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Dannible & McKee, LLP
2017 Construction Conference

Emerging Developments in Audit and Accounting

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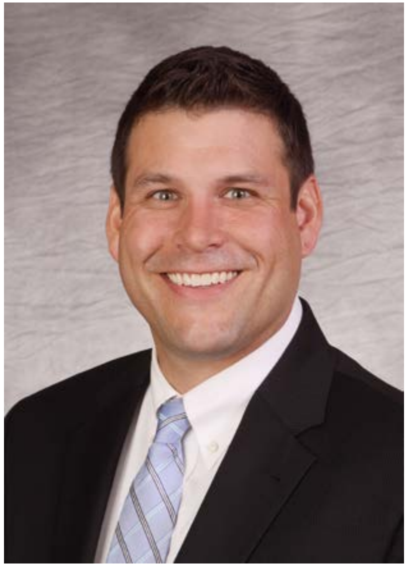
Benjamin Sumner, CPA

Senior Audit Manager



Email: bsumner@dmcpas.com

Web: www.dmcpas.com

Address:

Dannible & McKee, LLP
Financial Plaza
221 S. Warren St.
Syracuse, New York 13202-1628

Phone: (315) 472-9127x221

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Outline

1. **Newly effective or issued Accounting Standards Updates (ASU's)**
2. **Revenue Recognition**
3. **Leasing**
4. **Other matters**

1. Newly effective or issued Accounting Standards Updates (ASU's)

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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).

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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 limited circumstances.

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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 (Financing Outflow);
  - Contingent Consideration Payments Made after a Business Combination (Financing Outflow up to amount of liability, Operating Outflow for excess);
  - Proceeds from the Settlement of Insurance Claims (Consistent with nature of loss);
  - Proceeds from the Settlement of Corporate-Owned Life Insurance Policies, including Bank-Owned Life Insurance Policies (Investing Inflow);
- 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.

Statement of Cash Flows

ASU 2016-18 – Statement of Cash Flows (Topic 230): Restricted Cash

- Issued in November 2016.
- Requires entities to show the changes in <u>total</u> cash, cash equivalents, restricted cash, and restricted cash equivalents in the Statement of Cash Flows.
- No longer present transfers between cash and cash equivalents and restricted cash in the Statement of Cash Flows.
- 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.

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.

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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2. Revenue Recognition

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Revenue Recognition

- **ASU 2014-09 - Revenue From Contracts with Customers**
- Final standard issued in May of 2014.
- Why?
  - Convergence of U.S. and International Standards.
  - Create consistency between different industries for similar economic transactions.
- Effective: for annual reporting periods (and interim for public companies) beginning after Dec 15, 2017, (**2018**) and interim reporting periods for nonpublic companies in years beginning after Dec 15, 2018 (**2019**).
- Early adoption: permitted.

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Revenue Recognition

Core Principle -

- An entity shall recognize revenue to depict the **transfer** 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.
- No longer applicable in accounting principles
  - Earnings process, matching, or transfer of risks and rewards or title

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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.

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Revenue Recognition

<u>Step 1: Identify the Contract</u> –

- May be written, oral or implied.
- Contract must have commercial substance.
- Parties to the contract have approved the contract and are committed to satisfying their respective obligations.
- Each party must have **<u>enforceable</u>** rights regarding the goods or services being transferred. If both parties can cancel, then it is not a contract.
- The entity can identify the terms and manner of payment for those goods or services.
- **Collectability must be probable, or no revenue recognition.**

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Revenue Recognition

<u>Collectibility</u> – ASU 2016-12

- Only need to assess collectability of amounts related to goods or service that will be transferred before payment.
  - Prepayments manage risk.
  - Ability to stop delivering also manages risk; if service would be cut off in the event of non-payment, only need to assess probability of collection of amounts for services to be provided before cut off.

