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Accounting, Reporting, and Corporate Governance Update

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Outline

1. Corporate Governance Update - Thomas V. Fiscoe
2. Revenue Recognition - Kenneth C. Gardiner
3. Overview of the New Leasing Standard - Joseph Chemotti
4. Newly Effective or Issued Accounting Standards Updates (ASU's) - Joseph Chemotti
5. Pension/ERISA Update - Joseph Chemotti

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1. Corporate Governance Update

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Auditor’s Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion

AS 3101

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Summary

- Communication of critical audit matters.
- Disclosure of audit tenure.
- Other improvements to the auditor's report.

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Critical Audit Matters (CAMS)

A matter communicated to the audit committee that relates to material accounts or disclosures in the financial statements and involved challenging subjective or complex auditor judgement:

- Significant risk.
- Judgement or estimates by management.
- Significant or unusual transaction.
- Auditor subjectivity and specialized skill.

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Critical Audit Matters (Disclosure)

- Identify the critical audit matter.
- Describe principal consideration that led the auditor to determine it was a CAM.
- Describe how CAM was addressed in the audit.
- Refer to relevant financial statement accounts or disclosures.

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Additional Improvements to the Auditor’s Report

- Audit tenure.
- Independence.
- Addressee.
- Enhancement to the basic elements.
- Standardization of the auditor’s report.

Auditor Tenure

- A statement disclosing the year in which the auditor began serving consecutively as the company's auditor.

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Independence

- A statement that the auditor is required to be independent.

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Addressee

- The auditor’s report will be addressed to the company’s shareholders and Board of Directors.

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Enhancement to Basic Elements

- Changes to standardize language.
- “Whether due to fraud or error”.

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Standardization of the Auditor's Report

- The opinion will appear in the first section and section titles have been added to guide the reader.

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Effective Date

- All changes in the final standard except for CAM section for fiscal years ending on or after December 15, 2017.
- All Changes related to CAM disclosure:
  - Large accelerated filers for fiscal years ending on or after June 30, 2019.
  - All others - Fiscal years ending on or after December 15, 2020.
- Can adopt early.

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Exemptions from CAM Reporting

- Audits of Broker-Dealers.
- Benefit plans reporting on Form 11-K.

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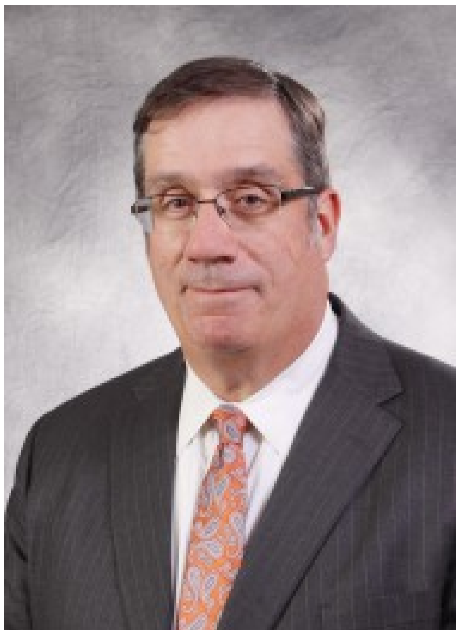

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2. Revenue Recognition

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The New Revenue Recognition Standards:
What does it REALLY mean to me?

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Revenue Recognition

- FASB and IASB issued converged standard May 2014.
    - o ***Revenue recognition from contracts with customers***, ASU 2014-09 (Topic 606) and IFRS 15.
- Public companies deferred effective date until calendar 2018. Effectively meaning restatement of 2016 and 2017.
- Private companies deferred effective date until calendar 2019. Effectively meaning restatement of 2018.

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Transition

- The new guidance allows companies to select between two transition methods
  - Full retrospective method.
  - Cumulative effect adjustment (simplified approach).
- **Full retrospective method**
  - A company would restate all periods presented as if they had been accounted for under ASC Topic 606 originally. Comparative periods would be restated.
- **Retrospective application with a cumulative effect adjustment (simplified approach) –**
  - A company can elect to apply ASC Topic 606 only to contracts that are in progress at the date of initial application and new contracts going forward. The cumulative adjustment to the opening balance sheet will be reflected in retained earnings. Disclosures in the financial statements will be required to explain the differences. Comparative periods would not need to be restated.

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Revenue Recognition

<u>Core Principle</u> -

- An entity shall recognize revenue to depict the **<u>transfer</u>** of goods or services to the customer in an amount that reflects the consideration the entity receives, or expects to receive, in exchange for those goods or services provided.

