Audit & Accounting Update

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Common Industry Transactions and Potential Impacts

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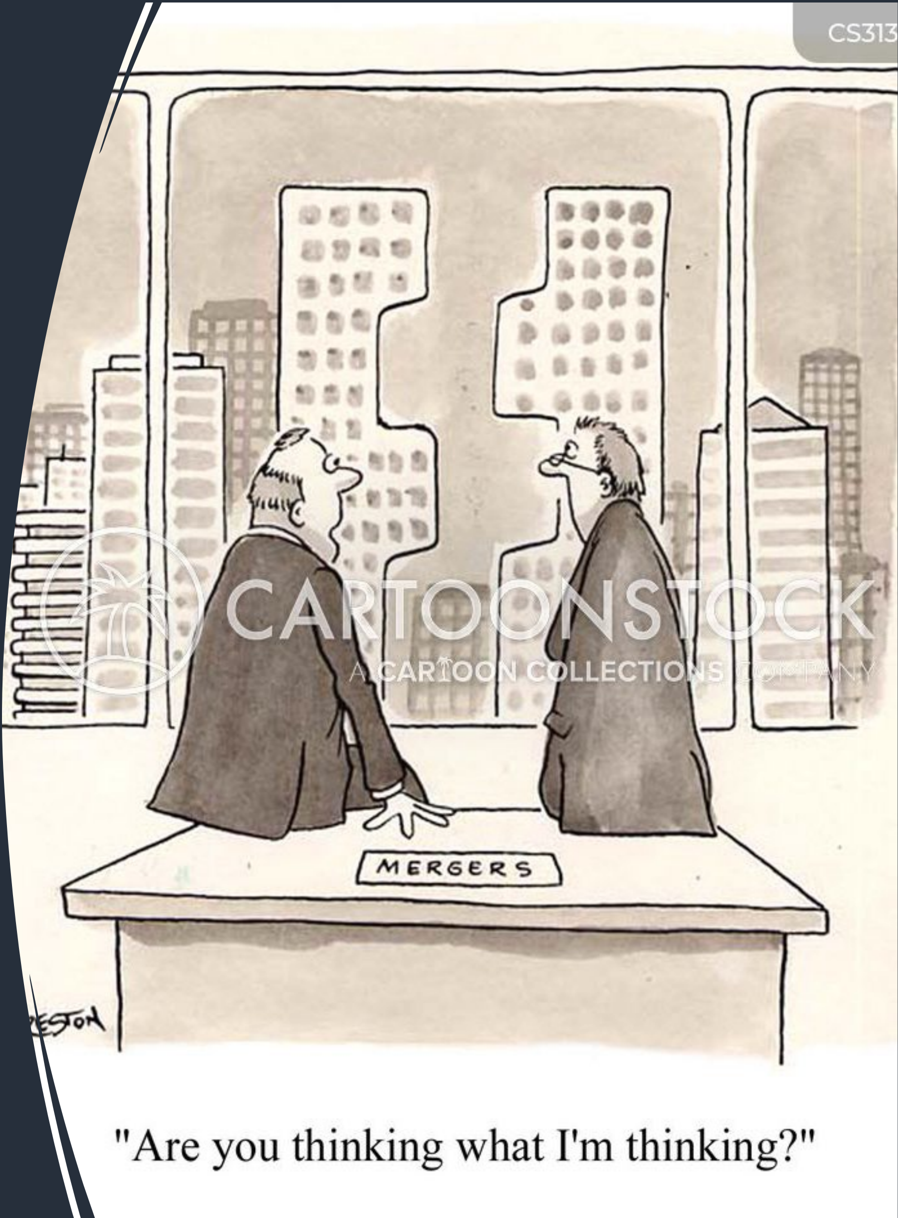
Mergers & Acquisitions

- Asset Acquisition vs Business Combination
  - ASU 2017-01
- Common Control Transactions
  - ASC 805-50-15-6
- Contingent Consideration/Embedded Derivatives
  - ASC 805 vs ASC 815



Asset Acquisition vs Business Combination ASU 2017-01

Step 1 – Screen Test

- Substantially all assets acquired concentrated in a single asset or group of similar assets
- No bright line - ~90% is common

Step 2 – Outputs

- Employees that perform a critical process
- Acquired contracts
- Ability to generate revenue