Revenue Recognition

Combining contracts (ASC 606-10-25-9)

- Required if contracts are with same (or related) customer, AND
  - Negotiated as a package with one objective, OR
  - Goods/services are interrelated, OR
  - Fee in one is affected by price/performance on other
- If contracts are combined, evaluate combined contract as one
  - Irrelevant which particular contract a performance obligation or payment is covered in

Revenue Recognition

- Contract Modifications(ASC 606-10-25-10 through 13)
  - Topic 606 has guidance on accounting for modifications. Change in Scope or Price or Both
  - If modification adds more “distinct” goods or services at a reasonable fee, treat as separate contract.
  - If more significant changes, consider remaining performance obligations in modified contract.
    - If what remains is distinct, treat as new contract.
    - If not distinct (price change), redo allocation taking into account modified contract and recognize “**cumulative catch-up**” in current year.

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Revenue Recognition

<u>Step 2: Performance Obligations</u> – (ASC 606-10-25-16 through 25-18)

- A promise to transfer a **<u>distinct</u>** good or service to the customer.
  - Explicit or implicit (due to business practice, published policies, marketing, etc.)
  - Includes a promise to "stand ready" to provide service, if that's what you are paid to do
  - Excludes activities that don't transfer goods or services (set-up, admin)
  - Promises that are "immaterial in the context of the contract" may be disregarded
  - Promise to ship or deliver a good to a customer may be treated as fulfillment activity

Revenue Recognition

Performance Obligations – "Distinct"

- A distinct promised item is a "performance obligation"
  - If not distinct, bundle with other items until bundle is distinct
  - A repetitive service is one performance obligation even if each instance is distinct
- A good or service (or bundle) is distinct if :
  - It is "capable of being distinct" - customer can benefit from it alone or with readily available resources (similar to current "standalone value" criterion); AND
  - It is separately identifiable and therefore "distinct within the context of the contract" (new criterion).

Revenue Recognition

Performance Obligations – "Distinct"

- Indicators that promises are not separately identifiable *(as clarified in exposure draft of forthcoming amendment).*
    - Seller integrates goods/services into a combined output,
        - In a contract to build a house, wood, paint, and HVAC aren't distinct.
    - One good or service significantly modifies another.
        - In a contract for customized software, the base software and customization services aren't distinct.
    - Two or more goods or services are highly interrelated.
        - In a hotel management contract, the individual activities (taking reservations, providing housekeeping, etc.) aren't distinct.

Revenue Recognition

Performance Obligations –

- Contractual terms that are not considered promised goods or services:
  - Activities that don't transfer goods or services (set-up, admin, mobilization etc.) (record asset/amort).
  - This is the separation from current practice
  - These costs will be **recorded as an asset** and amortized to costs of a contract over the duration of the contract, no revenue recognition until you deliver something to the customer.

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Revenue Recognition

<u>Step 3: Transaction Price</u> – (ASC 606-10-32-2)

- Definition: Amount that vendor ***<u>expects</u>*** to be entitled to for transferring goods or services.
- Probability-weighted amount of consideration that an entity expects to receive from the customer in exchange for the goods or services, or "the most likely amount".
- Collections on behalf of third parties are not part of price, but amounts charged to customer to reimburse seller costs are (Sales tax)
- **If the transaction price cannot be reasonably estimated, an entity shall not recognize revenue from satisfying a performance obligation.**
- Consider the effects of:
  - Variable amounts (incentives and penalties)
  - Non-cash consideration
  - Consideration payable to the customer
  - Financing component

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Revenue Recognition

<u>Transaction Price</u> – “<u>Variable consideration</u>”

- Estimate the effects of variable consideration.
  - Volume discounts, rebates, penalties, performance bonuses, usage-based fees, etc.
- Choose method that best predicts actual fee.
  - Probability-weighted (expected value) for large population.
  - Most likely amount for individual contracts.
- Limit estimates to amounts that are “probable” 75% not 51%.
- Update each period (cumulative catch-up) as estimates of “probable” consideration change.

