2020 Accounting & Auditing Update

November 12, 2020

Regulatory Updates

November 12, 2020

Speaker

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SEC Matters Update

SEC Update and Selected Topics

- Key Personnel Changes
  - Caroline Crenshaw (D) fills open Commission seat
  - Lindsay McCord named Chief Accountant in the Division of Corporation Finance
  - Diana Stoltzfus named Deputy Chief Accountant in the Office of the Chief Accountant
- SEC Rulemaking Update
- SEC Staff Guidance

SEC Rulemaking – Amendments to Regulation S-K

Item 101 Business	Item 103 Legal Proceedings	Item 105 Risk Factors
- Requires principles-based disclosure focused on information that is material - Adds disclosure topic for human capital resources - Allows general development of business disclosures to focus on current reporting period (w/hyperlink to prior filing for full discussion of business)	- Explicitly permits use of hyperlinks or cross-referencing to legal proceedings disclosure included elsewhere in filing - Raises threshold for reporting certain environmental proceedings	-Requires summary risk factor disclosure if risk factor disclosures exceed 15 pages -Requires disclosure of "material" risk factors and organization of disclosures under relevant headings

SEC Rulemaking – Modernization of Disclosures for Banking Registrants

- New subpart 1400 of Regulation S-K rescinds and replaces Industry Guide 3
  - Codifies and eliminates certain statistical disclosures under Guide 3
  - Adds several new disclosure requirements
  - Effective 30 days following publication in the Federal Register. Compliance mandatory for fiscal years after 12/15/21, but may be voluntarily applied earlier following the effective date.

SEC Rulemaking – Amendments to the Accelerated and Large Accelerated Filer Definitions

- Amendments to the Accelerated and Large Accelerated Filer definitions
  - Smaller reporting companies with less than $100 million in annual revenue are excluded from accelerated filer definition

	Current thresholds	Revised thresholds
Non-accelerated filer	Public float is less than $75 million	Public float is less than $75 million -OR- Public float is between $75 million and $700 million and annual revenue is less than $100 million
Accelerated filer	Public float is at least $75 million, but less than $700 million	Public float is at least $75 million, but less than $700 million and annual revenue is $100 million or more
Large accelerated filer	Public float is $700 million or more	Public float is $700 million or more

SEC Rulemaking – Amendments to the Accelerated and Large Accelerated Filer Definitions

- Accelerated Filer amendments (continued)
  - Business Development Companies with investment income less than $100 million and public float less than $700 million also excluded from accelerated filer definition
  - Public float thresholds for exiting status are higher
    - Exiting Accelerated Filer status under public float test increased from $50 million to $60 million
    - Exiting Large Accelerated Filer status increased from $500 million to $560 million
  - Effective for annual reports due on or after April 27, 2020 (even if fiscal year end precedes April 27)
  - Management's responsibility to establish, maintain, assess and report on internal controls over financial reporting remains unchanged

SEC Rulemaking – Amendments to the Accelerated and Large Accelerated Filer Definitions

- Updated criteria and filing requirements

	Public float[2]	Annual revenue[3]	ICFR audit[4]	Filing deadlines[5]
Non-accelerated filer and SRC	Less than $75 million	N/A	No	10Q - 45 Days 10K - 90 Days
	$75 million, but less than $700 million	Less than $100 million	No	10Q - 45 Days 10K - 90 Days
Accelerated filer and SRC	$75 million, but less than $250 million	$100 million or more	Yes	10Q - 40 Days 10K - 75 Days
Accelerated filer and not an SRC	$250 million, but less than $700 million	$100 million or more	Yes	10Q - 40 Days 10K - 75 Days
Large accelerated filer	$700 million or more	N/A	Yes	10Q - 40 Days 10K - 60 Days

Other SEC Rulemaking

- SEC amends definition of an accredited investor
  - Expands population of individuals and entities that can participate in private capital market transactions
  - Previously focused solely on investor's income and net worth – new qualifying categories based on financial knowledge, sophistication and expertise

- SEC initially approves NYSE proposal to permit companies conducting a direct listing to sell new shares to public as part of the transaction if certain criteria were met
  - Following a request from the Council of Institutional Investors, the SEC stayed its approval of the proposal

SEC Staff Guidance – Compliance and Disclosure Interpretations (C&DIs)

- C&DI 219.05 - Reporting compensation for periods affected by COVID-19
  - Are benefits provided to executives due to COVID-19 considered perks or personal benefits for purposes of S-K compensation disclosures?
    - *No - if benefit is integrally and directly related to performance of duties*
    - *Yes - if it confers a direct or indirect benefit and has a personal aspect (unless it's generally available to all employees)*

- C&DI 115.18 – Use of Form S-3 following a SPAC merger
  - May the combined entity rely on the SPAC's pre-combination reporting history to satisfy the eligibility requirements of Form S-3 during the 12 calendar months following the business combination?
    - *No - combined entity would need 12 months of Exchange Act reporting history following the merger to be S-3 eligible*

PCAOB and AICPA Update

PCAOB Recently Completed Standard-Setting

Project	Current Stage	Timing
Auditing Accounting Estimates, Including Fair Value Measurements, and Amendments to PCAOB Auditing Standards	Final Standard issued on 12/20/2018 – approved by SEC on 7/1/2019	Effective for audits of fiscal years ending on or after December 15, 2020.
Amendments to Auditing Standards for Auditor's Use of the Work of Specialists	Final Standard issued on 12/20/2018 – approved by SEC on 7/1/2019	Effective for audits of fiscal years ending on or after December 15, 2020.

Refer to: https://pcaobus.org/Standards/Pages/recently-completed-standard-setting-activities.aspx

AICPA Recently Issued Auditing Standards

SAS 142, Audit Evidence	SAS 143, Auditing of Estimates and Related Disclosures
Revisions address the evolving nature of business transactions and audit services. Considers: • Use of emerging technologies and techniques by both preparers and auditors • Application of professional skepticism • Expanding use of external information sources • Relevance and reliability of audit evidence **Effective**: Audits of F/S for periods ending on or after December 15, 2022	Focuses on degree to which estimates are subject to uncertainty • Requires a separate assessment of inherent risk and control risk at the assertion level and emphasizes auditors' consideration of controls and professional skepticism • Considers scalability - simple to complex estimates • Includes enhanced risk assessment by providing risk assessment requirements that are more specific to estimates **Effective**: Audits of F/S for periods ending on or after December 15, 2023

PCAOB Current Projects – Standard Setting

Project	Current Stage
Quality Control Standards, Including Assignment and Documentation of Firm Supervisory Responsibilities	On December 17, 2019, issued a concept release on potential approach for public comment were due March 16, 2020. Currently analyzing comments to determine next steps
Supervision of Audits Involving Other Auditors	Analyzing comments to determine next steps
Auditor Independence	Monitoring the SEC's rulemaking project on Rule 2-01 and developing a recommendation for the Board's consideration, if adopted

PCAOB Research Agenda

Project	Status
Changes in the Use of Data and Technology in the Conduct of Audits	Researching whether impediments exist in PCAOB audit standards.
Audit Evidence	Assessing need for guidance or changes to AS 1105

Refer to: https://pcaobus.org/Standards/research-standard-setting-projects/Pages/default.aspx

PCAOB– AS 3101, The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion

- Introduces a new component of the Independent Auditor's Report
  - Effective for large accelerated filers for fiscal years ending on or after June 30, 2019
  - Effective for all other companies subject to PCAOB audits for fiscal years ending on or after December 15, 2020
  - Most significant change to the required form and content of the Independent Auditor's Report in over 70 years
  - Provides auditors with unprecedented opportunities to communicate through the independent auditor's report by including adding a new section dedicated to Critical Audit Matters (CAMs)
  - Intended to increase transparency – they're the auditor's views and not those of management

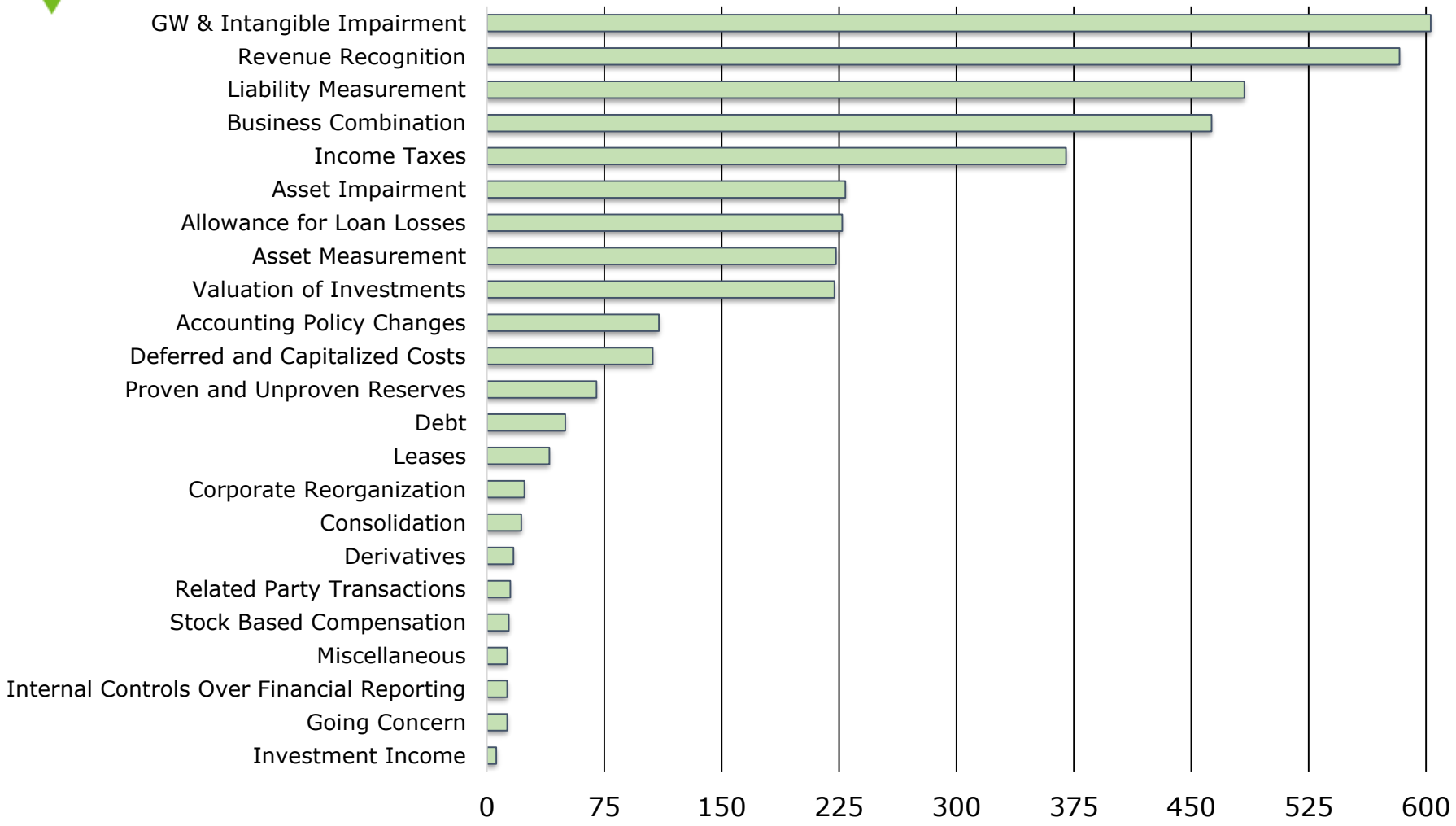
PCAOB– Critical Audit Matters (CAM)

