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Accounting Standard Updates

April 20, 2021

WELCOME! We will begin momentarily . . .

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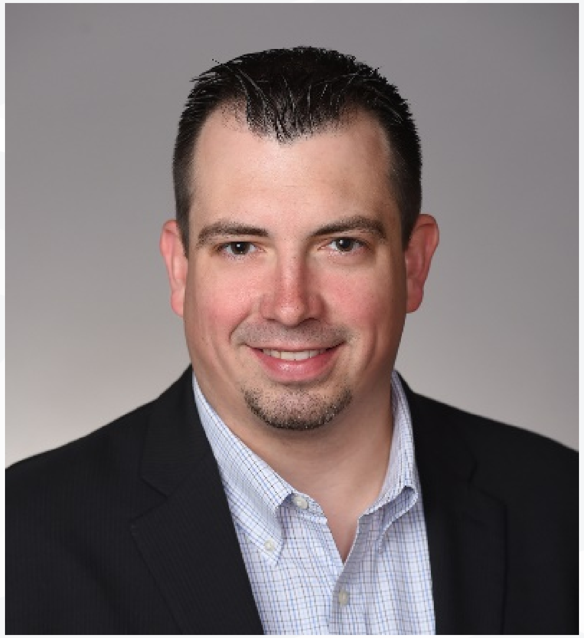
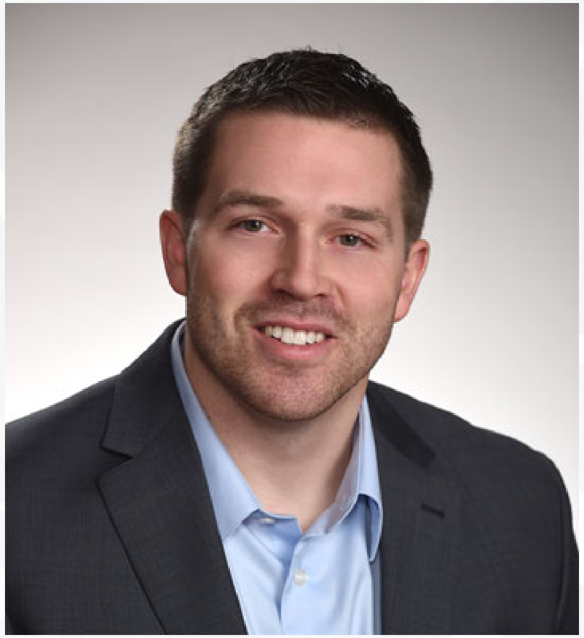
HOUSEKEEPING

- Attendees are encouraged to submit questions at any time using the Q&A function.
- Questions will be addressed at the end of the formal presentation if time permits.
- Additionally, all attendees will be emailed a link to a recording of the webinar and a pdf of the presentation including speaker biographies and contact information.
- **Today's presentation is not:**
    - Legal advice
    - The final word on today's topics – updates will be continuously provided via herbein.com
- ***Before taking any action, you should review this material with internal and/or external advisors.***

Speakers





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AGENDA

- ASC Topic 840 – Legacy Lease Accounting Refresher
- Why ASC Topic 842?
- ASC Topic 842

Poll #1

Do you feel prepared for the upcoming Lease Standards?

- Yes
- No
- Not sure

ASC Topic 840 – Legacy Lease Accounting Refresher

- U.S. Generally Accepted Accounting Principles (GAAP) as prescribed by accounting standards codification (ASC 840) focuses on whether the lease transfers substantially all of the risks and rewards of ownership

- Two Classifications –
  - Operating
  - Capital

- "Bright Line" criteria –
  - Lease term greater than or equal to 75% of useful life of the asset
  - Present value of minimum lease payments greater than or equal to 90% of fair value of the leased asset
  - Bargain purchase option
  - Title transferred at the end of the lease term
  - ANY condition exists = capital lease

