Accounting Updates:
The cure for your Valentine's Day hangover

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Accounting updates

- New Revenue Recognition standard, effective 2019
- New Lease standard, effective 2020
- Section 179D
- Research and Development changes

Revenue Recognition

General framework

- Step 1 – Identify the contract with a customer
- Step 2 – Identify the separate performance obligations in the contract
- Step 3 – Determine the transaction price
- Step 4 – Allocate the transaction price
- Step 5 – Recognize revenue when a performance obligation is satisfied

Step 1 - Identify the contract with a customer

Minimum requirements to recognize revenue under the standard:

- Arrangement must meet the definition of a contract
  - An agreement between two parties that creates enforceable rights and obligations
- Contract approval
- Identification of each party's rights
- Clear payment terms
- Contract has commercial substance
- Collectability is probable

Step 1 - Identify the contract with a customer

Combining Contracts:

- Contracts entered into at or near the same time with the same customer should be combined if any of the following conditions are met:
  - They were negotiated as a package with a single commercial objective
  - Consideration to be paid in one contract depends on the price or performance of the other contract
  - Some or all of the goods or services promised in the contracts are a single performance obligation

Step 2 - Identify the separate performance obligations in the contract

- A performance obligation is a promise (explicit or implicit) to transfer to a customer either:
  - A distinct good or service
  - A series of distinct goods or services that are substantially the same and have the same pattern of transfer
- Identified at contract inception and determined based on contractual terms, customer business practices

Performance obligations examples

- A contract that covers design of 10 miles of highway and two overpasses
- A contract that covers 10 miles of highway including a bridge
- Design of water treatment plant

Step 3: Determine the transaction price

- Transaction price is defined as the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer

- Transaction price includes the effects of:
  - Variable consideration
  - Significant financing component
  - Consideration paid or payable to a customer
  - Noncash consideration

Step 3: Determine the transaction price

Variable consideration

- Common types and events that cause consideration to be variable
  - Bonuses
  - Incentive payments
  - Penalties
  - Price concessions
  - Liquidating damages

Step 4 – Allocate the transaction price

- Transaction price allocated to separate performances obligations based on relative standalone selling prices (when the contract involves more than one performance obligation)

- For estimation, suitable approaches include:
  - Adjusted Market Assessment
  - Expected Cost plus Margin
  - Residual Approach

Step 5 –Recognize revenue when a performance obligation is satisfied

- Performance Obligations (PO) are satisfied when a promised good or service is **transferred** to a customer.

- Asset is transferred when the customer **obtains control** of the asset

- Transfer of control is determined on a basis of indicators
  - Company must determine at contract inception if PO's are satisfied over time or at a point in time; this is critical in the timing of revenue recognition
  - PO's settled over time can recognize revenue over time if one of the following criteria is met:
    - Customer simultaneously receives and consumes the benefits provided by the entity's performance
    - Entity's performance creates or enhances an asset the customer controls as the asset is created or enhanced (i.e. Work in Process)

Step 5 –Recognize revenue when a performance obligation is satisfied

- As each Performance Obligations are satisfied over time, Company will measure progress towards completion
  - Measure progress using acceptable methods
    - Input Method – Recognize revenue based on Company's efforts to satisfy the performance obligations (hours, time lapsed, costs incurred)
    - Output Method – Recognize revenue based on direct measurement of the value transferred to the customer (contract milestones, units delivered, etc.)

What's Changed with Disclosures – More Robust

Big Picture – How are the disclosures going to change?

- **Disaggregation of Revenue** (i.e. type of good/service, geography, market, type of contract, etc.) including description of how the nature, timing and uncertainty of revenue and cash flow are affected by economic factors

- **Performance Obligations** – disclosure of when they are typically satisfied, significant payment terms, nature of goods/services, types of warranties and other obligations around returns, refunds, etc.

- **Remaining PO's** – Disclosure of amount of the transaction price allocated to any remaining PO's, when the Company expects to recognize the revenue, and a qualitative description of any significant contract renewals and variable consideration not included within the transaction price

- **Reconciliation of Contract Balances**
  (1) Disclosure of opening/closing balances of contract assets/liabilities including quantitative and qualitative description of significant changes
  (2) Disclosure of how timing of the satisfaction of a PO relates to the timing of payment

What's Changed with Disclosures – More Robust

- **Costs to Obtain or Fulfill Contracts** – Disclose closing balances by main category of asset, of capitalized costs to obtain and fulfill a contracts and the amount of amortization.

- **Other Qualitative Disclosures –**
  - Significant judgements on the timing of satisfaction of PO's and transaction price and amount allocated to PO's
  - For PO's satisfied over time – input/output methods and why this method is chosen
  - For PO's satisfied at a point in time – judgements made to determine why the customer has control

Lease Accounting Changes

- Most leases will be recorded on the balance sheet
  - Lease asset
  - Lease liability
- Lease expense recognized in a manner similar to today
- Provides new presentation and disclosure requirements

Right to Use framework

- A contract is a lease if it conveys the right to control the use of identified property, plant or equipment (an identified asset) for a period of time in exchange for consideration.

- Two primary types of leases:
  - Finance lease (capital lease)
  - Operating lease

- Short term lease exemption – 12 months or less & no bargain purchase option

What are the mechanics?

- Lease payments will be present-valued at:
  - Incremental borrowing rate for similar term
  - Risk-free rate
- Lease asset and liability will decrease at the same rate
- Income statement expense will be unchanged
- Other lease factor considerations
  - Options to extend
  - Lease termination clauses
  - Residual value guarantees

Lease Accounting Disclosures (Lessee)

- Significant assumptions and judgments made in accounting
- Maturity analysis, including a reconciliation of undiscounted cash flows to the lease liability for lessees, as of the reporting date
- Separate quantitative disclosure of lease expense, by type (e.g. operating lease, short-term, variable)
- Weighted average remaining lease term, separately by lease type
- Weighted average discount rate, separately by lease type

What to do now?

- Review current leases and calculate impact
- Prepare financial statement forecast
- Calculate ratios – consider loan and employment agreement ratios
- Consider alternatives – Lease, purchase, sale/leasebacks
- Meet with your bankers – discuss impact on credit facilities

Research and Development credits

- Research and Development credits are being used by professional service firms
- R & D credits are made permanent
- R&D credits are allowed to offset AMT tax
  - For companies with revenue less than $50 million
- Start up companies may apply R&D credits against payroll tax

179 D: Energy Efficient Commercial Buildings

- Improvements in buildings related to Energy Efficiency:
  - Interior lighting
  - Building envelope
  - HVAC
  - Hot water system
- Deductions pass to the designer of the building rather than the owner
  - Federal, state, or local governments
- Deductions can be as high as $.60 to $1.80 per square foot
- Placed into service before December 31, 2016

Helping you get there….

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