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Revenue, lease accounting still challenge private companies

By Maria L. Murphy, CPA
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Revenue recognition and lease accounting remain a challenge for private companies after a one-year, pandemic-related delay in effective dates provided financial statement preparers some relief.

Changes to accounting for revenue under Accounting Standards Update (ASU) 2014-09, *Revenue From Contracts With Customers (Topic 606)*, and leases under ASU 2016-02, *Leases (Topic 842)*, have been on private companies' radar for many years. In June 2020, FASB deferred the effective dates of these standards for certain companies by one year, to provide relief as a result of the COVID-19 pandemic, by issuing ASU 2020-05.

As a result of ASU 2020-05, certain entities that have not yet issued their financial statements (or made financial statements available for issuance) reflecting the adoption of ASU 2014-09, may elect to adopt the guidance in Topic 606 for annual reporting periods beginning after Dec. 15, 2019, and interim periods beginning after Dec. 15, 2020. The ASU also deferred the effective date for applying Topic 842 by one year for entities within the "all other entities" category to be effective for fiscal years beginning after Dec. 15, 2021, and interim periods beginning after Dec. 15, 2022. Early adoption is still permitted for both standards.

FASB's deferral provided welcome relief to private companies already overwhelmed by the many challenges to their operations caused by the pandemic and working remotely. Because Topic 606 is effective earlier than Topic 842, the implementation issues and readiness of private companies for these two standards is very different.

"When the pandemic hit in March 2020 and the FASB deferral occurred a few months later, many companies adopting the revenue standard were almost ready to go based on the original effective date," said Robert Mercado, CPA, Construction Assurance Group leader at Marcum LLP. "At this point, many of our clients have been applying 606 for two years."

Carl Franseen, CPA, CFO and executive vice president, United Infrastructure Group, was one of those clients who adopted the new revenue standard in calendar year 2019. "Our

2019 audit was scheduled for March 2020 but was delayed by the pandemic," he said. "We and our auditors had challenges of working with new information and reports for the first time, along with working remotely, but we had worked out the key items in planning."

Franseen said his company's implementation process was seamless because its finance department was sophisticated and was familiar with the standard, planned ahead, addressed new issues early, saw what public companies were doing, and tested their outputs ahead of time. United Infrastructure developed new disclosures with its auditors in advance of its 2019 audit by looking at public company disclosures.

Although many private companies have adopted the new revenue standard, Mercado noted that many preparers and auditors are still learning how to apply it in practice. "GAAP usually provides so much detail, but Topic 606 provides the theory and not the specifics," he said. One of the standard setters' objectives in developing the new revenue recognition guidance was to provide a principles-based approach that applies to all companies and reduces industry-specific rules.

Mercado observed that although the FASB and IFRS revenue standards put everyone on the same theoretical basis, companies and their auditors still need to get more experience with the required accounting and how systems execute it. "Software vendors started and stopped their development over the years, so it could take a few more years for everyone to be comfortable," he said.

For private companies in all industries, accounting for nondistinct goods and services can be a difficult revenue issue. "For example, if a company builds conference rooms and buys televisions off the shelf for the customer for their conference room, under Topic 606 they can only record revenue up to the cost and not show profit on the televisions until they install them, because they didn't do anything except procure the goods," Mercado said. "This skews gross profit."

Revenue: Significant issues

For the construction industry, there are a number of common revenue implementation issues. "When the initial exposure draft was issued in 2012, the construction industry was expected to be one of the hardest hit," he said. "But changes were made that reduced the impact to contractors, and there have been few, if any, issues about performance obligations because most contracts only have one."

Mercado said the biggest impact for contractors is in Step 5, which requires that revenue be recognized when or as the entity satisfies a performance obligation. "Although revenue is still recorded based on costs incurred, as with the prior percentage of completion model, under Topic 606 the costs may not be the costs that are recorded on a job right away," he noted. "There are capitalized costs to fulfill, like mobilization, surety bonds, and administrative costs to set up a job, that affect the job in its entirety. They don't hit the job until work is performed, which slows down revenue recognition, and they are not a 'contract asset' but must be capitalized."

Franseen said the two most significant issues under Topic 606 for his company were projects with multiple performance obligations and accounting for capitalized upfront costs that lowered recognized revenues, as noted by Mercado. For his company's implementation, cost accumulation was critical.

"We made sure we had a team that included a cost engineer, accounts payable, the controller, and me that by Jan. 1, 2019, had worked on identifying cost codes where the data was collected to make sure we could keep track of which costs to count and have monthly cost detail by cost code to make monthly adjustments for work in process," Franseen said.

Another common issue in the construction industry is variable consideration. "Most contractors struggle with variable consideration relating to liquidating damages and having to determine the most likely outcome, calculate the cost, and adjust the contract value," Mercado said.