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Revenue Recognition

Five steps to apply the core principle:

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 satisfied a performance obligation.

Information to Consider

- Can we still achieve percentage of completion calculation?
- Guidance is based on a Contract-by-Contract analysis.
- Will the contractor require Multiple Profit Centers per contract?
- Will need to enhance internal controls consideration regarding assessment of Revenue Recognition.
- This does not change the IRS code.

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Step One – Identify the Contract

Criteria for Existence of a Contract

- Commercial substance.
- Approval and commitment by the parties to satisfying their obligation.
- Legal enforceable rights regarding transfer of goods and services.
- Identifiable payment terms.
- Consideration has probable possibility of collection in exchange for goods or services transferred.

Written agreements typically achieve the five criteria above; however, written contract is not required. Cannot start the revenue process without a "contract"

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Step One – Identify the Contract

Contract Modifications

- The new guidance defines a contract modification as "…a change in scope or price (or both) of a contract that is approved by the parties…"

  Accounting for change orders under the new guidance is more complex than it is under existing GAAP.

- C/O are added to the contract when it's probable the amount will be approved and can be estimated (70% - 80% likelihood). Similar to previous GAAP.

- New guidance will require management to determine if the modification should be accounted for as a separate contract.

- If change order is not ***distinct*** from the existing contract, it is accounted for as a cumulative catch up.

  If distinct, accounted for as a separate contract.

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Step Two – Identify Performance Obligations

Performance Obligation

- A promise in a contract with a customer to transfer a good or service to a customer – ***Explicit or Implied.***
- Contract will have multiple performance obligations if each is considered ***distinct.***
- Performance obligations are identified at contract inception and determined based on:

  Contractual terms.

  Customary business practice.
- Identifying performance obligations and how they are satisfied will directly affect when revenue is recognized.

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Step Two – Identify Performance Obligations

Performance Obligation

- Contracts for engineering, procurement and construction or design build projects have multiple services that must be evaluated to determine if the good or services represent multiple performance obligations.
- Operation and maintenance is most often a separate performance obligation from design / construction.
- Various factors may provide evidence that the customer can benefit from the good or service either on its own or in conjunction with other readily available resources. For example, the fact that an entity regularly sells a good or service separately would indicate that a customer can benefit from the good or service on its own or with other readily available resources.

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Step Two – Identify Performance Obligations

<u>Example #1</u>

A company enters into a contract to design and build an airport terminal. The company is responsible for the design and management of the project, including engineering, site clearance, foundation, procurement, construction of terminal space, airline office space and installation of equipment and finishing. As all of these goods are ***interdependent and interrelated*** (the customer cannot benefit from each good on its own), the contract would be considered one performance obligation.

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Step Two – Identify Performance Obligations

Practical Considerations

- Need to create multiple profit centers for tracking costs if more than one Performance Obligation is identified per contract.

- Revenue recognition based on Contract “type” identified in preparation of contract abstract:
  - Implement a control process to “audit” the completion of the Contract Abstract and conclude regarding multiple performance obligations.

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Step Three – Determine the Transaction Price

- Transaction price is the amount of consideration a contractor expects to be entitled to in exchange for its performance obligation.
- Typically the stated contract price in the contract .
- Items to consider:

  Contract price

  Customary business practice

  Variable consideration

- Amounts are only included in the contract price if it is ***probable*** that a significant reversal in the amount of revenue recognized will not occur in the future.

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Step Three – Determine the Transaction Price

<u>Variable Consideration</u>

- Evaluate whether to "constrain" amounts of variable consideration included in the transaction price.

  Objective of constraint – include all variable considerations in the transaction price only to the extent it is **probable that a significant revenue reversal will not occur when uncertainty is subjectively resolved**.

- Amount of variable consideration to include in the transaction price should consider both the likelihood and magnitude of a revenue reversal.

  Penalties, refunds, discounts.

  Claims, change orders, bonus and incentives .

  Could be explicit or implicit.

  Contract price being cut at the end of a project

- Contractor needs to determine (<u>even at the start</u>) all information (historical, current and forecast) to determine contract price.

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Step Three – Determine the Transaction Price

Variable Consideration

- An entity shall consider all the information (historical, current and forecast) that is reasonably available to the entity and shall identify a reasonable number of possible consideration amounts.
- The information that an entity uses to estimate the amount of variable consideration typically would be similar to the information that the entity's management uses during the bid-and-proposal process and is estimating prices for promised goods and services.
- Allocate Variable Consideration:

  - Generally allocate to all performance obligations.

