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2015 Financial Reporting Update for Contractors

Presented by:
Tara Schini
Matt Crane

What Topics will we Cover Today?

- Revenue recognition
- Lease accounting
- FASB Simplification Project
  - Equity method accounting
  - Tax Disclosures
  - Debt classifications
  - Business combination measurement period

What Topics will we Cover Today?

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- Private Company Council (PCC) Alternatives
  - Goodwill accounting & amortization
  - Interest rate swaps
  - Variable interest entity (VIE) exclusion
  - Business combinations
- Information Technology Considerations
- Fraud Considerations
- Business Succession Trends

Implementation of New Revenue Recognition Standard

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- Issued in May 2014; In July 2015, FASB voted to defer the standard by 1 year.
- Non-public entities (calendar year); January 1, 2019 effective date, first present in the financial statements for the year ended December 31, 2019
- Can early adopt, but not prior to public company implementation (1-year earlier)
- 5 step process; determination of "performance obligation"

Expanded Financial Statement Disclosures

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- Information about the contracts with customers, including significant payment terms, obligations for return of funds, warranties, etc.
- Disaggregation of revenue according to the timing of transfer of goods/services
- Qualitative information about how economic factors (type of customer and contract, geographical location) affect the uncertainty of revenue and cash flow
- Significant judgments and changes in judgment related to the contracts
- Assets recognized from the costs to obtain or fulfill a contract (incremental costs or contract fulfillment costs)

Status of New Lease Guidance

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- Expected to be issued in late 2015
- All leases on the balance sheet
- US GAAP will use a dual method for income statement effect – similar as the way we do it today (Straight-line and effective interest)
- No formal announcement on adoption date; based on October 20th meeting of the IASB board, heading towards an implementation date for fiscal years beginning on or after January 1, 2019

FASB Updates – Simplification Project

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- Simplification Initiative Objective
  - Reduce cost & complexity while maintaining or improving the usefulness of the information
  - Projects include narrow-scope items that the FASB can complete in the short term
- This project is moving along fairly fast

Simplifying the Equity Method of Accounting

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- When "significant influence exists," apply equity method of accounting

- Single line item on balance sheet

Proposal impacts:

- Recognition of the basis difference (difference between the cost of an investment and the amount of underlying equity in net assets)

  – Today - requires recognizing the investors' proportionate share of investee income or loss, adjusted for various items including amortization or accretion of basis difference

  – Today - retroactive accounting required for investment that becomes eligible for equity method accounting

Simplifying the Equity Method of Accounting

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- Equity method investment would be recognized at cost (and no longer be required to assess the acquisition date fair value of the investee's identifiable assets and assumed liabilities)
  - Transition: Cease accounting for the basis difference as of the effective date of the guidance
- Retrospective application would no longer be required
  - Would be applied as of the date the investment becomes eligible for equity method accounting
  - Transition: applied prospectively to investments that become eligible for equity method accounting after the effective date of the guidance

Simplifying Balance Sheet Presentation of Deferred Taxes

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Current GAAP

- Presented in a classified statement of financial position as:
  - Current deferred tax asset and liability
  - Noncurrent deferred tax asset and liability

- Classification:
  - Based on related asset or liability for financial reporting
  - Generally not classified based on when the temporary differences will reverse

Proposed GAAP

- Classify all deferred tax assets and liabilities as noncurrent

Debt - current / noncurrent classification - Tentative decisions

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Classify debt as noncurrent when, at balance sheet date:

- Liability is contractually due more than 12 months (or operating cycle, if longer) after balance sheet date

OR

- Entity has a legal right to defer settlement of the liability for at least 12 months (or operating cycle, if longer) after balance sheet date

So no more analyzing debt covenant violations at balance sheet and estimate if violate any covenants in the upcoming year.

No evaluation of Subjective Acceleration Clauses

Debt – current / noncurrent classification - Tentative decisions

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Debt refinanced after balance sheet date but before financials are issued:

- Current GAAP – Noncurrent
- Proposal – Current

Subjective acceleration clause:

- Current GAAP - Current if probable of occurring
- Proposal – Current only if triggering event occurred

Waiver received after balance sheet date but before financials are issued:

- Current GAAP - Noncurrent
- Proposal – Noncurrent (exception to principle)

Business combinations – measurement-period adjustments

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Changes to provisional amounts based on new information about facts that existed at acquisition date

- Current GAAP - Retrospectively adjust all comparative prior periods
- New GAAP - Recognize in period adjustment is identified

Present or disclose amounts related to prior periods by line item (e.g., amortization). So must present on the statements the change on their own line or in footnotes

- No changes to measurement period criteria or length

Effective – Public – Fiscal Years beginning after December 15, 2015.

Private companies – one year later. Early adoption is allowed.

How many pounds of flour does Tara use in a year?