Common Control Transactions

- Transfer of Net Assets between entities with common ownership
- Does not meet scope of business combination due to no change in control
- Net assets transferred at historical cost basis
- Transferring entity records disposal on effective date and no gain/loss on disposal (difference reflected in APIC)
- Receiving entity reports prospectively on effective date, unless the transaction triggers a “change in reporting entity”
- Receiving entity records at historical cost with any difference in consideration recorded in APIC
- Specific exceptions exist for transfer of financial assets

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Contingent Consideration/Embedded Derivatives

- Asset Acquisition vs Business Combination
  - Business Combination – Contingent consideration is valued on the date of the business combination and impacts the goodwill or gain calculation, any changes to contingent consideration subsequent to the transaction date impacts the P&L
  - Asset Acquisition:
    - Contingent consideration based on Company factors (eg EBITDA or Revenue goals) – Record when payment is probable and estimable, increases the cost basis of the assets
    - Contingent consideration based on a passage of time – may represent seller financing
    - Contingent consideration based on commodity pricing – likely needs to be evaluated for embedded derivative

Contingent Consideration Based on Commodity Prices
Embedded derivative guidance

- Example – Contingent payments if WTI prices average over $80 for 2023 and $72 for 2024 – Can also be tiered with different payouts between $80+, $70-80, $55-$70, with no payment required under $55
- Valuation will need to be performed at the effective date and each reporting date subsequent to the transaction (similar to valuations provided for swaps, puts, calls, collars)
- Transaction effective date – Record the expected contingent payments as an increase to the purchase price allocated to the assets purchased and book a related liability
- Subsequent reporting dates –changes in valuation increase or decrease the liability with the related change recorded through the P&L

Important Accounting Updates

ASU 2021-08 - Business Combinations: Accounting for Acquired Contract Assets and Contract Liabilities

- Acquired contract asset and liabilities related to contracts with customers within the scope of ASC 606 are **no longer recorded at fair value** upon adoption
- Instead, contract assets and liabilities are measured in accordance with the principals of ASC 606, based on the remaining performance obligations to be fulfilled

ASU 2021-08 - Business Combinations: Accounting for Acquired Contract Assets and Contract Liabilities

- Should result in most (but not all) contract assets and liabilities being recognized at “book value” at the date of the acquisition
- Does NOT impact the measurement or recognition of any customer intangible assets

ASU 2021-08 - Business Combinations: Accounting for Acquired Contract Assets and Contract Liabilities

- Effective dates:
  - PBEs – fiscal years beginning after December 15, 2022
  - All other entities – fiscal years beginning after December 15, 2023
- Early adoption is permitted and **highly recommended** for any clients with business combinations with acquired contract balance prior to the effective date

ASU 2021-10 – Disclosures by Business Entities about Government Assistance

- Does NOT provide any recognition or measurement guidance
- Required to disclose:
  - Nature of the transaction and the entity's related accounting policy
  - Financial statement lines affected and the amounts reflected in the current period
  - Any significant terms or conditions
  - General information if the entity is legally prohibited from making certain disclosures

ASU 2021-10 – Disclosures by Business Entities about Government Assistance

- Largely consistent with what is already being disclosed in practice (for example, PPP loan disclosures, ERC)
- Meant to reduce diversity in practice
- Effective for all entities for annual periods beginning after December 15, 2021, early adoption permitted

ASU 2020-06 – Debt with Conversion and Other Options and Derivatives and Hedging

- Simplifies accounting for convertible instruments by removing major separation models required under current U.S. GAAP.
- Eliminates cash and beneficial conversion features model – reduces bifurcation between liabilities and equity
- More convertible debt instruments will be reported as a single liability instrument and more convertible preferred stock as a single equity instrument with no separate accounting for embedded conversion features

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ASU 2020-06 – Debt with Conversion and Other Options and Derivatives and Hedging

- Simplifies the diluted earnings per share (EPS) calculation in certain areas
- Effective dates:
  - PBEs – fiscal years beginning after December 15, 2021 (including interim dates within those periods)
  - Non-PBEs – fiscal years beginning after December 15, 2023
  - Early adoption is permitted

ASU 2017-04 Goodwill Impairment

- Removes step 2 of the goodwill impairment test
  - In current GAAP, step 2 measures impairment loss by comparing implied fair value of the goodwill
- Now will apply one-step quantitative test
  - Impairment recorded as the excess of carrying amount of goodwill over the fair value of the reporting entity

