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Accounting and Finance Update

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Annual Construction Conference

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Outline

1. New Leasing Standard
2. ASC 606 Revenue Recognition Update
3. Accounting for Employee Retention Credits

1. NEW LEASING STANDARD

Leases

ASU 2016-02 – Leases

- Issued on February 25, 2016.
- **Required to be implemented for private companies for years beginning after December 15, 2021 (2022 calendar years)**.
- Implementation ***NOT*** required for interim financial statements.
- All leases will be capitalized. It is estimated that $2 trillion in liabilities will be added to balance sheets when the standard becomes effective!

Leases

What is a lease under ASC 842?

- An identified asset
  - May be explicitly or implicitly specified
  - No practical ability or economic incentive to substitute the asset
- The right to control the use of the asset during the term.
  - Decision-making authority held by lessee
  - Lessee obtains substantially all economic benefits
- Consideration must transfer from lessee to lessor.
- Month to month leases – often a related party lease. Need to consider if there is economic incentive/disincentive that make an extension reasonably certain, due to:
  - Costs of relocation / disruption to business
  - Significant investments in Leasehold Improvements
  - Regulatory approvals needed for location

Leases

How will leases be accounted for under the new guidance?

- Lessees will recognize a **"right-of-use"** asset (non-current) and a liability (current and non-current portions) for their obligation to make lease payments for ***all*** leases.
- Asset and liability are initially measured using the **present value (PV)** of the lease payments using a discount rate.
- Use an **expected-outcome approach:**
  - Contingent rentals and residual value guarantees are part of the right of use asset and lease liability if expected to be incurred.
  - 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.

Leases

How will leases be accounted for under the new guidance?

- **Includes** subleases, "embedded leases" and related party leases.
  - If related parties are consolidated for financial statements, leasing activity should be eliminated consistent with current standards.
  - Embedded leases are leases included in larger contracts or agreements (IT Contracts with server leases included).
- **Excludes** leases of all intangible assets, biological assets (e.g. timber), inventory and leases to explore for use of mineral oil and natural gas.
- **Excludes leases with a maximum possible term of 12 months or less**, expense on a straight-line basis.
  - Must consider legally enforceable terms.
  - Must consider expected outcome if unilateral option to cancel or renew.

Leases

Two elements form basis for PV of lease payments:

1) Lease Term

Noncancellable period for which a lessee has the right to use an underlying asset.

+

Any periods covered by an option to:

EXTEND THE LEASE If the lessee is reasonably certain to exercise that option.

TERMINATE THE LEASE If the lessee is reasonably certain they will not exercise that option.

Leases

Two elements form basis for PV of lease payments:

2) Lease Payments - INCLUDED

Fixed Payments
Fixed payments, including in-substance fixed payments, less any lease incentives paid or payable to the lessee.

Transaction Fees
Fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction.

Amounts Owed
Amounts it's probable the lessee will owe under residual-value guarantees.

Purchase Option
The exercise price of an option to purchase the underlying asset, if the lessee is reasonably certain to exercise that option.

Penalty Payments
Penalty payments for terminating the lease, when the lease term reflects the lessee exercising an option to terminate the lease.

Some Variable Payments
Variable lease payments that depend on an index or a rate (i.e. CPI), using best estimates.

Leases

Two elements form basis for PV of lease payments:

2) Lease Payments - EXCLUDED

Certain other variable lease payments

- Real estate taxes
- Building insurance
- Lease payments determined based on a percentage of sales

Amounts allocated to non-lease components

- Common area charges
- Service agreements

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)

- 5-part test – Financing lease if any of the 5 is met.
  1. Lease transfers ownership.
  2. Lease grants the lessee option to purchase and exercise of the option is reasonably certain.
  3. Lease term is for major part of the remaining economic life (~75% or more).
  4. Present value of future payments plus guaranteed residual value equals or exceeds substantially all of the fair value of the underlying asset (~90% or more).
  5. Asset is specialized in nature and has no alternative use to the lessor.

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 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 A__ – Financing Type (Capitalized)

- To amortize a 5-year lease at $20,000 / year with a 3% escalation ($106,183 total payments) using a 6% incremental borrowing rate.

Finance Lease						
	A	B	C	D	E - B	E
Year	Payment	Interest	Principal	Remaining	Asset Amortization	Total Expense
				$ 86,727		
1	$ 20,000	$ 6,071	$ 13,929	72,798	$ 17,345	$ 23,416
2	20,600	5,096	15,504	57,294	17,345	22,441
3	21,218	4,011	17,207	40,086	17,345	21,356
4	21,855	2,806	19,049	21,038	17,345	20,151
5	22,510	1,473	21,038	-	17,345	18,818
	106,183	19,456	86,727		86,727	106,183

- Note that the **asset amortization is static** from year to year.

