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New Accounting Rules for Revenue and Leases

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Recently-released standards

New guidance from the Financial Accounting Standards Board (FASB) has been issued that could have significant impact. What's changing, and what's the impact?

- **Revenue recognition**
 - Scope of change — high
 - Complexity — high
- **Lease accounting**
 - Scope of change — moderate
 - Complexity — moderate



- Revenue Recognition



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Revenue Recognition

- What is it? {a high level view}
- When is it effective?
- How will it be implemented?
- What are some common issues effecting contractors?



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What's the impact?

Moving from a rules-based approach to a principles-based model to recognize revenue from customer contracts.

- This requires significant understanding and judgment.
- It follows a five-step process:

- 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 satisfies a performance obligation

- Changes may have pervasive impacts on people, policies, processes and systems.
- The revenue line item for some entities could change significantly in the period of the change.
- Organizations won't know the impact until they deploy the new five-step process.



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Why did the FASB make these changes?

To establish principles to report useful information to financial statements users about the nature, amount, timing, and uncertainty of revenue from contracts with customers.

The new guidance:

- Removes inconsistencies and weaknesses in existing revenue requirements.
- Provides a more robust framework for addressing revenue issues.
 - Improves comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets.
 - Provides more useful information to users of financial statements through improved disclosure requirements.



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Revenue Recognition - When is it effective?

- Effective for **public** business entities, certain not-for-profit entities, and certain employee benefit plans for years beginning after **Dec. 15, 2017**
 - **{Calendar year 2018}**
 - *Includes entities that have issued public bonds*
 - *Includes entities with securities that have no restriction on transfer and required by law, contract, or regulation to prepare GAAP financial statements and make them publicly available*
- Effective for all other entities for years beginning after **Dec. 15, 2018**
 - **{Calendar year 2019}**
- Early adoption can be elected for years beginning after **Dec. 15, 2016**
 - **{Calendar year 2017}**



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Revenue Recognition – How will it be implemented?

Two choices to account for the implementation:

- Full retrospective – Cumulative effect as of beginning of the first year presented
- Modified retrospective – Cumulative effect as of beginning of only the year implemented



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How companies may view their implementation choices?

Options include:



Adopt the new standards



Adopt an OCBOA basis of accounting (cash, income tax, financial reporting framework for small and medium-sized entities)



Elect to do nothing (elections not to change may result in an adverse opinion on the financial statements, depending on impact)



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Revenue Recognition – What are some common issues effecting contractors?

1. Separating performance obligations
2. Variable consideration
 - a. Performance bonuses (or penalties)
 - b. Unpriced change orders
3. Recognition over time vs. when complete
4. Measuring progress toward completion



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Separating Performance Obligations

Separate performance obligations – only if good/service is “Distinct”:

- **Capable of being distinct** – Customer can use the good/service on its own or together with resources that are readily available, **AND**
- **Distinct within the context of the contract** – The promise to transfer the good/service is separately identifiable from other promises in the contract.

—Distinct performance obligations can be combined if the series of goods/services are substantially the same and have the same pattern of transfer to the customer.



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Separating Performance Obligations

Indicators supporting that a good/service is “Distinct”:

- a) The seller DOES NOT provide significant service in integrating the good/service with others promised in the contract.
- b) The good/service is NOT an input to deliver on the combined output
- c) Good/service DOES NOT significantly modify or customize another good/service promised in the contract
- d) The good/service is not highly dependent on or highly interrelated with other goods/services promised in the contract.

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Separating Performance Obligations

Some examples – how many performance obligations?

One a) Contract for the construction of a new commercial building – is there a separate performance obligation for each building component? (foundation, HVAC, structural, elevators, carpet, etc.)

Depends b) Contract to build an apartment complex with 8 buildings (each building is substantially the same)

Depends c) Contract to build a hospital and a parking garage

One d) Piping contract for a new construction, but the job requires significant in-house fabrication before installation at jobsite

One e) Design/build contract, or EPC contract (engineering, procurement, construction)

Two f) EPC contract with a 3 year maintenance period after completion

Depends g) Change orders





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Variable Consideration (Bonus, Change Order)

Include in the transaction price an estimate that is either of the following, whichever is a better prediction of the amount to which it will be entitled:

- a) Probability-weighted amount, or
- b) Most likely amount

Impact:

- Performance bonuses might be recognized sooner
- Unpriced change orders – ‘most likely amount’ might be similar to current practice for many contractors, or could accelerate recognition for others
- Can only recognize revenue to the extent it is PROBABLE that a significant subsequent reversal of revenue will not occur. (Referred to as “constraining” the estimate of consideration)



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Recognition over time vs. upon completion

To recognize revenue over time, must have at least one of the following criteria:

- Customer simultaneously receives and consumes the benefits received under the contract
- Customer controls an asset as it is being created/enhanced by the contractor
- The asset created by the contractor does not have an alternative use to the contractor, **AND** the contractor has enforceable right to payment for work completed to date



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Recognition over time vs. upon completion

Examples:

- Three-year maintenance contract

Over Time

- New construction built on customer's land

Over Time

- New construction of office building built on the land of a contractor's related party

It Depends

- Custom fabrication built in contractor's shop and shipped to customer

It Depends

Criteria

1. Simultaneously receives and consumes
2. Customer controlled
3. No alternative use AND right to payment

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Measuring progress toward completion

Can use input methods or output methods –
objective is to depict transferring control of
goods or services promised to the customer

- If using input method, it should not include inputs that don't depict entity's performance (like unexpected wasted materials or significant inefficiencies)
- Procurement, alone, may not be indicative of performance



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Disclosure requirements

- Objective: disclose sufficient information for users to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts
- Disclosures are extensive, both qualitatively and quantitatively
- Revenue
 - Disaggregation of revenue
 - Amounts recognized relating to performance in previous periods
- Contracts
 - Information about contract balances and changes
 - Information about performance obligations
 - Amounts allocated to remaining performance obligations
- Significant judgments
 - Timing of and methods for recognizing revenue
 - Determining the transaction price and amounts allocated to performance obligations



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Revenue Recognition – Suggested Resources

- Read the Implementation Guidance (ASC 606-10-55) – lots of great examples
- AICPA Revenue Recognition Industry Task Forces
 - Several industries, but check out Engineering & Construction Contractors
 - Non-authoritative guidance
 - 9 Issues identified, 3 of which have draft guidance written and out as exposure drafts:
 1. Identifying the Unit of Account
 2. Variable Consideration
 3. Acceptable Measures of Progress



- Lease Accounting



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Changes Are Coming...

- What you need to know
 - Impact on balance sheet
 - Impact on income statement
- Strategies



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Big Picture – What's Changing?

Leases are going on the balance sheet

* Of course, it is a little more complicated



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ASU 2016-02

Joint project with IASB – but not complete convergence

Effective Dates:

- Fiscal years beginning after December 15, 2018 for PUBLIC (calendar yr 2019)
- Fiscal years beginning after December 15, 2019 for NONPUBLIC (calendar yr 2020)

Scope:

- Leases <12 months scoped out
- Does the contract convey the right to control use of a specified asset
- Must be applied to all leases in place upon implementation (nothing is “grandfathered”)



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Lessee Accounting

Balance sheet –

- Asset representing the right to use the leased asset for the lease term – (Valued initially at the present value of the lease payments)
- Liability to make lease payments – (Also valued initially at the present value of the lease payments)



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Lessee Accounting - Example

- Lease term = 10 years
- Rent = \$4 psf, 500,000 sq ft; Annual rent = \$2 million
- Discount rate = 6%
- Calculated present value = approx. \$15 million

Journal entry at lease inception:

	Debit	Credit
Right-of-use Asset	\$15,000,000	
Lease Obligation Payable		\$15,000,000



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Lessee Balance Sheet Impact - Example

	Before <u>Implementation</u>	Adjust for <u>Leases</u>	<u>Adjusted</u>
Current assets	90,000,000		90,000,000
Noncurrent assets	<u>40,000,000</u>	<u>15,000,000</u>	<u>55,000,000</u>
Total assets	130,000,000	15,000,000	145,000,000
Current liabilities	45,000,000	1,100,000	46,100,000
Noncurrent liabilities	<u>45,000,000</u>	<u>13,900,000</u>	<u>58,900,000</u>
Total liabilities	90,000,000	15,000,000	105,000,000
Equity	30,000,000		30,000,000
Current ratio	2.00		1.95
Debt to equity	3.00		3.50



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Income statement

Income statement effect will be based on either:

- Amortization & interest expense (financing approach)
- Straight-line lease expense (operating lease approach)



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Financing Versus Operating

If any of these exist, it is financing:

- Ownership transfer
- Option to purchase, reasonably certain to exercise
- Lease term for “major part” of economic life
- PV of payments equals or exceeds “substantially all” of the fair value

Just like today’s capital versus operating test, EXCEPT:

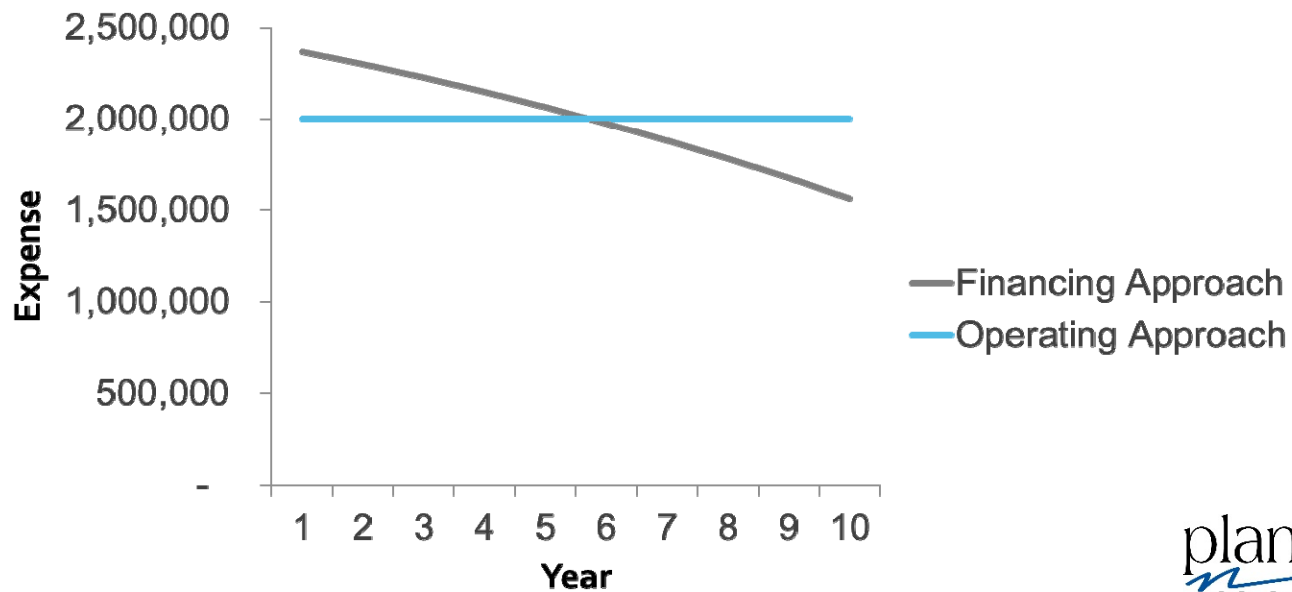
- No more clear, specific, bright-line tests – have to (or get to) apply judgment



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Lessee Income Statement Impact

Comparison of Annual Expense over the Lease Term





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Lessee Income Statement Impact – Example (Year 1 only)

	<u>Operating – 10 yr term</u>	<u>Financing – 20 yr term</u>	<u>Difference</u>
Gross Profit*	43,000,000	43,000,000	---
Operating Expenses*	<u>20,000,000</u>	<u>18,000,000</u>	<u>2,000,000</u>
EBITDA	23,000,000	25,000,000	2,000,000
Interest, Depreciation, Amortization	<u>10,000,000</u>	<u>12,600,000</u>	<u>2,600,000</u>
Pre-tax Income	13,000,000	12,400,000	(600,000)

*Excludes any interest, depreciation or amortization



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Lessee Balance Sheet Impact - Example

	Before <u>Implementation</u>	Adjusted – 10 <u>year lease</u>	Adjusted – 20 <u>year lease</u>
Current assets	90,000,000	90,000,000	90,000,000
Noncurrent assets	<u>40,000,000</u>	<u>55,000,000</u>	<u>63,300,000</u>
Total assets	130,000,000	145,000,000	153,300,000
Current liabilities	45,000,000	46,100,000	46,400,000
Noncurrent liabilities	<u>45,000,000</u>	<u>58,900,000</u>	<u>66,900,000</u>
Total liabilities	90,000,000	105,000,000	113,300,000
Equity	30,000,000	30,000,000	30,000,000

Current ratio	2.00	1.95	1.94
Debt to equity	3.00	3.50	3.77

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Leases

Complicating factors:

- Variable payments
- Discount rate
- Lease modifications
- Impairment
- Other services included in contract (ex. CAM)
- Multiple assets included in lease contract
- Sale leaseback
- Build to suit arrangements



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Strategies

Are there financial reporting objectives?

- Minimize balance sheet impact
 - Shorter term leases
 - Net leases
- Maximize EBITDA
 - Financing-type leases – generally longer term
 - Gross leases



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Strategies

Proactively negotiate with FS users (if possible)

- Re-set covenants or other financial measurements
- Message: Nothing has fundamentally changed with the financial stability of the company



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Lease Accounting Changes – 5 Key Takeaways

1. Leases are going on the balance sheet
2. Understand the impact on so you can proactively prepare the users of financial statements
3. Collaboration and communication between internal departments (accounting, finance, operations, real estate)
4. Don't let the tail wag the dog – still need to make good business decisions
5. Employ strategies in lease negotiation to drive financial statement outcome, if possible



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Thank You

Thank you for participating in our discussion.

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