- What are Critical Audit Matters (CAM) ?
  - Any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that:
    - Relates to accounts or disclosures that are material to the financial statements AND
    - Involved especially challenging, subjective, or complex auditor judgment.
  - Unique to each audit as auditors apply principles-based guidance and exercise significant auditor judgment in the determination of which matters involved especially challenging, subjective, or complex auditor judgement
  - Investors should be able to use CAMs to learn what "kept the auditor up at night"

PCAOB– Critical Audit Matters (CAM)

- Examples of CAM:
  - Center for Audit Quality Example - Goodwill Impairment Assessment
  - Microsoft – Revenue recognition and accounting for income taxes
  - News Corp (Wall Street Journal, New York Post) – Impairment Analysis over Indefinite-Lived Intangible Assets, Realizability of Deferred Tax Assets
  - Madison Square Garden Sports (Owners of the New York Knicks and New York Rangers – Related Party Transactions, Revenue Recognition
  - Many auditor's also included COVID-19 and a Company's response to the pandemic as a critical audit matter.

CAM Observations – All Industries
Reports Filed Through May 27, 2020



CAM from Microsoft 10-K

Revenue Recognition – Refer to Note 1 to the financial statements

Critical Audit Matter Description

The Company recognizes revenue upon transfer of control of promised products or services to customers in an amount that reflects the consideration the Company expects to receive in exchange for those products or services. The Company offers customers the ability to acquire multiple licenses of software products and services, including cloud-based services, in its customer agreements through its volume licensing programs.

Significant judgment is exercised by the Company in determining revenue recognition for these customer agreements, and includes the following:

- Determination of whether products and services are considered distinct performance obligations that should be accounted for separately versus together, such as software licenses and related services that are sold with cloud-based services.
- The pattern of delivery (i.e., timing of when revenue is recognized) for each distinct performance obligation.
- Identification and treatment of contract terms that may impact the timing and amount of revenue recognized (e.g., variable consideration, optional purchases, and free services).
- Determination of stand-alone selling prices for each distinct performance obligation and for products and services that are not sold separately.

Given these factors and due to the volume of transactions, the related audit effort in evaluating management's judgments in determining revenue recognition for these customer agreements was extensive and required a high degree of auditor judgment.

How the Critical Audit Matter Was Addressed in the Audit

Our principal audit procedures related to the Company's revenue recognition for these customer agreements included the following:

- We tested the effectiveness of controls related to the identification of distinct performance obligations, the determination of the timing of revenue recognition, and the estimation of variable consideration.
- We evaluated management's significant accounting policies related to these customer agreements for reasonableness.
- We selected a sample of customer agreements and performed the following procedures:
  - Obtained and read contract source documents for each selection, including master agreements, and other documents that were part of the agreement.
  - Tested management's identification and treatment of contract terms.
  - Assessed the terms in the customer agreement and evaluated the appropriateness of management's application of their accounting policies, along with their use of estimates, in the determination of revenue recognition conclusions.
- We evaluated the reasonableness of management's estimate of stand-alone selling prices for products and services that are not sold separately.
- We tested the mathematical accuracy of management's calculations of revenue and the associated timing of revenue recognized in the financial statements.

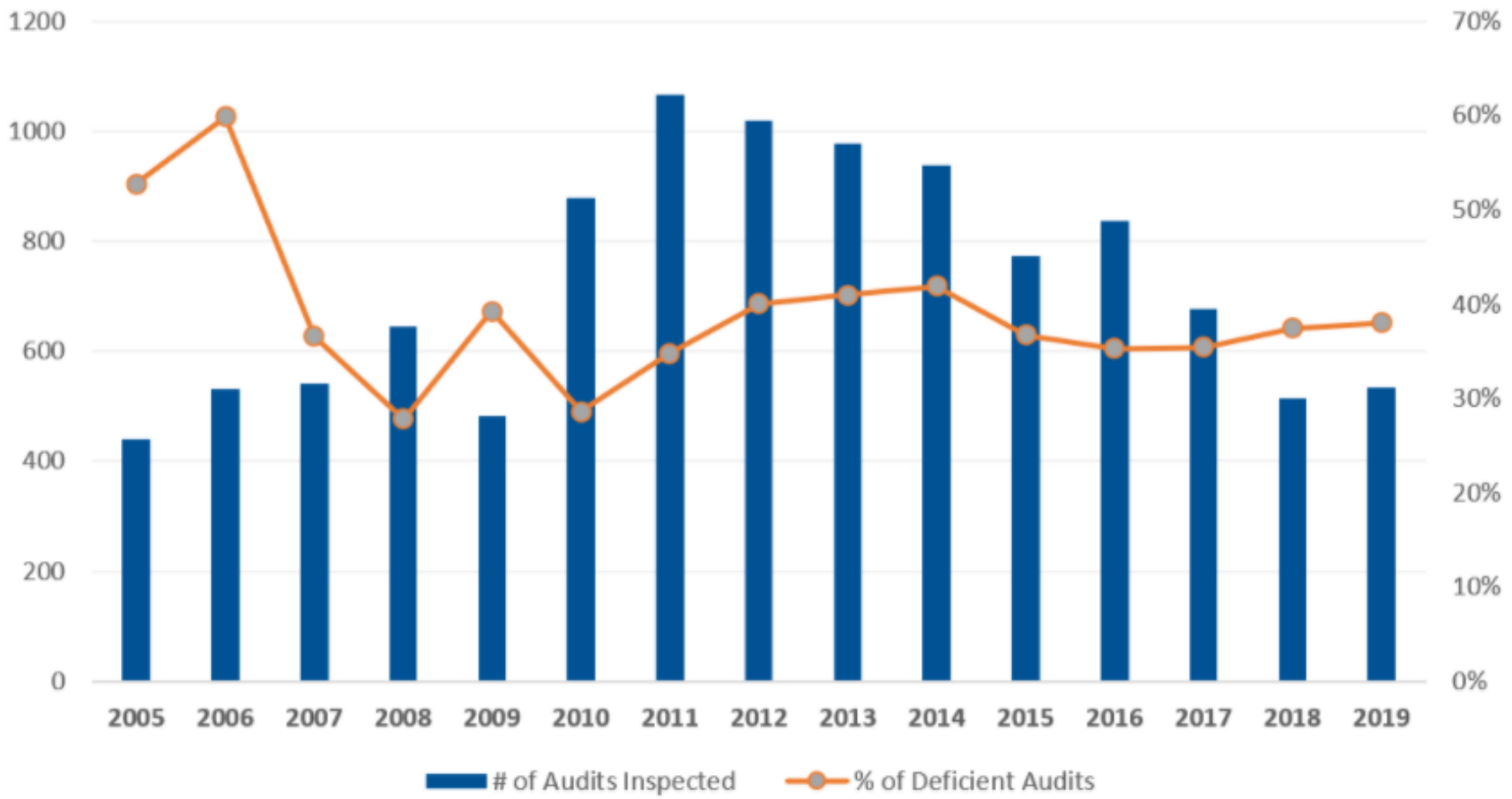
PCAOB Overview 2018 Inspection Findings

Areas of common audit deficiencies observed in 2018 –

- Internal Control Over Financial Reporting -
  - Insufficient testing of the design and operating effectiveness of controls that include a review element.
  - Did not select controls for testing that address specific risks of material misstatement.
- Risk of Material Misstatement - Design and performance of audit procedures that address the assessed risk of material misstatement, particularly auditing of revenue
- Accounting estimates – allowance for loan and lease losses, business combinations and fair value of financial instruments
- Engagement Quality Reviews – e.g., too much reliance on discussions with engagement teams or insufficient reviews

PCAOB Overview 2018 Inspection Findings

Audits Inspected vs. Deficient Audits



PCAOB Audit Committee & Stakeholder Outreach

In July 2020, the PCAOB released common themes from their outreach to audit committee chairs.

- CON: Increased risks associated with remote work
- PRO: Increased communications with auditor
  - Discussions about trends auditors are seeing across their client base, particularly those pertaining to industry peers
  - Presentations on areas of the audit that may or will warrant increased attention due to the effects of COVID-19, as well as how the auditor plans to approach those areas; and
  - Audit firm resources and webinars with industry-specific and emerging risks and opportunities content

Auditor Reporting: COVID-19 Considerations

In July 2020, the AICPA Center for Audit Quality issued a publication reviewing auditor reporting and how COVID-19 may impact audit reports including:

- Unqualified audit opinions with an explanatory paragraph
- Unqualified audit opinions with an emphasis of matter paragraph
- Qualified audit opinions
- Critical Audit Matters

The CAQ states: "The COVID-19 pandemic and the related market conditions create many new uncertainties for auditors, audit committees, investors and management of public companies… COVID-19 continues to impact public company financial statements in different ways and at differing levels of severity depending on an entity's capitalization, geographic location and the industry in which the entity operates, among other factors."

Questions

ASC 842 Leases – Guidance on Implementation

November 12, 2020

Speaker

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ASC 842 Leases – Current Dates

- ASC 842 – *Leases* was effective for public companies for years beginning after December 15, 2018 and thus has already been implemented across the public spectrum.
- This guidance was originally set to be effective for private companies for years beginning after December 15, 2019. However, this has since been deferred on two separate occasions for an additional year in each instance.
- As a result, ASC 842 – *Leases* is now required to be implemented by private companies for **fiscal years beginning after December 15, 2021** (calendar year 2022 for most entities).

ASC 842 Implementation

- Implementation method is a modified retrospective transition using EITHER of the following:
  - Comparative option applied to all periods presented
  - Effective date option where a cumulative-effect adjustment is made on the first day of the year of adoption to retained earnings (i.e. only the current year is impacted)
- Comparative will require comparative presentation of ASC 842 and also comparative disclosures.
- The effective date option is much simpler and will require in much less implementation effort from a financial reporting lens. However, for companies with significant ASC 842 adjustments, financials under this method will lack the comparability of the comparative option.

