Risk is not significant	Using whatever combination of tests of controls and substantive tests will reduce risk of material misstatement to a low level.

In the area of accounts receivable and revenue, auditors tend to primarily use tests of details for all assertions except valuation.

Audit procedures over revenue are performed in conjunction with those over accounts receivable. The procedures performed over accounts receivable are reviewed in a separate audit skills module and won't be repeated in this module. We will just focus on the incremental substantive procedures which should be performed to audit revenue.

The nature, timing and extent of these procedures will depend on the existence of fraud or significant risks related to one or multiple financial statement assertions, as well as the complexity of the entity's revenue recognition process. Representative substantive procedures include the following:

Assertions Addressed	Audit Procedure
E/O, R/O	Update understanding, if necessary, of the entity's policies, practices, and processes for entering into revenue contracts, from that obtained during planning.
E/O, C, V, A/CL, CO	<p>Perform and adequately document, on a disaggregated basis, the following analytical procedures as deemed appropriate.</p> <p>Obtain a schedule summarizing revenue by major product line, geographic location, or other appropriate level of disaggregation, for the year and meaningful interim periods (monthly or quarterly). Agree or reconcile the schedule to the general ledger.</p> <p>Test the mathematical accuracy of the schedule.</p> <p>Perform one or more of the following analytical procedures:</p> <ul style="list-style-type: none"> • Compare amounts to those of prior year(s) or other expectations; • Compare actual amounts to budgeted amounts; • Compare monthly or quarterly amounts to amounts for the period in the current or prior year and to budgeted amounts for the same interim period; and • Compute other ratios or expectations, unique to the industry or client, as applicable, including operating data.
E/O, C, A/CL	<p>In performing tests of details on revenue transactions and considering the nature of revenue transactions, the assessed level of risk of material misstatement at the financial statement assertion level, and the results of substantive analytics, perform the following:</p> <ul style="list-style-type: none"> • Obtain a listing of revenue contracts for which revenue was recognized during the period and reconcile the listing to the general ledger; • Select and document revenue transactions recorded during the year for testing, noting any significant or unusual transactions; and • Examine and document supporting contracts, shipping documents, and other documentation to determine whether revenue was recognized at the proper amount and in the current period. <p>Note that this analysis should address all five steps of the ASC 606 five-step revenue recognition process.</p>
E/O, C, R/O	<p>For a selection of contracts for which revenue was recognized during the period, perform the following to evaluate the entity's identification of the existence of valid contracts:</p> <ul style="list-style-type: none"> • Inspect evidence of the arrangement with the customer in the form of an executed contract, purchase order or other documentation to evaluate whether the arrangement meets the five criteria required for a contract to exist under ASC 606; • Consider any additional procedures, as applicable, for contracts approved via oral consent or those using customary business practices other than written agreement, including confirming key contractual terms with the customer and/or inquiry of appropriate internal resources; and • Consult with the client's internal or external counsel, as necessary, to address any concerns about the legal status of a contract. <p>Note that the auditor may use the same contracts for this audit procedure as those used to test the five steps of the revenue recognition process detailed above</p>
E/O, C, R/O	Obtain a listing of contracts with customers for which revenue was recognized during the period and select contracts entered at or near the same time with the same customer or related parties. Obtain evidence supporting management's judgment concerning combining the contract or not.

Assertions Addressed	Audit Procedure
E/O, C, R/O	<p>If management modifies contracts that span reporting periods, perform the following procedures:</p> <ul style="list-style-type: none"> • Obtain a list of contracts modified during the period and determine its completeness; and • For selected contracts on this listing, select contracts and assess the appropriateness of the client's accounting for the modification, as per ASC 606-10-25-10 through 13.
E/O, C, R/O	<p>For a selection of contracts for which revenue was recognized during the current period, perform the following procedures to evaluate the entity's identification of performance obligations:</p> <ul style="list-style-type: none"> • Read the contract and compare the goods or services promised to the entity's identification of performance obligations; and • Consider the existence of any implied promises in the entity's customary business practices and assess if these promises meet the definition of performance obligations and whether the entity has identified them as such. In performing this step, consider inquires of those in the sales, marketing, or legal functions, published entity policies or marketing materials or items on the entity's website or social media presence.
E/O, C, R/O, V	<p>For a selection of contracts for which revenue has been recognized during the period, perform the following to assess management's determination of contract price.</p> <p>Vouch management's determination of transaction price to the contractual terms.</p> <p>Determine whether the transaction price is affected by written or implicit variable consideration offered to the customer.</p> <p>If the amount promised in the contract includes a variable amount, perform the following procedures:</p> <ul style="list-style-type: none"> • Obtain management's method of estimating variable consideration and factors and assumptions considered in making the estimate; • Evaluate the reasonableness of management's estimation process, including whether management's method is in accordance with ASC 606, consideration of available information is sufficient, and its assumptions are reasonable and consistent with each other; and • Evaluate management's updates of its estimates of transaction price throughout the term of the contract, and whether the constraint affects the amount of variable consideration included in the transaction price.
E/O, R/O, V	<p>For a selection of contracts for which revenue was recognized during the period, perform the following to evaluate the entity's allocation of transaction price to performance obligations:</p> <ul style="list-style-type: none"> • Obtain an understanding of management's method for allocating transaction price to performance obligations in the contract, including the method of determining standalone selling price; • Review the contract for the stated price for the goods and services and the approved price list for these items; • Compare the stated price with evidence of past revenue from the same or similar products or services sold separately to similar customers in similar circumstances; and • When standalone selling prices are not readily observable, evaluate and test the entity's estimation process, including individual inputs to the process and how management maximizes observable inputs.

Assertions Addressed	Audit Procedure
E/O, R/O	<p>For a selection of contracts where revenue was recorded during the accounting period, perform the following procedures to evaluate whether the entity has satisfied a performance obligation and appropriately recognized revenue.</p> <p>Determine whether the performance obligation for which revenue is recognized is satisfied at a point in time or over time.</p> <p>For revenue contracts where revenue is recognized at a point in time, obtain evidence that the customer has obtained control of the good or service by performing the following:</p> <ul style="list-style-type: none"> • For goods, inspect shipping documents from third-party carriers; • For services, inspect documents such as work orders or service reports; and • For situations where customer acceptance is a condition for control passing, consider confirming or other appropriate method to validate the customer's acceptance. <p>For revenue contracts where revenue is recognized over time, obtain evidence that the customer has obtained control of the good or service by performing the following:</p> <ul style="list-style-type: none"> • Obtain an understanding of the entity's process for measuring progress toward completing a performance obligation whether it is in accordance with ASC 606; • Test the entity's application of the measurement process for the performance obligation and at period end; and • Consider legal interpretation of contractual clauses as necessary.
E/O, C, R/O, V, CO	Scan the listing of revenue transactions during the period and investigate large or unusual transactions near period end (both before and after) for their propriety.
E/O, C, R/O, V, CO	<p>If as part of the above procedures or as a result of inquiries or other procedures, significant unusual transactions are identified, perform the following:</p> <ul style="list-style-type: none"> • Inquire as to the nature of the transaction; • Obtain and review applicable support for the transaction; • Based on the above, determine if the transaction is accounted for appropriately; and • Consider any disclosure requirements related to significant unusual transactions and coordinate appropriately with audit team members reviewing financial statements disclosures.
P/D	<p>Obtain information related to ASC 606 disclosures and perform the following:</p> <ul style="list-style-type: none"> • For quantitative information, trace and agree information to the general ledger or obtain a reconciliation; • Assess whether quantitative information has been subject to audit procedures. If not, perform appropriate audit procedures to assure the completeness and accuracy of such information; and • For qualitative procedures, assure that the information disclosed is consistent with the auditor's understanding of such information, as obtained during planning and substantive procedures.
E/O, C, V, A/CL, CO	<p>As deemed necessary in order to obtain sufficient audit evidence, perform the following additional analytics related to revenue:</p> <ul style="list-style-type: none"> • Record the recorded volume of revenue with production capacity or statistics maintained by operating personnel; • Compare units of products shipped or services delivered by month with revenue recognized by month; • Analyze the trend of revenue and returns, refunds, or similar elements of variable consideration by month, including for the last month of the reporting period to the first month or two of next period; • Compare sales to cost of sales by month, product line, or location; • Obtain and review any applicable comparisons of budgeted or forecasted revenues to actual; and • Compare revenue trends by month or quarter to industry or other relevant trends.

Assertions Addressed	Audit Procedure
C	To test completeness of revenue, inquire of management as to steps to ensure that the trial balance is complete.
C, A/CL	<p>Perform the following to test the completeness of revenue:</p> <ul style="list-style-type: none"> • Select a sample of evidence of transfer of control to customers documenting the items tested; • Trace the information on the documents to the related invoices, noting if the details are appropriately reflected on the invoice; • Determine that the total revenue reported on the invoice is properly computed and approved; • Trace the amounts on invoices to the sales journal; and • Determine that the accounting treatment applied to the transaction is appropriate.
E/O, V, CO	<p>To test appropriate cutoff of revenue, perform the following procedures.</p> <p>Trace shipping documents from three to five days before and after the period's end to ensure that the revenue related to the shipments is recorded in the proper accounting period.</p> <p>Perform the following analytical procedures:</p> <ul style="list-style-type: none"> • Compare revenue for the last month of the year to revenue for the rest of the year and the first month of the following year; and • Compare monthly returns, credits, and other elements of variable consideration for the last few months of the fiscal year to the first few months following year-end. <p>Investigate the nature and cause of any significant differences disclosed by the previous substantive analytics and consider the need to perform additional procedures related to cutoff.</p> <p>Review returns, credits, and other elements of variable consideration for one or several months before and after the balance sheet date, investigating any unusual entries.</p>
E/O, C, A/CL, CO	<p>Perform the following procedures to test revenue cutoff. Note that the following are generally performed in response to identified fraud risks:</p> <ul style="list-style-type: none"> • When a fraud risk exists related to revenue transaction cutoff, inquire of sales or marketing personnel about revenue or shipments near year-end and their knowledge of unusual terms or conditions related to those transactions; • Compare revenue recorded daily shortly before and after the reporting date for unusual fluctuations; • Compare monthly cash receipts during the year to cash receipts subsequent to year-end to determine if receipts subsequent to the balance sheet date are unusually low in comparison to the months under audit; • Vouch large or unusual revenue transactions for which revenue was recognized at or near year-end to source documents; and • Coordinate as appropriate cutoff procedures performed during the physical inventory to those performed as part of substantive audit procedures.

E. Other considerations related to substantive procedures over revenue

Note that based on the complexity of the entity's revenue recognition process, the auditor may need to perform additional procedures to address other risks noted in the risk assessment process. For example, the existence of any of the following would require the performance of other, specifically identified procedures to address relevant financial statement assertions:

- a. Nontrade and/or interest-bearing receivables;
- b. Related-party receivables and significant unusual transactions;
- c. Estimate of credit losses;
- d. Collateralization or factoring of accounts receivables;
- e. Bill and hold transactions;
- f. Deferred revenue and other contract liabilities;
- g. Significant financing components; and
- h. Product warranties.