  - Allocate to one performance obligation if:

    - Terms of the variable payments relate significantly to it.
    - Results in reasonable allocation to other performance obligations.
    - Cumulative catch-up method.

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Step Three – Determine the Transaction Price

Variable Consideration

- Variable consideration is accounted for using either:

  Expected Value Approach

  - Expected amount in a range of values.
  - Contractor will evaluate based on prior experience and judgment.
  - Only include amounts that have a probable chance of collection.

  Most Likely Amount Approach - "*All or Nothing*"

  - If performance obligation met - receive incentive.
  - If not met - receive nothing.
  - Can include up to maximum amount expected to be collected based on prior experience and judgment.

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Step Four- Allocating the Transaction Price

- If more than one performance obligation;

  - allocate the transaction price of each performance obligation based upon an estimate of the ***stand-alone selling price.***

- Stand-alone selling price.

  - Price an entity would sell a promised good or service to a customer:

    - Determined at contract commencement.
    - Applied to goods/services based on each separate performance obligation.
    - Consider discounts .

- The best evidence of a stand-alone selling price would be the observable price for which the entity sells the good or service separately.

  - In the ***absence of separate observable sales***, the stand-alone selling price would ***be estimated***.

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Step Five – Recognizing Revenue

- An entity recognizes revenue when a performance obligation is satisfied.

  <u>Satisfied</u> - Transferred a promised good or service to a customer.

  An asset is transferred when the customer obtains ***control of that asset.***

- ***Satisfaction of control*** occurs when –

  The customer has the ability to direct the transferred good or service **AND**

  The customer receives the benefit of the transferred good or service.

- Recognize revenue when the entity <u>satisfies ***each*** performance obligation</u>.

  Amount recognized = Transaction price allocated.

  Satisfied obligation = Transferred or customer takes ***control.***

  Can be ***at a point in time or over time.***

  At a point in time – Typically for transferred goods.

  Over time – Typically for transferred service.

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Step Five – Recognizing Revenue

- Control is transferred ***over time when at least one*** of the following criteria is met:

  1 - Customer simultaneously ***receives and consumes*** the benefits of the contractor's performance ***as the contract progresses.***

  2 - Contractor's performance of a contract ***creates or improves*** the asset ***controlled by the customer.***

  3 - An asset with an ***alternative use to the customer*** is not created but the contractor has a right to payment for the performance completed to date.

- A performance obligation is <u>satisfied at a point in time if it does not meet the criteria noted above</u>.

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Step Five – Recognizing Revenue

- Under the new standard, measuring progress towards completion is performed using one of the following methods:

  Input method

  Output method

- Company needs to determine which is the most appropriate regarding performance of the contract.

  Needs to be consistently applied

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Step Five – Recognizing Revenue

- Input method:
  - Recognize revenue on the basis of the contractor's efforts or inputs to the satisfaction of a performance obligation.
  - Examples - labor hours, labor dollars, machine hours, ***costs incurred,*** or material quantities used, relative to the total expected inputs to the satisfaction of that performance obligation.
  - Costs incurred related to rework or wasted materials would be excluded from input measurement, as these costs do not represent the transfer of goods or services to the customer.

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Step Five – Recognizing Revenue

- Output method:

  Recognize revenue on the basis of direct measurement of the value to the customer of goods or services transferred to date relative to the remaining goods or services promised under the contract.

  Examples include: surveys of goods or services transferred to date, appraisals of results achieved, milestones reached, or units produced or delivered.

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Step Five – Recognizing Revenue

Certain Cost Recognition

- The new standard identifies certain types of costs that may need to be ***capitalized***.
- Incremental costs –
  - These are costs of obtaining a contract that a contractor ***would not have incurred*** if the contract had not been obtained.
  - These costs are recognized as assets if they are ***expected to be recovered*** and are amortized as control of goods or services to which the asset relates is transferred to the customer.
  - If the amortization period is less than one year, these costs may be expensed as incurred (included in job costs).
  - Costs to obtain a contract that would have been ***incurred regardless of whether the contract was obtained*** (e.g. certain bid costs) would be expensed as incurred unless the contract explicitly states they are chargeable to the customer.

