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Accounting, Reporting and Corporate Governance Update

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Outline

1. PCAOB Update.
2. LIBOR Rate's Future.
3. Pension/ERISA Update.
4. Newly Effective and Issued Accounting and Auditing Standards.
5. Changes to Accounting for Leases.
6. Revenue Recognition Change is Here!

1. PCAOB UPDATE

PCAOB Update

- **PCAOB Release No. 2018-005**, *Auditing Accounting Estimates, Including Fair Value Measurements, and Amendments to PCAOB Auditing Standards.*
- **PCAOB Release No. 2018-006**, *Amendments to Auditing Standards for Auditor's Use of the Work of Specialists.*

PCAOB Update

- PCAOB Release No. 2018-005, *Auditing Accounting Estimates, Including Fair Value Measurements, and Amendments to PCAOB Auditing Standards.*
  - The new standard differs from the current requirements in several important ways. Among other things, the standard:
    - Better integrates the requirements for auditing accounting estimates with the PCAOB's risk assessment standards;
    - Extends certain key requirements in the current standard for auditing fair value measurements to all accounting estimates;
    - Provides greater specificity about procedures expected to be performed by the auditor – e.g. when evaluating methods used by the company to develop an accounting estimate; and
    - Places greater emphasis on the auditor's consideration of potential management bias in accounting estimates.

PCAOB Update

- PCAOB Release No. 2018-006, Amendments to Auditing Standards for Auditor's Use of the Work of Specialists.
  - The most significant changes relate to the requirements for the auditor's use of the work of the company's specialists.
    - The amended standard formally expands the requirements for testing and evaluating the work of the specialist to explicitly include:
      - Evaluating the reasonableness of all significant assumptions used by the specialist (whether developed by management or the specialist);
      - Evaluating whether the methods used by the specialist are appropriate under the circumstances; and
      - Testing the accuracy and completeness of company-produced data used by the specialist and evaluating the relevance and reliability of data from external sources that are used by the specialist.

PCAOB Update

- **Effective Date and Implementation.**

  - The new standards and related amendments will take effect for audits of financial statements for fiscal years ending on or after December 15, 2020 (**2020**).

PCAOB Update

CRITICAL AUDIT MATTERS

- **Effective Date and Implementation**
  - The requirement to communicate CAMs in the auditors' report is effective for audits of large accelerated filers ending on or after June 30, 2019.
  - For all other filers for which CAM requirements are applicable, it is effective for fiscal years ending December 15, 2020 (**2020**).

PCAOB Update

CRITICAL AUDIT MATTERS (CAM)

– A CAM is any matter arising from the audit that was communicated or required to be communicated to the audit committee; and

1) Relates to accounts or disclosures **material** to the financial statements; and
2) Involved especially challenging, subjective or complex auditor judgement.

PCAOB Update

CRITICAL AUDIT MATTERS

Examples:

- Significant subjective estimates (i.e. contingencies, goodwill and/or impairment).
- Going concern issues.
- Revenue recognition policies.
- Unrecognized tax benefits

– Not all inclusive.

PCAOB Update

CRITICAL AUDIT MATTERS

- Auditors will focus on:
  - Risks of material misstatement.
  - Estimates with significant uncertainty.
  - Unusual transactions – nature and timing – audit effort needed.
  - Degree of auditor subjectivity in applying and evaluating audit procedures.
  - Degree of specialized auditor knowledge needed.
  - Nature of audit evidence.

PCAOB Update

CRITICAL AUDIT MATTERS

- Identify the CAM;
- Describe principal considerations that led the auditor to determine that the matter is a CAM;
- Describe how the CAM was addressed in the audit; and
- Refer to the relevant financial statement accounts or disclosures that relate to the CAM.

PCAOB Update

CRITICAL AUDIT MATTERS – Example

Critical Audit Matters

The critical audit matters communicated below are matters arising from the current period audit of the consolidated financial statements that were communicated or required to be communicated to the audit committee and that: (1) relate to accounts or disclosures that are material to the consolidated financial statements, and (2) involved our especially challenging, subjective, or complex judgments. The communication of critical audit matters does not alter in any way our opinion on the consolidated financial statements, taken as a whole, and we are not, by communicating the critical audit matters below, providing separate opinions on the critical audit matters or on the accounts or disclosures to which they relate.

Environmental remediation liability

As discussed in Note 15 to the consolidated financial statements, the Company's environmental remediation liability as of August 31, 2019, was $15.9 million. The environmental remediation liability represents the estimated future costs associated with the Company's plan to reduce the level of contamination at the XYZ, Anywhere Superfund site.