Also, many auditors have developed standardized checklists to facilitate the auditing of revenue. These checklists generally address the key components and estimates made when an entity applies ASC 606 and can be an effective documentation tool for documenting an understanding of the entity's controls over revenue recognition and accounts receivable, as well as to document both testing of controls and substantive procedures related to revenue. However, AU-C §315 provides for a stand-back requirement by the auditor to ensure completeness of the auditor's identification of transactions, account balances, and disclosures, so checklists should be modified or revised for the auditor's findings throughout the audit process.

Further, the above substantive procedures include many substantive analytics. When determining the nature, timing and extent of procedures related to revenue, auditors can obtain significant audit comfort from well-designed substantive analytical procedures. However, remember that substantive procedures alone are not sufficient to address significant or fraud risks. Also, the auditor must obtain and substantiate explanations for variances which exceed the threshold for investigation. Substantive analytics provide the most audit comfort when expectations are precise and when they are performed at an appropriately disaggregated level. When predictable relationships between the components of substantive analytics do not exist, substantive analytical procedures should not be performed. In such circumstances, the auditor frequently spends more time trying to obtain and validate explanations for amounts exceeding the threshold for investigation than if the auditor had attempted to obtain evidence via tests of details.

Auditors also need to be aware of unique factors which may impact their revenue-related substantive analytics. For instance, operational slow or shutdowns related to unforeseen circumstances may significantly impact the comparability of revenue amounts between years. Further, impacts of unforeseen circumstances may have resulted in a significant change in an entity's distributions channels, such as from "brick and mortar" revenue to online revenue. Such shifts should be incorporated into auditor expectations, or the auditor may not achieve the assurance desired from the substantive analytical procedure. Lastly, the auditor must ensure the completeness and accuracy of the information used in the substantive analysis. The underlying entity data must be subject to a tested system of internal controls, or the information must be otherwise substantively tested.

The nature, timing and extent of substantive procedures related to revenue should be considered. Per above, revenue can constitute a significant amount of the substantive testing time spent on an audit. While it is key for an audit to be effective, i.e., performing sufficient procedures to obtain reasonable

assurance that the financial statements are not materially misstated, audits must also be performed efficiently. That means getting the right mix of controls testing, substantive analytics, and tests of details, as well as complying with professional standards.

Many companies have at least some controls addressing aspects, if not all of the revenue recognition process. While the auditor can't rely on inadequately designed or implemented controls, or those which are not operating as designed, auditors often miss the opportunity to gain reliance on certain financial statement assertions related to revenue. While such assurance can't be obtained when well-designed controls do not exist or are not implemented, many times such controls do exist and auditors nevertheless default to high control risk, thereby requiring a purely substantive approach to obtaining sufficient audit evidence. Often such an approach requires sampling of revenue transactions, which may result in large sample sizes and a lot of audit work. The auditor should consider where even limited control testing, where effective controls exist, may result in a more efficient audit approach, as compared to a fully substantive one.

For example, limited testing of controls over revenue recognition, even to just obtain moderate control reliance, may result in either reducing sample sizes or even resulting in target testing of revenue contracts providing sufficient evidence. Such an approach, while still effective, may also be more efficient as well.

As our documentation of our client's revenue recognition processes, along with our understanding of them, should have improved as a result of the implementation of ASC 606, it may be time to readdress our audit strategy as well. AU-C §315 contains documentation requirements for auditors, as we must document our evaluation of the design of identified controls and our determination of whether such controls were implemented. Additionally, we must document our rationale for significant judgments regarding identified and assessed risks of material misstatement.

Accounting for and Auditing Leases

Learning objectives	1
I. Introduction	1
A. Overview of ASC 842, Leases	1
B. Key changes	1
II. The lease accounting guidance from 30,000 feet	2
A. Definition of a lease	2
B. Identified assets	2
C. The lessee accounting model	3
1. <i>Finance leases</i>	3
2. <i>Operating leases</i>	3
3. <i>Determination of a finance or operating lease</i>	4
D. The lessor accounting model	4
1. <i>Lessor classification</i>	4
2. <i>Sales-type and direct financing leases</i>	5
3. <i>Operating leases</i>	5
E. Exercise 1 – Lease classification	5
III. Details of the lease accounting guidance	5
A. Separating lease and nonlease components of a contract	5
1. <i>Lessor</i>	6
2. <i>Lessee</i>	6
B. Discount rate	7
C. Practical expedients and elections	7
1. <i>Short-term leases</i>	7
2. <i>Portfolio application and materiality considerations for high-volume, low-dollar leases</i>	7
3. <i>Materiality</i>	8
D. Related-party leasing transactions	8
E. Taxes and insurance	9
F. Lease measurement	9
1. <i>Lease term</i>	9
2. <i>Leases with no explicit end</i>	10
G. Test yourself #1	11
H. Calculating the lease asset and liability	11
1. <i>Lease liability</i>	11
2. <i>Fixed lease payments</i>	11
3. <i>Variable lease payments</i>	11
4. <i>Residual value guarantees</i>	12
5. <i>Right-of-use assets</i>	12
6. <i>Applying the guidance</i>	12
7. <i>Remeasurement</i>	15
8. <i>Lease modifications</i>	16
9. <i>Initial direct costs</i>	17
I. Subleases	17
J. Financial statement presentation	18
1. <i>Statement of financial position</i>	18
2. <i>Statement of comprehensive income</i>	18
3. <i>Statement of cash flows</i>	18
4. <i>Disclosures</i>	19
K. Test yourself #2	25
L. Exercise 2 – Lease contracts	25
IV. Auditing leases	25
A. Risks related to leases	25
B. Common areas of inherent risk	26
C. Assessing control risk	27
1. <i>Common controls over lease accounting</i>	28
2. <i>Common control activities over lease accounting</i>	29
3. <i>Other control considerations</i>	30

D. Determining the risk of material misstatement	31
E. Substantive audit procedures performed on lease balances	32
1. <i>Significant risk</i>	32
2. <i>Substantive analytical procedures</i>	33
3. <i>Substantive procedures to perform on leases under ASC 842</i>	34
V. Solutions to test yourself questions and exercises	36
A. Test yourself #1	36
B. Test yourself #2	36
C. Exercise 1 – Lease classification	36
D. Exercise 2 – Lease contracts	36

Accounting for and Auditing Leases

Learning objectives

After completing this chapter, the reader should be able to:

- Reference the FASB's comprehensive lease accounting guidance found in ASC 842, *Leases*; and
- Understand auditing considerations related to ASC 842.

I. Introduction

A. Overview of ASC 842, *Leases*

In February 2016, the FASB issued ASC 842, *Leases*. This standard replaces the guidance regarding accounting for leases found in Accounting Standards Codification (ASC) 840, *Leases*. While the standard has changed significantly since the FASB originally proposed an update to accounting for leases, the final issued standard retained much of the legacy guidance for lessors, achieves significant but not total convergence with the IFRS accounting for leases and generally results in little impact to the income statement treatment for lessee finance leases and operating leases. However, there is a significant balance sheet impact for lessees for operating leases.

The lease accounting guidance in ASC 842 applies to all leases except for:

- a. Leases of intangible assets;
- b. Leases to explore for or use minerals, oil, natural gas, and similar nonregenerative resources;
- c. Leases of biological assets, including timber;
- d. Leases of inventory; and
- e. Leases of assets under construction.

The guidance is intended to improve the quality and comparability of financial reporting by providing greater transparency about leverage, the assets an organization uses in its operations, and the risks to which it is exposed from entering leasing transactions.

This chapter will review the major provisions of the lease standard. However, there are other provisions in the standard as well as detailed implementation examples that you may need to be familiar with for your clients. You should perform a detailed read of the standard in order to understand all of its nuances.

B. Key changes

ASC 842 retains much of the previous guidance for lessees and lessors, but it also contains some significant changes. The following table contains a summary of some of the most significant changes made to the final standard.

Updates to ASC 842	Similarities Between ASC 840 and 842
Lessees record operating leases on the balance sheet	Very few changes for lessors
Finance leases (previously capital leases)	ASC 842 generally retains a dual-model expense recognition approach for lessees, similar to prior GAAP
Principles-based lease classification	No changes to accounting for finance leases
No deferred or prepaid lease expense for operating leases	Reasonably assured is now reasonably certain but concept remains the same (used for adding options to renew leases)
More stringent capitalization criteria for initial direct costs	Few changes to lease modification and remeasurement accounting
Enhanced footnote disclosure	
Inception vs. commencement	

The amendments are effective with the effective date of ASC 842.

II. The lease accounting guidance from 30,000 feet

A. Definition of a lease

The lease accounting guidance defines a lease as:

A contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration.

An entity will determine whether a contract contains a lease by assessing whether the use of an identified asset is either explicitly or implicitly specified and the customer controls the use of the identified asset.

B. Identified assets

A contract will not involve the use of an identified asset if a supplier has the substantive right to substitute the asset used to fulfill the contract. A supplier will have the substantive right to substitute an asset if it has the practical ability to substitute the asset and it can benefit from exercising that right of substitution.

A contract conveys the right to control the use of an identified asset if, throughout the period of use, the customer has the right to direct the use of the identified asset and obtain substantially all of the economic benefits from directing the use of the identified asset.

A customer has the right to direct the use of an identified asset whenever it has the right to direct how and for what purpose the asset is used, including the right to change how and for what purpose the asset is used, throughout the period of use.

If neither the customer nor the supplier controls how and for what purpose the asset is used throughout the period of use, the customer is considered to have the right to direct the use of the identified asset if the customer has the right to operate the asset or to direct others to operate the asset in a manner that it determines (with the supplier having no right to change those operating instructions) or the customer designed the asset, or caused the asset to be designed, in a way that predetermines during the period of use how and for what purpose the asset will be used or how the asset will be operated.

In addition, a supplier's protective rights (for example, a contract may specify the maximum amount of use of an asset to protect the supplier's interest in the asset) over the identified asset typically define the scope of the customer's use of the asset but do not, in isolation, prevent the customer from having the right to direct the use of the asset.

It is interesting to note that a physically distinct portion of an asset (for example, a floor of a building) can be an identified asset. However, a capacity portion of an asset (for example, a capacity portion of a fiber-optic cable that is less than substantially all of the capacity of the cable) cannot be an identified asset because it is not physically distinct from the remaining capacity of the asset.

C. The lessee accounting model

The core principle of the lessee accounting model is that an entity should recognize assets and liabilities arising from leases with a lease term of more than 12 months.

A lessee will recognize a right-of-use (ROU) asset representing its right to use the leased asset for the lease term and a liability to make lease payments.

The recognition, measurement, and presentation of expenses and cash flows arising from a lease by a lessee would depend on whether the lessee obtains control of the underlying asset.

1. Finance leases

For most leases of assets other than property (e.g., cars and trucks, construction and manufacturing equipment), a lessee will classify the lease as a finance lease and recognize:

- a. A right-of-use asset and a lease liability, initially measured at the present value of lease payments, as defined in the ASU; and
- b. The unwinding of the discount on the lease liability as interest expense, using the effective interest method, separately from the amortization of the right-of-use asset.