Lessees

<u>Approach B</u> – Operating Type, Straight-line Approach.

- To amortize a 5-year lease at $20,000 / year with a 3% escalation ($106,183 total payments) using a 6% incremental borrowing rate.

Operating Lease						
	A	B	C	D	E - B	E
Year	Payment	Interest	Principal	Remaining	Asset Amortization	Total Expense
				$ 86,727		
1	$ 20,000	$ 6,071	$ 13,929	72,798	$ 15,166	$ 21,237
2	20,600	5,096	15,504	57,294	16,141	21,237
3	21,218	4,011	17,207	40,086	17,226	21,237
4	21,855	2,806	19,049	21,038	18,431	21,237
5	22,510	1,473	21,038	-	19,764	21,237
	106,183	19,456	86,727		86,727	106,183

- Note that the **total expense is static** from year to year.

Leases

Presentation for Lessees

Balance sheet

- Either present separately or combine with appropriate class of assets and liabilities with proper disclosure.

- No co-mingling of *Approach A* (financing) and *Approach B* (operating) leases, either present separately or disclose separately.

Income statement

- No change to how capital leases and operating leases are currently being charged to expense.

Side by Side Comparison
Balance Sheet

	Old Standard	New Standard
Assets		
Cash	$ 2,000,000	$ 2,000,000
Accounting receivable	11,500,000	11,500,000
Contract asset	1,500,000	1,500,000
Prepaid expenses and other current assets	500,000	500,000
Total Current Assets	15,500,000	15,500,000
Property and Equipment	10,279,000	10,000,000
Operating Lease Right of Use Asset	--	5,805,000
Financing Lease Right of Use Asset	--	279,000
Total Assets	$ 25,779,000	$ 31,584,000
Liabilities and Stockholder's Equity		
Line of credit	$ 3,500,000	$ 3,500,000
Current portion of operating lease liability	--	510,000
Current portion of financing lease liability	--	92,000
Current portion of capital lease obligations	92,000	--
Accounts payable and accrued expenses	7,000,000	7,000,000
Contract liability	2,000,000	2,000,000
Total Current Liabilities	12,592,000	13,102,000
Operating Lease Liability, less current portion	--	5,295,000
Financing Lease Liability, less current portion	--	191,000
Capital Lease Obligations, less current portion	191,000	--
Total Liabilities	12,783,000	18,588,000
Stockholder's Equity	12,996,000	12,996,000
Total Liabilities and Stockholder's Equity	$ 25,779,000	$ 31,584,000

	Old Standard	New Standard
Debt to Equity Ratio		
Total Liabilities	$ 12,783,000	$ 18,588,000
Total Equity	12,996,000	12,996,000
Debt to Equity Ratio	0.98	1.43

	Old Standard	New Standard
Current Ratio		
Current Assets	$ 15,500,000	$ 15,500,000
Current Liabilities	12,592,000	13,102,000
Current Ratio	1.23	1.18

	Old Standard	New Standard
Working Capital		
Current Assets	$ 15,500,000	$ 15,500,000
Current Liabilities	12,592,000	13,102,000
Working Capital	$ 2,908,000	$ 2,398,000

Side by Side Comparison
Income Statement

	Old Standard	New Standard
Revenues Earned	$ 40,000,000	$ 40,000,000
Cost of Revenues Earned	35,000,000	35,000,000
Gross Profit	5,000,000	5,000,000
General and Administrative Expenses		
Office salaries, payroll taxes and benefits	3,400,000	3,400,000
Rent	595,000	--
Operating lease	--	595,000
Travel and entertainment	300,000	300,000
Depreciation and amortization	248,850	248,850
Office expense	200,000	200,000
Total General and Administrative Expenses	4,743,850	4,743,850
Income from Operations	256,150	256,150
Other Expense		
Interest expense	11,150	11,150
State Income Tax Expense	50,000	50,000
Net Income	$ 195,000	$ 195,000

	Old Standard	New Standard
Debt Coverage Ratio		
Net Income	195,000	195,000
Plus: Interest expense	11,150	11,150
Plus: Taxes	50,000	50,000
Plus: Depreciation and amortization	248,850	248,850
Plus: Operating lease expense	--	--
EBITA	505,000	505,000
Current debt and capital/financing leases	92,000	602,000
Interest expense	11,150	11,150
Debt Service	103,150	613,150
Debt Coverage Ratio	4.90	0.82

Leases

Adoption and Implementation

- Classification, measurement, and recognition are all done at commencement.
- Measurement is done using remaining lease payments as of the date of application.
- 2 optional modified retrospective methods of adoption:

    1) Comparative Date Method
        - Date of initial application is at the beginning of the earliest comparative period (ex: 1/1/21 for a 2022 calendar year-end private entity).
        - Restate comparative periods presented.
        - ASC 842 disclosures required for all periods presented.