Variable consideration relating to claims is also difficult. "Under the prior standard, you couldn't record profit and could only record the claim up to the cost for the project, but now you record revenue and profit based on what you will probably collect as long as there is no significant reversal in the future," he said. "CPAs are struggling with this change because although it is easier to record a claim, constraints must be put on it and there must be a legal basis to collect it."

Mercado said the new disclosures required under Topic 606 are extensive. "Disclosures have increased from half a page to three to four pages and can be confusing to readers who don't understand the standard," he said. "We are seeing that preparers are still all over the place, and although the disclosures are getting better, they are still lacking in a lot of areas."

Leases: The pause has ended

For lease accounting, FASB's deferral was welcome to companies working on implementation because of the time until the effective date and the potential magnitude of changes to balance sheets for certain industries, including construction. Many private companies in all industries have not yet adopted the new standard. Some companies started working on implementation but then paused and are just now picking it back up.

"Some of our clients have started to be ready for adoption on Jan. 1, 2022, because they recognize it is a big undertaking, but we have not seen a huge spike in private company adoption yet," said Lisa Kaestle, CPA, director in Accounting Advisory at Grant Thornton. She attributes this to companies being overwhelmed last year, including some that started implementation and had to pause to keep their businesses going. In addition, because many private companies do not prepare quarterly financial statements and have less stringent internal control requirements for adopting new standards than public companies, they have the flexibility to wait a little longer.

Mercado agrees that many of his clients think they still have enough time.

“Strong controllers and CFOs are thinking about Topic 842, but the average company has so many pressing issues as a result of the pandemic, like remote work and PPP and other programs, and will defer thinking about it as long as they can,” he said. “In the construction industry, companies and banks are not ready for lease accounting yet.”

LeaseCrunch, a cloud-based lease accounting software company, conducted a survey of auditors at 21 CPA firms in March and April of this year about their clients’ readiness for lease accounting. The results were that only a little over half of their GASB and nonpublic FASB clients had completed implementation of the new standards, and over 80% had their clients’ leases affected by COVID-19. (GASB also delayed the effective date of its lease accounting standard, Statement 87, as a result of the pandemic.) Of those surveyed, 22% of the clients had not yet completed their lease inventory.

Because ASC 842 is balance-sheet focused, Kaestle is advising her clients not to wait until the end of the year of adoption because implementation will likely take longer than expected. “Lease consultants and software vendors will likely get overwhelmed by the volume of requests as the deadline gets closer, so it’s better to start as early as possible,” she said. “Have conversations with your auditors as you are going through your adoption activities so you can share your challenges and they can plan and perform procedures before year end.”

Leasing by its nature crosses all industries, and the needs of clients for assistance varies. “Some need help with the technical guidance or lease accounting software,” she said. “Some don’t have the capacity to do implementation activities on their own and need help so they can be up and running on day one and can handle day two accounting.” This includes having discussions with management, getting everyone on board, forming a team, training, policy elections, reviewing lease contracts, and data validation.

In Kaestle’s experience, the following are the biggest challenges in lease accounting implementation:

- Identifying embedded leases: This is the most widespread issue affecting all companies, to make sure they have the complete lease population.
- Finding all the lease contracts and ensuring accuracy of the data: “Because many companies have a decentralized approach to leasing today, ASC 842 forces everyone to organize that data and allows for smarter business decisions,” Kaestle said.
- Standardizing procedures and making changes to internal controls over negotiating new leases, renewals, and modifications so all departments get the information they need: “Software workflow solutions can help to get everyone on board and remain compliant,” Kaestle said. “However, certain businesses practices are not going to change, and accounting shouldn’t necessarily drive that.”
- New disclosure requirements: These can be challenging because of the number of them. “There is an enhanced risk of error by doing this manually, and there is a good number of affordable, third-party software solutions to be considered, but clients may need help implementing software to understand the impact of lease accounting overall on their organizations,” Kaestle said.

In the construction industry, embedded leases are also a significant concern. “Contractors don’t realize that a crane on the side of the building that they now rent for several years and record as month-to-month rent expense will become an operating lease asset,” Mercado said. He also includes identifying the population of lease contracts and new disclosures on his list of significant challenges.

Kaestle recommends that private companies learn from public company implementation. “There’s a reason public companies go first, and there are lessons to be learned by companies, their auditors and consultants, and software providers,” she said. She suggests private companies look at public company disclosures to see what accounting expedients the majority of public companies have taken.

Private companies can also benefit from public company experiences in making decisions about investments in software solutions. Kaestle recommends companies demo at least three software solutions before choosing one. “Each is tailored to different needs, and it is important to choose the right one and not have to switch because it is costly and time-consuming.”

Mercado said, “There are some lease accounting systems and software solutions out there now, but there will be a much greater need for them going forward. There will be a bigger burden on CPAs in the beginning, as smaller private companies will likely ask their accountants to help them track their leases like they do for fixed assets.” Auditors will continue to need to be aware of auditor independence issues that prevent them from performing management functions for their audit clients.

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