The lease liability is reduced by the amount of the periodic lease payment less the amount recognized as interest expense for the period.

With respect to certain leases entities need to consider the CECL impairment model if they are a lessor. ASC 326 applies to net investments in leases associated with sales-type leases and direct financing leases. ASC 326 requires an allowance for credit losses to be recognized on the date that a sales-type lease or direct financing lease receivable is recognized, either through origination or acquisition. An entity's estimate of expected credit losses includes the expected risk of credit loss (even if that risk is remote). Estimates of expected credit loss should be on a collective (pool) basis when individual assets share similar risk characteristics.

2. Operating leases

For most leases of property (e.g., land and/or a building or part of a building), a lessee would classify the lease as an operating lease and will recognize:

- a. A right-of-use asset and a lease liability, initially measured at the present value of lease payments; and
- b. A single lease cost, combining the unwinding of the discount on the lease liability with the amortization of the right-of-use asset, on a straight-line basis.

The lease liability is reduced by the amount of the periodic payment less the amount of that payment attributable to interest, using the effective interest method while amortization of the right-of-use asset is the difference.

3. Determination of a finance or operating lease

The lessee should look to factors similar to those used in U.S. generally accepted accounting principles (GAAP) to make the determination as to whether the lease arrangement is a finance or operating lease. These factors are:

- a. Payments represent substantially all of the asset fair value;
- b. The lease term is for a major portion of the asset's economic life;
- c. There is a bargain purchase option that the lessee is reasonably certain to exercise;
- d. Title transfers automatically at the end of the lease; and
- 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.

Thresholds for the fair value and economic life tests are expected to be similar to the legacy percent tests under ASC 840 (superseded by ASC 842), respectively, but they do not serve as bright lines as they do under prior lease guidance.

Additionally, a lessee is required to reassess the classification of a lease when there is a change in the lease term or a change in the lessee asset purchase option as well as when the lease is modified and not determined to be a new contract.

The IASB lease standard contains only one lease classification for its lessee model, mirroring the finance lease discussed above.

D. The lessor accounting model

1. Lessor classification

A lessor will determine lease classification as either a sales-type, direct financing, or operating lease, on the basis of whether the lease is effectively a financing or sale rather than an operating lease. This guidance is largely unchanged from the previous accounting guidance, only conforming certain glossary terms to those used by lessees and aligning lessor accounting guidance to guidance in ASC 606. However, leveraged leases have been eliminated, though existing ones are grandfathered in under ASC 842 if they commenced before the effective date of ASC 842.

This classification is made at the lease commencement date and is not reassessed by the lessor unless the lease is modified and not accounted for as a new lease (discussed below).

A lessor will classify a lease as sales-type if any of the five criteria discussed above for lessee classification as a finance lease are met. If none of the five criteria are met, the lessor will classify the lease as either operating or a direct financing lease.

The lease is classified as a direct financing lease if both of the following criteria are met:

- a. The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments and/or any other third party unrelated to the lessor equal or exceeds substantially all of the fair value of the underlying asset; and
- b. It is probable that the lessor will collect the lease payments plus any amount necessary to satisfy a residual value guarantee.

A lease that is not classified as a sales-type or direct financing is an operating lease.

2. Sales-type and direct financing leases

Profit would be recognized on day one for sales-type leases while profit is deferred and recognized over the term of the lease in a direct financing lease. For both types of leases, the underlying asset is derecognized at the commencement date if collection of the lease payments, as defined in ASC 606, *Revenue from Contracts with Customers*, is probable. The balance sheet should reflect a lease receivable and the lessor's residual interest in the underlying asset. The lease receivable is reduced as lease payments are received from the lessee, with a portion of the payment recorded as interest income.

3. Operating leases

For most leases of property, a lessor will classify the lease as an operating lease and apply an approach similar to existing operating lease accounting; that is, the lessor will continue to recognize the underlying asset, and recognize lease income over the lease term, typically on a straight-line basis.

ASC 842 contains guidance for accounting for lease payments when collectability is not probable for both sales-type/direct finance and operating leases.

E. Exercise 1 – Lease classification

A lease has the following key terms. In applying the guidance of ASC 842, determine the appropriate classification of this lease from the lessee's perspective.

- a. The lease is a 10-year lease of equipment with a total economic life of 12 years;
- b. Lease payments are \$9,000 per year discounted at 5 percent;
- c. The present value of lease payments is \$69,500; and
- d. The fair value of the leased asset at commencement is \$75,000.

III. Details of the lease accounting guidance

The key objective of the lease accounting guidance is for lessees and lessors to report more useful information to financial statement users about the amount, timing, and uncertainty of cash flows arising from a lease. In this respect, an entity should consider all of the terms and conditions of a contract and all of the related facts and circumstances in order to consistently apply ASC 842 to leases with similar characteristics and in similar circumstances.

A. Separating lease and nonlease components of a contract

After determining that a contract contains a lease, an entity should identify each separate lease component within the contract.

In this respect, the right to use an asset is considered to be a separate lease component if both of the following criteria are met:

- a. The lessee can benefit from use of the asset either on its own or together with other resources that are readily available to the lessee. Readily available resources are goods or services that are sold or leased separately by the lessor or other suppliers, or resources that the lessee has already obtained from the lessor or from other transactions or events; and
- b. The underlying asset is not dependent on or highly interrelated with the other underlying assets in the contract.

The right to use land is always treated as a separate lease component unless the accounting effect of doing so would be insignificant.

The entity then accounts for each lease component as a separate lease, apart from the nonlease components of the contract by allocating the consideration in the contract to each separate lease component that has been identified as follows.

1. Lessor

After identifying the lease components in a contract, a lessor should allocate the consideration in the contract using the requirements outlined in the section on allocating the transaction price to performance obligations in the new revenue recognition standard, ASC 606, *Revenue from Contracts with Customers*.

Also, as mentioned earlier, under ASU No. 2018-11, lessors may make a similar election. However, they may elect this option only if the pattern of income recognition for the lease and nonlease component is identical, and when the lease would be classified as an operating lease even if all of the contract consideration is accounted for as rent. Examples where this expedient may be applicable would be for leases of real estate which also contain a service or maintenance component.

2. Lessee

A lessee should separate lease components from nonlease components unless it applies the accounting policy election below.

A lessee should allocate the consideration in a contract to the lease and nonlease components on a relative standalone price basis. Activities (or costs of the lessor) that do not transfer a good or service to the lessee are not components in a contract. A lessee should also reallocate the consideration in a contract when there is a reassessment of either the lease term or a lessee's purchase option, or there is a contract modification that is not accounted for as a separate new contract.

A lessee should use observable standalone prices, if available, otherwise it should use estimates of the standalone price for lease and nonlease components, maximizing the use of observable information.

A lessee will be permitted, as an accounting policy election by class of underlying asset, to not separate lease components from nonlease components. Instead, a lessee would account for lease and nonlease components together as a single lease component.

As mentioned above, ASU No. 2018-11 provides a similar option to lessors, in certain circumstances. Lessors account for the contract under ASC 842 or ASC 606, depending on whether the lease or nonlease component is predominant.

A price is observable if it is the price that the lessor (or similar suppliers) charges for similar goods or services on a standalone basis.

B. Discount rate

The discount rate used to discount the future cash flows is determined as follows. First, use rate implicit in the lease. The implicit rate is the rate where present value of lease payments and residual value equal fair value of leased asset at lease commencement.

If the rate is not known by the lessee, lessees can use the following:

- a. The incremental borrowing rate; or
- b. For nonpublic companies, there's an option to use the company's risk-free interest rate.

C. Practical expedients and elections

1. Short-term leases

ASC 842 has the threshold of a short-term lease as a lease that, at the commencement date, has a lease term under the contract of 12 months or less and is not reasonably expected to be extended beyond 12 months.

As a matter of accounting policy, a lessee may elect not to apply the requirements in ASC 842-20, *Leases – Lessees*, to short-term leases. Instead, a lessee may recognize the lease payments in profit or loss on a straight-line basis over the lease term. The accounting policy election for short-term leases should be made by class of underlying asset to which the right of use relates.

As a matter of accounting policy, a lessor may elect not to apply the requirements in ASC 842-30, *Leases – Lessors*, to short-term leases, except for the requirement to disclose short-term lease income recognized in the reporting period (in a tabular format). Instead, a lessor may recognize the lease payments in profit or loss over the lease term on either a straight-line basis or another systematic basis, if that basis is more representative of the pattern in which income is earned from the underlying asset. The accounting policy election for short-term leases should be made by class of underlying asset to which the right of use relates.

An entity that accounts for short-term leases in accordance with the above accounting policy exceptions should disclose that fact.

2. Portfolio application and materiality considerations for high-volume, low-dollar leases

For high-volume, small-value leases (e.g., mobile phones), lessees and lessors will be permitted to apply the lease guidance at a portfolio level by grouping contracts together. This approach is similar to that included in the new revenue recognition standard.

3. Materiality

The FASB's basis for conclusions (BC421) discusses how IFRS allows for the establishment of a materiality threshold of \$5,000 or less for leases that would not be recognized. The FASB includes no such threshold and observes that, in addition to accounting for some leases at a portfolio level, entities will likely be able to adopt reasonable capitalization thresholds.

D. Related-party leasing transactions

Leases between related parties should be classified in accordance with the lease criteria applicable to all other leases on the basis of the legally enforceable terms and conditions of the lease. Entities should assess the need for disclosures. More recently, the FASB issued ASU 2023-01, an amendment for entities under common control (effective now), which provides a practical expedient for entities under common control. Conduit bond obligor not-for-profit entities are not eligible for the practical expedient.

The standard states that the recognition and measurement requirements for all leases should be applied by lessees and lessors that are related parties based on the legally enforceable terms and conditions of the lease. In addition, lessees and lessors will be required to apply the disclosure requirements for related-party transactions in ASC 850, *Related Party Disclosures*.

Questions arise about applying the 12-month practical expedient to related-party leases, which may often be month-to-month contractual arrangements or even nonwritten contracts. In such instances, lessees should apply the written terms of the lease agreement in determining the term of the lease, considering whether the lessee has a significant economic incentive to extend the lease. Lessees should also consider verbal agreements with lessors, if applicable, to determine the true economic substance of the lease agreement.

In March 2023, the FASB issued ASU No. 2023-01 related to common control arrangements. ASU 2023-01 provides a practical expedient, which may be applied on an arrangement-by-arrangement basis, for private companies and not-for-profit entities that are not conduit bond obligors to use the written terms and conditions of a common control arrangement to determine:

- a. Whether a lease exists;
- b. The classification of and accounting for the lease (if it exists); and
- c. The practical expedient. However, this may only be applied if written terms and conditions exist. Otherwise, an entity cannot apply the practical expedient and would continue to use the legally enforceable terms and conditions to apply the guidance.