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Revenue Recognition

Transaction Price – Financing Component (ASC 606-10-32-15 through 18)

- Must adjust for significant financing component
  - Advance payment = interest expense and more revenue
  - Delayed payment = interest income and less revenue
- Significant financing component likely exists if:
  - Promised consideration varies from cash price
  - >1 year between payment and transfer of goods/services

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Revenue Recognition

<u>Step 4: Allocation of Transaction Price to Performance Obligations – </u><u>(ASC 606-10-32-31 through 34)</u>

- Allocation is based on relative standalone selling price.
- **<u>Defined term:</u>** The price at which an entity would sell a promised good or service separately to a customer.
- Use observable transactions if exist; Otherwise, whatever is best:
    - o Expected cost plus margin; market assessment; valuation
    - o Residual approach ok (if highly variable or uncertain)
- Applies to all industries, including software.

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Revenue Recognition

<u>Transaction Price</u> – "<u>Variable consideration allocation</u>"

- Generally, allocate proportionally to all performance obligations.
- **Allocate to one performance obligation (or one distinct portion of a series) if:**
  - Terms of variable payment relate specifically to it, and
  - Results in reasonable allocation to other performance obligations
- Allocate changes in transaction price (including completed) on same basis as initial allocation.
  - Cumulative catch-up adjustment

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Revenue Recognition

Step 5: Recognize Revenue as Performance Obligations are Satisfied – Based on "Transfer of Control"

- Obligation is satisfied when control over good or service is transferred to customer.
- Control is the ability to direct use of the asset and obtain substantially all benefits from it.
- Control may pass **at a point in time or over time.**
  - "Over time" generally earlier recognition for goods and service, as delivery or completion.
  - "Point in time" generally earlier for IP licenses, as it would happen at start of license, rather than over time.
- Focus on control, rather than risks and rewards.

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<u>Recognize Revenue as Performance Obligations</u> –

Transfer of control occurs *<u>over time</u>* if:(ASC 606-10-25-17)

- Customer benefits as performance occurs.
  - E.g., replacement provider wouldn't have to start over.
- Customer controls asset that vendor's performance is creating or enhancing. (Most construction contracts)
- Work does not create an asset with alternative use to vendor AND vendor has right to payment for work to date if customer cancels.
  - Contract and practical considerations affect "alternative use".
  - Legal remedies affect "right to payment".

More tasks will be "over time" than under current GAAP.

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Revenue Recognition

<u>Recognize Revenue as Performance Obligations</u> – Transfer of control occurs *<u>over time</u>*

Revenue recognized based on a single measure of progress.

- Can’t use multiple measures for multiple payment streams.
  - Eliminates the “milestone method” and certain other commonly used methods.
- Input methods (costs, labor hours, time)
  - Ignore costs that don’t relate to performance. (upfront costs)
  - Adjust “cost” if pattern does not reflect performance.
- Output methods (hourly billings, milestones).
- “Passage of time” Ok if performance is even.
- If progress cannot be measured, no revenue.

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Revenue Recognition

<u>Recognize Revenue as Performance Obligations</u> –
Transfer of control *<u>over time</u>* (ASC 606-10-25-31 thru 37: 606-10-55-18)

- Practical expedient for certain contracts, Applies if fees are based on activity and correlate to value
  - Billings based solely upon hours of service
  - Set amount for each of various activities
  - If expedient applies, recognize revenue consistent with contract

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Revenue Recognition

<u>Recognize Revenue as Performance Obligations</u> –

Transfer of control occurs *<u>at point in time</u>* if

- Transfer of control of goods
  - Non-custom goods, generally at delivery
  - Custom goods, perhaps during production
    - May meet the “no alternative use” criterion
- Transfer of control for services
  - Generally, over time
  - However, if no value received by customer until completion (e.g. final report), wait until completion (A/E services)

Likely to be more recognition before delivery for goods than there is today.