Step Five – Recognizing Revenue

Fulfillment Cost

	Contract Price	Estimated Gross Profit	Contract Revenue	Costs incurred to date	Gross Profit	Percent Complete
Existing GAAP	1,000,000	50,000	210,526	200,000	10,526	21.05%
Unamortized Bond				(80,000)		
New Standards	1,000,000	50,000	126,316	120,000	6,316	12.63%

Wasted Cost Recognition / Example

	Contract Price	Estimated Gross Profit	Contract Revenue	Costs incurred to date	Gross Profit	Percent Complete
Existing GAAP	1,000,000	100,000	222,222	200,000	22,222	22.22%
New Standards	1,000,000	110,000	213,483	190,000	23,483	21.35%
Additional exp	-	(10,000)	-	10,000	(10,000)	
	1,000,000	100,000	213,483	200,000	13,483	22.22%

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Step Five – Recognizing Revenue

Uninstalled materials

- Project often requires a wide range of goods to be assembled to produce a combined unit of output (Single performance obligation).
- Material may arrive on the job site or at the shop in advance of the contractor's ability to install.
- Using cost-to-cost method, costs incurred may not be proportionate to the progress to satisfy performance obligation – obtain goods before integrated into the project.
- Consider whether the inclusion of these uninstalled materials would result in recording revenue prematurely.

Step Five – Recognizing Revenue

<u>Uninstalled materials</u>

- Item procured to complete a performance obligation may not immediately transfer into the control of the customer -

  - Certain of the costs may qualify as inventory – no control.
  - If the customer obtains control of the goods before installed, they would not be considered inventory.
  - However, if the customer does obtain control but the material is not integrated into the overall project, these costs should be excluded from the measure of progress.
  - Record the uninstalled materials at zero profit (revenue = costs incurred).

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Step Five – Recognizing Revenue

Uninstalled materials / Example

	Contract Price	Estimated Gross Profit	Contract Revenue	Costs incurred to date	Gross Profit	Percent Complete
Existing GAAP	2,000,000	200,000	333,333	300,000	33,333	16.67%
New Standards	1,800,000	200,000	112,500	100,000	12,500	6.25%
New Standards	200,000	-	200,000	200,000	-	100.00%
	2,000,000	200,000	312,500	300,000	12,500	16.67%

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Step Five – Recognizing Revenue

Contract Asset / Liability

- Contractors must recognize a ***contract asset*** if goods and services are delivered to a customer before control is transferred.
  - Similar to: *Cost and estimated gross profit in excess of contract billings.*
- Contractors must recognize a ***contract liability*** if customer pays consideration prior to the goods and services being delivered.
  - Similar to: *Billings in excess of cost and estimated gross profit on contracts in process.*

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Disclosures

<u>Disclosure requirements</u>

- New ***comprehensive disclosure requirements*** that are expected to provide users of the financial statement with detailed information regarding revenue recognition.
    - Revenue disaggregated according to the timing and ***qualitative information about how economic factors*** will affect the nature, amount, timing and uncertainty of revenue and cash flows (such as significant judgments and changes in judgments and assets recognized from costs to obtain or fulfill a contract).
    - The opening and closing balance of receivables, contract assets, contract liabilities from contract with customers, if it is not separately presented or disclosed.
    - An entity shall disclose ***information about its performance obligations*** in contracts with customers:
        - When the entity normally fulfills its performance obligations.
        - Any significant payment terms.
        - Nature of the promised goods or services.

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Revenue Recognition

What should you be doing NOW?

- Read the new standard, understand its potential impact.
- Form an implementation task force.
- Begin to develop your specific implementation issues.
- Begin understanding how day-to-day accounting and execution of contracts may change.
- Planning early will make adoption much easier in 2019.

Kenneth C. Gardiner

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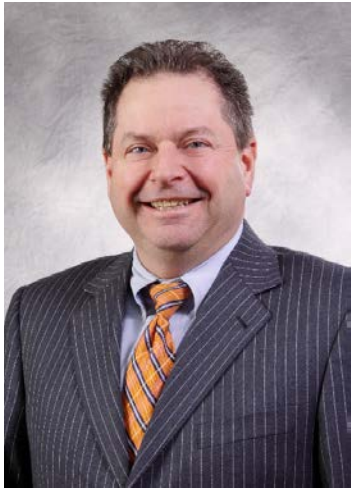

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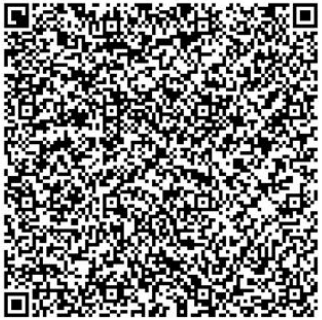