The ASU requires that leasehold improvements associated with leases between entities under common control be:

- a. Amortized by the lessee over the economic life of the leasehold improvements (regardless of the lease term), so long as the lessee controls the use of the underlying asset through a lease. However, the amortization may not exceed the lease term associated with the lessor's lease with another uncontrolled entity.
- b. Accounted for as a transfer between entities under common control through an adjustment to equity (or net assets for not-for-profit entities) when the lessee no longer controls the use of the underlying asset. Those leasehold improvements would also be subject to the impairment guidance in ASC 360, *Property, Plant, and Equipment*.

All lessees that are a party to a lease between entities under common control in which the lessee is the owner of leasehold improvements would be affected by the amendments related to leasehold improvements in this proposed ASU. The amendments would be applicable to all entities including, but not limited to, public business entities, private companies, and all not-for-profit entities. This ASU is effective now.

E. Taxes and insurance

Lease payments for taxes and insurance are not lease components. They may be included in the lease liability and ROU asset. It does not matter whether the lessee reimburses the lessor or pays a third party on the lessor's behalf – the deciding factor is whether the **payments are fixed or variable**.

- a. Payments are fixed – The payments should be included in contract consideration as fixed lease payments and allocated to the lease and nonlease components.
- b. Payments are actual amounts – The payments are considered variable lease payments not tied to a rate or index and should be **excluded** from the ROU asset and liability and expensed as incurred.

F. Lease measurement

1. Lease term

ASC 842 defines the term of a lease as the noncancellable period for which a lessee has the right to use an underlying asset, together with both of the following:

- a. Periods covered by an option to extend the lease if the lessee has a significant economic incentive at the commencement date to exercise that option; and
- b. Periods covered by an option to terminate the lease if the lessee has a significant economic incentive at the commencement date not to exercise that option.

The lease term begins at the commencement date and includes any rent-free periods provided to the lessee by the lessor. As a note of distinction, the lease inception date is the earlier of either the date of the lease or the date of commitment by the parties for principle provisions of the lease.

When determining the lease term an entity should consider all relevant factors that create a significant economic incentive to exercise an option to extend, or not to terminate, a lease. An entity should include such an option in the lease term only if it is reasonably certain that the lessee will exercise the option having considered the relevant economic factors. Reasonably certain in this case is a high threshold. The lease term also includes periods covered by renewal or early termination options if their exercise is controlled by the lessor.

Factors an entity should assess in determining whether the lessee has a significant economic incentive to exercise, or not to exercise, either of the above options include:

- a. Contractual terms and conditions for the optional periods compared with current market rates, such as:
 - (i) The amount of lease payments in any optional period;
 - (ii) The amount of any variable lease payments or other contingent payments, such as payments under termination penalties and residual value guarantees; and

- (iii) The terms and conditions of any options that are exercisable after initial optional periods, for example, the terms and conditions of a purchase option that is exercisable at the end of an extension period at a rate that is currently below market rates;
- b. Significant leasehold improvements that are expected to have significant economic value for the lessee when the option to extend or terminate the lease or to purchase the asset becomes exercisable;
- c. Costs relating to the termination of the lease and the signing of a new lease, such as negotiation costs, relocation costs, costs of identifying another underlying asset suitable for the lessee's operations, or costs associated with returning the underlying asset in a contractually specified condition or to a contractually specified location; and
- d. The importance of that underlying asset to the lessee's operations, considering, for example, whether the underlying asset is a specialized asset and the location of the underlying asset.

A lessee should reassess the lease term only upon the occurrence of a significant event or a significant change in circumstances that are within the control of the lessee, including if any of the following occurs:

- a. There is a significant event or a significant change in circumstances that is within the control of the lessee that directly affects whether the lessee is reasonably certain to exercise or not exercise an option to extend or terminate the lease or to purchase the underlying asset. However, a change in market-based factors, such as market rates to lease a comparable asset, should not be used in isolation to trigger reassessment of the term of a lease;
- b. There is an event that is written into the contract that obliges the lessee to exercise (or not exercise) an option to extend or terminate the lease; or
- c. The lessee does either of the following:
 - (i) Elects to exercise an option even though the entity had previously determined that the lessee did not have a significant economic incentive to do so; or
 - (ii) Does not elect to exercise an option even though the entity had previously determined that the lessee had a significant economic incentive to do so.

A lessor will not be required to reassess the lease term. An entity should account for purchase options in the same way as options to extend, or not to terminate, a lease.

2. Leases with no explicit end

Companies may enter into leases with related or unrelated parties that have no explicit end. The lessee and lessor should evaluate the **enforceable rights and obligations** of the contract (an agreement between two or more parties that creates enforceable rights and obligations). Any period that may not be canceled by the lessee should be included in the lease evaluation. When assessing the length of the noncancellable period of a lease, an entity should apply the definition of a contract. A lease is no longer enforceable when both the lessee and the lessor have the right to terminate the lease without permission from the other party with no more than an insignificant penalty.

G. Test yourself #1

A lessee wants to make the appropriate decision regarding a lease term. In evaluating whether the lessee is reasonably certain to exercise an option, which of the following factors would be the least important to consider?

- A. Contractual terms and conditions for the option periods compared with current market rates.
- B. The entity's reluctance to move.
- C. Significant leasehold improvements that may not be removed from the premises.
- D. Costs incurred in terminating a lease, moving, and signing a new lease.

H. Calculating the lease asset and liability

1. Lease liability

Under ASC 842, the lessee is required to recognize a lease liability equal to the present value of the lease payments. Lease payments consist of the following:

- a. Fixed payments, including in-substance fixed payments, less any lease incentives paid or payable to the lessee.
- b. Variable lease payments that depend on an index or a rate (i.e., Consumer Price Index), measured at the rate at lease commencement date. Variable payments not tied to such an index are excluded and recognized in the period incurred.
- c. The exercise price of an option to purchase the underlying asset if the lessee is reasonably certain to exercise the option.
- d. Payments for penalties for terminating the lease, if the lease term reflects the lessee exercising this option.
- e. Fees paid by the lessee to the owners of a special purpose entity for structuring the transactions.
- f. For lessees only, amounts probable of being owed by the lessee under residual value guarantees.

2. Fixed lease payments

Fixed payments are payments required by the terms of the contract. These payments can be fixed or variable fixed in substance.

If payment of taxes and insurance is included along with the lease payment, this is a fixed payment. It is not a separate component of the lease; therefore, it's included.

Leasehold improvement payments may also be included. The lessee determines whether leasehold improvements belong to the lessor; if they do not, they are not included. The lessee should consider whether these payments are required to be paid under the lease. If they are not, then they should be excluded. If the leasehold improvements could be used by future tenants and the payments are a required part of the lease payment, they should be included.

3. Variable lease payments

If payments are tied to a rate or index, they are included in the liability. Variable lease payments are often tied to performance (such as a percentage of revenue). Sometimes, they are based on the usage of an asset (e.g., car loans wherein high mileage results in additional payment).

Example: Treasury rate

A lessee enters into an agreement to lease space in a building. The contract calls for an escalation rate equal to the five-year Treasury rate at the date of the lease commencement. The rate is 3.5 percent, and the initial rent is \$13,000. The controller calculates the following:

Year 1	13,000
Year 2	13,455
Year 3	13,926
Year 4	14,413
Year 5	14,918

The leased liability equals the sum of the payments (including escalation) over the period. A remeasurement does not occur, even if the Treasury rate changes.

Example: Change in the CPI

A lessee enters into an agreement to lease space in a building. The contract calls for an escalation rate equal to the increase in the Consumer Price Index (CPI) at the date of the lease commencement. The initial rent is \$13,000. The controller makes no calculation because the change in the CPI is not known at the commencement of the lease.

Example: In-substance fixed payments

A lessee enters into an agreement that calls for an increase each year of either 1.5 percent of revenue or 2 percent of the previous year's lease payments, whichever is greater. Since there is a floor of 2 percent of the previous year's lease payments, that would be calculated and used in the calculation of the liability.

4. Residual value guarantees

A residual value guarantee is a guarantee to the lessor that the value of the asset will be at least a certain amount at the end of the lease. Guarantees may be made by the lessee or by a third party. Only the amount probable of being paid under the guarantee is included in the lease liability and ROU asset. In determining the lease classification, use the full amount, not just the probable amount.

5. Right-of-use assets

Initial measurement of the right-of-use asset includes:

- a. The initial measurement of the lease liability determined above;
- b. Any lease payment made at or before the lease commencement date, less any incentives received; and
- c. Any initial direct costs incurred by the lessee (discussed below).

6. Applying the guidance

The following examples demonstrate the calculations and accounting for operating leases, finance leases, and purchase options.

Example: Operating lease

A company enters into a five-year lease for office space classified as an operating lease. The company uses an incremental borrowing rate of 5 percent to discount the lease, since the rate implicit in the lease is not readily determinable. There are no initial direct costs, no prepayments before commencement, no lease incentives, and no option to purchase. The payments outlined below are at a fixed escalating rate with no variable payments. The ROU asset and lease liability are the same.

	Interest	Liability Amortization	Payment
12/31/X1	4,250	10,750	15,000
12/31/X2	3,713	12,288	16,000
12/31/X3	3,098	13,902	17,000
12/31/X4	2,403	15,597	18,000
12/31/X5	1,623	17,377	19,000
Totals	15,087	69,913	85,000

The ROU asset is amortized using the straight-line method. The straight-line expense makes the amortization different than the lease liability. The “plug” is the difference between the cash outlay and the straight-line lease expense.

	Interest	Lease Expense	ROU Amortization
12/31/X1	4,250	17,000	12,750
12/31/X2	3,713	17,000	13,288
12/31/X3	3,098	17,000	13,902
12/31/X4	2,403	17,000	14,597
12/31/X5	1,623	17,000	15,377
	15,087	85,000	69,913

Journal entries for the first year are as follows.

1/1/X1	Record the operating lease		
	ROU asset	69,913	
	Lease liability		69,913
12/31/X1	Record the first-year amortization and payment of cash to the lessor		
	Lease expense	17,000	
	Lease liability	10,750	
	ROU asset		12,750
	Cash		15,000

Example: Finance lease

On January 1, 20X1, a company leases equipment under a three-year noncancellable agreement. The company determines that the lease is a finance lease. Fixed payments are due on December 31 each year in the following amounts: \$10,000 in 20X1, \$11,000 in 20X2, and \$12,000 in 20X3. The company determines that the discount rate is 4 percent, and the present value of the lease liability at commencement of the lease is \$30,453. Private University prepares the following amortization table for the lease liability:

Payment date	Payment amount	Liability amortization component	Interest component
12/31/X1	10,000	8,782	1,218
12/31/X2	11,000	10,133	867
12/31/X3	12,000	11,538	462
Totals	33,000	30,453	2,547

The company also determines that the lease asset at commencement of the lease (i.e., \$30,453) should be amortized in a straight-line manner over the lease term. Private University prepares the following amortization table for the lease asset:

Period	Lease asset amortization amount
Year X1	10,151
Year X2	10,151
Year X3	10,151
Totals	30,453

Journal entries for the first year are as follows.