ASC 842 Crash Course

- The "end game" is to get all leases with service lengths greater than 12 months onto the balance sheet.
- Leases 12 months or less in length are excluded from the guidance and are expensed pro-rata over the contract with no balance sheet impact.
- Operating/capital terminology replaced with operating/finance leases.
- Finance lease requirements remained relatively unchanged outside of the following:
    - Bargain purchase option reworded to purchase option reasonably certain to be exercised
    - New 5th category – specialized nature asset that only the lessee can use (i.e. no alternative use to the lessor without significant modification)

ASC 842 Crash Course

- Recognition patterns for capital/finance leases remains relatively unchanged:
  - Record a "right of use" asset and corresponding liability based on the present value of future lease payments (lease incentives such as tenant improvement allowances are included in this ROU asset calculation)
  - Subsequent payments are recorded as reduction in the liability principal with the remainder to interest expense based on either the implicit rate or incremental borrowing rate
  - The "right of use" asset is depreciated/amortized on a straight line basis (typically over the lease term).
  - Principal payments are recorded as financing outflows with the interest portion being recorded within operating activities in the statement of cash flows

ASC 842 Crash Course

- The major change within ASC 842 revolves around the recording of operating leases.

- Pre-ASC 842 (ASC 840) guidance was to record the expense straight-line over the life of the lease.
    - Any escalation in payments over the lease would result in a deferred rent liability
    - Typically no other balance sheet impact other than this.

- ASC 842 will require all operating leases greater than 12 months in duration to be recorded on the balance sheet as a "right of use" asset with a corresponding lease liability at the present value of future payments.

ASC 842 Crash Course

- The initial ROU asset and lease liability for operating leases will be calculated in the same manner as a capital/financing lease.

- Additionally, interest will be recorded on the lease liability in the same manner as a capital/financing lease and then the ROU asset will be amortized so that the total expense (interest component and amortization component) is recognized on a straight-line basis over the lease.

Rental expense – interest expense = ROU amortization

ASC 842 – Operating & Finance Lease Example

Fact Pattern

- 3 year lease from 1/1/2022 – 12/31/2024
- $300,000 present value of future lease payments
- Payment stream – Year 1 $100,000, Year 2 $110,000, Year 3 $125,000
- 5.51% interest rate implied in the lease
- No renewals periods
- No initial direct costs

Finance Lease Under ASC 842

Fact Pattern

Term: 1/1/2022 - 12/31/2024
$300k PV of future payments at 1/1/2022

Payments:
Year 1 - $100k
Year 2 - $110k
Year 3 - $125k

5.51% implied interest rate

LEASE COMMENCEMENT

	Debit	Credit
ROU Asset	$ 300,000	
Lease Liability		$ 300,000

YEAR ONE ENTRY

Interest Expense	$ 16,535	
Amortization Expense	$ 100,000	
Lease Liability	$ 83,465	
ROU Asset		$ 100,000
Cash		$ 100,000

YEAR TWO ENTRY

Interest Expense	$ 11,935	
Amortization Expense	$ 100,000	
Lease Liability	$ 98,065	
ROU Asset		$ 100,000
Cash		$ 110,000

YEAR THREE ENTRY

Interest Expense	$ 6,530	
Amortization Expense	$ 100,000	
Lease Liability	$ 118,470	
ROU Asset		$ 100,000
Cash		$ 125,000

Operating Lease Under ASC 842

Fact Pattern

Term: 1/1/2022 - 12/31/2024
$300k PV of future payments at 1/1/2022

Payments:
Year 1 - $100k
Year 2 - $110k
Year 3 - $125k

5.51% implied interest rate

LEASE COMMENCEMENT

	Debit	Credit
ROU Asset	$ 300,000	
Lease Liability		$ 300,000

YEAR ONE ENTRY

Lease Expense	$ 111,667	
Lease Liability	$ 83,465	
ROU Asset		$ 95,132
Cash		$ 100,000

YEAR TWO ENTRY

Lease Expense	$ 111,667	
Lease Liability	$ 98,065	
ROU Asset		$ 99,732
Cash		$ 110,000

YEAR THREE ENTRY

Lease Expense	$ 111,667	
Lease Liability	$ 118,470	
ROU Asset		$ 105,137
Cash		$ 125,000

Comparison

FINANCE LEASE

	Year One	Year Two	Year Three	Total
Interest Expense	$ 16,535	$ 11,935	$ 6,530	$ 35,000
Amortization Expense	$ 100,000	$ 100,000	$ 100,000	$ 300,000
Total Expense	**$ 116,535**	**$ 111,935**	**$ 106,530**	**$ 335,000**
Operating Cash Flow	$ 16,535	$ 11,935	$ 6,530	$ 35,000
Financing Cash Flow	$ 83,465	$ 98,065	$ 118,470	$ 300,000
Total Cash Flows	**$ 100,000**	**$ 110,000**	**$ 125,000**	**$ 335,000**

OPERATING LEASE

	Year One	Year Two	Year Three	Total
Interest component	$ 16,535	$ 11,935	$ 6,530	$ 35,000
Amortization component	$ 95,132	$ 99,732	$ 105,137	$ 300,000
Total Rental Expense	$ 111,667	$ 111,667	$ 111,667	$ 335,000
Operating Cash Flow	$ 100,000	$ 110,000	$ 125,000	$ 335,000

Some Takeaways

- Recognition patterns for capital/finance leases are relatively unchanged from ASC 840 to ASC 842. The biggest changes for these leases is enhanced disclosures.

- The primary difference in recognition pattern between operating and finance leases is how the ROU asset is amortized.
    - ROU asset for financing leases is amortized over the shorter of their estimated useful lives or the terms of the respective leases, including periods covered by renewal options that the Company is reasonably assured of exercising.
    - ROU asset for operating leases is amortized based on total rental expense compared to the amount representing interest

- Additionally, operating leases result in greater operating cash outflows when compared to finance leases whose cash outflows are considered akin to debt.

Lessons Learned from Implementation

- Now that we've covered, on a very high level, the changes within ASC 842, what are some lessons that have been learned from companies who have already implemented?
    - Start sooner rather than later. This WILL take longer to implement than you realize.
    - Solicit the involvement of the entire company.
    - Utilize technological solutions where and when necessary.
    - Lease contracts are everywhere! There are even what is referred to as "embedded leases" that are, by definition, embedded within other service contracts previously not considered leases.

Start Sooner rather than Later

- If you have any operating leases, this new standard WILL impact your financial statements. Not only will it affect financial statement amounts, but there are additional disclosure requirements as well.
    - Expanded qualitative disclosures (significant judgments and practical expedients elected among others) and expanded quantitative disclosures (additional breakout of lease cost)
    - Changes in cash flow presentation and non-cash activities (i.e. addition of ROU assets/liabilities)
    - Weighted average disclosures for remaining lease term and discount rate for both operating and finance leases
- If there is one consensus from public companies who have already adopted, it is that this standard stretched their accounting personnel more than they envisioned and the amount of time that leases took to implement greatly exceeded their expectations.
- Also, even if implementing using the transition method, the cumulative effect adjustment will require assessment at the BEGINNING of the year of adoption.

Disclosure Examples – ASC 840

The disclosure examples on the following tabs were taken from Wendy's 10-K

Rental expense for operating leases consists of the following components:

	Year Ended		
	2018	2017	2016
Rental expense:			
Minimum rentals	$ 95,749	$ 90,889	$ 77,952
Contingent rentals	18,971	19,021	18,291
Total rental expense (a) (b)	$ 114,720	$ 109,910	$ 96,243

	Rental Payments	
Fiscal Year	Capital Leases	Operating Leases
2019	$ 47,087	$ 95,877
2020	45,947	93,372
2021	47,604	92,987
2022	48,687	92,830
2023	50,193	92,807
Thereafter	699,697	1,058,037
Total minimum payments	$ 939,215	$ 1,525,910
Less interest	(483,579)	
Present value of minimum capital lease payments (a)	$ 455,636	

Disclosure Examples – ASC 842

	December 29, 2019	December 30, 2018
ASSETS		
Current assets:		
Cash and cash equivalents	$ 300,195	$ 431,405
Restricted cash	34,539	29,860
Accounts and notes receivable, net	117,461	109,805
Inventories	3,891	3,687
Prepaid expenses and other current assets	15,585	14,452
Advertising funds restricted assets	82,376	76,509
Total current assets	554,047	665,718
Properties	977,000	1,023,267
Finance lease assets	200,144	189,969
Operating lease assets	857,199	—

LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Current portion of long-term debt	$ 22,750	$ 23,250
Current portion of finance lease liabilities	11,005	8,405
Current portion of operating lease liabilities	43,775	—
Accounts payable	22,701	21,741
Accrued expenses and other current liabilities	165,272	150,636
Advertising funds restricted liabilities	84,195	80,153
Total current liabilities	349,698	284,185
Long-term debt	2,257,561	2,305,552
Long-term finance lease liabilities	480,847	447,231
Long-term operating lease liabilities	897,737	—

Disclosure Examples – ASC 842

	Common Stock	Additional Paid-In Capital	Retained Earnings (Accumulated Deficit)	Common Stock Held in Treasury	Accumulated Other Comprehensive Loss	Total
Balance at December 30, 2018	47,042	2,884,696	146,277	(2,367,893)	(61,673)	648,449
Net income	—	—	136,940	—	—	136,940
Other comprehensive income, net	—	—	—	—	7,845	7,845
Cash dividends	—	—	(96,364)	—	—	(96,364)
Repurchases of common stock, including accelerated share repurchase	—	(15,000)	—	(202,771)	—	(217,771)
Share-based compensation	—	18,676	—	—	—	18,676
Common stock issued upon exercises of stock options	—	(808)	—	28,944	—	28,136
Common stock issued upon vesting of restricted shares	—	(13,677)	—	5,050	—	(8,627)
Cumulative effect of change in accounting principle	—	—	(1,105)	—	—	(1,105)
Other	—	114	(23)	89	—	180
Balance at December 29, 2019	$ 47,042	$ 2,874,001	$ 185,725	$ (2,536,581)	$ (53,828)	$ 516,359

	December 29, 2019	December 30, 2018	December 31, 2017
Cash flows from operating activities:			
Net income	$ 136,940	$ 460,115	$ 194,029
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	131,693	128,879	125,687
Share-based compensation	18,676	17,918	20,928
Impairment of long-lived assets	6,999	4,697	4,097
Deferred income tax	837	(6,568)	(119,330)
Non-cash rental expense (income), net	28,202	(17,043)	(11,822)
Change in operating lease liabilities	(41,911)	—	—

Disclosure Examples – ASC 842

The components of lease cost for 2019 are as follows:

	Year Ended 2019
Finance lease cost:	
Amortization of finance lease assets	$ 11,241
Interest on finance lease liabilities	37,012
	48,253
Operating lease cost	90,537
Variable lease cost (a)	58,978
Short-term lease cost	4,717
Total operating lease cost (b)	154,232
Total lease cost	$ 202,485

The following table includes supplemental cash flow and non-cash information related to leases:

	Year Ended 2019
Cash paid for amounts included in the measurement of lease liabilities:	
Operating cash flows from finance leases	$ 39,887
Operating cash flows from operating leases	91,824
Financing cash flows from finance leases	6,835
Right-of-use assets obtained in exchange for lease obligations:	
Finance lease liabilities	50,061
Operating lease liabilities	15,411

Disclosure Examples – ASC 842

	Year End December 29, 2019
Weighted-average remaining lease term (years):	
Finance leases	17.1
Operating leases	15.4
Weighted average discount rate:	
Finance leases	9.87%
Operating leases	5.09%
Supplemental balance sheet information:	
Finance lease assets, gross	$ 242,889
Accumulated amortization	(42,745)
Finance lease assets	200,144
Operating lease assets	857,199

The following table illustrates the Company's future minimum rental payments for non-cancelable leases as of December 29, 2019:

	Finance Leases		Operating Leases	
Fiscal Year	Company-Operated	Franchise and Other	Company-Operated	Franchise and Other
2020	$ 3,088	$ 47,041	$ 19,971	$ 70,301
2021	3,220	46,932	19,783	70,272
2022	3,270	48,079	19,473	70,176
2023	3,223	49,709	19,439	70,026
2024	3,316	50,069	19,385	69,901
Thereafter	40,096	664,005	183,460	755,026
Total minimum payments	$ 56,213	$ 905,835	$ 281,511	$ 1,105,702
Less interest	(24,543)	(445,653)	(86,422)	(359,279)
Present value of minimum lease payments (a) (b)	$ 31,670	$ 460,182	$ 195,089	$ 746,423

Solicit the Involvement of the Entire Company

- Make sure that legal, purchasing, IT and other departments are engaged with accounting during the transition process.

- Accounting should ask each department what leases they are aware of that accounting doesn't know about and also for service contracts that potentially contain "embedded leases" (more information later)

- This is inevitably the only way to determine that you have a complete population of leases.

- Accounting should treat this as a project management effort:
    - What data do we need?
    - Any new policies or procedures that need to be implemented? (both operationally as well as new key controls in financial reporting and other processes).

Technology Solutions

- If you are a company with a large lease portfolio (restaurants, retail, certain manufacturing/distributing, etc.) it will make sense to solicit appropriate technology to make implementation easier.

- There are many competitive software forms out in the marketplace that can make implementation MUCH easier by tracking journal entries, financial statement disclosures, etc.
    - Lease Crunch
    - Lease Query
    - Lease Accelerator
    - Capterra

- There are pro's and con's to each software package that you will want to consider when making this determination (i.e. cost, functionality, sophistication of the software based the makeup of your lease portfolio, etc.).

Embedded Leases

- An embedded lease is a lease agreement that exists within a contract.

- Organizations that typically have service contracts often have embedded leases. In today's environment, this means that most companies or organizations are impacted.

- The general rule under the new model is that an arrangement contains a lease if (1) there is an explicit or implicit identified asset in the contract, and (2) the customer controls use of the identified asset.

- Payments made under service contracts are required to be allocated between the lease and non-lease components of the contract.
    - This determination will be placed under scrutiny as this will determine ROU assets and lease liabilities on the balance sheet. P&L impact remains unchanged. It could also change P&L recognition patterns depending on the terms of the contract.

Embedded Leases

- Expense recognition for the service portion of the contract will remain unchanged (typically pro-rata over the contract term). However, the lease portion of the contract will then need to be accounted for under new operating lease guidance in ASC 842.

- Common examples of embedded leases are as follows:
    - IT contracts (usage of servers)
    - Transportation contracts (usage of equipment such as rail cars, forklifts, etc.)
    - Contract manufacturing arrangements (usage of dedicated tooling)
    - Advertising arrangements (usage of advertising medium such as billboards, etc.)

Lessor Impact

- We’ve concentrated our time on the impact to lessees, however, lessors are also impacted under ASC 842
    - Enhanced disclosures

Qualitative	Quantitative
— Significant accounting judgments and estimates — Information about the nature of leases, such as the nature of variable payment arrangements, and termination, renewal, and purchase options — Information about how the lessor manages residual asset risk, including information about residual value guarantees and other means of limiting that risk	— Maturity analysis of lease receivables for sales-type and direct financing leases and of lease payments for operating leases — Selling profit (or loss) recognized at lease commencement and interest income for sales-type and direct financing leases — Operating lease income — Variable lease income

Lessor Impact

- Impacts (continued):
  - Separation of lease and non-lease components required based on guidance in ASC 606. However, practical expedients are available to NOT separate if the timing and pattern of transfer between the lease and non-lease components are the same and the lease is an operating lease.
  - Executory costs concept no longer applies and are considered non-lease components (i.e. maintenance, taxes, insurance, etc.).
  - Narrower definition of initial direct costs could accelerate expenditures.

Typical initial direct costs	
Include	**Exclude**
— Commissions — Payments made to an existing tenant to incentivize that tenant to terminate the lease	— Legal fees — Costs of evaluating the prospective lessee's financial condition — Costs of negotiating lease terms and conditions — General overheads

Implementation Practical Expedients

- Practical expedients package (must be adopted on an "all or nothing" approach)
    - No reassessment of lease classification.
    - No reevaluation of existing/expired contracts for embedded leases
    - No reassessment of previously recorded initial direct costs.
- Hindsight expedient (lease terms, options, etc.).
- Combination of lease and non-lease components
    - Would just require the PV of fixed consideration to be calculated (i.e. fixed lease payments excluding executory costs such as CAM, insurance, etc.). Can be elected based on asset class.
- Private company discount rates
    - The risk-free interest rate can be utilized if there is no discount rate implicit in a lease contract.
    - Will result in larger lease liabilities on the balance sheet.
- Land Easement expedient – historical treatment applies.

COVID Impact and Reminders

It wouldn't be an accounting webinar in 2020 without discussing the impacts related to COVID! Some potential considerations of COVID impact for lease portfolios are as follows:

- Lease concessions
  - There are two options for accounting for lease concessions: 1) Negative variable lease payment or 2) Accounted for as if no changes to the agreement occurred and payables would be recorded for the deferred charge
- Impairment
  - ROU assets fall within the impairment guidance in ASC 360 (think of operating leases for a retailer/restaurant entity that is closing down stores/locations)
- Reassessment
  - ASC 842 requires reassessment when a "triggering event" occurs. The COVID-19 pandemic could trigger entities to make decisions relating to the likelihood or executing a renewal, termination, etc.

Questions?

EBP and ERISA Accounting Update

November 12, 2020

Speaker

Mike Purcell, CPA
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Learning Objectives

- COVID-19 Impact and Plan Considerations
- Legislative Updates
- Accounting Updates

COVID-19 Impact

- Changes in business processes and internal controls (frequently due to remote working), including those at third-party service providers
- Estimates and judgments
- Market volatility and economic uncertainties
- Financial health and viability of plan sponsors
- Changing regulatory landscape, including temporary changes

COVID-19 Potential Considerations

- Matching contribution curtailment:
  - Best practice to provide employees notice for discretionary
  - Required notice for nondiscretionary
- Safe harbor match
- Vacation payouts: usually subject to 401(k) deferral contributions
- Severance payouts: usually not subject to 401(k) deferrals, however check plan document

Partial Plan Terminations (PPT)

- Generally, if 20% reduction of plan participants due to layoff or other employer action
  - Does not include furloughed employees
  - Calculation only includes involuntary terminations
  - Generally viewed for the plan year, but measurement period may be longer based on facts and circumstances

- If a PPT occurs, the plan fully vests the affected participants' benefits
  - May require restoring any forfeited amounts retroactively

- If not properly administered, entire plan may be disqualified if affected participants do not receive vested benefits

Bipartisan Budget Act of 2018

- Effective January 1, 2019
- Removes the six month deferral suspension requirements following hardship distributions
    - Can continue to be applied on distributions made through December 31, 2019, however removal of deferral suspension becomes mandatory January 1, 2020
- No longer necessary to require a participant loan be taken before a hardship withdrawal
- Permits hardship withdrawals to be taken from earnings on deferrals as well as QNEC, QMAC and safe harbor sources
- Amendment will be required to update plan documents for these provisions

Setting Every Community Up for Retirement Enhancement (SECURE) Act

- Affects plans and benefits offered and individual retirement options
- Most provisions effective for plan years beginning after December 31, 2019
- Plan amendments (retroactive to first day that new rules apply) – generally required by the last day of the first plan year beginning on or after January 1, 2022

Required or Optional	Provision	Timing
Required	Prohibits using credit/debit cards for plan loans	December 20, 2019
Required	Must allow long-term, part-time employees to make salary deferrals	Plan years beginning after December 31, 2020
Required	Defined contribution plans must provide annual lifetime income disclosures	12 months after DOL finalizes regulations
Required	Eliminates "stretch" beneficiary designations	Effective for deaths after December 31, 2019
Required	IRS penalties increased 10x for failure to file Form 5500	Plan years beginning after December 31, 2019
Required	Other IRS penalties also increased 10x	Plan years beginning after December 31, 2019

Setting Every Community Up for Retirement Enhancement (SECURE) Act (continued)

Required or Optional	Provision	Timing
Optional	Raises age 70 ½ to age 72 for RMDs	For individuals who turn 70 ½ after December 31, 2019
Optional	Auto enroll safe harbor plans (QACA) may increase auto escalation cap to 15% from 10% cap	December 20, 2019
Optional	Birth or adoption in-service withdrawals of up to $5,000	Distributions after December 31, 2019
Optional	QNEC safe harbor plan design can be elected as late as 30 days before plan year-end, but 4% QNEC is required	Plan years after December 31, 2019
Optional	Employers can adopt a tax qualified retirement plan up to the extended due date of tax return	After December 31, 2019

CARES Act

- Increased participant loans up to 100% of vested balance or $100,000, whichever is less
- Can defer participant loan repayments for one year
- Coronavirus-Related Distribution (CRD) of up to $100,000
- Relief from Required Minimum Distributions (RMDs)
- Delayed contribution funding for defined benefit plans
    - 2020 required payments now due January 1, 2021

FLSA Overtime Final Rules

- Effective January 1, 2020
- According to the DOL, will make 1.3 million American workers eligible for overtime pay
  - Covered employers must pay minimum wage and overtime that is at least 150% of regular wage for work hours exceeding 40 in a week
  - Rule updates the earnings thresholds necessary to exempt executive, administrative, or professional employees from the minimum wage and overtime pay requirements
- Defined contribution plans that include overtime pay in their definition of compensation may see increased matching and other employer contributions
- For defined benefit plans, the increased overtime may increase pension costs and the amount the plan sponsor needs to pay into the plan