Leases

Adoption and Implementation

- 2 optional methods of adoption (continued):

  2) Effective Date Method
     - Date of initial application is the effective date (ex: 1/1/22 for a 2022 calendar year-end private entity).
     - No requirement to adjust comparative periods or provide comparative period disclosures.
     - Make disclosures under ASC 840 for comparative period and ASC 842 disclosures for post-adoption period.

- Full retrospective method is ***not*** allowed (i.e. going back to beginning of each lease).

Leases

Disclosures

- Information about lease assets by class of asset, including cash flows.
- Maturity analysis of lease liabilities.
- Description of extension and termination options.
- Basis on which variable lease payments are determined .
- Quantitative table of lease cost, cash flows, and remaining balances for finance leases and separately for operating leases .
- Cumulative effect of the change on retained earnings, if any.
- Nature & reason for the change.
- Effect on income from continuing operations, net income, or any other line item.
- Lease descriptions & terms.

Leases

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,	
	20X2	20X1
Other information		
(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%

Leases

Significant challenges

- Lease discovery.
- Determining lease term.
- Segregating non-lease components.
- Segregating embedded leases from contracts.
- Accounting for related party leases.
- Data mining and organization for completing note disclosures.
- Master lease agreements.

Leases

Example #1 – Related party month-to-month lease

Lessee, a private company, has been making monthly payments to an affiliate (related party) under an unwritten lease agreement. In exchange, Lessee has received exclusive use of a storage facility owned by the affiliate. Lessee's legal counsel believes that based on the laws of the jurisdiction where the property is located, both Lessee and the affiliate must consent to continue the lease each month. In other words, either party can terminate the verbal arrangement with one month's notice.

Accordingly, the legally enforceable terms and conditions indicates that the arrangement is a one-month lease. Lessee does not have the unilateral right to renew or extend the lease and, therefore, should not evaluate whether it is reasonably certain that the lease term will extend beyond one month.

However, because the lease term is just one month, any leasehold improvements associated with the property would be required to be amortized over a period no longer than one month.

Leases

Example #2 – Related party month-to-month lease

Lessee, a private company, has been making monthly payments to an affiliate (related party) under an unwritten lease agreement. In exchange, Lessee has received exclusive use of a manufacturing facility owned by the affiliate. Lessee's legal counsel believes that based on the laws of the jurisdiction where the property is located, Lessee has the unilateral right to renew the lease each month.

Therefore, the legally enforceable terms and conditions indicates that the noncancellable term of the lease contract is one month, but that the Lessee also possesses an option to renew the lease on a month-to-month basis thereafter. Lessee should evaluate whether it is reasonably certain that the lease term will extend beyond one month based on contract-, entity-, asset-, and market-specific factors. In particular, Lessee should consider the cost and useful lives of any leasehold improvements it has made to the leased facility, which may provide strong evidence that it is reasonably certain that Lessee will extend or renew the lease for periods beyond the initial one-month noncancellable period.

Leases

Example #3 – Variable lease payments

Lessee X agrees to lease a retail store for five years with the following payment terms:

- Base annual rent of $120,000 in Year 1. The base annual rent will be increased by the change in the Consumer Price Index (CPI) in each subsequent year.
- Contingent rent calculated at 1% of sales revenue generated at the store.
- Reimbursement of insurance premiums that will vary each year depending on the actual amounts levied by the insurer.

Leases

Example #3 – Variable lease payments

Item	Include in Lease Payments?
Base rent indexed by CPI	Yes and no. Variable lease payments that depend on an index or rate are included in lease payments. However, these payments should be measured using the index or rate in existence as of lease commencement without consideration of estimated future movements in the index or rate.
Contingent rent of 1% of sales revenue	No. Lease payments exclude any payments that are based on the usage or performance of the asset.
Reimbursement of variable insurance premiums	No. Lease payments also exclude variable payments made by the lessee to reimburse the lessor for insurance or property taxes.