1/1/X1	ROU asset	30,453	
	Lease liability		30,453
12/31/X1	Lease liability	8,782	
	Interest expense	1,218	
	Cash		10,000
12/31/X1	Amortization expense – ROU asset	10,151	
	Accumulated amortization – ROU asset		10,151

Example: Purchase option

A lessee enters into a five-year lease of equipment. Annual payments are \$59,000 at the end of each year. There are no initial direct costs. The lessee has an option to purchase the equipment for \$5,000, and the lessee has a significant economic incentive to exercise the purchase option. Fair value at commencement of the lease is \$250,000. The estimated useful life is seven years. The rate implicit in the lease is 6.33 percent. This lease is classified as a finance lease.

Payment year 1	59,000
Payment year 2	59,000
Payment year 3	59,000
Payment year 4	59,000
Payment year 5	59,000
Purchase option	5,000
	300,000
Discounted at 6.33%	(50,000)
	250,000

ROU asset	250,000
Lease liability	250,000

Amortization happens over seven years since there is an economic incentive to purchase. At the end of year 5, the lessee pays the lessor \$5,000. The lessee can choose to present the ROU asset in property or separately.

7. Remeasurement

The standard also provides guidance on when a lessee should remeasure the lease liability after the lease commencement date. After the lease commencement date, a lessee should remeasure the lease liability to reflect changes to the lease payments for any of the following:

- a. The lease is modified and not accounted for as a new contract. Note that all assumptions should be updated when a lease is modified
- b. The contingency upon which some or all of the variable lease payments were excluded from the calculation of the lease liability has been resolved such as to meet the definition of a fixed payment.
- c. A change in any of the following:
 - (i) The lease term (determine revised lease payments based on the revised lease term).
 - (ii) Relevant factors that result in the lessee having or no longer having a significant economic incentive to exercise an option to purchase the underlying asset (determine revised lease payments to reflect change in amounts payable under purchase option).
 - (iii) The amounts probable of being paid under residual value guarantees (determine revised lease payments to reflect change in amounts expected to be payable under residual value guarantees).

When a lessee remeasures the lease payments in accordance with the above, the variable payments based on an index or a rate used to determine lease payments should be measured using the rate or index at the remeasurement date (determine revised lease payments using index or rate at the end of the reporting period).

When one of the above events occurs, the lessee should remeasure the lease liability to reflect the changes to the lease payments due to these events. The amount of the remeasurement of the lease liability should be recorded as an adjustment to the right-of-use asset. However, if the carrying amount of the right-of-use asset is reduced to zero, any remaining amounts would be recorded in the income statement.

Also, when remeasuring, the lessee should update the discount rate for the lease at the date of the remeasurement, unless the discount rate already reflects the lessee's option to extend or terminate the lease or to purchase the underlying asset. The updated rate is the rate the lessor would charge the lessee at that date (or the lessee's incremental borrowing rate at that date if the rate the lessor would charge the lessee at that date is not readily determinable, or the risk-free rate at that date for a nonpublic entity that elected to use the risk-free rate) on the basis of the remaining lease term.

Also, if the remeasurement is due to a change in the amounts probable of being owed under a residual value guarantee, or a change from the resolution of a contingency over variable lease payments, the lessee will not update the discount rate.

Example: A lessor (Lessor Corporation) and a lessee (Lessee Corporation) enter into a five-year operating lease of real estate on January 1, 20X1. The lease permits Lessor Corporation to pass on depreciation costs to Lessee Corporation for capital improvements made to the building during the lease term. On January 1, 20X2, Lessor Corporation completes a roof replacement project for a total cost of \$100,000 with a useful life of 10 years. Under the lease provisions, Lessee Corporation will be responsible for paying additional rent of \$10,000 per year during the four-year remaining lease term.

Lessee Corporation should account for the obligation to pay the additional rent to Lessor Corporation as a contingency resolution and remeasure.

8. Lease modifications

The standard defines a lease modification as any change to the contractual terms and conditions of a lease that was not part of the original terms and conditions of the lease. The substance of the modification should govern over its form.

Both lessees and lessors should account for lease modifications as a new lease, separate from the lease being modified, only when: (1) the modification grants the lessee an additional right of use that was not in the original lease; and (2) the additional right of use is priced commensurate with its standalone price.

When the modification is not accounted for as a new contract, the lessee needs to reassess the lease classification as well as remeasure the lease liability, after remeasuring and reallocating the consideration in the contract, if applicable, using the relevant assumptions at the date of the modification.

If the modification grants the lessee an additional right of use not in the original contract (e.g., use of an additional floor of a building) extends or reduces the term of an existing lease other than through exercise of an option (which is not a modification) or changes the consideration in the contract only, the lessee should adjust the value of the right-of-use asset for the amount of the change in the remeasured lease liability. When the modification partially or fully terminates a lease, the lessee should decrease the right-of-use asset proportionally to the impact that the termination of the existing lease has on the lease liability. Any difference between the reduction of the lease liability and the proportional reduction in the right-of-use asset would be recognized as a gain or loss.

Lessor accounting for lease modifications can be complex. First, lessors should determine if the modification represents a new contract, using the same criteria as lessees detailed above. For lessors, the accounting for modifications that do not result in a separate new lease varies based on whether the original lease is a sales-type, direct financing, or operating lease as well as whether the reassessment results in a reclassification of the lease.

- a. **Sales-type leases** – If the modified lease is reassessed as a sales-type or direct financing lease, adjust the discount rate so the initial net investment of the modified lease equals the carrying amount of the net investment of the original lease immediately before the effective date of the modification. If the reassessment results in the modified lease being classified as an operating lease, the underlying asset is recognized at an amount equal to the net investment in the original lease immediately before the modification effective date.

- b. **Direct financing leases** – If the classification of the modified lease does not change, adjust the discount rate such that the initial net investment in the modified lease equals the carrying amount of the net investment in the original lease immediately before the modification effective date. Lessors should follow the sales-type lease guidance of the reassessment results in the modified lease being classified as a sales-type lease. If the reassessment results in the modified lease being classified as an operating lease, the underlying asset is recognized at an amount equal to the net investment in the original lease immediately before the modification effective date. This is the same treatment as that for a sales-type lease.
- c. **Operating leases** – The modification is accounted for as if it were a termination of the existing lease and the creation of a new lease that commences on the modification effective date. If the reassessment results in a determination that the new lease is an operating lease, include all prepaid or accrued lease rentals related to the original lease to the sum of the modified lease payments for purposes of calculating the straight-line rental income under the new lease. If the new lease is determined to be a sales-type or direct financing lease, the lessor should re-recognize any prepaid or deferred rent and adjust selling profit or loss.

9. Initial direct costs

The standard states that only incremental costs should qualify as initial direct costs subject to capitalization in both lessor and lessee accounting. These costs are those that the entity would not have incurred if the lease had not been entered into. These include commissions or payments to existing tenants to obtain the lease and are the same for both the lessor and lessee.

The lessee should include initial direct costs in its initial measurement of the right-of-use asset and amortize them over the term of the lease.

Lessor accounting for such costs varies based on the type of lease. For sales-type leases, the lessor should expense such costs at lease inception if the lessor recognizes selling profit at the inception of the lease. Alternatively, the lessor should include these costs in determining the lease receivable by considering them in its measurement of the net investment in the lease.

Initial direct costs are deferred and included in the net investment in the lease at its commencement date for direct financing leases.

For operating leases, such costs should be expensed over the term of the lease.

I. Subleases

An intermediate lessor, that is, an entity that is both a lessee and a lessor of the same underlying asset, should account for a head lease and a sublease as two separate contracts. The head lease should be accounted for in accordance with the new lessee accounting guidance and the sublease in accordance with the new lessor accounting guidance (unless those contracts meet the contract combinations guidance touched upon above). When classifying a sublease, an intermediate lessor should determine the classification of the sublease with reference to the underlying asset – for example, the item of property, plant, and equipment that is the subject of the lease, rather than with reference to the right-of-use asset arising from the head lease.

An intermediate lessor should not offset lease assets and lease liabilities arising from a head lease and a sublease that do not meet the U.S. GAAP financial instruments requirements for offsetting – or lease income and lease expense related to a head lease and a sublease – unless it recognizes sublease income as revenue and acts as an agent, assessed in accordance with the principal agent guidance in the ASC 606, *Revenue from Contracts with Customers*.

J. Financial statement presentation

The objective of the disclosures required under ASC 842 is to allow financial statement users to assess the timing, amount, and uncertainty of cash flows arising from leases. As such, lease disclosures under the standard are likely to be detailed in both a quantitative and qualitative nature.

1. Statement of financial position

A lessee should present all of the following items in the statement of financial position (or disclose these items in the notes to the financial statements):

- a. Right-of-use assets separately from other assets;
- b. Right-of-use assets arising from finance leases separately from right-of-use assets arising from operating leases;
- c. Lease liabilities separately from other liabilities; and
- d. Lease liabilities arising from financing leases separately from lease liabilities arising from operating leases.

If a lessee does not present right-of-use assets and lease liabilities separately in the statement of financial position, the lessee should present right-of-use assets within the same line item as the corresponding underlying assets would be presented if they were owned and disclose which line items in the statement of financial position include right-of-use assets and lease liabilities.

A lessor should present its net investment in sales-type and direct financing leases on the statement of financial position, separate from the lessor's other assets.

2. Statement of comprehensive income

A lessee should present both of the following items in the statement of comprehensive income:

- a. For finance leases, the unwinding of the discount on the lease liability separately from the amortization of the right-of-use asset.
- b. For operating leases, the unwinding of the discount on the lease liability together with the amortization of the right-of-use asset.

3. Statement of cash flows

In the statement of cash flows, a lessee should classify:

- a. Cash payments for the principal portion of the lease liability arising from finance leases within financing activities;
- b. Cash payments for the interest portion of the lease liability arising from finance leases within operating activities;
- c. Cash payments arising from operating leases within operating activities; and
- d. Variable lease payments and short-term lease payments not included in the lease liability within operating activities.

Lessors must classify cash receipts from leases within operating activities.

4. Disclosures

Qualitative disclosures for lessees include the following:

- a. Information about the nature of its leases (and subleases), including:
 - (i) A general description of those leases;
 - (ii) The basis, and terms and conditions, on which variable lease payments are determined;
 - (iii) The existence, and terms and conditions, of options to extend or terminate the lease. A lessee should provide narrative disclosure about the options that are recognized as part of the ROU assets and lease liabilities and those that are not;
 - (iv) The existence, and terms and conditions, of residual value guarantees provided by the lessee; and
 - (v) The restrictions or covenants imposed by leases.
- b. Information about leases that have not yet commenced but that create significant rights and obligations for the lessee.
- c. Information about significant assumptions and judgments made in applying the requirements of the leases standards, which may include the following:
 - (i) The determination of whether a contract contains a lease;
 - (ii) The allocation of the consideration in a contract between leases and nonlease components; and
 - (iii) The determination of the discount rate.
- d. The main terms and conditions of any sale and leaseback transactions.
- e. Whether an accounting policy election was made for the short-term lease exemption.

The FASB decided if the short-term lease expense does not reflect the lessee's short-term lease commitments, a lessee should disclose that fact and the amount of its short-term lease commitments.