We identified the evaluation of the environmental remediation liability as a critical audit matter. Subjective auditor judgment was required to evaluate the assumptions related to the anticipated remediation activities and the cost of those activities. These assumptions have a range of potential outcomes and a revision to them could have a material impact on the financial statements.

The primary procedures we performed to address this critical audit matter included the following. We tested certain internal controls over the Company's process to estimate future remediation costs, including controls related to the development of the anticipated remediation activities and the cost of those activities. To assess the accuracy of the liability, we compared the estimated remediation costs for activities comprising the liability to historical costs incurred for similar activities or current estimates of their future costs. We also involved an environmental professional with specialized skills and knowledge, who assisted in (1) assessing the Company's environmental specialist's qualifications, and (2) evaluating the Company's planned remediation activities through comparison of the Company's selected remediation activities to those communicated to the U.S. Environmental Protection Agency and those commonly observed in conducting remediation.

2. LIBOR RATE'S FUTURE?

LIBOR Rate's Future?

Is LIBOR really being discontinued?

– Yes, all indications are that LIBOR will cease to exist at some point over the next few years.

When?

– Presumed to be end of 2021.

How is the financial services industry preparing?

– Federal Reserve ("the Fed") established the Alternative Reference Rate Committee (ARRC) to explore the replacement for USD LIBOR.

– ARRC has recommended the Secured Overnight Financing Rate (SOFR) as the alternative rate index.

– ARRC published the Paced Transition Plan, outlining specific steps and timeliness for the transition to and implementation of SOFR, including developing the framework for term-structure SOFR.

– International Swaps and Derivatives Association (ISDA) is conducting consultations on the benchmark transition.

Understand "SOFR"

The Market's Proposed Replacement Rate

What is SOFR?

– SOFR, the Secured Overnight Financing Rate, is the presumptive replacement for USD LIBOR.
– Designed and implemented by the Federal Reserve Bank of New York (FRBNY) and the U.S Treasury office of Financial Research (OFR).
– Reflects overnight U.S Treasury repo transaction activity nearing ~$750 billion daily.

Understand "SOFR"

The Market's Proposed Replacement Rate

How does SOFR differ from LIBOR?

LIBOR	SOFR
– Unsecured rate	– Secured rate
– Various maturities	– Overnight, for now
– Built-in credit risk component	– Essentially, a risk-free rate
– Partially transaction based	– Wholly transaction based
– $500 *million* underlying transactions	– $750 *billion* underlying transactions

Takeaway: SOFR does <u>not</u> equal LIBOR!

Educate Stakeholders Within Your Organization

Who in my organization should be informed about the upcoming cessation of LIBOR?

- Team members with signatory authority to enter into credit facilities or hedging instruments
  - Procurement, Accounting, Finance, and Legal departments

What do they need to know?

- Understand the types of **fallback language** that may be included in new agreements as well as potential amendments to existing agreements.
- Should have a general awareness of the planned transition from LIBOR to an alternative reference rate, presumably SOFR.

When do they need to know?

- Financial institutions have already started incorporating updated fallback language in standard loan documents.
- Should have a general awareness of the planned transition from LIBOR by **mid-2020**.

Review LIBOR Fallback Language With Your Legal Counsel

What is "fallback language"?

– Provisions incorporated into LIBOR-based loan documents to facilitate a transparent and orderly transition from a LIBOR index and rate to a new benchmark index and rate.

The ARRC recommends two approaches for fallback language for loans:

(1) "Hardwired" Approach

– Provides a clear waterfall for selecting a replacement benchmark and spread adjustment that would apply if LIBOR is no longer usable.

(2) "Amendment" Approach

– Provides a streamlined amendment mechanism that offers flexibility in selecting a replacement benchmark and spread adjustment.

What approach is preferable?

– Current State: Amendment Approach – To preserve flexibility for lenders and borrowers.

– Future State: Hardwired Approach – To achieve certainty and operational efficiency.

Review LIBOR Fallback Language With Your Legal Counsel

LIBOR fallback language has three primary components:

1. **Trigger Events –** These are the events that define what can prompt a transition to a replacement index/rate. Examples include if LIBOR is no longer representative or if LIBOR ceases to exist.
   – Permanent Cessation (i.e., definitive announcement that LIBOR has or will cease to exist as of a certain date)
   – Pre-Cessation (UK FCA declares LIBOR "non-representative")
   – Early "Opt-In" (loan parties opt to transition away from LIBOR)
2. **New Benchmark Index Selection –** The new benchmark index is likely to be based on SOFR, but the "amendment" approach preserves flexibility to react to evolving industry standards for the calculation of interest rates.