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3. Overview of the New Leasing Standard

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Accounting for Leases

- The FASB issued ASU 2016-02 that has made significant changes to accounting for leases in convergence with the IASB. Operating leases under SFAS 13 are gone!
- All leases will be capitalized. It is estimated that $2 trillion in liabilities will be added to balance sheets when the standard becomes effective!
- Final standard issued as ASU 2016-02 on February 25, 2016. *Effective date for public entities will be for year ends beginning after December 15, 2018 (**2019**), and year ends beginning after December 15, 2019 for private entities (**2020**).* Early Adoptions is permitted.
- Must be adopted retrospective to the beginning of the earliest year presented in the financial statements.

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Accounting for Leases

Definition – "A contract in which the right to **control** the use of a specified (**physically distinct**) asset (the underlying asset) is conveyed for a period of time in exchange for consideration."

- A physically distinct portion of a larger asset of which a customer has exclusive use is a specified asset (e.g. a building).
- A capacity portion of a larger asset that is not physically distinct (e.g., a capacity portion of a pipeline or fiber optic cable) is not a specified asset.

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Accounting for Leases

- **<u>Includes</u>** subleases and related party leases.
  - If related parties are consolidated for financial statements, leasing activity should be eliminated consistent with current standards.
- **<u>Excludes</u>** leases of all intangible assets, biological assets (e.g. timber), inventory and leases to explore for use of mineral oil and natural gas.
- **<u>Excludes leases with a maximum possible term of 12 months or less</u>**, expense on a straight-line basis.

Accounting for Leases

- Lessees will recognize a **"right-of-use"** asset and a liability for their obligation to make lease payments for ***all*** leases. Measured using the present value of the lease payments using a discount rate.

- Under an expected-outcome approach, contingent rentals and residual value guarantees as part of the lease liability. The lessee bases its inclusion of rentals for renewal periods in the lease liability on the longest possible term that is more likely than not to occur.

- Initial **direct** costs are added to the cost of the asset, such as commissions to a broker or costs to prior lessees. Legal and accounting costs are expensed.

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Accounting for Leases

Measure at present value (PV) of lease payments

- Based on both lease term and rentals.
- Discount at lessee's incremental borrowing rate or rate lessor charges, if known.

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Accounting for Leases

Two elements form basis for PV of lease payments:

1) Lease Term

- Estimated as the non-cancellable period of the lease
- Include periods under option to extend IF lessee has *significant economic incentive to exercise* option.
- Include periods under option to terminate IF lessee has *significant economic incentive NOT to exercise* option.

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Accounting for Leases

Two elements form basis for PV of lease payments:

2) Lease Payments

- Fixed lease payments (less incentives to be paid by lessor).
- Contingent rentals tied to an index (amount is based on index at inception).
- Contingent rentals which are in substance fixed payments.
- Variable rents are NOT included in lease payments. Expense upon payment. (e.g. lease based on % of monthly retail sales).
- Residual value guarantees.
- Exercise price of purchase option IF lessee has *significant economic incentive to exercise* option.
- Termination penalties IF lease term reflects lessee exercising option.

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Lesees

- Lease classification for lessees
  - Two approaches based on the “lease classification test.”
    - Approach A – Financing Type (Current “Capital Lease”)
    - Approach B – Operating Type

The only difference is how you charge the lease asset and payments to operations.

Lessees

- ***Approach A*** – Financing Type (Capitalized)
- When **any** of the following criteria is met:
  - Ownership transfers at or by the end of the lease;
  - Option to purchase, is reasonably certain to exercise (<FMV);
  - Lease term is for a significant portion of the remaining economic useful life of the asset (old 75% rule);
  - The present value of lease payments and residual value equals or exceeds the FV of the asset (old 90% of FMV rule); or
  - The lease asset is specialized and will have no alternative use at the end of the lease (no FMV).

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Lessees

Approach A – Financing Type (Capitalized), continued

Separately reflected in P&L:

- Accretion of lease liability as interest.
- Amortization of Right of Use asset.
- Variable lease payments incurred after commencement are operating expense.

Amortize on straight line basis:

- Shorter of the estimated lease term or underlying asset's useful life.
- If significant economic incentive to exercise a purchase option, amortize asset to end of useful life of underlying asset.