The following quantitative disclosures are required to be made by lessees by the standard:

- a. Finance lease expense segregated between amortization of ROU assets and interest on lease liabilities.
- b. Operating lease expense.
- c. Short-term lease expense, excluding expenses relating to leases with a lease term of one month or less.
- d. Variable lease expense.
- e. Sublease income.
- f. Cash paid for amounts included in the measurement of lease liabilities, segregated between operating and financing cash flows and between finance and operating leases.
- g. Supplemental noncash information on lease liabilities arising from obtaining ROU assets, segregated between finance and operating leases.
- h. Weighted-average remaining lease term disclosed separately for finance and operating leases.
- i. Weighted-average discount rate for finance and operating leases as of the reporting date.
- j. Gains and losses arising from sale and leaseback transactions.

Expense items disclosed include any amounts capitalized as part of the cost of another asset.

Example: Sample judgments and estimates footnotes

The present value of the lease payments is calculated using the incremental borrowing rate for operating and finance leases, which was determined using a portfolio approach based on the rate of interest that the Organization would have to pay to borrow an amount equal to the lease payments on a collateralized basis over a similar term. The Agency uses an unsecured borrowing rate and risk-adjusts that rate to approximate a collateralized rate which will be updated on a quarterly basis for measurement of new lease liabilities.

For most leases, the implicit rate is not readily determinable. Accordingly, the Agency uses a discount rate in determining the present value of future payments based on the yield-to-maturity of our secured publicly traded debt instruments interpolating the duration of the debt to the term of the executed lease.

The lease liabilities are measured at the lease commencement date and determined using the present value of the minimum lease payments not yet paid and the Organization's incremental borrowing rate, which approximates the rate at which the Organization could borrow, on a secured basis. The interest rate implicit in the lease is generally not determinable in transactions where the Organization is the lessee.

The Organization generally uses its fully collateralized incremental borrowing rate as of the commencement date to calculate and record the lease. The incremental borrowing rate is influenced by factors such as credit rating and lease term and therefore, may differ for individual leases, embedded leases, or portfolios of leased assets.

Additionally, a lessee must disclose a maturity analysis of its lease liabilities, showing the undiscounted cash flows on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years, and reconciling the undiscounted cash flows to the discounted lease liabilities recognized in the statement of financial position.

Lessor disclosures include the following:

- a. Information about the nature of its leases, as well as information about significant assumptions and judgments made in applying the leases requirements;
- b. A table of lease income during the reporting period; and
- c. Information about how a lessor manages its risk associated with the residual value of its leased assets.

A lessor should treat assets subject to operating leases as a major class of depreciable assets, further distinguished by significant class of underlying asset. Accordingly, a lessor should provide the required property, plant, and equipment disclosures for assets subject to operating leases separately from owned assets held and used by the lessor.

A lessor should be required to disclose the following quantitative information:

- a. For sales-type and direct financing leases, a maturity analysis of the undiscounted cash flows that comprise the lessor's lease receivables for each of the first five years following the reporting date and a total of the amount for the remaining years thereafter. A lessor should reconcile the maturity analysis to the balance of lease receivables presented separately in the balance sheet or disclosed separately in the notes; and
- b. For operating leases, a maturity analysis of the undiscounted future lease payments to be received for each of the first five years following the reporting date and a total of the amount for the remaining years thereafter.

A lessor will also be required to disclose the components of its net investment in sales-type and direct financing leases (that is, its lease receivables, its unguaranteed residual assets, and any deferred selling profit on direct financing leases) in the notes. In addition, lessors are required to provide an explanation of the significant changes in the components of the net investment in sales-type and direct finance leases other than the lease receivable during the reporting period.

Lastly, both lessees and lessors are required to apply the disclosure requirements for related-party transactions in accordance with ASC 850.

Example: Weighted average lease term and weighted average discount rate
Weighted average lease term calculation:

	Lease liability at 12/31/X1	Percent of total lease liability	Months remaining on the lease	Weighted average	
Operating lease 1	45,440	14.88%	24	3.572	
Operating lease 2	125,885	41.23%	51	21.026	
Operating lease 3	68,970	22.59%	12	2.711	
Operating lease 4	39,850	13.05%	15	1.958	
Operating lease 5	25,200	8.25%	25	2.063	
Total lease liability	305,345	100.00%		31.33	2.610731304

The weighted average remaining lease term for the operating leases was 2.6 years or 31.33 months.

Weighted average discount rate calculation:

	Lease 1 remaining payments	Lease 2 remaining payments	Lease 3 remaining payments	Lease 4 remaining payments	Lease 5 remaining payments	Total remaining payments
20X2	22,720	29,616	68,970	31,872	12,096	165,274
20X3	22,720	29,616		7,978	12,096	72,410
20X4		29,616			1,008	30,624
20X5		29,616				29,616
20X6		7,421				7,421
Total	45,440	125,885	68,970	39,850	25,200	305,345

Percent remaining payments to total	14.88%	41.23%	22.59%	13.05%	8.25%	100.00%
Discount rate at commencement	4.20%	4.40%	5.00%	3.75%	4.50%	
Weighted average discount rate	0.63%	1.81%	1.13%	0.49%	0.37%	4.43%

The weighted average discount rate for the operating leases was 4.43 percent.

Example: Accounting policy

Leases

The Agency determines if an arrangement is a lease at **inception**. Operating leases are **included** in operating lease right-of-use (ROU) assets, other current liabilities, and operating lease liabilities in the consolidated balance sheets. Finance leases are included in property and equipment, other current liabilities, and other long-term liabilities in the consolidated balance sheets. ROU assets represent the right to use an underlying asset for the lease term and lease liabilities represent the obligation to make lease payments arising from the lease. Operating lease ROU assets and liabilities are recognized at **commencement date** based on the present value of lease payments over the lease term. As most of the leases do not provide an implicit rate, **the Agency generally uses an incremental borrowing rate** based on the estimated rate of interest for collateralized borrowing over a similar term of the lease payments at commencement date.

Example: Disclosures related to income statement

Note 14 – Leases

The Organization has operating and finance leases for datacenters, corporate offices, research and development facilities, and certain equipment. These leases have remaining lease terms of one year to 19 years, some of which include options to extend the lease for up to five years, and some of which include options to terminate the lease within one year.

The components of lease expense were as follows (millions).

Year ended	6/30/22	6/30/21	6/30/20
Operating lease cost	2,461	2,127	2,043
Finance lease cost			
Amortization of ROU assets	980	921	611
Interest on lease liabilities	429	386	336

Example: Financial statements

The following table outlines the statements of financial position (in millions).

	6/30/22	6/30/21
ASSETS		
Current assets:		
Cash and cash equivalents	\$104,757	\$130,334
Accounts receivable (net of allowance for doubtful accounts of \$633 and \$751)	44,261	38,043
Inventories	3,742	2,636
Other current assets	16,924	13,393
Total current assets	169,684	184,406
Noncurrent assets:		
Property and equipment (net of accumulated depreciation of \$59,660 and \$51,351)	74,398	59,715
Operating lease right-of-use assets	13,148	11,088
Equity investments	6,891	5,984
Goodwill	67,524	49,711
Intangible assets (net)	11,298	7,800
Other long-term assets	21,897	15,075
Total assets	\$364,840	\$333,779
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Current portion of long-term debt	\$19,000	\$15,163
Accrued compensation	10,661	10,057
Short-term unearned revenue	15,278	12,639
Other current liabilities	13,067	11,666
Total current liabilities	95,082	88,657
Noncurrent liabilities:		
Long-term debt	30,851	41,364
Long-term unearned revenue	2,870	2,616
Operating lease liabilities	11,489	9,629
Total liabilities	198,298	191,791
Commitments and contingencies		
NET ASSETS		
Without donor restriction	82,261	83,111
With donor restriction	84,281	58,877
Total net assets	166,542	141,988
Total liabilities and net assets	\$364,840	\$333,779

Example: Supplemental balance sheet information

Supplemental balance sheet information related to leases was as follows (in millions except lease term and discount).

	6/30/22	6/30/21
OPERATING LEASES		
Operating lease ROU assets	\$13,148	\$11,088
Other current liabilities	2,228	1,962
Operating lease liabilities	11,489	9,629
Total operating lease liabilities	13,717	11,591
FINANCE LEASES		
Property and equipment, at cost	\$17,388	\$14,107
Accumulated depreciation	(3,285)	(2,306)
Property and equipment, net	14,103	11,801
Other current liabilities	1,060	791
Other long-term liabilities	13,842	11,750
Total finance lease liabilities	14,902	12,541
WEIGHTED AVERAGE REMAINING LEASE TERM		
Operating leases	8 years	8 years
Finance leases	12 years	12 years
WEIGHTED AVERAGE DISCOUNT RATE		
Operating leases	2.1%	2.2%
Finance leases	3.1%	3.4%

Example: Lease maturity schedule in footnotes

The following table outlines the maturities of lease liabilities as of June 30, 2022 (in millions).

Year ended	Operating leases	Finance leases
6/30/23	\$2,456	\$1,477
6/30/24	2,278	1,487
6/30/25	1,985	1,801
6/30/26	1,625	1,483
6/30/27	1,328	1,489
Thereafter	5,332	9,931
Total lease payments	15,004	17,668
Less imputed interest	(1,287)	(2,766)
Total	13,717	14,902

As of June 30, 2022, the Center has additional operating and finance leases, primarily for datacenters, that have not yet commenced of \$7.2 billion and \$8.8 billion, respectively. These operating and finance leases will commence between fiscal year 2023 and fiscal year 2028 with lease terms of one year to 18 years.

Example: Supplemental cash flow information

Supplemental cash flow information related to leases was as follows (in millions).

Year ended	6/30/22	6/30/21
Cash paid for amounts included in the measurement of lease liabilities:		
Operating cash flows from operating leases	2,368	2,052
Operating cash flows from finance leases	429	386
Financing cash flows from finance leases	896	648
ROU assets obtained in exchange for lease obligations:		
Operating leases	5,268	4,380
Finance leases	4,234	3,290

K. Test yourself #2

Under ASC 842, which of the following lease types is not required to be recognized on the balance sheet?

- A. Operating lease.
- B. Finance lease.
- C. Short-term lease where the lessee is not reasonably certain to exercise any option to extend.
- D. Related-party lease.

L. Exercise 2 – Lease contracts

Determine if a contract with the following characteristics would be a lease under the guidance of ASC 842.

- a. Contract for the use of 10 shipping containers of particular specifications kept on the customer's premises.
- b. Carrier cannot retrieve containers during contract.
- c. Customer directs the use of the containers.
- d. Customer can receive a replacement when one needs repair.

What if the carrier had the right to substitute one of the 10 identified containers?

IV. Auditing leases

A. Risks related to leases

As all leases are capitalized under ASC 842, our audit considerations related to leases must address both the initial and subsequent accounting of the lease liability as well as the initial and subsequent accounting for the ROU assets that must be recorded under ASC 842 for all leases. The application of ASC 842 by an entity with a significant operating lease portfolio will most likely have a material impact on the entity's financial statements, as well as potentially introducing new risks to the audit process. These potential new risks include:

- a. Identification of all leases, included embedded leases;
- b. Determination of lease term;
- c. Calculation of fixed and variable payment streams;
- d. Interest rate determination; and
- e. Initial and subsequent accounting.