ASU 2017-04 Goodwill Impairment

- Effective date and transition requirements:
  - Public companies (SEC filers) with fiscal years beginning after December 15, 2019
  - Public companies (Non-SEC filers) with fiscal years beginning after December 15, 2020
  - Nonpublic companies with fiscal years beginning after December 15, 2021
  - Early adoption is permitted

ASU 2021-03 Updated Goodwill Impairment

- Current GAAP requires monitoring throughout the year for "triggering events"
  - Macroeconomic conditions
  - Company financial performance
- ASU Effective for private companies and not-for profits
- Removes continuous monitoring – only assessment needs to be performed at the end of the Company's reporting date
- Effective date – Fiscal years beginning after December 15, 2019

Diving into ASC 842

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ASC 842 Leases

- Current lease guidance has been criticized for allowing leased assets and the obligations to be excluded from the balance sheet
- ASC 842 retains a dual model that includes **financing leases**, similar to capital leases, and **operating leases**
- Under this dual model, determining whether a lease is a finance or operating lease will be based on guidance similar to current GAAP, but without the “bright lines”
- Operating leases will now be included in the balance sheets as both an asset and liability

ASC 842 Leases

- Identifying If You Have a Lease
  - A contract that conveys the right to control the use of an identified asset for a period of time in exchange for consideration
- Keys to identifying a lease
  - Identified asset
  - Right to control
- Scoped in the new guidance
  - Office space leases
  - Equipment leases (vehicles, compressors, etc)
  - Drilling contract (most, but not all)
  - Storage contracts (possible)

ASC 842 Leases

- Oil and Gas Considerations
  - Land Easements for oil wells and pipelines
    - Extremely long-term arrangements provide potential for large ROU assets and lease liabilities, potential for finance lease treatment.
  - Segregating between lease and non-components
    - Likely to have significant non-lease components (For example, drilling rig arrangements may include operating crews and maintenance services)
  - Variable Lease Payments
    - Significant usage-based costs are prevalent

ASC 842 Leases

- Oil and Gas Considerations
  - Lease Terms
    - Potential for incentives to exercise renewals due to specialization of equipment, high costs of mobilization, and/or potential penalties for not renewing contracts.
    - Lease terms expressed in units of production versus units of time can provide challenges in determining lease term.
  - Joint operating party arrangements
    - Challenges in determining who has the contractual arrangement with a supplier
    - Potential for sublease arrangements between parties

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ASC 842 Leases

- Example – Drilling Rig:
  - Operator enters into a contract with a Contractor to provide a drilling rig for the purposes of drilling an oil well.
  - Drilling rig make, size and model is explicitly identified in the contract
    - Substituting the drilling rig after commencement would not be economically practical
  - Location of well, commencement date and depth (within a range) is predetermined in the contract
  - Operator directs the drilling operations

Does the contract contain a lease?

ASC 842 Leases

- The contract does contain a lease
  - There is an identified asset
    - The drilling rig is explicitly specified in the contract, and the Supplier does not have the rights to substitute that specific rig.
  - Customer has the right to obtain substantially all of the economic benefits from use of the rig over the period of use.
    - NOTE: Lease may qualify for short-term lease exception depending on term.
  - Decision making rights are predetermined, however, Operator has the right to operate with the contractor changing the operating instructions.
    - Examples of decision making rights include: 1) When the rig operates, 2) Where it operates, 3) Whether it operates, and 4) Depth of the well

ASC 842 Leases

- Accounting for operating leases:
  - Recognize a right-of-use (“ROU”) asset and a lease liability, initially measured at the PV of the lease payments
    - ROU asset = initial direct costs + prepaid amts + lease liability– lease incentives
    - Lease liability = PV of lease payments not yet paid
  - Amortization of ROU asset and interest expense combined and reported as lease expense
  - Classify all cash payments within operating activities in the statement of cash flows

ASC 842 Leases

- Mike's Exploration enters into a lease for office space in Midland
  - Lease term – 4 years
  - Rent payments - $10,000 with $500 escalation per year
  - Interest rate – 5% - Use rate implicit in the lease – if no implicit rate, private entities can use their incremental borrowing rate
  - Economic life – 7 years

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ASC 842 Leases

Interest Rate	5%
YR1 Payment	10,000
YR2 Payment	10,500
YR3 Payment	11,000
YR4 Payment	11,500
	43,000
Straight line per year	10,750
NPV	38,011
Lease Term (years)	4

