Caution: Accounting Roadwork Ahead

By George Whitehead, CPA, Partner

We want to make our *Dealings* readers aware of two significant accounting standards changes that will potentially impact most businesses in the next year or two:

- revenue recognition, and
- lease accounting.

In this article, we are providing an overview of each of these changes; but as you can imagine, a deeper dive will be required by companies that are ultimately impacted.

Revenue Recognition

In 2014, the new revenue recognition standard — accounting standards codification 606 (ASC 606) ***Revenue from Contracts with Customers*** — was released creating a one size fits all approach for companies when recognizing revenue. This release was comprehensive and resulted in the elimination of previously issued industry-specific revenue recognition guidance. In connection with the release of ASC 606, a joint transition resource group and 16 industry-specific task forces were established by the AICPA.

For public companies, ASC 606 was required to be adopted for annual periods beginning on or after December 15, 2017, while private companies get an additional year and must adopt for annual periods beginning on or after December 15, 2018.

The transition to ASC 606 can be accomplished by using one of two approaches; either:

1. a full retrospective approach requiring restatement of all prior periods presented in the financial statements; ***or***
2. a modified retrospective approach which requires a cumulative effect adjustment to opening retained earnings in the year of adoption.

Our experience has been that companies in the private arena are favoring the modified retrospective approach.

As the title of the standard implies, it encompasses all contracts that an entity can have with its customers, whether written, oral or customary, subject to certain scope exceptions. Each customer contract must be evaluated under a five-step process as follows:

1. Identify the contract with the customer;
2. Identify the separate performance obligations in the contract (i.e., deliverables);
3. Determine the transaction price;
4. Allocate the transaction price to the separate performance obligations; ***and***
5. Recognize revenue when the performance obligations are satisfied.

It should be noted that each of the above steps need to be passed in order to recognize revenue. Careful consideration should be given to each of the deliverables included in the contract and a deliverable may be implied if it is a customary practice. When there is more than a single good or service included in a contract, each must be accounted for separately provided that they are capable of being distinct or offering stand-alone value to the customer. The consideration to be received by the seller is to be allocated to each of the distinct performance obligations as if they were sold separately.

Revenue is recognized under the standard as a customer obtains control of an asset, or when an asset is transferred either over time or at a point in time. For revenue to be recognized over time, the customer receives benefits provided by the seller as the seller performs, and the seller has a right for consideration for the work performed to date (i.e., long-term contracts). This can be measured using output methods (completion of performance) or input methods (seller's labor or costs). Point-in-time revenue recognition occurs when a customer has legal title to a transferred asset and has risks and rewards of ownership and has accepted the asset from the seller.

Regardless of whether ASC 606 requires a change in a company's revenue recognition practices, additional financial statement disclosures are required, including, but not limited to:

- a description of the types of contracts companies enter into,
- significant judgments used in the determination of revenue recognition,
- customer acquisition assets,
- disaggregation of revenue,
- performance obligations, ***and***
- allocation of consideration to remaining performance obligations.

The key takeaway here is to understand the types of customer contracts into which your company enters. For those contracts that are significant to your company's revenue stream, a thorough review should be conducted using the five-step process noted above in order to conclude whether or not there will be a change in accounting. In general, companies that provide multiple goods and services to a single customer are more likely to have a potential impact from adoption of ASC 606 than those that provide a single good or service.

Last but not least, as the implementation date for private companies is quickly approaching, adoption of this significant new standard needs to be moved to the top of a finance department's priority list.

Lease Accounting

Accounting Standards Update No. 2016-02 ***Leases*** (ASU 2016-02) is a significant accounting change of which all businesses need to be aware. It is broad in scope and applies to all leases and subleases for all entities, both for lessees and lessors.

For public companies, ASU 2016-02 is effective for fiscal years beginning after December 15, 2019, while private companies get an additional year and must adopt for fiscal years beginning after December 15, 2020.

For lessees, under the new rules, leases are classified in one of three ways:

1. finance leases;
2. operating leases; ***or***
3. short-term leases (duration of less than one year).

The criteria for distinguishing between finance and operating leases remains substantially similar to classification criteria for capital and operating leases under current GAAP, with the primary differences being the elimination of bright line tests for 75% of an asset's useful life (now a major portion of useful life)

and the present value of the lease payments exceeding 90% of an asset's fair value (now substantially all of the fair value). Operating leases from the perspective of a lessee is any lease other than a finance lease.

The principal difference in ASU 2016-02 to note from the current lease guidance is that operating leases will be recognized on the balance sheet as assets and liabilities. For many businesses with outstanding indebtedness, loan covenant issues may arise upon the adoption of this ASU, particularly if the debt agreements contain financial loan covenants such as fixed charge, debt to equity, maximum capex. Additionally, there will be differing income statement between operating leases and finance leases whereby operating lease expense will be presented as a single expense similar to current guidance, while finance lease expenses will have two components: amortization and interest expense.

As most businesses have operating and finance leases of some kind, we expect that ASU 2016-02 will have a significant impact. Proper planning will be the key to a successful adoption and that planning process should begin as soon as possible. Companies should organize all of the current lease agreements and begin to consider the impact that the new lease standard will have on their financial statements.

Contact Us

If you have any questions about either of these two new ASUs, please contact the partner named below or any member of your client service team at PKF O'Connor Davies.

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