Remember that a risk is not considered a significant risk unless it is at the upper end of the inherent risk spectrum. The issues above may not reach that level.

From the asset perspective, the approach to auditing the ROU asset recorded under ASC 842 would be similar to that for auditing PP&E additions. While some entities enter into a high volume of lease agreements, for many entities, new lease activity represents a few number of potentially high dollar arrangements. As such, the auditing of increases in the ROU asset very often will be obtained via target testing of new lease arrangements which the entity entered into during the year.

As with PP&E, amortization of the ROU asset is a relative straight forward accounting entry. Most entities elect to use a straight-line method to amortize the ROU asset for finance leases. However, note that under ASC 842, amortization expense of the ROU asset is part of the straight-line lease expense that entities recognize for operating leases. As such, unlike amortization expense with a finance lease, amortization of the ROU asset resulting from an operating lease is not identifiable, nor is it the same in each accounting period. Auditors will need to focus on this aspect of operating lease subsequent accounting as they develop the nature, timing and extent of their procedures related to leases, as using substantive analytics to test operating lease amortization expense and the related change in accumulated amortization may not be a feasible audit approach.

B. Common areas of inherent risk

From the lease liability perspective, the approach to auditing the lease liability established for both operating and finance leases will be similar to that for auditing debt agreements, as both represent contractual commitments of company resources. Again, for most entities, the entering into a lease arrangement is a fairly unique event. As such, the entity may not have a sophisticated process for accounting for leases. As such, the process may not lend itself to being well controlled. Nonetheless, a company may still have well designed and implemented controls over the lease accounting process. As part of the risk assessment process, the auditor will need to assess the inherent risk associated with the client's leasing activities.

Key elements of inherent risk, by relevant financial statement assertion, related to leases are as follows:

Relevant financial statement assertion	Risks
Existence/occurrence	Has the lease agreement been properly approved by management and/or those charged with governance? Do all contracts accounted for as leases contain the following? <ul style="list-style-type: none"> • Identifiable asset; and • No significant restrictions on the lessee's ability to use the asset.
Completeness	Have all leases been identified and accounted for? Have contracts been reviewed for the existence of embedded leases?
Rights and obligations	Have all lease components been identified in lease contracts? Have nonlease components been identified in lease contracts? Has the entity considered any third-party restrictions on entering into new debt arrangements, such as debt covenants?
Accuracy/classification	Has the lease been classified accurately? Have the appropriate payment streams been included in the lease liability and ROU asset? Has the appropriate subsequent accounting guidance been accurately followed for either operating or finance leases? Have the other relevant provisions of ASC 842 been followed?
Valuation	Has an appropriate discount rate been used? Have reasonable estimates for residual value guarantees been utilized?
Cutoff	Have leases been recorded in the proper accounting period?
Presentation and disclosure	Has the lease liability been accurately separated between current and long-term? Has the ASC 842 financial statement presentation guidance been followed? Has the financial statement disclosure information been obtained and is it accurately computed?

Lease accounting is a frequent source of proposed adjusting entries on the audits of many smaller and medium-sized companies, especially for operating leases with escalating payment streams. Further, many entity's disclosures related to operating, such as the five-year table of minimum lease payments, are frequently incomplete, as the entities fail to include all lease commitments in the disclosures. These challenges must be considered as companies must capitalize all operating and finance lease obligations and related assets.

C. Assessing control risk

As part of the risk assessment process, the auditor must also assess control risk related to each financial statement assertion related to leases. As we are focusing on both an asset and liability when auditing ASC 842, it's likely that all financial statement assertions will be relevant. Further, there is risk of both overstatement of the ROU asset as well as understatement of the lease liability. Entity controls should address both risks.

As entering into lease transactions may be an infrequent event, client controls in this area may be poorly designed or implemented. However, most companies will have at least some controls over this process, as entering into a lease represents a potentially significant financial commitment for many organizations.

1. Common controls over lease accounting

Common controls that entities may have (by COSO component) include the following:

COSO Component	Representative Controls
Control environment	Overall commitment of senior management to effective financial reporting. Hiring of competent personnel in financial reporting process. Appropriate review and approval by senior managements and governance of significant transactions.
Risk assessment	Evaluation of financing options. Assessment of impact on other contractual commitments, such as debt covenants. Identification of other risks related to entering into a leasing arrangement.
Information and communication	Systems (lease accounting software, spreadsheets, etc.) used to account for leases. Spreadsheet version and accuracy controls. Development of standardized policies and procedures to address accounting for leases under ASC 842. Communication of materials to appropriate personnel.
Monitoring	Periodic and/or ongoing monitoring of accounting and operational considerations related to leases.

While companies should have controls that address each of the five COSO components, the auditor's focus on controls will be primarily at the control activity level. Controls should address both the initial and subsequent recording of the lease liability as well as the recording and subsequent accounting of the ROU asset.

2. Common control activities over lease accounting

Common control activities over the lease accounting process are covered in the following table.

Process Addressed by Control(s)	Control	Primary Financial Statement Assertion Addressed
Controls over lease contracts	All lease contracts are appropriately approved by management or governance based on established criteria.	E/O
	Final executed copies of all lease agreements are received.	C, E/O
	All relevant contracts are evaluated for embedded leases.	C, R/O, V, A/CL
	Relevant contractual terms from contracts with embedded leases are identified and considered for appropriate accounting.	C, R/O, V, A/CL
	All relevant contracts are reviewed to determine if the contract should be accounted for under ASC 842.	A/CL
Controls over original recording of lease liability and ROU asset	Cash flow streams are appropriately identified for inclusion into lease liability and ROU asset.	V, A/CL
	Variable payment streams are assessed as whether they are tied to a rate or index and, if so, properly calculated.	V, A, CL
	Residual value guarantees are assessed to determine which amount is likely to be paid at the end of the lease and thereby included in the lease liability.	V, A/CL
	Leased asset purchase provisions are assessed, with management determining the likelihood of the provision being exercised.	V, A/CL
	Options to extend or terminate leases are evaluated and appropriately considered when determining lease term and lease payment streams.	V, A/CL
	Lease contracts meeting the short-term lease practical expedient criteria are identified and accounted for in accordance with management's election.	A/CL
	Lease and embedded leases are evaluated for proper classification, per ASC 842 criteria.	A/CL, R/O, C
	Appropriate discount rate determined in accordance with ASC 842 is selected and applied.	V, A/CL
	Payment streams are appropriately discounted, using the applicable discount rate.	V, A/CL
	Payments made at or before lease commencement are identified and appropriately considered in valuing the ROU asset.	A/CL
	Initial lease costs are evaluated for proper capitalization.	A/CL
	ROU amortization period and method established for finance leases.	V, A/CL
	The determination of the lease commencement date is performed.	V, A/CL

Process Addressed by Control(s)	Control	Primary Financial Statement Assertion Addressed
Review and supervisory controls	Initial recording of journal entries for new leases at the lease commencement date is reviewed by appropriate supervisory accounting personnel for completeness and accuracy.	A/CL, V, C, R/O, CO
	Subsequent accounting for both operating and finance leases is reviewed by appropriate supervisory accounting personnel for completeness and accuracy.	A/CL, C, CO
	Management reviews the entity's financial statements on a periodic basis and investigates significant variances from budget and expected results.	E/O, A/CL, V, C, CO, R/O
Presentation and disclosure controls	Lease liability is appropriately classified between current and noncurrent portions.	P/D
	Other information required for appropriate financial statement presentation and disclosure is obtained and checked for completeness and accuracy.	P/D
Controls over lease modifications and remeasurement events	Lease modifications are identified, with accounting implications appropriately determined and recorded.	A/CL, V
	Lease modifications are reviewed and appropriately approved by the requisite level of management.	A/CL, V
	Other lease remeasurement events and identified, with implications appropriately accounted for.	A/CL, V
Controls related to related-party leases and significant unusual events	Management reviews lease and embedded lease agreements for identification of potential related parties and considers the appropriate disclosure requirements.	P/D
	Management reviews leases and embedded lease agreements for identification of potential significant unusual transactions and considers the propriety of such transactions.	P/D, A/CL

Given the complexities of applying ASC 842, companies may benefit from developing a standardized checklist or template that identifies the key considerations when applying ASC 842 to new leases. The checklist can be completed by the person performing the task and can be reviewed and approved by appropriate accounting supervisory personnel.

3. Other control considerations

Further, many companies will be using spreadsheets to perform the lease classification calculations as well as to develop lease amortization schedules. Such spreadsheets can also be used to support the ASC 842 financial statement disclosures. If companies use spreadsheets to support lease accounting calculations, the spreadsheet should be subject to effective internal controls as well. Key controls over spreadsheets include the following:

- a. Restricted access to the spreadsheet;
- b. Version control over the spreadsheets;
- c. Proof of mathematical accuracy over the calculations performed;
- d. Controls over inappropriate changing of formulas;
- e. Controls over completeness and accuracy of data inputted into the spreadsheets;
- f. Controls over completeness and accuracy of the output of the spreadsheet; and
- g. Procedures for retiring and archiving older versions of spreadsheets.

Similarly, many companies have employed lease accounting software to support their lease accounting processes. Such software can significantly increase the efficiency of the lease accounting process. However, the use of such software should also be subject to effective controls. Some representative controls include the following:

- a. Restricted access to the software;
- b. Controls over the completeness and accuracy of data input;
- c. Review of the software outputs;
- d. Obtaining SOC1 or SOC2 report to support accuracy of the software's calculation; and
- e. Agreement of software outputs to journal entries and relevant footnote disclosures.

Lastly, some companies may look to automate the financial reporting process by using robotic process automation (RPA) to populate adjusting journal entries with the output of lease accounting software or spreadsheets. While RPA may significantly enhance the financial reporting process, company management must ensure that the data being captured via RPA is complete and accurate. Further, there should be appropriate restricted access and program maintenance controls to assure that the RPA formula, or "bot" operates as intended in all instances and that any program changes are adequately tested before being placed into a live environment.

Auditors must assess the design of company controls over the lease accounting process to determine whether they are designed to prevent or detect a material misstatement. Further, they must determine whether the controls have been implemented. Design effectiveness is generally performed by reviewing relevant system documentation and confirming process and control design via inquiry. Implementation is generally assessed via a walkthrough.

Based on this understanding, the auditor will assess control risk, the risk that the controls will not prevent or detect a material misstatement. This assessment is performed for each relevant financial statement assertion. If the auditor assesses control risk at anything but high, the auditor must test the operating effectiveness of the controls in order to rely on these controls.

If control risk is assessed at high for a relevant assertion, the auditor's entire audit support must come from substantive procedures.

D. Determining the risk of material misstatement

The outcome of the risk assessment process is to develop an assessment of the risk of material misstatement (RMM), at the relevant assertion level, for both the lease liability as well as the ROU asset. Note that the RMM can also be performed at the relevant class of transactions level, as appropriate. For instance, there may be a different RMM for assertions related to operating or finance leases.