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Lesseees

Approach A – Financing Type (Capitalized), continued

	Year 1	Year 2	Year 3	Year 4	Total
Interest Expense	$ 28,911	$ 23,773	$ 17,541	$ 9,775	$ 80,000
Amortization Expense	105,000	105,000	105,000	105,000	420,000
	$ 133,911	$ 128,773	$ 122,541	$ 114,775	$ 500,000

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Lessees

- ***Approach B*** – Operating Type, Straight-line approach
  - For all leases **not** meeting the Financing criteria above.
  - Depreciate the "right-of-use" asset each period as a balancing figure such that the total lease expense would be recognized on a straight-line basis regardless of timing of lease payments.
  - Recognize lease expense **as a single cost in the income statement.**
  - Combine effective interest on lease liability with amortization of ROU asset so that the remaining cost of lease is allocated over remaining lease term equally on a straight-line basis.

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Lessees

Approach B – Operating Type, Straight-line approach

	Year 1	Year 2	Year 3	Year 4	Total
Interest Component	$ 28,911	$ 23,773	$ 17,541	$ 9,775	$ 80,000
Amortization Component	96,089	101,227	107,459	115,225	420,000
Total Lease Expense	$ 125,000	$ 125,000	$ 125,000	$ 125,000	$ 500,000

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Lessees

Presentation for Lessees

Balance Sheet

- Either present separately or combine with appropriate class of assets and liabilities with proper disclosure.
- No co-mingling of Type A (financing) and Type B (operating) leases, either present separately or disclose.

Balance Sheet- Lessees

ABC Corp.
(An S Corporation)

BALANCE SHEETS

	December 31,	
Assets	**2020**	**2019**
Current assets:		
Cash and cash equivalents (Note 1)	$ 1,146,036	$ 1,131,826
Accounts receivable, less allowance for uncollectible accounts of $10,000 in 2016 and 2015 (Note 1)	2,017,088	2,158,920
Inventories (Notes 1 and 2)	1,891,758	1,840,577
Total current assets	5,054,882	5,131,323
Property and equipment, net (Notes 1 and 3)	10,257,191	9,644,871
Right-of-use asset, net (Note 7)	**323,911**	**420,000**
Goodwill, net (Notes 1 and 4)	133,369	133,369
	$15,769,353	$15,329,563
Liabilities and Stockholder's Equity		
Current liabilities:		
Current portion of long-term debt (Note 6)	$ 1,072,796	$ 901,024
Current portion of lease liability (Note 7)	**100,497**	**92,795**
Accounts payable	405,915	402,758
Customer deposits	14,393	-
Accrued liabilities	8,448	173,240
Total current liabilities	1,602,049	1,569,817
Long-term debt (Note 6)	7,458,547	7,482,970
Lease liability (Note 7)	**226,708**	**327,205**
Stockholder's equity (Note 8):		
Common stock, no par value - 200 shares authorized; 144 shares issued and outstanding	1,440	1,440
Retained earnings	6,480,609	5,948,131
	6,482,049	5,949,571
	$15,769,353	$15,329,563

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Lessees

Presentation for Lessees

Statement of Cash Flows

- Operating activities
  - Interest on lease liability arising from Type A leases
  - Payments arising from Type B leases
  - Variable lease payments and lease payments not included in lease liability
- Financing activities
  - Principal repayments on Type A leases

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Lessees

Presentation for Lessees – Additional disclosures

	Year Ending December 31,	
	20X2	20X1
Lease cost		
Finance lease cost:	$XXX	$XXX
Amortization of right-of-use assets	XXX	XXX
Interest on lease liabilities	XXX	XXX
Operating lease cost	XXX	XXX
Short-term lease cost	XXX	XXX
Variable lease cost	XXX	XXX
Sublease income	(XXX)	(XXX)
Total lease cost	$XXX	$XXX

	Year Ending December 31,	
Other information	20X2	20X1
(Gains) and losses on sale and leaseback transactions, net	$(XXX)	$XXX
Cash paid for amounts included in the measurement of lease liabilities	XXX	XXX
Operating cash flows from finance leases	XXX	XXX
Operating cash flows from operating leases	XXX	XXX
Financing cash flows from finance leases	XXX	XXX
Right-of-use assets obtained in exchange for new finance lease liabilities	XXX	XXX
Right-of-use assets obtained in exchange for new operating lease liabilities	XXX	XXX
Weighted-average remaining lease term—finance leases	X.X years	X.X years
Weighted-average remaining lease term—operating leases	X.X years	X.X years
Weighted-average discount rate—finance leases	X.X%	X.X%
Weighted-average discount rate—operating	X.X%	X.X%

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Lessees

Impacts on banking evaluations

- Working capital
- Subordinated debt
- Debt covenants

Lessors

Must classify leases into one of three categories:

- **Sales Type -** Must meet any of the 5 criteria in the financing lease above and collection must be probable.
- **Direct Financing -** Same as a Sales Type lease except that the residual value guarantee is from an unrelated third party, fairly rare in occurrence (Defer the gain through effective interest).
- **Operating** - All other leases.