Other Regulatory Updates

- IRS Chief Counsel Memorandum dated December 9, 2019, states that IRS will **not** follow a recent court decision that allowed an ESOP plan sponsor to maintain a tax-qualified plan even though, during an IRS audit, sponsor could not produce a signed and dated copy of the Plan document
    - Court found extraordinary circumstances excused the lack of having a signed plan document, including flooding of the employer's premises during a natural disaster

- IRS Rev. Rul. 2019-19: Tax Treatment of Uncashed Retirement Plan Distribution Checks
    - Even if participant does not cash the check or the check becomes sale, participant has taxable income in the year the plan distribution check is sent to the participant
    - Plan has reporting and withholding obligations in the year the check is sent to the participant
    - Guidance applies to active, terminated and missing participants

SAS No. 136: Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA

- Effective for periods ending on or after December 15, 2021; early adoption is permitted
- Prescribes certain new performance requirements for an audit of financial statements of employee benefit plans
- Changes the form and content of the related auditor's report
    - Limited-scope audits: now called ERISA section 103(a)(3)(c) audit; election is no longer a scope limitation
- Applies to ERISA plans only

103(a)(3)(C) Report

- Format of Independent Auditor's Report for ERISA Section 103(a)(3)(C)
  - Scope and nature of ERISA section 103(a)(3)(C) audit
  - Opinion section
  - Basis for opinion section
  - Enhanced auditor reporting relating to going concern (if applicable)
  - Key audit matters (if applicable)
  - Expanded description of management's responsibilities for the financial statements
  - Expanded description of the auditor's responsibilities for the audit of the financial statements
  - Required other-matter paragraph (e.g., Supplemental Schedules Required by ERISA)

Key Provisions of SAS 136

- Management acknowledges and understands its responsibility for:
  - Maintaining a current plan instrument, including all plan amendments
  - Administering the plan and determining that transactions presented and disclosed in the financial statements are in conformity with the plan's provisions, including maintaining sufficient records with respect to each of the participants to determine the benefits due or that may become due to such participants
  - Additional matters related to an ERISA Section 103(a)(3)(C) audit
  - Agreement to provide to the auditor, prior to dating of the auditor's report, a draft of the Form 5500 that is substantially complete

ASU 2018-13, *Changes to the Disclosure Requirements for Fair Value Measurement*

- Modifies disclosure requirements in ASC Topic 820, *Fair Value Measurement*
- Eliminates, amends and adds disclosure requirements
- Applies to all entities that are required to disclose under existing GAAP to disclose recurring or non-recurring fair value measurements
- Effective for reporting periods beginning after December 15, 2019

ASU 2018-13, *Changes to the Disclosure Requirements for Fair Value Measurement* (continued)

- Eliminated Disclosures
  - Amount of and reasons for transfers between Level 1 and 2
  - Policy for timing of transfers between various levels
  - Valuation processes for Level 3 measurements
  - For nonpublic entities, changes in the unrealized gains and losses for the period, including in earnings for recurring Level 3 fair value measurements
- Amended Disclosures
  - For nonpublic entities, disclose purchases/sales and transfers into and out of Level 3 instead of rollforward
  - For investments measured at NAV, only disclose timing of liquidation and lapse of restrictions, if known
  - Include information about the uncertainty in measurement as of the reporting date
- New Disclosures (11-Ks only)
  - Disclose additional supporting information used to derive significant unobservable inputs for Level 3

Questions

Break

We will resume at 3:30 PM

Cybersecurity and IT General Controls

November 12, 2020

Speaker

Doug Davidson, CISA
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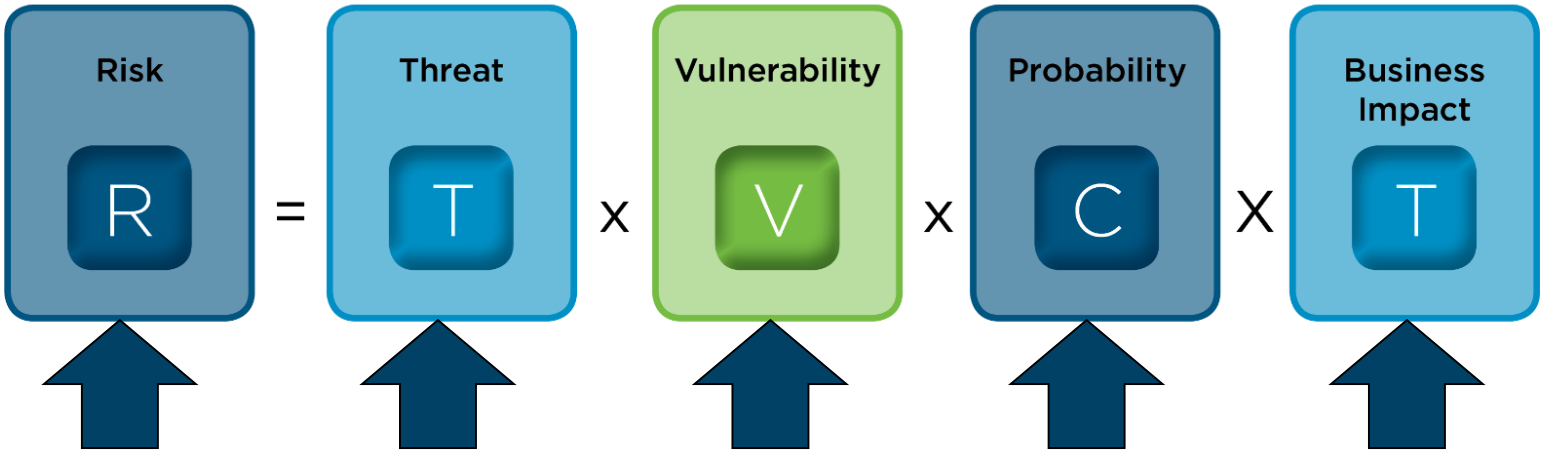
Cybersecurity and IT General Controls

- 2020 Cyber Risk Landscape
- What are ITGCs?
- Types of ITGCs
- What is a cybersecurity control framework?
- Selecting a cybersecurity control framework
- What should management “know” about your firm’s cyber risks

Cyber Risk Rising During 2020



Risk elevated throughout 2020 (& beyond) given pandemic, social unrest, election dynamics, foreign influence, etc.

Bad actors using COVID-19, social unrest and election themed attacks to conduct Business Email Compromise, ransomware, Denial of Service.

Attack surface rapidly expanded with work from home / remote connections in support of social distancing

IT staffs are spread thin

IT staffs are supporting users with weaker skills and inadequate tools

FBI, FTC, Homeland Defense all have published advisories on COVID-19 themed attacks

Incident numbers of all attack types on the rise.

Electronic storefronts, phone, email systems most businesses only way to serve customers

Weak cash flow positions for many firms will magnify a cyber event's impact

Distributed infrastructure may lengthen detecting, response, recovery times.

2020 Cyber Risk Trends

- **Workers Remain the Weakest Link in the Corporate Security Chain**
  - New Infrastructure Leaves them Further Exposed
  - Attack Patterns Showing Hacker Awareness of Weaknesses

- **Cybercriminals are taking advantage:**
  - Cyberattacks tripled in the 2nd quarter of 2020 over the 1st quarter.
  - Cybercrime losses increased by 50% over the last 12 months.
  - Complaints about cyberattacks to FBI's Cyber Division up to as many as 4,000 a day.
  - According to a Microsoft report:
    1. Phishing and social engineering attacks have increased to close to 30,000 a day in the United States.
    2. Ransomware attacks jumped 800% since the beginning of 2020

Someone's Bad Day

- 500 employee medical clinic (not a GBQ client or a local firm)
- Management Letter Comments showed weaknesses in the IT General Controls including business continuity & disaster recovery
- Ryuk ransomware attack (Russian-based)
- ALL systems encrypted and unrecoverable
- HIPAA breach event

Importance of IT General Controls

Sustaining reliable financial information is dependent upon effective internal control and IT General Controls are a key part of entities' internal control framework.

What are ITGCs?

- Information Technology General Controls (ITGC) are controls that apply to all systems, components, processes, and data for a given organization or information technology (IT) environment. The objectives of ITGCs are to ensure the proper development and implementation of applications, as well as the integrity of programs, data files, and computer operations.

- As part of every audit, we're required to gain an understanding of key information systems and how they impact the financial statements.

- Why are ITGC's important?
  - Support all of a Company's key business processes
  - Support financial statement assertions of completeness and accuracy of data
  - Support internal control structure by enforcing effective segregation of duties

Types of ITGCs

- **Logical Access Controls** - Logical access controls tools are used for credentials, validation, authorization, and accountability in an infrastructure and the systems within. These components enforce access control measures for systems, applications, processes, and information.
  - Usernames
  - Passwords
  - User administration and review
- **Program Change Controls -** Systematic approach to managing all changes made to a product or system. The purpose is to ensure that no unnecessary changes are made, that all changes are documented, that services are not unnecessarily disrupted and that resources are used efficiently.
  - These controls are only relevant when a Company maintains the information system. For packaged software, program changes are performed by the Vendor (think Microsoft Office updates!)
  - More common in complex, integrated ERP Systems such as Oracle or SAP
- **Data Processing Controls –** Some information systems allow users to schedule jobs, which automate certain data-gathering tasks and compile the results for review by interested users.
  - As with Program Change Controls, these are more common in complex, integrated ERP Systems

Note: Even the most unsophisticated ERP Systems (such as QuickBooks) have logical access controls!

