Postlethwaite & Netterville

Accounting Standards Update

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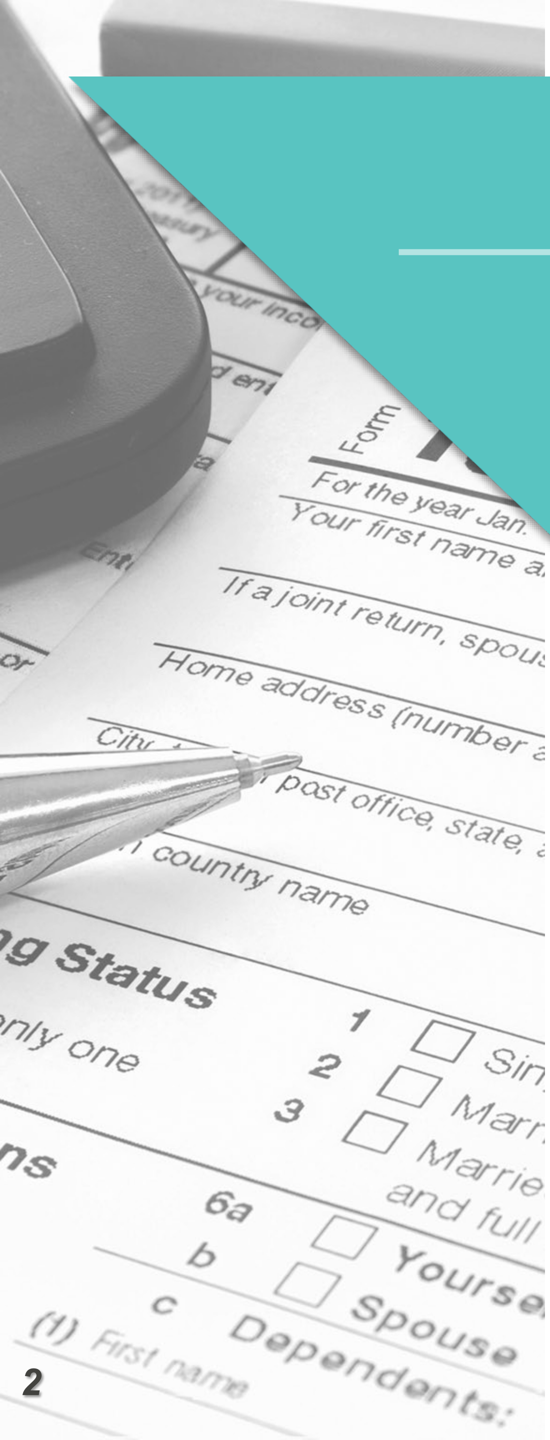

Agenda

1. Summary of Accounting Standards Updates (ASUs)
2. Government assistance programs
3. On the horizon
4. Other reminders

FASB - Current/Upcoming Effective Dates

- **Leases**
  - FYB after 12/15/2022
- **CECL***
  - FYB after 12/15/2022
- **Business Combinations**
  - FYB after 12/15/2022 (Public)
  - FYB after 12/15/2023 (Non-public)
- **Supplier Finance Programs**
  - FYB after 12/15/2022
- **Insurance**
  - FYB after 12/15/2022 (Public)
  - FYB after 12/15/2024 (Non-public)

Reflecting latest possible implementation date based on available deferrals in ASU 2019-09, ASU 2019-10*, and ASU 2020-11

Leases

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Leases (Topic 842)

- **ASU 2016-02: Leases (Topic 842)**
  - *ASU 2018-01: Leases (Topic 842) – Land Easements Practical Expedient for Transition to Topic 842*
  - *ASU 2018-10: Codification Improvements to Topic 842, Leases*
  - *ASU 2018-11: Leases (Topic 842) – Targeted Improvements*
  - *ASU 2018-20: Leases (Topic 842): Narrow Scope Improvements for Lessors*
  - *ASU 2019-01: Leases (Topic 842): Codification Improvements*
  - *ASU 2019-10 (Superseded) and ASU 2020-05 amended the effective dates of Topic 842*
  - *ASU 2021-05: Leases (Topic 842): Lessors – Certain Leases with Variable Lease Payments*

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Leases (Topic 842)

A lease must explicitly or implicitly identify a *specific asset* that is the subject of the contract, and the customer controls the use of the specific asset for a period of time. Therefore, if the supplier has a substantive *substitution* right, the contract is not a lease.