ASC Topic 840 – Legacy Lease Accounting Refresher

- Capital Lease
  - Recorded on the Balance Sheet
    - The present value of all lease payments is considered to be the cost of the asset, which is recorded as a fixed asset with an offsetting credit to a capital lease liability account
  - Financial Statement Disclosure
    - Gross amount of assets in the balance sheet recorded under capital leases and the accumulated amortization by major classes according to nature or function
    - Lease obligations classified as current and long-term
    - Future minimum lease payments as of the latest balance sheet presented, in the aggregate and for each of the five succeeding fiscal years, with appropriate separate deductions therefrom for imputed interest to reduce net minimum lease payments to present value

- Operating Lease
  - No Balance Sheet impact – only need to record each lease payment as an expense
  - Financial Statement Disclosure
    - Future minimum rental payments required as of the date of the latest balance sheet presented, in the aggregate and for each of the five succeeding fiscal years

ASC Topic 840 – Legacy Lease Accounting Refresher

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Why ASC Topic 842?

- U.S. GAAP has often been criticized as being too reliant on bright lines and subjective judgments
- Many believe that such reliance has led entities to account for economically similar transactions differently and has presented opportunities for entities to structure transactions to achieve a desired accounting effect
- Such criticism prompted the SEC – in its 2005 report on off-balance sheet arrangements – to recommend that the FASB undertake a project on lease accounting
- Increase transparency by bringing all current off-balance sheet leasing activities onto the balance sheet
- Allowing investors and other users of financial statements to more readily and accurately understand the rights and obligations associated with a Company's leasing transactions

ASC Topic 842

- In February 2016, the FASB issued Accounting Standards Update (ASU) 2016-02, *Leases*, which provided new guidelines that change accounting for leasing arrangements
- These new guidelines are contained in Accounting Standards Codification (ASC) Topic 842, Leases
- Compared with legacy lease accounting, ASC Topic 842 primarily changes the accounting for lessees, requiring lessees to record assets and liabilities on the balance sheet for almost every lease
- This significantly differs from legacy accounting for operating leases, under which they were viewed as executory contracts not recognized for accounting purposes—in other words, they were off balance sheet
- FASB has issued ASU 2017-13, ASU 2018-01, ASU 2018-10, ASU 2018-11, ASU 2018-20, ASU 2019-01, ASU 2019-10, and ASU 2020-05
  - Latest ASU 2020-05 delayed effective dates to fiscal years beginning after December 15, 2021

ASC Topic 842 – Lease Definition

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- Definition of a Lease
  - ASC Topic 842 defines a lease as:
    - "a contract, or part of a contract, that conveys the right to control the use of an identified asset for a period of time in exchange for consideration."
  - A contract is (or contains) a lease if the following two conditions are met:
    - Identified Asset – the contract explicitly or implicitly specifies the use of the identified property, plant, or equipment;
    - Customer Control – the customer controls the use of the identified asset for a period of time.

ASC Topic 842 – Identified Asset?

- Identified Asset
  - A lease must explicitly or implicitly identify a specific asset that is the subject of the contract.
  - Therefore, if the supplier has a substantive substitution right, the contract isn't a lease.
  - Substantive Substitution Rights
    - Supplier has the practical ability to substitute the identified asset
    - Supplier can benefit from exercising that right of substitution
    - Both conditions met = supplier has the substantive right to substitute an asset
  - In some situations, judgment is necessary to determine if a contract specifies an identified asset.
  - For example, transportation contracts may explicitly or implicitly specify the exact vessel, rail car, or truck to be used. If no other practical alternatives can be used to fulfill the transportation services, the contract may be (or contain) a lease, depending on whether the customer can control the use of the transportation vehicle.

ASC Topic 842 – Customer Control?

- Customer Control
    - Under ASC Topic 842, a contract conveys the right to control the use of an identified asset if, throughout the period of use, the customer has the right to both:
        - Direct the use of the identified asset
        - Obtain substantially all of the economic benefits from the use of the identified asset
        - Both conditions met = Customer has right to control the asset
    - The right to direct the use of an identified asset means the lessee has the right to direct how the asset is used and for what purpose. This includes the right to change how the asset is used throughout the contract term. ASC Topic 842 further indicates a supplier's protective rights over the identified asset don't necessarily prevent the customer from having the right to direct its use.