Cybersecurity Control Frameworks

An organized reference of controls defining principles and/or prescriptive technologies to be used in building a security program that **protects, detects and responds** to security events in a manner that provides for the **confidentiality, integrity and availability of company information assets.**

Cybersecurity Control Frameworks Practice

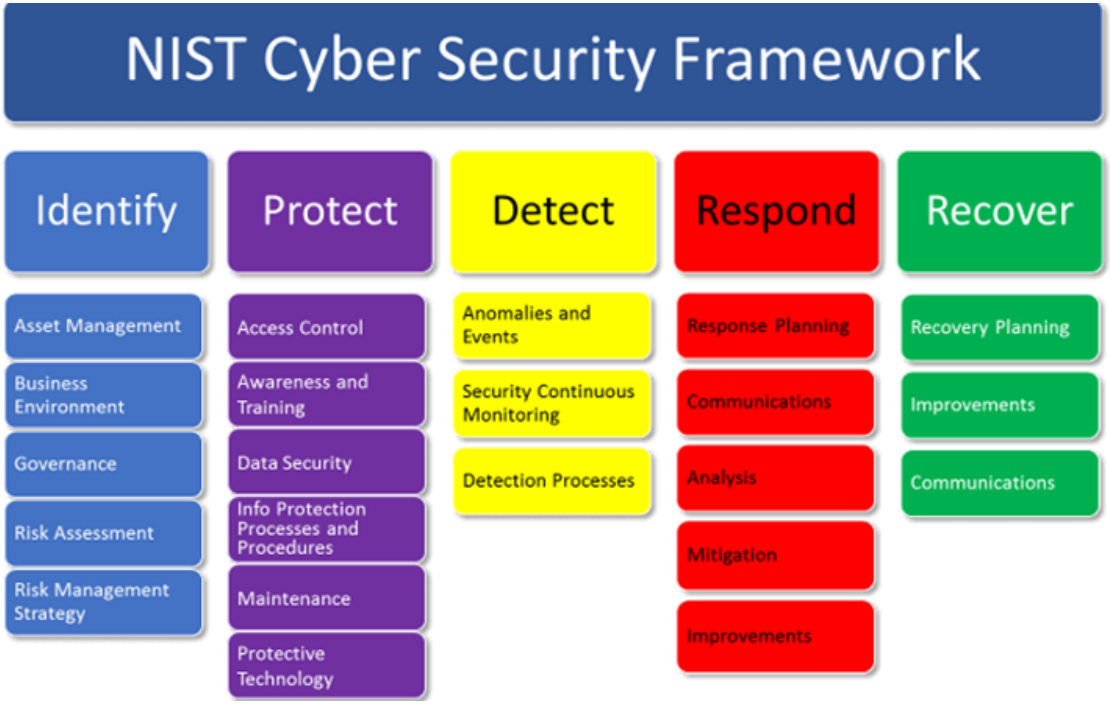
- Management selects a framework:
  - Considers Business Context, regulatory obligations, customer / client risk tolerance
- Management selects a framework:
  - Guides control selection
  - Provides a security program measuring stick
  - Provides "defense-in-depth”
  - Considers protection – detection – response
- Conduct an annual risk assessment using selected framework against entire digital asset inventory
- Build security program based on risk priorities

Cybersecurity Control Frameworks

- Do we select a broad business focused framework or a technically prescriptive control set? Or both?
- What does our market (customers / clients) expect?
- What do our regulators expect?
- What is our firm's tolerance for risk?

NIST Cyber Security Framework (NIST CSF)

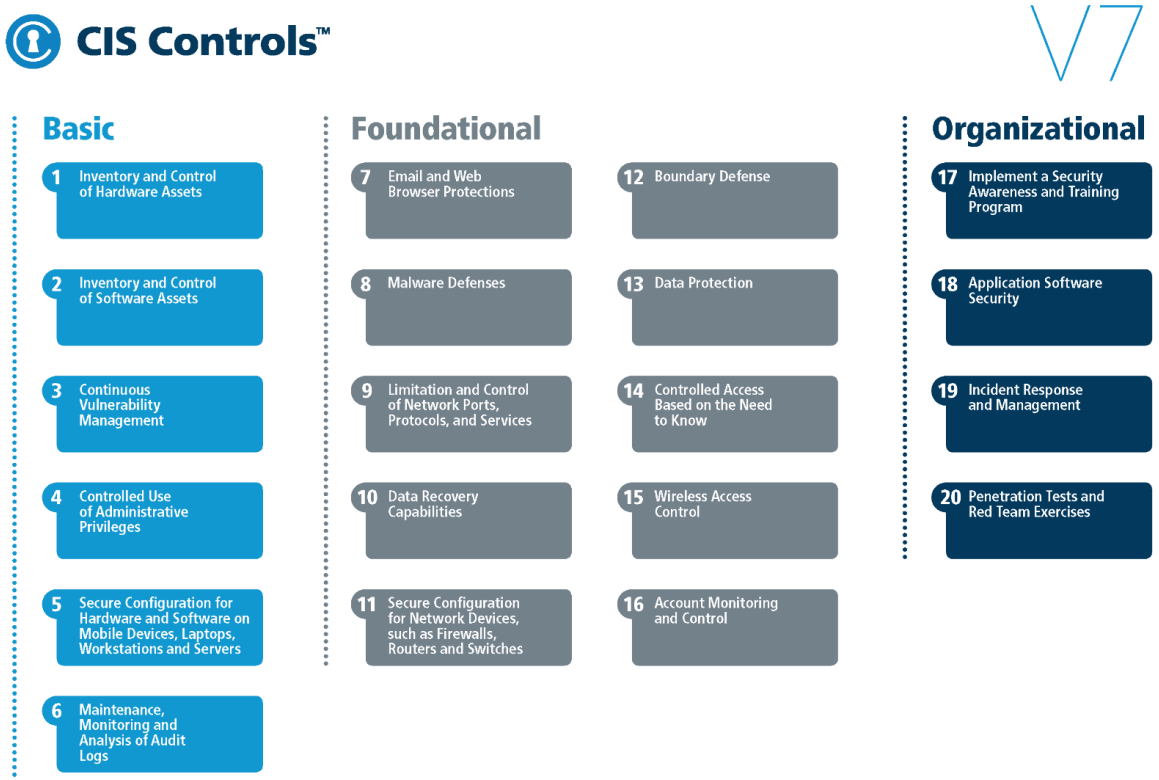
- ✓ Voluntary control framework not required by any regulation
- ✓ Broadly focused across the entire business
- ✓ Not technically descriptive across all controls
- ✓ Meets requirement of the Ohio Data Protection Act



National Institute of Science and Technology (NIST) Cyber Security Framework (CSF)
https://www.nist.gov/cyberframework

Center for Internet Security Critical Security Controls (CIS 20)

- ✓ Voluntary control framework not required by any regulation
- ✓ Deeply focused on technical prescription for systems under control of company
- ✓ Not concerned with business issues
- ✓ Meets requirement of the Ohio Data Protection Act



Center for Internet Security Critical Security Controls (CIS 20)
https://www.cisecurity.org/

Get to Yes on Key Questions

Question	Get to yes!
What are your company's cybersecurity risks?	Security Risk Assessment
What is your inventory of systems, software, applications, data?	Conduct an inventory – maintain it
Has management selected a recognized framework?	Select a Framework (NIST CSF, CIS 20 or oher)
Have you conducted security testing? Risk assessment? Program assessment? Penetration Test?	Test routinely: • Risk Assessment (annually or when things change) • Program Assessment (annually) • Penetration Test (annually)
What is our risk from 3rd party providers?	Assess risk of 3rd parties with access to critical data or networks
Ongoing, company-wide awareness and training program established around cybersecurity?	Create an awareness program
Do new technology plans include plans for risk management?	Consider cyber risk as part of purchasing process
Is an executive level management member involved in regular updates from those in the firm responsible for security operations	Get involved! If there is a serious incident or breach you will be involved – be prepared!

Questions

Impairment and Valuation Considerations

November 12, 2020

Speaker

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GBQ's Valuation Practice

Transaction Support & Opinions:

- Fairness Opinions
- Solvency Opinions
- Shareholder Transactions
- Mergers & Acquisitions

ESOP Consulting & Valuation:

- Feasibility Studies & Pre-ESOP Planning
- Implementation Consulting
- ESOP Valuations
- ESOP Transactions
- ESOP Valuation Reviews

Succession & Wealth Planning:

- Date-of-Death Estate Valuations
- Gifting Valuations
- Charitable Donations

Financial Reporting:

- Purchase Price Allocations
- Goodwill Impairment Testing
- Stock Option Valuations
- Fair Value Measurements

Corporate Planning & Assistance:

- Buy-Sell Agreements
- Issuing Stock/Synthetic Equity
- Corporate Redemptions
- Evaluating Targets
- C-to-S Conversions

Expert Opinion Valuations:

- Shareholder Disputes
- Marital Disputes
- Business Damages

Agenda

- Agenda
  - Current Market Overview
    - Public Equity Markets
    - Economic Indicators
  - Trends in M&A
    - Transaction Volume
    - Impact on Valuation
    - ESOPs
  - Valuation Process
    - Overview
    - Income Approach
    - Market Approach
  - Financial Reporting Considerations
    - Impairment Overview
    - Other Financial Reporting Considerations

Current Market Overview

- Valuation is a financial exercise, so we first take a deep dive into factors impacting a company's cash flow

- The COVID-19 pandemic has impacted virtually every business (some good, some bad)

- Examples of negative impacts of COVID-19 include:
  - Closing of retail locations
  - Disruption of supply chains
  - Reductions in demand, volume and revenue
  - Less productive remote workforces
  - Layoffs, furloughs & pay reductions
  - Tripping debt covenants

- Examples of positive impacts of COVID-19 include:
  - Acceleration of trend away from brick and mortar to e-commerce
  - More mobile workforce, increased talent pool

- For many, revenue & profit declined and the outlook is uncertain

Current Market Overview

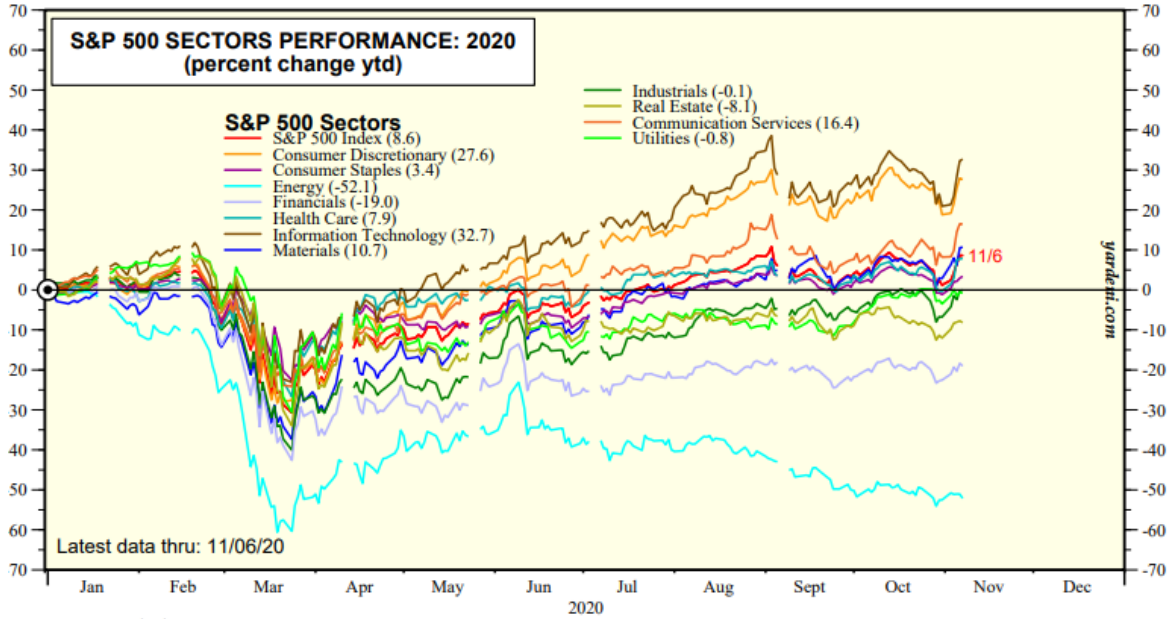
Public Equity Markets

- The plunge in public equities happened at record speed
- Peak to trough saw the S&P 500 decline 34% in about five weeks
- Federal Reserve and governments take unprecedented action
- S&P 500 overall has recovered all of its losses in 2020, largely due to heavy tech weighting in the index

Current Market Overview

Public Equity Markets (cont.)

