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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

"Are you thinking what I'm thinking?"

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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

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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

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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

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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

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

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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

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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

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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

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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

- 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

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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