ASC Topic 842 - Classification

- Two classifications under ASC Topic 842 –
  - Finance (previously Capital)
  - Operating
- Determining Lease Classification –
  - Finance Lease Criteria
    - The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.
    - The lease provides the lessee an option to purchase the underlying asset, and that option is reasonably certain to be exercised.
    - The lease term is for the **major part** of the remaining economic life of the underlying asset, even if title isn't transferred.
    - The present value of the lease payments—plus any residual value guaranteed by the lessee that isn't already reflected in the lease payments—equals or exceeds **substantially all** the fair value of the underlying asset.
    - The underlying asset is of such a specialized nature that only the lessee can use it without major modifications. In other words, the lessor expects to have no alternative use for the leased asset at the end of the lease.
    - ANY condition exists = finance lease
    - If no conditions exist = operating lease

ASC Topic 842 – Considerations

- Date of Assessment – now lease commencement date (not inception date under legacy lease accounting)
- Short-Term Leases – lease term of 12 months
- Small-Ticket Items – no scope exceptions
- Non-lease components – goods/services provided to the lessee separate from the right to use the leased asset

ASC Topic 842 – Most Significant Change

- All leases, both operating and finance, will be recognized on the balance sheet.
  - A right-of-use (ROU) asset
    - Initial lease liability + any lease payments made at or before lease commencement date +and initial direct costs – any lease incentives received from the lessor
  - A lease liability
    - Present value of the remaining lease payments due over the lease term, discounted at the rate implicit in the lease

ASC Topic 842 - Application

- Applying ASC Topic 842
  - The following six specific areas of focus –
    - Lease Term
      - Determining the lease term, considering extension, renewal, and early termination clauses
    - Purchase Options
      - Evaluating purchase options, term-extension options, and early termination clauses
    - Lease Payments
      - Determining the six key components lease payments comprise under ASC Topic 842
    - Discount Rate
      - Discerning the discount rate used to calculate the present value of the future lease payments
    - Initial Direct Costs (IDCs)
      - Defining lessee IDC regulations after entering into a lease under ASC Topic 842
    - Financial Statement Presentation
      - Calculating balance sheet, income statement, and statement of cash flows

Poll #2

What will be your biggest challenge for the upcoming year?

- Revenue recognition
- Lease standard implementation
- Both
- Neither
- Other
- Not sure

ASC Topic 842 – Areas of Focus

- Lease Term
  - Determined at commencement date
  - Consider extensions, renewals, and early termination clauses
  - Used to calculate the initial measurement of the ROU asset and lease liability
  - Reasonably Certain Threshold
  - Reassessing the Lease Term

ASC Topic 842 – Areas of Focus

- Purchase Options
  - Evaluated in the same as term-extension options or early termination clauses
  - Determine whether it’s reasonably certain to exercise a purchase option

ASC Topic 842 – Areas of Focus

- Lease Payments
  - Fixed Payments
  - Transaction Fees
  - Purchase Option
  - Penalty Payments
  - Amounts Owed
  - Variable Lease Payments

ASC Topic 842 – Areas of Focus

- Discount Rate
  - Implicit Rate
  - Incremental Borrowing Rate
  - Risk-Free Rate

ASC Topic 842 – Areas of Focus

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- Initial Direct Costs (IDC)
  - Lessees may defer IDC of entering into a lease
  - Include in initial measurement of ROU asset
  - Narrowed qualification requirements

ASC Topic 842 – Areas of Focus

- Financial Statement Presentation
  - Balance Sheet
    - ROU assets and lease liabilities must be presented by lease classification (operating vs finance)
      - Finance lease – ROU assets
      - Operating lease – ROU assets
      - Finance lease – liabilities (current and noncurrent)
      - Operating lease – liabilities (current and noncurrent)