3. **New Benchmark Spread Adjustment –** SOFR differs from LIBOR; therefore, it is expected that there will be an additional spread associated with an SOFR-priced loan.

3. ERISA/PENSION UPDATE

Regulatory Update – Pension Limits

2020 Pension Limits:

	2020	2019	2018
401k Elective Deferrals (Section 402g)	$ 19,500	$ 19,000	$ 18,500
Catch-Up Contribution Limit (Section 414v)	$ 6,500	$ 6,000	$ 6,000
Annual Defined Contribution Limit (Section 415)	$ 57,000	$ 56,000	$ 55,000
Annual Compensation Limit (Sections 401, 404, 408)	$ 285,000	$ 280,000	$ 275,000
Social Security Wage Base	$ 137,700	$ 132,900	$ 128,400
SIMPLE Employee Deferrals	$ 13,500	$ 13,000	$ 12,500
SIMPLE Catch-Up Deferrals	$ 3,000	$ 3,000	$ 3,000

Regulatory Update – Determination Letters

- **New IRS Determination Letter Program**
  - Revenue Procedure 2016-37.
  - Eliminates the 5-year remedial amendment cycle system for **Individually Designed Plans (IDP).**
  - IRS will issue an annual **Required Amendment List** (RA List) after October 1, detailing amendment required to retain tax qualified status.

https://www.irs.gov/retirement-plans/required-amendments-list

  - Required plan amendments must be adopted by the **end of the second calendar year** following the year the RA List is published.

SAS 136 - Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA

- Issued July 2019.
- Includes new requirements in all phases of an EBP audit: engagement acceptance, risk assessment and response, communication with those charged with governance, performance procedures, and reporting.
- Significantly changes the form and content of the related auditor's report.
- Audits performed pursuant to ERISA section 103(a)(3)(C) will no longer be referred to as a "limited scope audit" but rather an "ERISA section 103(a)(3)(C) audit."
- **Introduces CAM's into ERISA Audit Opinion**

SAS 136 - Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA

- As a result, the Opinion Section of the report will now be in two parts:
  - The first part will address the amounts and disclosures not covered by the certification and will affirm that they are in accordance with the applicable financial reporting framework; and
  - The second will state whether the investment information related to the certification agrees with the information provided by a qualified institution.

SAS 136 - Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA

- Sample Opinion Section of the report:

Opinion

In our opinion, based on our audits and on the procedures performed as described in the Auditor's Responsibilities for the Audit of the Financial Statements section:

the amounts and disclosures in the accompanying financial statements, other than those agreed to or derived from the certified investment information, **are presented fairly, in all material respects, in accordance with accounting principles generally accepted in the United States of America.**

the information in the accompanying financial statements related to assets held by and certified to by a qualified institution agrees to, or is derived from, in all material respects, the information prepared and certified by an institution that management determined meets the requirements of ERISA Section 103(a)(3)(C).

SAS 136 - Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA

- Effective: Audits of financial statements for periods ending on or after December 15, 2020 **(2020)**.
- Early Adoption: Not permitted

4. NEWLY EFFECTIVE OR ISSUED ACCOUNTING AND AUDITING STANDARDS

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, no longer through other comprehensive income. Eliminates the available for sale category.
- Effective: Annual reporting periods for public businesses beginning after December 15, 2017 (**2018**), and annual reporting periods for nonpublic companies in years beginning after December 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.

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 total 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 December 15, 2017 (**2018**), and annual reporting periods for nonpublic companies in years beginning after December 15, 2018 (**2019**). Early adoption is permitted.

Credit Losses on Financial Instruments

ASU 2016-13: Measurement of Credit Losses on Financial Instruments

- Issued in May 2016.
- Entirely new model for recognizing and measuring credit losses on loans receivable and debt securities.
- Instead of today's incurred loss model, record a loss reserve for all "expected losses" immediately when the loan is made or purchased.
- Goal is in part to ensure loan losses are recognized earlier than they were in 2007/8 crisis.
- Effective: Annual reporting periods for SEC public businesses beginning after December 15, 2019 (**2020**), and annual reporting periods for nonpublic companies in years beginning after December 15, 2020 (**2021**), HOWEVER, delay until **2023** proposed!