<u>Similar to current accounting standards</u>

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Accounting for Leases

What should you being doing now?

- Begin with an evaluation of the lease portfolio, starting with the largest leases, and assess how they will be accounted for. Make certain consideration is given to renewal provisions, if favorable.
- Focus on reducing the spread between a lease's liability and the corresponding "right of use" asset. The more these two items are out of balance, the more skewed the impact will be on the balance sheet and shareholder equity.
- Consider renegotiating leases now, even if they are not up for renewal.
- Consider impact on loan covenants, talk to the banker now.

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4. Newly Effective or Issued Accounting Standards Updates (ASU's)

Inventory

ASU 2015-11 - Inventory (Topic 330), Simplifying the Measurement of Inventory

- Issued in July 2015.
- Measure inventory at the lower of cost or net realizable value.
- Net realizable value is the estimated selling price in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation.
- Does not apply to inventory measured using LIFO or retail inventory method.
- Effective: Annual reporting periods for nonpublic companies in years beginning after Dec 15, 2016 (**2017**).
- Applied prospectively.

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Deferred Income Taxes

ASU 2015-17 - Simplifying the Presentation of Deferred Income Taxes

- Issued in November 2015.
- Will now be presented as a long-term asset or liability and **NOT** as a component of working capital.
- Effective: Annual reporting periods for public businesses beginning after Dec 15, 2016 (**2017**), and annual reporting periods for nonpublic companies in years beginning after Dec 15, 2017 (**2018**).
- Can be applied prospectively or retrospectively.
- Early adoption: Permitted. Most companies will early adopt if they have current deferred tax liabilities (cash basis taxpayers).

Financial Instruments

ASU 2016-01 – Overall: Presentation and Measurement of Financial Assets and Liabilities

- Issued in January 2016.
- Changes in fair value of certain equity investments (available for sale securities) will be now be recorded through net income in the Income Statement.
- Effective: Annual reporting periods for public businesses beginning after Dec 15, 2017 (**2018**), and annual reporting periods for nonpublic companies in years beginning after Dec 15, 2018 (**2019**).
- Applied with a cumulative-effect adjustment to the Balance Sheet as of the beginning of the year of adoption.
- Early adoption only permitted under certain circumstances.

Statement of Cash Flows

ASU 2016-15 – Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments

- Issued in August 2016.
- Provides specific guidance for cash flow classifications for certain transactions, including the following:
  - Debt Prepayment or Debt Extinguishment Costs (Financial Outflow);
  - Contingent Consideration Payments Made after a Business Combination(Financial Outflow up to Liability Balance – Operating Thereafter);
  - Proceeds from the Settlement of Insurance Claims (Based on Nature of Loss – Same Classification);
  - Proceeds from the Settlement of Corporate-Owned Life Insurance Policies, including Bank-Owned Life Insurance Policies (Investing Inflow);
  - Distributions Received from Equity Method Investees (Generally Operating).
- Effective: Annual reporting periods for public businesses beginning after Dec 15, 2017 (**2018**), and annual reporting periods for nonpublic companies in years beginning after Dec 15, 2018 (**2019**). Early adoption is permitted.

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Consolidation

ASU's 2015-02 and 2016-17 – Consolidation (Topic 810)

- Issued in February 2015 and October 2016.
- Various clarifications and simplifications of the VIE consolidation guidance, including:
  - Status of limited partnerships as VIE's;
  - Evaluations of fees paid to a decision maker as part of the consolidation analysis;
  - Amendments to how variable interests held by a reporting entity's related parties would affect the analysis
    - ASU 2016-17 amends ASU 2015-02 – A decision maker entity will need to consider only its proportionate indirect interest in the VIE held through a common control party, NOT treating the indirect interest as if the decision maker held the interest itself.
- Effective: Annual reporting periods for public and private businesses beginning after Dec 15, 2016 (**2017**). Early adoption is permitted.