- While the overall market is up for the year, performance by sector varies dramatically
- Sectors that have benefited from COVID include Information Technology, Consumer Discretionary, and Communications
- Sectors that have been severely impacted include Energy, Financials, and Real Estate (commercial)



Source: Standard & Poor's.

Current Market Overview

Economic Indicators

- In the most recent meeting on September 16, 2020, the Federal Open Market Committee (the "FOMC") decided to maintain the target range for the federal funds rate at 0.0% to 0.25%, the lowest level since the global financial crisis in 2008 and 2009.

- The Fed will continue to purchase Treasury securities and agency mortgage-backed securities in the amounts needed to support smooth market functioning and effective transmission of monetary policy to broader financial conditions.

- The FOMC will include purchases of agency commercial mortgage-backed securities in its agency mortgage-backed security purchases, and will continue to offer large-scale overnight and term repurchase agreement operations.

Current Market Overview

Economic Indicators (cont.)

- In the worst month, total nonfarm payroll employment fell by 20.5 million in April and the unemployment rate rose to 14.7%.

- Nonfarm payrolls increased by 638,000 in October (vs. a forecast of 530,000) much stronger than the 650,000 increase expected and the unemployment rate slid to 6.9% (vs. a forecast of 7.7%)

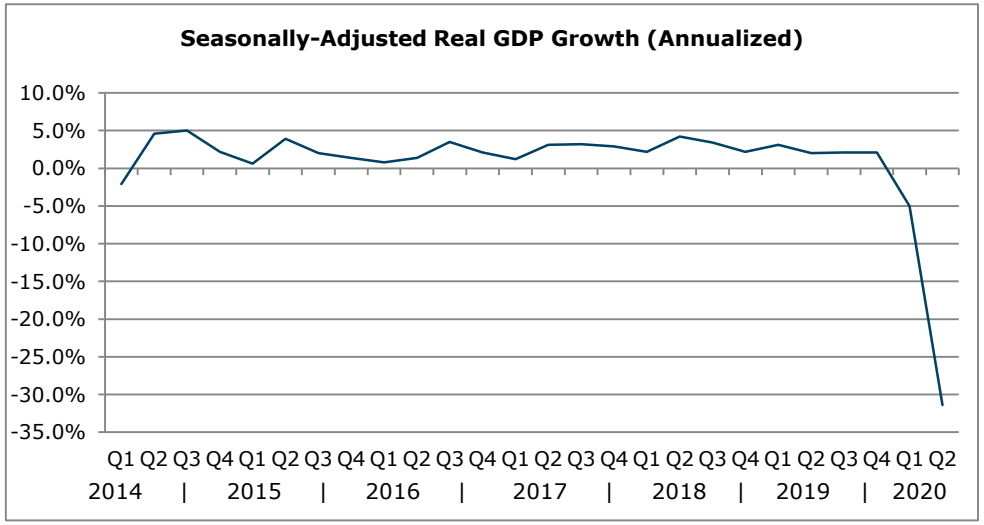
- These improvements in the labor market reflected a limited resumption of economic activity that had been curtailed in March and April due to the COVID-19 pandemic and efforts to contain it.

Current Market Overview

Economic Indicators (cont.)

- According to the "third" estimate released by the Bureau of Economic Analysis ("BEA"), real GDP declined at an annual rate of 31.4% in the second quarter of 2020

- The decline in second quarter GDP reflected the response to the spread of COVID-19, as governments issued "stay-at-home" orders in March. This led to rapid changes in demand, as businesses and schools switched to remote work or canceled operations, and consumers canceled, restricted, or redirected their spending.



Current Market Overview

Economic Indicators (cont.)

- The CBO expects that the economy will contract sharply during 2020 as a result of the continued disruption of commerce stemming from the spread of COVID-19.

- The agency's current economic forecast, which underlies its baseline budget projections, includes projections of real (inflation-adjusted) gross domestic product (GDP; also referred to as output or actual output), inflation, interest rates, and other key variables for the years from 2020 to 2030.

CBO Economic Projections

	Actual	Forecast			Annual Average	
Economic Metric	**2019**	**2020**	**2021**	**2022**	**2023-2024**	**2025-2030**
Real GDP[1]	2.3%	-5.8%	4.0%	2.9%	2.2%	2.1%
Nominal GDP[1]	4.1%	-5.1%	4.8%	4.6%	4.2%	4.2%
Consumer Price Index[1]	1.8%	0.9%	1.2%	1.9%	2.2%	2.2%
Unemployment Rate[2]	3.7%	10.6%	8.4%	7.1%	6.3%	4.8%

[1] *Represents year-to-year percentage change.*

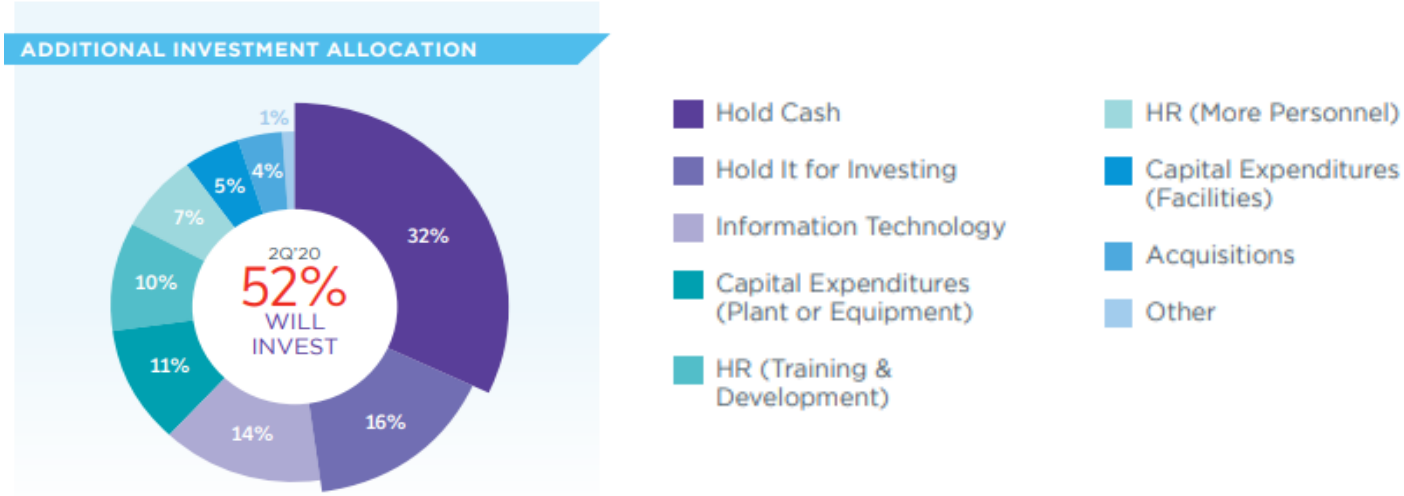
[2] *Represents calendar-year average percentage.*

Current Market Overview

Economic Indicators (cont.)

- The National Center for the Middle Market ("NCMM") is the leading source of knowledge, leadership, and innovative research on the middle market economy. The middle market, which the NCMM defines as companies with between $10 million and $1 billion in revenue, includes approximately 200,000 businesses, and accounts for one-third of private sector GDP and employment.

- The NCMM's middle market executives' plans for expansion is exhibiting softness.



Current Market Overview

Economic Indicators - Summary

- American households remain the linchpin of economic growth, and have been significantly impacted by COVID-19.
- Concerns related to COVID-19 have resulted in significant market volatility in recent months, and have heightened uncertainty surrounding near-term global growth.
- Sectors have been impacted very differently. Technology continues to see strong gains while companies in Energy or Leisure & Hospitality will likely take several years to recover.
- The Federal Reserve maintained the federal funds rate in September 2020 to 0.0% to 0.25%, indicating significant structural instability in the US and global economies. While the timeline of the pandemic is unknown, the impact on GDP growth, unemployment, interest rates, and fiscal and monetary policy are likely to be significant.

Trends in M&A

COVID-19 has been a meaningful disruption to the M&A market and fundamentally changed the outlook of many buyers and sellers.

Short Term Impact

- Sharp M&A Decline
- EBITDA Deterioration
- Uncertainty of future performance
- Supply Chain Issues
- Employee and Labor Challenges
- Lengthened due diligence process