Private Company Council (Since 2009)

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- PCC Members
  - 9 to 12 members, appointed by FAF Trustees
    - Currently 10 members
    - Members have backgrounds as users, preparers, and public accountants of private company financial statements
- PCC Responsibilities
  - To determine whether modifications or exceptions to existing U.S. GAAP are warranted to address the needs of users of private company financial statements
  - To serve as the primary advisory body to the FASB on private company considerations related to current FASB projects

Private Company Council – New GAAP for Private Companies

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Definition of a Public Entity:

- Is the entity required by the Securities and Exchange Commission (SEC) to file or furnish financial statements?
- Is the entity required furnish financials statements with a regulatory agency?
- Significant acquisitions are included (Sec 3.05)
- Employee Benefit Plans and Non-profit organizations are scoped out

Private Company Council – New GAAP for Private Companies

- If a Private Company Proposal is Endorsed by the FASB – it is considered “GAAP”
  - Private Companies do not have to apply these private company exceptions
    - Can pick a la carte

Private Company Council – New GAAP for Private Companies – Goodwill Amortization

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- Goodwill acquired in a business acquisition can be amortized over 10 years
- Tested for impairment only when a triggering event occurs and at the entity level, not reporting level
- Approved - effective for years beginning after December 15, 2014 with early adoption allowed
- **Prospective adoption**
- If goodwill not amortizable for tax – would create a perm difference.

Private Company Council – New GAAP for Private Companies – Interest Rate Swaps

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Simplified Hedge Accounting Approach

- Interest rate swaps can be assumed to have no hedge ineffectiveness and thus qualify for hedge accounting
- Formal hedging documentation can be completed by financial statement date, rather than inception of the swap
- Measured using fair value or settlement value of the swap
- Election can be made on a swap-by-swap basis

Private Company Council – New GAAP for Private Companies – Interest Rate Swaps

Criteria for Simplified Approach:

- Both the variable rate on the swap and the borrowing are based on the same index or interest rate
- The terms of the swap are typical, and there is no floor or cap on the variable interest rate of the swap unless the borrowing has a comparable floor or cap
- The repricing and settlement dates of the swap and the borrowing match or differ by no more than a few days
- The swap's fair value at inception is at or near zero
- The notional amount of the swap is equal to or less than the principal amount of the borrowing
- The term of the swap is equal to or less than the term of the borrowing

Private Company Council – New GAAP for Private Companies – Interest Rate Swaps

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Simplified hedge accounting approach

- Under this approach, an interest rate swap will not be considered a derivative instrument (Exclude from FV or special derivative footnotes)

- Transition to the simplified hedge accounting approach would be applied on either a **modified retrospective** approach or on a **full retrospective** approach

- Effective date for annual periods beginning after December 15, 2014 with early adoption permitted

Private Company Council – New GAAP for Private Companies – Variable Interest Entities

Under the alternative, a private company would have the option to exempt itself from applying the VIE consolidation model:

- The private company and the lessor (which is a separate legal entity) are under common control;
- The private company has a leasing arrangement with the lessor;
- Substantially all of the activities between the private company and the lessor are related to the leasing activities (including supporting leasing activities) of the lessor; and
- The principal of any lessor obligation related to the leased asset for which the private company provides an explicit guarantee does NOT exceed the value of the leased asset at inception of guarantee. However, operating Company can guarantee residual value of lessor building (considered leasing activity)

Private Company Council – New GAAP for Private Companies – Variable Interest Entities

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- Under the alternative, it is anticipated that what qualifies as a “common control” transaction will be broader than current accepted practice

- Private companies that elect the alternative would be required to provide additional disclosures, including the amount and key terms of the lessor’s significant liabilities (such as debt) and a qualitative description of significant arrangements (such as certain commitments and contingencies) not recognized that expose the private company to having to provide financial support to the lessor

- A private company electing the exemption would need to do so for all of its leasing arrangements that meet the requirements for applying this approach, and would do so on a **full retrospective basis**

Private Company Council – New GAAP for Private Companies – Business Combinations

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- PCC voted and the FASB endorsed its approach to Intangible Assets Acquired in a business combination
- Customer related intangibles are limited to those capable of being sold or licensed independently
  - No longer break out customer lists, non-competes
- PCC decided not to require more disclosure for companies.
- Entities that elect the alternative would be required to amortize goodwill

Private Company Council – New GAAP for Private Companies – Business Combinations

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Business Combinations:

- The alternative would be applied on a **prospective** basis for all business combinations entered into after the effective date.

- The PCC affirmed its decision that a Company would continue to recognize and measure intangible assets that exist as of the beginning of the period of adoption in accordance with existing U.S. GAAP.

- The alternative should be effective for the first annual period beginning after December 15, 2015. Early adoption permitted.

How many gallons of water does the Crane Coliseum hold?