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Goodwill

ASU 2017-04 – Intangibles - Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment

- Issued in January 2017.
- Removes Step 2 of goodwill impairment test to calculate the goodwill impairment as the difference between the carrying value and the implied fair value of goodwill for a reporting unit at the calculation date.
- Instead, only Step 1 should now be applied to assess the carrying value of the reporting unit as a whole compared with the value of goodwill and record impairment for the difference, if any.

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Goodwill (continued)

ASU 2017-04 – Intangibles - Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment

- Impairment charges can only be recorded up to the carrying value of goodwill.
- Effective: Annual reporting periods for SEC public businesses beginning after Dec 15, 2019 (**2020**); non-SEC public businesses beginning after Dec 15, 2020 (**2021**); and annual reporting periods for nonpublic companies in years beginning after Dec 15, 2021 (**2022**).
- Early adoption is permitted for goodwill impairment tests performed on testing dates after January 1, 2017.

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Hedging

ASU 2017-12 – Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities

- Issued in August 2017.
- Various revisions to current standards for both financial (e.g. interest rate) and commodity risks to more closely align hedge accounting with a Company's risk management activities.
- Eliminates separate measurement and reporting for ineffectiveness.
- Enhanced disclosures and financial statement presentation.
- Effective: Annual reporting periods for public businesses beginning after Dec 15, 2018 (**2019**), and annual reporting periods for nonpublic companies in years beginning after Dec 15, 2019 (**2020**). Early adoption is permitted.

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Hedging

	Hedge of Nonfinancial Item	Hedge of Financial Instrument
Fair Value Hedge	Hedge of inventory	Swap fixed rate debt to floating
Cash Flow Hedge	Hedge of forecasted purchase or sale of inventory	Swap floating rate debt to fixed

For Qualifying Hedging Relationships

- Effective and ineffective portions of derivative gain / loss recorded in current period earnings
- NEW: Presentation of derivative gain / loss in the same income statement line item as hedged item.
- Basis of hedged item adjusted for changes in FV attributable to hedged risk--also through earnings
- Basis adj offsets derivative mark to earnings

- Effective portion of derivative gain / loss deferred in OCI
- NEW: Ineffective portion of derivative gain / loss deferred in OCI
- Amounts previously recorded in AOCI reclassified to earnings when the hedged item affects earnings
- NEW: Presentation of amounts reclassified to earnings in the same income statement line item as hedged item.

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5. Pension/ERISA Update

Pension/ERISA Update

- **Employee Benefit Plan ERISA Audits – Revisions to Auditor's Report, Proposed new AU-C section (703)**
  - Meant to enhance audit quality and provide better insight into responsibilities of management and the auditor.
  - Proposed SAS includes:
    - Form and content of unmodified opinion;
    - Procedures and new opinion for ERISA limited scope audit;
    - Procedures and **reporting requirements on findings** related to testing specific plan provisions.

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Pension/ERISA Update

2018 Pension Limits

	2018	2017	2016
401k Elective Deferrals (Section 402g)	$ 18,500	$ 18,000	$ 18,000
Catch-Up Contribution Limit (Section 414v)	$ 6,000	$ 6,000	$ 6,000
Annual Defined Contribution Limit (Section 415)	$ 55,000	$ 54,000	$ 53,000
Annual Compensation Limit (Sections 401, 404, 408)	$ 275,000	$ 270,000	$ 265,000
Highly Compensated Employees (Section 414q)	$ 120,000	$ 120,000	$ 120,000
FICA Wage Limit	$ 128,700	$ 127,200	$ 118,500

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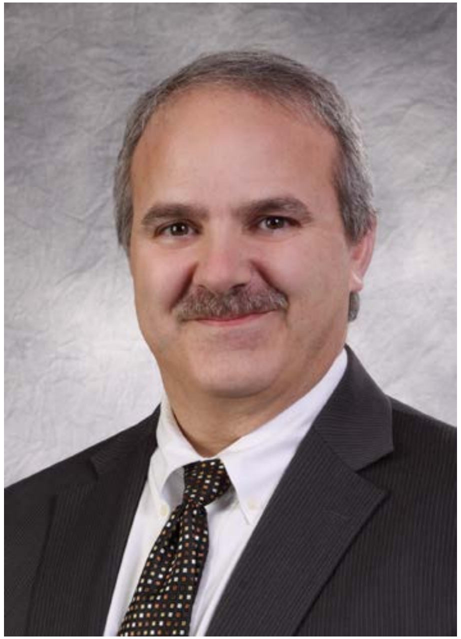

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