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Revenue Recognition

<u>Recognize Revenue as Performance Obligations</u> –

Transfer of control occurs <u>*at point in time*</u> Indicators that control has transferred

- Customer has legal title
- Vendor has right to non-refundable payment
- Customer has physical possession
- Customer has significant risks/rewards of ownership

Customer acceptance (ASC 606-10-55-85 thru 87)

- Control transfers ahead of acceptance only if vendor can objectively determine that terms are met.

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Revenue Recognition

<u>Warranties</u> (ASC 606-10-55-30 through 35)

- If sold separately, treat as separate performance obligation.
- Evaluate standard warranties for element that goes beyond assurance that product works as promised.
  - E.g, free maintenance or coverage for accidental damage.
  - If no service or insurance element, just accrue costs.
  - Any service or insurance element is treated as separate performance obligation, with revenue recognized over term.
- Generally same as current GAAP except for possible "insurance" element.
  - Accrue costs as a liability, no revenue impact.
  - Warranty disclosure and roll forward of liability.

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Revenue Recognition

<u>Cost guidance</u> (ASC 340-40)

- No new onerous (“loss”) contract requirements.
  - Retain existing guidance in ASC 605-35 (SOP 81-1)
  - Accrue losses when identified
- Incremental costs of obtaining contract are an asset.
  - Ok to expense costs as incurred if amortization period would be one year or less.
- Direct costs to fulfill a contract are an asset if they enhance resources to satisfy performance obligations in the future.
- Cost guidance is all new – should increase consistency.

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Revenue Recognition

<u>Presentation</u> (ASC 606-10-45)

- If vendor performs (i.e., recognizes revenue) ahead of payment, recognize a “contract asset”.
- If customer pays ahead of performance.
  - “Contract liability” for amounts probable of being kept
  - “Refund liability” for other amounts
  - Does not trigger revenue (ASC 606-10-55-51)
- Recognize receivable if right to payment conditional only upon passage of time.
  - If receivable is recognized without revenue, adjust contract asset/liability

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Revenue Recognition

Disclosures(ASC 606-10-50)

The objective of the disclosure requirements is for an entity to disclose sufficient information to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers.

The disclosure requirements found in the new revenue recognition guidance are significantly in excess of what is currently required under U.S. GAAP.

Revenue Recognition

Disclosures

An entity shall disclose qualitative and quantitative information about amounts in the Financial Statements :

- Revenue from contracts with customers (as distinct from any other revenue)
- Receivables, contract assets and contract liabilities:
  - Opening and closing balances
  - Losses from impairments of receivables or contract assets
- Assets from costs to obtain or fulfill contracts
  - Closing balances
  - How amounts to capitalized were determined
  - Amortization and impairment

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Revenue Recognition

Disclosures

Disaggregated Information

- Revenue disaggregated into categories (by segment) that reflect different responses to economic factors
    - Customer type, contract duration, timing of transfer of goods/services, type of fee, etc.
    - Multiple breakdowns may be necessary
    - Private companies may just use over time vs. point in time

Revenue Recognition

Disclosures

Factual Information

- Information about promised goods and services
  - Nature of performance obligations, highlighting situations in which company acts as agent
  - Events that satisfy performance obligations
  - Warranty and similar provisions
- Information about payment terms
  - Fixed or variable, and nature of variability
  - Timing of payment becoming due in comparison to transfer of goods and services
  - Rights of refund and return

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Revenue Recognition

Disclosures

Information about the Transaction Price

- Methods, inputs and assumptions used to determine transaction price in Step 3, including:
  - Whether there is a financing component, and how determined
  - How variable consideration is estimated, and the company determined what amounts are probable of becoming due
  - How non-cash consideration was measured
  - How refund and return obligations were measured
- *Private companies need only discuss how probable amount of variable consideration was determined*