Other Notable Standard Updates Issued Prior to 2019

(private company effective date in red)

ASU 2017-07 – Net Period Pension Cost (2019)

- Recognize "service cost" component of pension expense within same line item as compensation cost (not within other pension cost "below the line").

ASU 2018-07 – Compensation-Stock Compensation (2020)

- Aligns accounting for share-based payments to non-employees to the current guidelines for employee share-based payments.

ASU 2018-13 – Fair Value Measurement (2020)

- Updates and simplifies certain disclosure requirements for Level 1, 2 and 3 investments.

ASU 2018-14 – Compensation—Retirement Benefits—Defined Benefit Plans (2022)

- Updates and simplifies certain disclosure requirements for defined benefit pension plans within an entity's financial statements.

ASU 2018-17 – Consolidation (Topic 810) – Variable Interest Entities (VIE) (2021)

- Expands previously issued private company guidance allowing election to NOT consolidate legal entities under common-control when certain criteria are met.

Newly Issued ASU's in 2019

(private company effective date in red)

ASU 2019-02 – Entertainment – Films - Other Assets - Film Costs (2021)

- Addresses when an organization should assess films and license agreements for program material for impairment at the film-group level.

ASU 2019-03 – Not-for-Profit Entities: Updating the Definition of Collections (2020)

- Modifies the definition of the term collections and requires that a collection-holding entity disclose its policy for the use of proceeds from when collection items are deaccessioned (i.e., removed from a collection).

ASU 2019-06 – Intangibles—Goodwill and Other (Immediately)

- Extends previously issued Private Company Council Accounting Alternative for recognition of intangible assets in an acquisition and amortization of goodwill over 10 years or less to not-for-profit entities.

Auditing Updates

SAS 134, Auditor Reporting (AU-C 700)

- Issued May 2019.
- Effective for audits of periods ending after December 15, 2020 (**2020**).
- Revises form and content of auditor opinion.
- Opinion comes first.
- Expanded discussion of management & auditor responsibilities.
- Guidance for Key Audit Matters (KAM):
  - Matters that “required significant auditor attention”.
  - Auditor must be engaged to report on KAMs.

Auditing Updates

SAS 135, Omnibus Statement on Auditing Standards

- Issued May 2019.
- Effective for audits of periods ending after December 15, 2020 (**2020**).
- Focuses on auditor procedures for related party transactions, communication of potential future effects of uncorrected misstatements, unusual transactions.

SAS 137, The Auditor's Responsibilities Relating to Other Information Included in Annual Reports

- Issued July 2019.
- Effective for audits of periods ending after December 15, 2020 (**2020**).
- Requires the auditor to read and consider the other information for potential inconsistencies (*opinion still does not cover other information*).

5. CHANGES TO ACCOUNTING FOR LEASES

Leases

ASU 2016-02 – Leases

- Issued on February 25, 2016.
- All leases will be capitalized. It is estimated that $2 trillion in liabilities will be added to balance sheets when the standard becomes effective!
- Effective date for public entities is for year ends beginning after December 15, 2018 (**2019**).
- Effective date for private companies was for year ends beginning after December 15, 2019 (2020), ***HOWEVER*****, FASB has voted and affirmed to extend the effective date by one year (2021)**.
- Must be adopted retrospective to the beginning of the earliest year presented in the financial statements.
- The **only exception is for leases of 12 months or less**, these leases can still be expensed.

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.

Lessees

Approach A – Financing Type (Capitalized)

- Separately reflected in P&L.
- Present value the lease liability with interest expense.
- Amortize right of use asset on a straight line basis.
- Variable lease payments incurred after commencement are operating expense.
- 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)

	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

What have we learned from Public Company Implementation?

- **Start Early**
  - Many have reported that implementation was more challenging and required larger cross-sectional effort than expected.
- **Review Agreements and Lease Inventory**
  - Identification of the population of leases and review of all lease agreements was consistently noted as a challenging aspect of implementation.
- **Accounting Software Selection**
  - Testing of your current accounting system is critical to identify its ability to handle the new reporting requirements. Do you need to invest in new software?
- **Accountant Communication**
  - Communicate early with your auditor or accountant in order to understand their process of auditing or reviewing the leasing activity and financial statement disclosures.

6. Revenue Recognition Change is Here!

Revenue Recognition

Core Principle

- 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.
- No longer applicable in accounting principles:
  - Earnings process, matching, or transfer of risks and rewards or title.

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.

Revenue Recognition – Step 3

Step 3: Determine the Transaction Price

- Definition - Amount that vendor ***expects*** 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”.
- **If the transaction price cannot be reasonably estimated, an entity shall not recognize revenue from satisfying a performance obligation.**

Variable Consideration

- 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.