	Balance Sheet	Income Statement	Cash Flow Statement
Finance Lease	Right-of-use asset Lease liability	Amortization expense Interest expense	Cash paid for principal and interest payments
Operating Lease	Right-of-use asset Lease liability	Single lease expense on a straight-line basis	Cash paid for lease payments

Leases (Topic 842) – Example Lessee Finance Lease

FACTS:

>lease payments due each year $100,000-year 1; $110,000-year 2; $125,000-year 3; total lease payments = $335,000

>discount rate 5.51%

>present value of $335,000 based on above discount rate = $300,000

	YEAR 1	YEAR 2	YEAR 3	TOTAL
ROU asset - beginning of year	$ 300,000	$ 200,000	$ 100,000	
Less: amortization component	(100,000)	(100,000)	(100,000)	
ROU asset - end of year	200,000	100,000	-	
Lease liability - beginning of year	$ 300,000	$ 216,535	$ 118,470	
Less: principal paydown **	(83,465)	(98,065)	(118,470)	
Lease liability - end of year	216,535	118,470	-	
Interest component **	16,535	11,935	6,530	35,000
Amortization component	100,000	100,000	100,000	300,000
	116,535	111,935	106,530	335,000
** Principal paydown	83,465	98,065	118,470 → Financing cash flows	
Interest component	16,535	11,935	6,530 → Operating cash flows	
Total payment cash flows	100,000	110,000	125,000	

Amortization of the ROU is recognized evenly over the 3-year lease term

$300,000 / 3 years = $100,000 per year

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Leases (Topic 842) – Example Lessee Operating Lease

FACTS:

>lease payments due each year $100,000-year 1; $110,000-year 2; $125,000-year 3; total lease payments = $335,000
>discount rate 5.51%
>present value of $335,000 based on above discount rate = $300,000

	YEAR 1	YEAR 2	YEAR 3	TOTAL
ROU asset - beginning of year	$ 300,000	$ 204,868	$ 105,136	
Less: amortization component	(95,132)	(99,732)	(105,136)	
ROU asset - end of year	204,868	105,136	-	
Lease liability - beginning of year	$ 300,000	$ 216,535	$ 118,470	
Less: principal paydown **	(83,465)	(98,065)	(118,470)	
Lease liability - end of year	216,535	118,470	-	
Interest component **	16,535	11,935	6,530	35,000
Amortization component	95,132	99,732	105,136	300,000
Total single lease expense	111,667	111,667	111,666	335,000
** Principal paydown	83,465	98,065	118,470	
Interest component	16,535	11,935	6,530	
Total payment cash flows	100,000	110,000	125,000	

Operating cash flows

Amortization of the ROU is not a constant but rather as a balancing figure that keeps **total operating lease expense** constant over the lease term

$335,000 / 3 year = $111,667 per year

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Leases (Topic 842) - Embedded Leases

- Not every lease says "lease" on the cover
- Significant considerations:
  - Evaluation of all significant service contracts that may contain an identified asset
  - Determination of the portion of purchase commitments or service fees that would apply to the lease liability
  - Assessment of the financial consequences if required purchase levels for consumables are not attained
- Examples:
  - Information technology contracts (e.g., servers, railcars, set-top boxes)
  - Construction (e.g., specified equipment, power plants, drilling rigs)
  - Advertising (e.g., billboards)

Leases—Discount Rate for Lessees That Are Not Public Business Entities- Current Project

- **Determining the Discount Rate**
  - Utilize explicit rate stated within the lease agreement
  - If rate is not explicitly stated:
    - Utilize incremental borrowing rate (IBR) – must use if public entity
    - Utilize the risk free rate – available to non-public entities only
- **Additional notes for determining discount rate**
  - Allow risk-free rate election by class of underlying asset
  - Disclose which asset classes it has elected to apply a risk-free rate
  - The lower your rate the higher your ROU asset and lease liability
    - IBR is more accurate but more time consuming and harder to determine
    - Risk free rate is less time consuming but is typically a lower rate

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Capitalization Policy

- **Materiality threshold can be set to a reasonable threshold similar to capitalization policies for PP&E**
- **An entity should not simply default to its existing capitalization threshold for PP&E**
  - Aggregate amounts may become material with additional assets introduced.
  - PP&E does not effect the liability side of the balance sheet
- **Further considerations:**
  - Gross balance for each side of the lease entry (not necessarily the net balance)
  - Disclosure requirements
  - Internal controls (applying and monitoring capitalization thresholds)

Implementation Process

- **Identify the lease population**
  - Number of leases, type of leases, complete and accurate population, and assessment of policies
- **Finalize timeline, budget, and expectations**
  - Who will take the lead, goal date, internal or use of third party
- **Assessing the lease population and support**
- **Identifying process and controls**
- **Consider business implications**
  - i.e. financial ratios and covenant calculations

CECL (Topic 326)

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CECL (Topic 326)

- ASU 2016-13 – *Financial Instruments – Credit Losses* issued June 2016
- New standard estimates credit losses over the entire "contractual term" of the instrument from the date of initial recognition of that instrument ("life of loan" model)
  - Current GAAP delays recognition until it is probable the loss has been incurred (incurred loss model); considers past events and current conditions
- Entities must base measurements on current market conditions, **reasonable and supportable forecasts over the lifetime**, availability of quality data, and segmentation/granularity of instruments that share similar risk characteristics, such as:
  - Payment status
  - Internal/external credit score
  - Risk rating or classification
  - Geographic location
  - Collateral type
  - Vintage