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Revenue Recognition

Disclosures

Information about Allocation of the Transaction Price

- How standalone selling prices were estimated
- Whether allocation is based on relative standalone selling prices or adjusted in some way
- How discounts and variable consideration were allocated

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Revenue Recognition

Disclosures

Information about Satisfaction of Performance Obligations

- For performance obligations satisfied over time
  - Methods used
  - Explanation of why those methods are appropriate *(private companies may omit)*
- For performance obligations satisfied at a point in time
  - Judgments made in determining the right point in time *(*private companies may omit)
- For bill-and-hold arrangements, specific discussion of when performance obligations are satisfied

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Revenue Recognition

Disclosures

Public Companies only:

- Revenue recognized that was included in contract liability at beginning of period (i.e., that was prepaid in prior period)
- Revenue recognized related to performance obligations satisfied in prior period (e.g., due to changes in variable consideration)
- Explanation of changes in contract balances due to:
- Adjustments in estimates of progress toward completion
- Changes in estimates of variable consideration
- Other events not related to performance or payment
- Amount of transaction price allocated to remaining unsatisfied performance obligations
- Explanation of when these amounts are expected to be recognized
- May be done qualitatively or quantitatively
- Discussion of any amounts not included in transaction price because they are not probable of becoming due

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Transition

- Methods:
  1. Full Retrospectively to all periods (Restate all prior periods)
  2. Retrospectively to all periods but with permitted practical expedients.
     - Example: Use transaction price at completion rather than estimating variable consideration in comparative periods.
  3. Cumulative effect at date of initial application to reflect effect of new standard on contracts not completed at adoption, plus disclosures.
- No alternative transition method for private companies.

Revenue Recognition

What should you be doing NOW?

- Read the new standard, understand its potential impact.
- 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.

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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 Adoption 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 – Current GAAP

How are leases accounted for under current GAAP?

- Evaluate every lease using a 4 part test:
  - Is the lease term > 75% of the estimated useful life of the leased property?
  - Is the PV of lease payments > 90% fair market value of the leased property?
  - Is there a bargain purchase option?
  - Does ownership transfer to the lessee by the end of the lease term?

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Accounting for Leases – Current GAAP

- If "Yes" to any of the 4 criteria → Capital Lease classification.
  - Capitalize asset and record liability.
  - Depreciate asset and accrete liability with lease payments against principal & interest expense (Treat as if it is a loan for the purchase of an asset).

- If "No" to all of the 4 criteria → Operating Lease classification.
  - No asset or liability is recorded.
  - Expense lease payments straight-line to operating expense.
  - Disclose amount of expense in financial statements and future minimum lease payments for a five-year period.

Accounting for Leases – New Guidance

How will leases be accounted for under the new guidance?

- 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 – New Guidance

- **<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.

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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.

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.

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.

Lessees

- 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.

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Lesees

- ***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.

Lessees

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
Total	$ 133,911	$ 128,773	$ 122,541	$ 114,775	$ 500,000

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.

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 separately.

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Balance Sheet- Lessees

Assets	Current Presentation	New Presentation
Current assets:		
Cash and cash equivalents (Note 1)	$ 1,146,036	$ 1,146,036
Accounts receivable, less allowance for uncollectible accounts of $10,000 in 20X2 and 20X1(Note 1)	2,017,088	2,017,088
Inventories (Notes 1 and 2)	1,891,758	1,891,758
Total current assets	5,054,882	5,054,882
Property and equipment, net (Notes 1 and 3)	10,257,191	10,257,191
Right-of-use asset, net	-	**323,911**
Goodwill, net (Notes 1 and 4)	133,369	133,369
	$15,445,442	$15,769,353
Liabilities and Stockholder's Equity		
Current liabilities:		
Current portion of long-term debt (Note 6)	$ 1,072,796	$ 1,072,796
Current portion of lease liability	-	**100,497**
Accounts payable	405,915	405,915
Customer deposits	14,393	14,393
Accrued liabilities	8,448	8,448
Total current liabilities	1,501,552	1,602,049
Long-term debt (Note 6)	7,458,547	7,458,547
Lease liability	-	**226,708**
Stockholder's equity (Note 7):		
Common stock, no par value - 200 shares authorized; 144 shares issued and outstanding	1,440	1,440
Retained earnings	6,483,903	6,480,609
	6,485,343	6,482,049
	$15,445,442	$15,769,353