This RMM drives the nature, timing, and extent of the auditor's substantive procedures, which are performed in relation to detection risk, the risk that the auditor's procedures will not detect a material misstatement in the financial statements. The lower the risk of material misstatement, the higher detection risk with which the auditor can accept. A higher detection risk results in less assurance being needed from the substantive procedures performed.

The following summarizes the relationship between RMM and detection risk, as it relates to the nature, timing, and extent of substantive procedures which the auditor needs to perform in order to reduce audit risk to an acceptable level.

$$\text{Detection risk} = \frac{\text{Audit risk}}{\text{Inherent risk} \times \text{control risk}}$$

Inherent Risk	Control Risk	RMM
High	High	High
High	Moderate	High
High	Low	Moderate
Moderate	High	Moderate
Low	High	Low
Moderate or Low	Moderate	Low/Moderate
Moderate or Low	Low	Low

Anticipated reliance on controls requires the auditor to test their operating effectiveness. AU-C §315 indicates that if tests of controls are not performed, control risk is assessed at the maximum (or high) and the risk of material misstatement equals inherent risk. In the model above, the RMM follows this convention except where inherent risk is low and control risk is high, this is an area where the RMM is assessed at slightly higher than the inherent risk when the control risk is high, and under AU-C §315 the auditor can consider whether the moderate RMM can be reduced to low. Many factors impact the decision whether to test the system of internal controls over the leasing process. The effectiveness of the design and implementation of the controls is the primary factor. However, another factor is the number of new leases entered into by the company. If the entity enters into only a few leases during the year, it may be more efficient to substantively test the new leases, especially given the judgment and documentation requirements under ASC 842, than to test controls, especially if substantive procedures must still be performed on some leases anyway. The auditor should use professional judgment, based on knowledge of the entity, its controls and the number of leases entered into, to develop an audit approach that is both efficient and effective.

E. Substantive audit procedures performed on lease balances

Like auditing PP&E and debt, the approach to auditing leases, both for the liability and the ROU asset, is likely to include substantive procedures, at least to some extent.

1. Significant risk

First, the auditor should determine if a significant or fraud risk exists related to accounting for leases. If so, the auditor must follow the following guidance related to auditing such risks:

When...	The auditor may...
There is a significant risk	Use tests of details alone, use SAP and tests of details, use tests of controls and SAP, or use tests of controls and tests of details. Note that analytical procedures alone will not provide sufficient audit evidence where there are significant risks.
Risk is not significant	Using whatever combination of tests of controls and substantive tests will reduce risk of material misstatement to a low level.

Given the risk assessment performed at the relevant assertion level, and consideration of whether significant or fraud risks exist, the auditor will respond to detection risk by designing and performing sufficient substantive procedures, in sufficient extent and at the appropriate time to reduce audit risk to an acceptable level. Substantive procedures can include substantive analytics and tests of details. Tests of details can include target testing or sampling. Substantive testing of new leases can often be performed before year-end, with roll-forward procedures performed to audit new activity from the interim testing date to the financial reporting date.

2. Substantive analytical procedures

Substantive analytical procedures can be an effective and efficient way to obtain audit assurance when predictable relationships exist between and among account balances. Generally, such relationships exist among income statement accounts as opposed to balance sheet accounts. As such, it may be efficient for an auditor to perform well-designed analytics to obtain assurance over the completeness and accuracy of operating lease expense, and amortization of the ROU asset for finance leases. Operating lease expense is a straight-lined amount which is the same for an operating lease every year. A very predictable relationship. Assuming that the company amortizes the ROU asset on a straight-line basis, again, a predictable relationship should exist year to year. Accordingly, a well-designed substantive analytic should provide sufficient assurance over multiple financial statement assertions.

Note that the interest expense recognized annually on finance leases is based on the effective interest method and, as such, will change every year over the term of the lease. Further, the amortization of the ROU asset for an operating lease also changes each year, for similar reasons.

When designing a substantive analytical procedure for the finance lease interest expense or operating lease ROU asset amortization, an allotment for these annual changes must be factored into the analytics' expectations. Such amounts may be more efficiently tested substantively, especially if the company has a relatively small lease portfolio.

Further, the expectations for all substantive analytics should reflect the impact of any new leases entered into during the year.

A common substantive analytical procedure performed on ROU assets, amortization expense and changes in accumulated amortization is a reasonable test where the average ROU asset balance is divided by the average term of the leases. This test provides an estimate of annual ROU amortization expense and the change in the accumulated amortization expense account.

The formula for this analytic would be as follows: $(\text{BOY balance} + \text{EOY balance}) \times 0.5 \div \text{average lease term}$.

As operating lease expense is recorded on a straight-line method as well, a similar approach could be employed to test operating lease expense during the year.

Often, auditors perform some level of test of details on both the asset and liability account balances related to leases, as well as on some income statement accounts related to leases. The scope will be based on the year's activity and the effectiveness of the company's internal controls over leases.

3. Substantive procedures to perform on leases under ASC 842

The following table covers representative substantive procedures that can be performed over lease balance sheet and income statement balances.

Assertions	Substantive Audit Procedure
C, R/O, V, A/CL	<p>For all leases and outsourcing, service, supply, or similar contracts, perform the following procedures.</p> <p>Obtain an analysis of lease contracts, separated by class of asset and lease classification, that performs rollforwards for the following:</p> <ul style="list-style-type: none"> • Lease liabilities: <ul style="list-style-type: none"> ○ Beginning-of-the-year balance; ○ Liabilities related to new leases entered into during the year; ○ Repayment of lease liability; ○ Other adjustments (modifications or remeasurements) as applicable; and ○ End-of-the-year lease liability balance. • ROU assets: <ul style="list-style-type: none"> ○ Beginning-of-the-year balance; ○ ROU assets added due to new leases entered into; ○ Amortization of ROU assets during the year; ○ Other adjustments (modifications, remeasurements, impairments) as applicable; and ○ End-of-year ROU asset balance. <p>Test the accuracy of the analysis and agree beginning of the year balances to prior year workpapers and end of year balances to the trial balance.</p> <p>Perform substantive analytics, as appropriate, on balance sheet and income statement accounts included in the rollforward.</p>
C, R/O, V, A/CL	<p>For any leases and outsourcing, service, supply, or other similar contracts not previously tested that were not previously tested or which were modified during the period, perform the following:</p> <ul style="list-style-type: none"> • Obtain and review lease contracts or other contracts, as applicable, to assess the contracts for meeting the definition of a lease, including contracts that potentially contain embedded leases; • Assess whether the entity has properly identified all lease components and nonlease components, and allocated the contract consideration in accordance with the entity's policy decision related to lease and nonlease components; and • Consider confirming significant lease obligations as deemed appropriate.

Assertions	Substantive Audit Procedure
V, A/CL	<p>Based on the terms of the leases reviewed, assess the appropriateness of the following:</p> <ul style="list-style-type: none"> • Classification of the lease as operating or finance; • Discount rate used: <ul style="list-style-type: none"> ○ If management uses the rate implicit in the lease, assess the reasonableness of its estimation of the fair value of the leased asset as well as the mathematical accuracy of its calculation of the discount rate; ○ If management uses its incremental borrowing rate, assess the reasonableness of the rate; and ○ If management uses the risk-free rate, assess the appropriateness of the rate used and the appropriateness of the risk-free securities maturity, in regard to the terms of the lease; • The reasonableness of management's estimate of the remaining useful life of the leased asset; • Management's adjustments to the noncancellable term of the lease to reflect options to extend or terminate the lease and assess if the options are reasonably certain to be exercised; • The reasonableness of both the amount of the residual value guarantee included in the lease classification calculation, as well as that used in recording the lease liability under ASC 842; and • Initial measurement of the lease liability and ROU asset. <p>Inquire about whether the sale of fixed assets was part of a sales-leaseback arrangement. If so, assess the appropriateness of the accounting for the transaction.</p> <p>Inquire and assess related-party leases for the following:</p> <ul style="list-style-type: none"> • They are classified and recorded based on their legally enforceable terms and conditions; and • Relevant information for related-party disclosures is obtained. <p>For leases modified during the accounting period:</p> <ul style="list-style-type: none"> • Assess the appropriateness of the accounting for the lease as either a new lease or remeasured lease. • For modified leases accounted for as new contracts, assess the propriety of the recognition of the new lease liability and ROU asset. • For modified leases that are remeasured, assess the assumptions used, classification of the modified lease, and recognition of the lease remeasurement. <p>Evaluate the reasonableness of the ROU asset's remaining useful life and whether the ROU assets carrying value is recoverable.</p> <ul style="list-style-type: none"> • Consider the need to apply impairment accounting under ASC 360 to impaired lease. • Assess management's accounting for the lease, given the above considerations. <p>If appropriate, perform the following analytical procedures on the following account balances:</p> <ul style="list-style-type: none"> • Interest expense; • Operating lease expense; and • ROU asset amortization.
V, A/CL, P/D	Evaluate whether the balance sheet, income statement and statement of cash flows presentation is consistent with the guidance in ASC 842.
V, A/CL, P/D	Obtain and summarize information necessary for financial statement disclosures under ASC 842.

V. Solutions to test yourself questions and exercises

A. Test yourself #1

A lessee wants to make the appropriate decision regarding a lease term. In evaluating whether the lessee is reasonably certain to exercise an option, which of the following factors would be the least important to consider?

- A. Contractual terms and conditions for the option periods compared with current market rates.
- B. The entity's reluctance to move.**
- C. Significant leasehold improvements that may not be removed from the premises.
- D. Costs incurred in terminating a lease, moving, and signing a new lease.

B. Test yourself #2

Under ASC 842, which of the following lease types is not required to be recognized on the balance sheet?

- A. Operating lease.
- B. Finance lease.
- C. Short-term lease where the lessee is not reasonably certain to exercise any option to extend.**
- D. Related-party lease.

C. Exercise 1 – Lease classification

A lease has the following key terms. In applying the guidance of ASC 842, determine the appropriate classification of this lease from the lessee's perspective.

- a. The lease is a 10-year lease of equipment with a total economic life of 12 years;
- b. Lease payments are \$9,000 per year discounted at 5 percent;
- c. The present value of lease payments is \$69,500; and
- d. The fair value of the leased asset at commencement is \$75,000.

As the lease term is for a significant portion of the asset's life, and the lease payments represent a significant portion of the asset's fair value, this lease would be considered a finance lease.

D. Exercise 2 – Lease contracts

Determine if a contract with the following characteristics would be a lease under the guidance of ASC 842.

- a. Contract for the use of 10 shipping containers of particular specifications kept on the customer's premises.
- b. Carrier cannot retrieve containers during contract.
- c. Customer directs the use of the containers.
- d. Customer can receive a replacement when one needs repair.

What if the carrier had the right to substitute one of the 10 identified containers?

As leased assets are specifically identified and the customer controls their use, this would be considered a lease. In the second scenario, as the carrier has the right to substitute one of the containers, this agreement would not be considered a lease under the guidance of ASC 842.