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Business Combination Issues

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ACQUISITIONS

- Identifying and valuing intangible assets
- PCC alternatives for goodwill and intangible assets
- Assigning useful lives and amortization methods
- Contingent consideration vs. compensation

Business Combination Issues

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Identifying intangible assets

Recognize intangible assets if they (just one required):

1) Arise from contractual or other legal rights, or

2) Are capable of being separated from the acquired business and sold, transferred, licensed, rented or exchanged

Common intangible assets (liabilities):

- Customer relationships
- Trademarks/trade names
- Patents
- Licenses
- Non-compete agreements
- Don’t forget - favorable (unfavorable contracts)

Business Combination Issues

PCC alternative—Intangible assets

Provides private companies the option to not recognize and measure:

- Certain (most) customer-related intangible assets
- Non-compete agreements
- Remaining purchase prices recorded as goodwill
- Adoption of alternative would require the adoption of the goodwill accounting alternative (i.e., goodwill amortization/simplified impairment)

Business Combination Issues

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Assigning useful lives and amortization methods

- Assets may have finite or indefinite lives
- Useful life = the period over which the asset is expected to contribute directly or indirectly to future cash flows
- Factors to consider include:
  - Expected use of the asset or related assets
  - Legal, regulatory, or contractual provisions
  - Effects of obsolescence, demand, competition, and other economic factors
  - Level of maintenance expenditures required

Amortization Methods:

- Don’t default to straight-line
- Consider whether benefits received from consuming asset are greater in beginning or latter part of asset’s life

Business Combination Issues

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Contingent consideration vs. compensation

- Contingent payment arrangements may represent consideration transferred for the acquiree or compensation for post-combination services

- A contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is compensation for post-combination services

- If continuing employment is not required, other factors must be evaluated

Business Combination Issues

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Contingent consideration vs. compensation

Example:

- Company acquires a business, Agrees to pay selling shareholder additional $100k one year from acquisition date if:

  1) Acquired business meets post-acquisition EBITDA targets, and

  2) Selling shareholder continues employment for full year after acquisition

  Evaluation:

  – If the $100k payment is forfeited if selling shareholder terminates employment prior to end of year - **Compensation**

  – If payment is only dependent on the EBITDA targets, regardless of continuing employment status - **Contingent consideration**

Business Combination Issues

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Contingent consideration vs. compensation

Example—Cash flows: *Contingent consideration is additional purchase price*

- FV of liability at acquisition date is $100k; when paid it is $100K or less the amount is a Financing Activity
- If FV of liability at acquisition date is $100k, but ultimately $120k is paid: Then $100K is Financing Activity and $20K is operating

Contingent consideration if compensatory (Compensation expense to seller)

- All cash flows should be classified as operating cash flows

Business Combination Issues

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DISPOSITIONS

- Allocating assets, liabilities and goodwill to the disposed business
- Impairment considerations—held and used model vs. held for sale
- Discontinued operations

Business Combination Issues

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Calculating gain or loss on disposal

FV of consideration received

Less:

CV of assets/liabilities in disposal group*****

= **Gain or loss on disposal**

*Goodwill must also be allocated to disposal transaction

- Goodwill is allocated to the disposed of business on a relative fair value basis
- Guidance on allocating goodwill is less prescribed under PCC alternative

Business Combination Issues

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Discontinued operations (Effective in 2015)

- Captures only <u>strategic shifts</u> that have a major effect (Strategic shift can be geographical)
- Fewer disposals anticipated to qualify
- Significant continuing involvement or continuing cash flows will no longer preclude discontinued operations presentation
- Increased disclosures required

Information Technology Considerations

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- Access controls, hard drive lock
- Passwords – expiration, complexity, encryption
- Cloud computing – security, redundancy, uptime
- Implementations – test environment vs production, small sample rollout for updates
- Intrusion testing

Fraud Realities

- Addictions, marital issues, financial hardship
- Employees will steal given the opportunity
- Insurance coverage can be limited – prior knowledge, untimely notification
- Bad behavior is usually habitual
- Background checks are helpful

Common Fraud Schemes

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- Dummy vendors
- Theft of building supplies, tools
- Inappropriately running personal expenses through the company
- Expense reimbursement
- Credit card refunds

Fraud Protections

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- Separate job functions
- Vendor approvals
- Owner review of vendor purchases
- Disbursement approval and review
- Periodic review of bank activity and transactions

Business Succession: Are you Ready to Sell?

- Are your profits where they should be?
- Is the offer reasonable?
- How does a stock sale differ from an asset sale?
- Is the business ready?
- Would the company be able to continue without you?

Is the Business Ready to be Sold or Transitioned?

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- Is a management team in place?
- Does the company have a diverse customer base? (any 10% customers?)
- Is your company the “go-to” supplier for our services?
- What is the status of your workforce?

Have you Identified Possible Buyers?

Family members

Key employees

Employee Stock Ownership Plans (ESOPs)

Strategic buyer

Financial buyer

Presented by:

BOULAY

Tara Schini, CPA
Partner
952.841.3047
tschini@boulaygroup.com

Matt Crane, CPA
Partner
952.841.3051
mcrane@boulaygroup.com