	Current Presentation	New Presentation
Working capital	$ 3,553,330	$ 3,452,833
Current Ratio	3.37	3.16

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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

Consider using tabular format similar to current debt disclosures!

	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 and bonding evaluations

- Working capital
- Subordinated debt
- Debt covenants

Lessors

Must classify leases into one of three categories:

- Sales Type
- Direct Financing
- Operating

Similar to current accounting standards

Lessors

- **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.

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Lessors

Sales Type Accounting:

- Derecognize the underlying asset.
- Record the net investment in the lease:
  - Receivable for the present value of the lease payments including any expected residual value of the asset guaranteed by the lessee.
  - The present value of the unguaranteed expected residual value of the underlying asset.
- Record profit or loss at the inception of the lease.
- Expense all initial direct costs.

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Lessors

Financing Type Accounting:

- Derecognize the underlying asset.
- Record the net investment in the lease:
  - Receivable for the present value of the lease payments, including any expected residual value of the asset guaranteed by the lessee.
  - The present value of the unguaranteed expected residual value of the underlying asset.
  - Any profit and initial direct costs are included in the net investment.
- The profit (net of costs) is recognized over the life of the lease as payments are received.

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Lessors

Operating Type Accounting:

- The asset remains on the lessor's balance sheet.
- Initial direct costs are deferred, amortized over the lease term to expense.
- Recognize rental income **equally** over the lease term.
- Variable lease payments are recognized as income when earned.

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. Other matters

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PCAOB Audit Report

PCAOB Release No. 2017-001 – The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion

- Issued in June 2017.
- Still subject to SEC approval.
- New auditor reporting standard AS 3101.
- Significantly more information now required to be included in the report.
- Effective: Annual reporting periods ending on or after June 30, 2019 for large accelerated filers, and Dec 15, 2020 for all others.

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PCAOB Audit Report

- **Significant Changes**
  - Requires a discussion of critical audit matters (CAMs)
    - Matters communicated to the audit committee or required to be communicated to the audit committee that relate to accounts or disclosures that are material to the financial statements and involved especially challenging, subjective or complex auditor judgment.
  - Requires information on auditor tenure.
  - Required statement that auditors are required to be independent.
  - Requires the phrase "whether due to error or fraud" in the description of the auditor's responsibilities to obtain reasonable assurance about whether the financial statements are free from material misstatement.

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PCAOB Audit Report

- **Critical Audit Matters (CAMs)**
  - If no CAMs are identified, then a statement to that effect must be included in the auditor's report.
    - PCAOB expects that, in most audits, the auditor will identify at least one CAM
  - For each CAM, auditors are required to

    (1) Identify the matter;

    (2) Describe the principal considerations in determining that the matter was a CAM;

    (3) Describe how the matter was addressed in the audit; and

    (4) Refer to the relevant financial statement accounts or disclosures.

PCAOB Audit Report

- **Critical Audit Matters (CAMs)**
  - Auditors can satisfy the requirement to describe how they addressed each CAM with any of the following:

    (1) Describe their response or approach that was most relevant to the matter;

    (2) Provide a brief overview of procedures performed;

    (3) Provide an indication of the outcome of those procedures;

    (4) Provide key observations with respect to the matter; or

    (5) A combination of these elements.

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Exposure Drafts, Proposals, etc…

- **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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QUESTIONS

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