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CECL (Topic 326)

- **Standard applies to a number of commonly held assets:**
  - Loan commitments (financing receivables)
  - Financial guarantee contracts
  - Certain debt instruments held to maturity (other than those measured at fair value through net income)
  - Lease receivables from resulting sales-type or direct financing leases ASC 842
  - Trade receivables and contract assets recognized under ASC 606
  - Reinsurance receivables on insurance contracts

- **Standard does NOT apply to:**
  - Financial assets measured at fair value through net income
  - AFS debt securities
  - Policy loan receivables of an insurance entity
  - Promises to give (pledges receivable) for NFP
  - Loans and receivables between entities under common control
  - Loans to participants in defined contributions employee benefit plans

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Current Expected Credit Losses (CECL) (Topic 326)

What will not be new:

- Assessing history of payment
- Aging of receivables

What might be new:

- Considering current conditions and the foreseeable future
- Additional disclosures to help users understand how credit losses are estimated

Current Expected Credit Losses (CECL) (Topic 326)

Helpful tools:

- FASB Staff Q&A on:
  - Historical loss information
  - Developing reasonable and supportable forecasts
  - Reversion to historical loss information

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Government Assistance

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Employee Retention Credits (ERC)

- **Background:** The Employee Retention Credit (ERC) is a refundable tax credit designed to encourage employers to keep employees on their payroll. The ERC is subject to certain qualifications.
- Included in The Coronavirus Aid, Relief, and Economic Security (CARES) Act, The Consolidated Appropriations Act (CAA), and American Rescue Plan (ARP).
- **Financial Reporting Considerations**
  - Not a loan like PPP; ERC most likely to be considered a form of government grant
  - For-profits, by analogy to: (1) conditional grant/contribution model in Subtopic 958-605 (2) government assistance model in IAS 20, or (3) Topic 450, Contingencies

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Disclosures of Government Assistance

Disclosure of Significant Accounting Policies

Paragraph 235-10-50-3:

- Entities are required to identify and describe the accounting principles that materially affect the financial statements.
- Disclosures generally include judgments as to appropriateness of principles relating to recognition of revenue and allocation of asset costs to current and future periods.

Specific Disclosures by Business Entities about Government Assistance

- Nature of assistance, related accounting policies, and effect on financial statement amounts
  - Identifies each line item of the balance sheet or income statement affected by the assistance received
- Significant terms and conditions of the agreement (ex. duration, contingencies, commitments)
- If specific information is omitted because it is legally prohibited from being disclosed, the entity should disclose a description of the general nature of the information omitted and the specific source of prohibition.

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Disclosures of Government Assistance by Business Entities

FASB Board Decisions—May 2021

The annually-required disclosures apply to a business entity that has accounted for a transaction with a government by analogizing to a grant or contribution accounting model.

For example, IAS 20 on accounting for government grants, or Subtopic 958-605, Not-for-Profit Entities—Revenue Recognition

The amendments are effective for fiscal years beginning after December 15, 2021, for **all business entities**. Early adoption is permitted.

Ex. transaction with government that **would** require disclosure:
A receipt of cash or other assets from the government that is accounted for as a contribution applying **Subtopic 958-605** by analogy.

Ex. transaction with government that **would not** require disclosure:
A forgivable or below-market interest rate loan from the government in which a business entity concludes that the transaction is deemed to be a loan within the scope of **Topic 470, Debt,** and is accounted for as such.

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On the Horizon

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FASB Technical Agenda Highlights

- Accounting for and Disclosure of Crytpo Assets
  - Exposure draft out. Comments due June 6, 2023
- Accounting for and Disclosure of Software Costs
  - Board deliberation
- Improvements to Income Tax Disclosures
  - Exposure draft out. Comments due May 30, 2023

Other Reminders

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Goodwill Accounting Alternative—Private Companies and Not-for-Profits

Reminder: Under this accounting alternative:

- Amortize goodwill over **10** years (or less, if another useful life is more appropriate)
- Accounting policy election to test goodwill for impairment at the entity level **or** the reporting unit level
- Impairment testing required only upon a triggering event **(see Update 2021-03 for alternative)**

Updates AUSs 2014-02 and 2019-06

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Triggering Events

Several **examples** of such events and circumstances (paragraph 350-20-35-3C):

- Macroeconomic conditions—deterioration in general economic conditions
- Industry and market considerations—deterioration in the environment in which an entity operates
- Cost factors—increases in raw materials, labor, or other costs that have a negative effect on earnings and cash flows
- Overall financial performance—negative or declining cash flows or a decline in actual or planned revenue or earnings

Considerations:
Broad changes in facts and circumstances over a period of time?
Occurrence of a specific or discrete event?
Occurrence of multiple events?

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