	Inception
Balance Sheet Impact	**1/1/2014**
Right of use asset	38,011
Lease Liability	(38,011)

ASC 842 Leases

Amortization of Lease Liability			NPV	38,011	Ending Liability
		Payment	Interest	Principal	Balance
YR1 Payment		10,000	1,901	8,099	29,911
YR2 Payment		10,500	1,496	9,004	20,907
YR3 Payment		11,000	1,045	9,955	10,952
YR4 Payment		11,500	548	10,952	-

ASC 842 Leases

Journal Entries

Year 1	Rent expense		10,750	
	Lease liability		8,099	
		Cash		10,000
		Right of use		8,849
Year 2	Rent expense		10,750	
	Lease liability		9,004	
		Cash		10,500
		Right of use		9,254
Year 3	Rent expense		10,750	
	Lease liability		9,955	
		Cash		11,000
		Right of use		9,705
Year 4	Rent expense		10,750	
	Lease liability		10,952	
		Cash		11,500
		Right of use		10,202

ASC 842 Leases

- Accounting for financing leases:
  - Recognize a ROU asset and a lease liability, initially measured at the PV of the lease payments
  - Recognize interest expense on the lease liability separately from amortization of the ROU asset on the income statement
  - Classify repayments of the principal portion within financing activities and payments of interest within operating activities in the statement of cash flows

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ASC 842 Leases

- Mike's Exploration enters into a lease for workover rig
  - Lease term – 4 years
  - Rent payments - $10,000 with $500 escalation per year
  - Interest rate – 5%
  - Trigger finance lease
  - Economic life – 5 years
  - Bargain purchase option

ASC 842 Leases

Interest Rate	5%
YR1 Payment	10,000
YR2 Payment	10,500
YR3 Payment	11,000
YR4 Payment	11,500
	43,000
NPV	38,011

	Inception
Balance Sheet Impact	**1/1/2014**
Right of use asset	38,011
Lease Liability	(38,011)

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ASC 842 Leases

Amortization of Lease Liability		NPV	38,011	Ending Liability
	Payment	**Interest**	**Principal**	**Balance**
YR1 Payment	10,000	1,901	8,099	29,911
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YR3 Payment	11,000	1,045	9,955	10,952
YR4 Payment	11,500	548	10,952	-

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ASC 842 Leases

Amortization of Asset

Total NPV	38,011
Year 1	9,503
Year 2	9,503
Year 3	9,503
Year 4	9,503
	38,011
Lease Term (years)	4

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ASC 842 Leases

Journal Entries				
Year 1	Amortization of right of use asset		9,503	
	Interest expense		1,901	
	Lease liability		8,099	
		Cash		10,000
		Right of use asset		9,503
Year 2	Amortization of right of use asset		9,503	
	Interest expense		1,496	
	Lease liability		9,004	
		Cash		10,500
		Right of use		9,503
Year 3	Amortization of right of use asset		9,503	
	Interest expense		1,045	
	Lease liability		9,955	
		Cash		11,000
		Right of use		9,503
Year 4	Amortization of right of use asset		9,503	
	Interest expense		548	
	Lease liability		10,952	
		Cash		11,500
		Right of use		9,503

ASC 842 Leases

- One year or less
  - For leases with a term of 12 months or less, a lessee is permitted to make an accounting policy election by class of underlying asset not to recognize ROU assets and lease liabilities.

Subleases

- The original lease (the “head lease”) and any subleases are treated as separate contracts that should be separately analyzed to determine proper classification
- Head lease may be classified as a finance lease while the sublease is classified as an operating lease
- No offset of lease expense related to a head lease with lease income related to a sublease in the income statement
- Assets and liabilities from the head lease and sublease shouldn’t be combined on the balance sheet

ASC 842 Leases

- Presentation for lessees
  - Balance sheet
    - Either present separately or combine with appropriate class of assets and liabilities with proper disclosure
    - No co-mingling of Financing and operating leases
  - Income statement
    - Financing – Present interest separately from amortization
    - Operating – Present interest and amortization together in lease expense
  - Statement of cash flows
    - Operating activities
      - Interest on financing leases
      - Payments on operating leases
    - Financing activities
      - Principal repayments on financing leases

ASC 842 Leases

- Adoption Method Practical expedients -
  - No reassessment of expiring contracts
  - No reassessment of lease classification
  - No reassessment of initial direct costs
    - *Must adopt all three*

Questions

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