Leases

Example #4 – Embedded Leases

A general contractor has a contract to build a new high-rise office building. The contractor signs an agreement with a subcontractor to provide and erect scaffolding. During the project, the contractor can direct the subcontractor to move the scaffolding or change its configuration, and at the end of the three-year estimated build time, the subcontractor will disassemble it and remove it from the construction site.

Is use of the scaffolding be considered an embedded lease?

Leases

Example #4 – Embedded Leases

1) Is there an identified asset? ***YES***
   - The scaffolding that will be used in the project is unlikely to be replaced with different scaffolding, and once it is on site, the scaffolding will be used *only* in this project.
2) Does the contractor have the right to control or use the asset? ***YES***
   - As part of the agreement, the contractor can ask the subcontractor to move or alter the scaffolding to fit its needs.
3) Is there a set lease term? ***YES***
   - The contractor can use the scaffolding for the entire three years stated in the contract.
4) Was there consideration transferred for the use of the asset? ***YES***

Leases

Example #4 – Embedded Leases

Under current GAAP, the contractor would charge the invoice obtained from the subcontractor to the project on a monthly basis.

Under ASC 842, the contract with the subcontractor is considered an embedded lease. Therefore, the scaffolding lease would be recorded as an operating lease right to use asset and a corresponding lease obligation. The contractor would amortize the lease cost over the three-year term of the lease to the project.

Leases

Early Adopters and Public Companies – What Have We Seen?

- Significant judgments made in applying the guidance such as in determining the discount rate, whether the contract contains a lease.
- Transition Approach - Effective date method much more popular than comparative method.
- Utilization of lease software.
- Expanded footnote disclosures.

Leases

What should you be doing now?

- Start reviewing and evaluating now.
- Take inventory & gather documentation for all leases – centralized location.
- Assign “champion” or lead personnel for the project.
- Maintain written policies on the thresholds to be used & any “reasonable” approaches to be used.
- Determine accounting treatment for each lease.
- Start reviewing impact to covenants and KPI’s.
- Talk to bankers, sureties, stockholders, lenders.
- Review lease software options – Find what is right for you / your client.
  - There are over 30 different lease software solutions in the market today – various price points, industry focuses, implementation difficulties, features & benefits.
- Apply the policies consistently for all leases.

2. ASC 606 Revenue Recognition Update

Revenue Recognition (ASC 606)

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.

Revenue Recognition (ASC 606)

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 – Observations

- All companies that have contracts with customers should now have fully adopted this standard.
- It has largely resulted in many new disclosures, but very few adjustments.
  - You cannot assume there is no impact, you must document that the standard has no effect.
- The most significant changes are found on contracts with:
  - Large upfront costs before any product or service is transferred to the customer.
    - For example: Mobilization on heavy highway contracts, tooling that is not charged to the customer, bonding costs.
  - Inventory purchased and not yet installed.
    - For example: Masonry brick sitting purchased and on the job site, but not yet installed. Different treatment based on when control transfers.

Revenue Recognition – Retainage

How is retainage on uncompleted contracts treated?

- ASC 606 defines receivables as amounts that are collectible over the passage of time.
- Retainage on uncompleted contracts that have not been formally released by the owner are, by their nature, not collectible over the passage of time, but instead are only collectible once the provisions of the contract have been met.
  - Therefore, retainage on uncompleted contracts that is conditional to the provisions of a contract being met <u>cannot be classified as receivables</u>.

Revenue Recognition – Retainage

If the amounts cannot be classified as receivables, how are they shown on the balance sheet?

- These amounts should be shown as a contract asset or liability on the balance sheet.
- ASC 606 defines that <u>each</u> contract shall only have one contract asset or liability on the balance sheet, and therefore, the standard implies that you should net the conditional retainage balance with underbilling or overbilling amounts.
- However, **we recommend presenting retainage as a separate line on the balance sheet** to avoid confusing the users who are familiar with retainage provisions and provide adequate note disclosures regarding the conditional nature of retainage.

3. Accounting for Employee Retention Credits

Employee Retention Credit (ERC)

What is the Employee Retention Credit (ERC)?

- The Employee Retention Credit (ERC) is a fully refundable **payroll tax credit** for eligible employers based upon eligibility and payment of qualified wages and health plan expenses
- ERC applies to qualified expenses paid after March 12, 2020, and is set to expire on December 31, 2021 (or September 30, 2021, with current pending legislation)

Who is eligible for ERC's?