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- Financial Statement Presentation -continued
  - Income Statement
    - Finance Lease
      - Interest presented below the line in nonoperating section
      - Amortization of the ROU asset presented above the line
    - Operating Lease
      - Single lease expense presented as component of income (loss) from continuing operations

ASC Topic 842 – Areas of Focus

- Financial Statement Presentation -continued
  - Statement of Cash Flows
    - Finance lease cash payment for principal portion of lease liability is shown as cash outflow from financing activities
    - All other lease related cash payments, operating and finance, are shown as cash flows from operating activities
    - Initial recording of ROU assets and lease liabilities for the noncash portion would be shown as a supplemental disclosure of noncash operating or financing activities

ASC Topic 842 – Areas of Focus

- Financial Statement Presentation -continued
  - Footnote Disclosure Requirements
    - Information about the nature of the leases (and subleases)
      - General description of leases
      - Basis, terms and conditions, on which variable lease payments are determined
      - Existence, terms and conditions of options to extend or terminate the lease
      - Existence, terms and conditions of lessee residual value guarantees
      - Restrictions or covenants imposed by leases
    - Information about leases that haven't yet commenced, but create significant rights and obligations for lessees

ASC Topic 842 – Areas of Focus

- Financial Statement Presentation -continued
  - Footnote Disclosure Requirements – continued
    - Information about significant judgments and assumptions made in accounting for leases
      - Determination of whether a contract contains a lease
      - Allocation of the consideration in a contract between lease and non-lease components
      - Determination of the discount rate
    - Main terms and conditions of any sale-leaseback transactions
    - Whether an accounting policy election was made for the short-term lease exemption.

ASC Topic 842 – Transition Method

- ASU 2016-02 originally required a "modified retrospective" approach
- ASU 2018-11 amended ASU 2016-02 and allows entities to elect not to recast their comparative periods in transition

ASC Topic 842 – Preparing for Adoption

1. Inform management, staff, board, and others on the key attributes of the new standard.
2. Assess the company's resources needed to implement.
3. Develop an implementation plan and timeline.
4. Perform an inventory of existing leases and collect all pertinent data.
5. Pinpoint opportunities for accumulating similar leases.
6. Identify which practical expedients, if any, will be applied.
7. Talk with your banker with respect to renegotiating or removing debt covenants.

Poll #3

How did Revenue Recognition implementation go?

- Implementation was smooth
- Implementation was okay
- Implementation wasn't smooth
- We didn't implement

ASC 606

AGENDA

- ASC Topic 606 – Overview
- Disclosures
- Potential impacts of COVID 19

ASC 606 Overview

- Principles based framework
- Recognition is focused more on the transfer of control of the goods or services
- Management's judgement and estimates are key part of the process
- Over 1,000 pages of guidance
- Adoption date originally January 1, 2019; however, on June 3, 2020, it was moved to January 1, 2020

ASC 606 Overview

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- Core principle of ASC 606:
  - Recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

5 Steps for Revenue Recognition

1. Identify the contract with a customer
2. Identify the separate performance obligations in the contract
3. Determine the transaction price
4. Allocate the transaction price to the separate performance obligations in the contract
5. Recognize revenue when (or as) entity satisfies a performance obligation

ASC 606 - Adoption Methods

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Full Retrospective Method

- Retrospectively to each prior reporting period presented

- Or -

Modified Retrospective Method

- Retrospectively with the cumulative effect recognized at the date of initial application

Prospective transition is not allowed

ASC 606 – Costs of Obtaining a Contract

- Incremental costs of obtaining a contract are defined as those costs that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained
  - i.e. sales commissions and performance based comp
- Incremental costs that the entity expects to recover should be deferred and amortized on a systematic basis consistent with the pattern of revenue recognition
  - If that amortization period is less than one year, then the costs may be recognized as a period expense

ASC 606 – Costs of Fulfilling a Contract

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- Costs incurred in fulfilling a contract are those that meet the following criteria:
  - Costs related directly to a performance obligation under a contract or anticipated contract
  - Costs generate or enhance resources of the vendor that will be used to satisfy performance obligations in the future, and
  - Costs are expected to be recovered through future sales

ASC 606 – Disclosure Requirements

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The objective of the disclosure requirements related to ASC 606 is 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."