Variable Consideration

- 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.

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.

Revenue Recognition – Step 5

Step 5: Recognize Revenue as (or when) Performance Obligations are Satisfied.

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

Fulfillment Costs

Contract fulfillment costs:

- Cost that relate to progress to completion.
- If not capitalized under other GAAP (inventory), fulfillment costs should only be capitalized if the following criteria exist:
  - Costs are ***directly related to a specific contract***, (relates to future performance).
  - Costs ***generate or enhance a resource that is used to fulfill performance obligation***; **AND**
  - Costs are ***recoverable***.
- Contract fulfillment costs will need to be considered for impairment.

Fulfillment Costs

Capitalized Contract Fulfillment Costs – Pre-Contract Costs.

- Costs to fulfill a contract that are incurred ***prior to the transfer of control*** to the customer are subject to review for capitalization.
- Amortization will most likely be evenly spread over the estimated contract duration.
- Contract fulfillment cost to consider:
  - *Insurance/bonding.*
  - *Mobilization costs of equipment and labor to and from the job sites.*
  - *Engineering and Design on the basis of commitments.*
  - *Costs for production equipment and material relating to specific anticipated contracts (costs for purchase of equipment, material or supplies).*

Incremental Costs to Obtain a Contract

- 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.

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.
- Contractor should consider whether the inclusion of these uninstalled materials would result in recording revenue prematurely.

Uninstalled Materials

- The following criteria if met may indicate a cost incurred is <u>not proportionate to the entity satisfying progress</u> in satisfying the performance obligation:
  - The good is not distinct;
  - The customer is <u>expected to obtain control of the good significantly before receiving services</u> related to the good;
  - The cost of the transferred good is significant relative to the total expected costs to completely satisfy the performance obligation; and
  - The entity procures the good from a third party and is not significantly involved in designing and manufacturing the good.

Uninstalled Materials

- The contractor should recognize revenue from uninstalled materials only to the extent of the costs incurred (zero profit). The costs would be excluded from the cost to cost calculation.
- Need to evaluate at inception and throughout the duration of the contract.

Uninstalled Materials

- 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).

Transition

The new guidance allows companies to select between two transition methods –

- ✓ Full retrospective method.
- ✓ Cumulative effect adjustment (simplified approach).

Disclosures

Disclosure requirements –

- New ***comprehensive disclosure requirements*** that are expected to provide users of the financial statement with detailed information regarding revenue recognition:
  - Revenue <u>disaggregated</u> 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).

Disclosures

Disclosure requirements, continued:

- 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.

Any Other Reporting Options??

- FASB – No Private Company Alternative available!
- GAAP Exception to remain on Percentage of Completion?
  - FASB – Financial Statements are NOT GAAP if Topic 606 not followed!
- Tax Basis of Accounting for Financial Statements?
  - Many smaller contractors may convert to Completed Contract method due to tax law changes!
  - Not GAAP! Will need to discuss with users of financial information!
  - Can't pick and choose which tax methods to use!! (Tax depreciation)
- Financial Reporting Framework for Small and Medium Sized Entities (FRF for SME's)?
  - Not GAAP! Will need to discuss with users of financial information!
  - Users (Banks, Sureties, GC's, etc…) may not be comfortable with the change.

Resources

Tools and Resources:

- CICPAC Contract Abstract Analysis Tool
- CICPAC Revenue Recognition Implementation Guide
- CFMA Revenue Recognition Implementation Guide
- Dannible & McKee Articles

Available at:

www.dmcpas.com/revenue-recognition-resource-center

Questions

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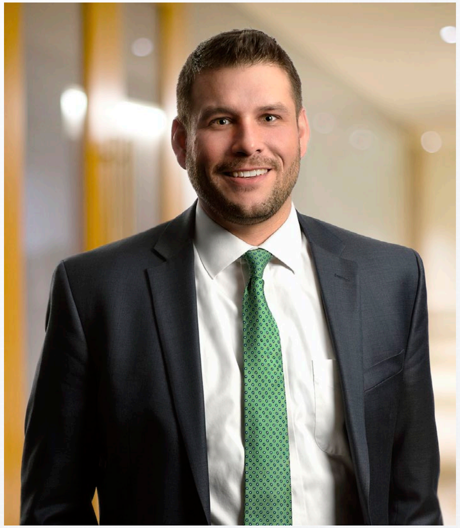

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