- An eligible employer is any employer carrying on a "trade or business" during the ERC period (March 13, 2020, through December 31, 2021), that **either**:

  a) Fully or partially suspended operation during any calendar quarter during the ERC period due to orders from an appropriate governmental authority limiting commerce, travel, or group meetings, due to COVID-19; **or**

  b) Experience a "significant decline in gross receipts" during the calendar quarter

Employee Retention Credit (ERC)

2020

- 50% of Qualified Wages
- Maximum $10,000 of Qualified Wages per employee
- $5,000 maximum credit per employee from March 13, 2020, through December 31, 2020

2021

- 70% of Qualified Wages
- Maximum $10,000 of Qualified Wages per employee
- $7,000 maximum credit per employee/per quarter (up to $28,000 credit per employee)

Employee Retention Credit (ERC)

How is the credit claimed?

- For prior quarter ERC claims, refund claim is filed via “amended” Form 941 quarterly payroll tax return.
- For “current” ERC claims (no Form 941 currently filed for the quarter), employer is able to reduce required future payroll deposits and excess ERC (if any) is refunded.
- Employers can request “advance payment” of the credit on Form 7200

Should financial statements reflect the credit?

- Yes, the credit amount should be recorded as a receivable on your internal and external financial statements as of the end of the period for which you are claiming the credit.
- For instance, ERC’s received for Q3 2021 eligible wages, should be recorded as a receivable as of September 30, 2021.

Employee Retention Credit (ERC)

Are the credits recorded as a reduction in payroll tax expense?

- No, the credit is meant to supplement wages, similar to PPP. It is just claimed through payroll tax filings.

Ok, so the credit is recorded as a reduction in wage expense?

- IRS guidance indicates that the credit should be reflected as a reduction in wage expense, HOWEVER, this could lead to a problem of comparability from one period to another for financial reporting.
- Alternatively, separately recording the credits claimed as “Other Income” using the government grant model (similar to PPP) would allow for comparable presentation of financial information from one year to the next.
- If separately reporting ERC’s within “Other Income” there would still be a required adjustment to reclassify against wage expenses for Federal income tax reporting purposes.

Employee Retention Credit (ERC)

How are ERC receivables relieved?

- For credits received as refunds, relieve the receivable when the cash is received.
- For credits used to reduce future payroll tax deposits, the receivable should be reduced each pay period and payroll tax expense charged for the amount of the credit used.

What do the journal entries look like?

- Initial accounting should be:
  - Debit: ERC Receivable $XXX,XXX
  - Credit: Other Income $XXX,XXX

Employee Retention Credit (ERC)

What do the journal entries look like (continued)?

- Journal entry to record receipt of cash refunds:
  - Debit: Cash $XXX,XXX
  - Credit: ERC Receivable $XXX,XXX

- Journal entry to record use of ERC's to reduce future payroll tax deposits:
  - Debit: Payroll tax expense $XXX,XXX
  - Credit: ERC Receivable $XXX,XXX

Questions

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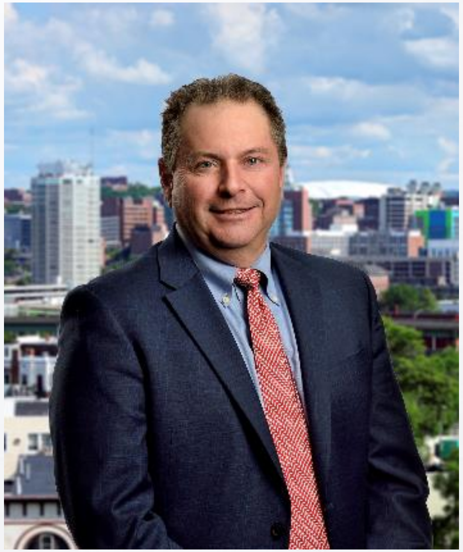

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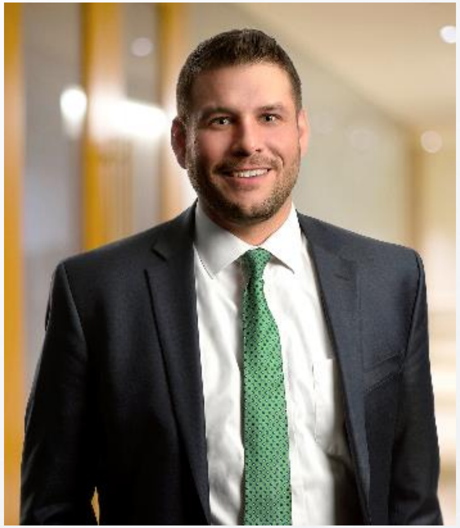

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