- Substantial disclosures are required around:
  - Disaggregation of revenues
  - Contract balances
  - Performance obligations
  - All significant judgements employed in recognizing revenue
  - Costs to obtain contracts
  - Significant changes in contracts

ASC 606 – Business Considerations

- What can impact covenant compliance?
  - Lost (disappearing) revenue
  - Material Rights/Options
  - Adjustments to equity
- Tax implications

ASC 606 – COVID 19 Considerations

- Collectability
- Extended Payment Terms
- Contract Modifications
- Price Concessions and other variable consideration
- Contract costs
- Disclosures

Poll #4

Would you like someone from HC to contact you about Revenue Recognition or Lease Standards?

- Yes – please contact about Revenue Recognition
- Yes – please contact about Lease Standards
- Yes – please contact about both
- Yes – please contact me about my other 'biggest challenge'
- No – no contact needed at this time

QUESTIONS?

Speakers

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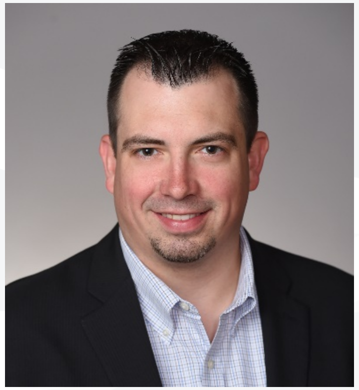
Presenter Biographies



Christopher S. Kunkle, CPA, CFE, CITP, is a Senior Manager in Herbein’s Accounting and Auditing Department. His primary areas of expertise are related to software and manufacturing clients, as well as employee benefit plan audits. Chris is responsible for managing audits of all sizes, ranging from large software developers to small, local manufacturing, construction, and professional service clients. He is heavily involved within the firm's cyber security area niche, being one of two employees with the Certified Information Technology Professional certification. As this area changes regularly for our clients, Chris is instrumental in staying up to date with different security trends. Chris is the Herbein lead in the area of Revenue Recognition for our clients. ASC 606 continues to impact many of our clients, and Chris is working both internally to educate employees, as well as externally to make our clients aware of what needs to be done in order to comply with this new standard. Internally, Chris is a key team leader is many aspects of how Herbein operates. Chris is the chair of the Auditing and Accounting Software Committee that analyzes various software packages and evaluates future opportunities internally, and a member of the Information Technology Committee. Chris is also the committee chair for the Herbein Hero Committee that awards money to a community hero every quarter, as a way to recognize and reward those who are focused on making our communities better. Chris is a proud graduate of Leadership Berks, and in 2018 was named a recipient of the Pennsylvania Institute of Certified Public Accountants (PICPA) Young Leader award. DID YOU KNOW: Chris rappelled down the Abraham Lincoln Tower in Reading, PA as a way to raise money for Bethany Children’s Home!

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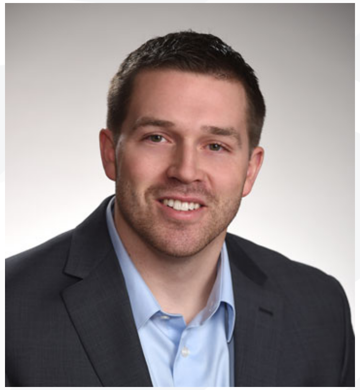

Cory earned his B.S.B.A, with an accounting concentration, from Kutztown University. In 2009, he joined Herbein and has worked his way up to the Manager level in the Accounting and Auditing Department. In his role as Manager, Cory is responsible for overseeing multiple firm audit engagements. Cory manages a variety of clients including dairies, cooperatives, nonprofits, and manufacturing and distribution entities. Cory is a member of Allinial Global and the American Institute of Certified Public Accountants (AICPA). In addition, he serves on the Supervisory Committee of Discovery Federal Credit Union and is on the Executive Committee of the Pennsylvania Institute of Certified Public Accountants (PICPA).

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