Longer Term Impact

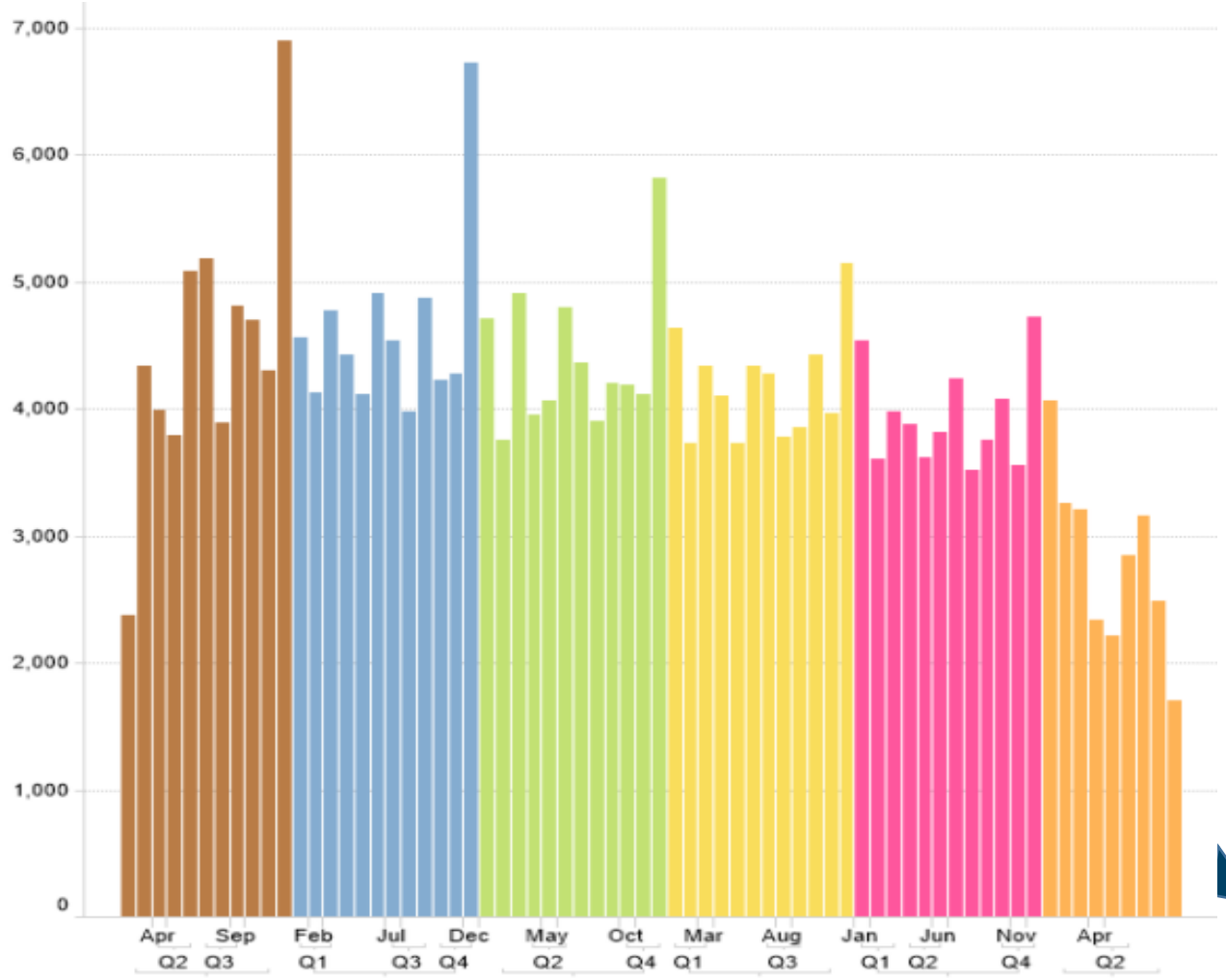
- Increased virtual meetings
- QofE more necessary to normalize earnings
- Increase in PE dry powder
- Strong companies in control

Topics for Discussion

- Deals in Process
- Three Performance Categories
- Outlook for Deals
- Effect on Valuation
- Uptick in ESOP sales

Trends in M&A

M&A Transaction Volume by Month (Source: S&P Capital IQ)



Note: Q3 and Q4 volume may be lower since many Q2 and early Q3 transactions were already in the pipeline

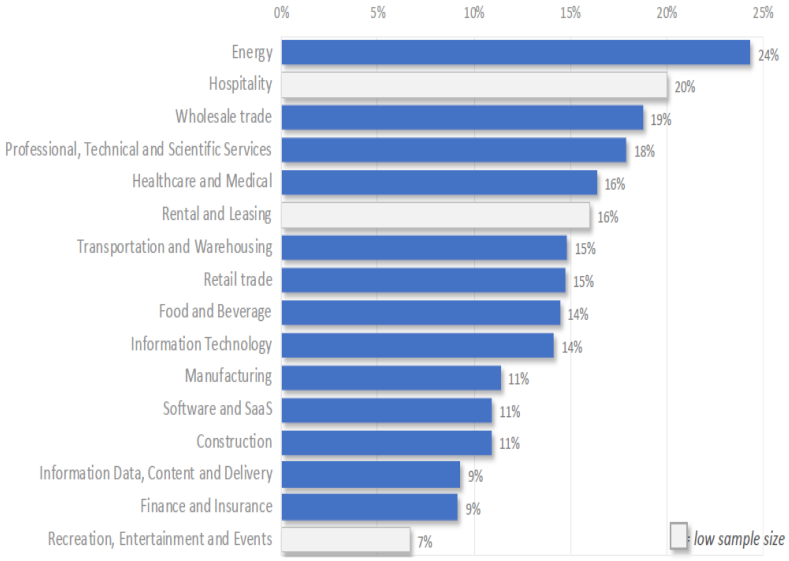
Trends in M&A

Impact on Valuation

According to a survey completed by the AM&AA, the average drop in valuation, for deals that are still actively in-progress, was 14% and ranged by industry from 7% to 24%.

- All time highs to "it depends"
- No blanket approaches, each situation is unique
- Future cash flows are key
- Well performing companies will continue to have strong valuations, with significant interest from buyers as a result of fewer deals in market
- Companies who have a different long-term outlook, as a result of COVID-19, will have a negative valuation impact
- Increased use of contingent payments based upon future performance

Drop in Valuation for Active Deals Still in Progress (Figure 2.4)



** Out of 196 respondents. Q22: Since February 2020, has the total consideration for closed deals or the valuation for active in-progress deals dropped? Q24: In which industry/industries are those DEALS ACTIVELY IN PROGRESS located? Select all that apply.*

Trends in M&A

Impact on Valuation (cont.)

No Negative Impact or a Beneficiary

- Companies that were largely unaffected or were benefited in as a result of the pandemic
- No decrease in sales or even increased in sales
- Were deemed "essential" and did not experience a shutdown

Short or Medium-Term Impact

- Companies that were affected by the pandemic, however, have either recovered or operations will likely normalize soon
- Sales decreased, but company was able to utilize liquidity to weather the storm
- Shutdown was short-term and was considered a one-time event

Long-Term or Permanent Impact

- Companies that still have not rebounded from the affects of the pandemic
- Sales decreased and it is unclear when/if sales will rebound
- Shutdown has had long-term impact, which may be consumer, supplier or industry related

Trends in M&A

ESOPs

- Viewed as an alternative to traditional M&A
- ESOP stands for Employee Stock Ownership Plan and is a qualified retirement plan under ERISA
- Selling shareholders sell stock to the ESOP in exchange for cash (typically provided from a bank) and/or notes to the seller
- ESOP shares are allocated to participants over time
- All employees who meet eligibility requirements will receive shares
- Participants cash out ESOP shares for fair market value when they retire

Trends in M&A

ESOPs

- ERISA prohibits ESOPs from paying more than (or receiving less than) adequate consideration (i.e., fair market value) for company stock
- ESOP transactions are negotiated between the sellers(s) and the ESOP trustee. As the buyer, the trustee (with help from an ESOP valuation firm), ultimately determines how much an ESOP can pay (by determining their opinion of fair market value)
- Selling shareholders will not see the ESOP trustee's valuation analysis, nor will they know the maximum price the ESOP can pay. As such, it is helpful for selling shareholders to have an experienced ESOP financial advisor "on their side"
- The DOL has repeatedly and aggressively challenged prices paid (and other financial terms) in ESOP transactions
- ESOP companies are valued every year. The annual ESOP valuations determine the value of participants' accounts and any payouts

Trends in M&A

ESOPs

- How an ESOP Transaction can Overcome Common Reasons M&A transactions Fall Apart

Reason	Explanation	How an ESOP Can Help
Valuation	• Buyer and seller cannot agree on a purchase price • Unreasonable expectations (by either party)	• A good ESOP feasibility study (prepared by a firm with experience representing ESOP trustees) will: (a) properly set expectations and (b) be credible with ESOP trustees and independent ESOP valuation firms
Culture	• Incompatible cultures • Concerned about changes for management and employees	• Culture does not change post-ESOP since same individuals run the company • No risk to management or employees

Buyer Backs Away	• Buyers back out of transactions for a variety of reasons, including:
	  • Findings in due diligence
	  • Change in corporate priorities
	  • Inability to finance
	  • Changes in market conditions
	  • Changes in target's performance
	  • Get "cold feet"
		• The "close rate" for ESOP transactions is extremely high
		• ESOP trustees rarely back out of potential ESOP deals (typically, when proposed terms are unreasonably aggressive)
		• A ESOP "deal quarterback" dramatically increases the likelihood of successful closing

Trends in M&A

Key Takeaways

- Certain types of transactions are becoming more prevalent, including recapitalizations to strengthen the balance sheet and stockholder-led take-private transactions.
- We are seeing deals at or past the LOI stage being put on hold while macroeconomic and company-specific developments are monitored.
- Deals moving forward generally involve ESOPs, strategic buyers involving significant synergies and/or are capable of being completed with little or no debt financing
- Adjustments to financial performance for COVID-19 will become part of the discussion in every deal.
- Why will deals happen in the next 12 months
    - Financial reasons.
    - COVID-19 has exposed weaknesses that can be solved with new capital and new management.
    - Companies have something unique to offer and are a great candidate for an acquisition by a PE firm or strategic buyer
    - Baby boomers have had enough.

Valuation Process

How Companies are Valued

Income Approach

- Based on a company's anticipated future cash flows and an investor's required rate of return

Market Approach

- Compare the company to publicly traded and/or transacted companies and apply valuation multiples

Asset Approach

- What are the company's assets and liabilities worth?

Valuation Conclusion

Valuation Process

Discounted Cash Flow Method

- **Premise:** The value of a business can be estimated based on the present value of the future economic benefits it generates

- **Steps in performing the income approach:**

1. Select & Determine Earnings Stream
   - Net cash flow is preferred measure
   - Can be debt-free or net-of-debt
2. Develop Appropriate Required Rate of Return
   - CAPM is most common approach
   - Can be cost of equity or WACC
3. Select & Apply Multi-Period or Single-Period Model
   - Multi-period models (e.g., discounted cash flow) are more flexible

Valuation Process

Developing a Forecast During COVID-19

Considerations to account for when developing a forecast in the current environment:

- Is the company in a sector and industry that is directly impacted by COVID-19?
- Is the company operating in geographies that are being impacted or is the company's geography limited?
- Quality of the customers?
- Is there any customer concentration or concerns over large non-payments?
- Are there any vendors or suppliers in distress?
- Will the company need to manage cash balances differently or modify its policies around working capital?
- Will capital expenditure policy need to be revisited or will there be a need to defer capital expenditures?

Valuation Process

Developing a Forecast During COVID-19 (cont.)

- An important factor to consider when forecasting future economic results is how long the disruption is expected to last.

- While assessing recovery expectations, one may consider the different shapes of economic recovery that are possible during and after COVID-19:
  - **V-shaped recession**, whereby the economy suffers a sharp but brief period of economic decline with a clearly defined trough, followed by a strong recovery;
  - **U-shaped recession**, which is longer than a V-shaped recession, and has a less-clearly defined trough;
  - **W-shaped recession**, which is also known as a double dip recovery, is when the economy falls into a recession, recovers with a short period of growth, then a slower period of growth (possibly a recession), before finally recovering; and
  - **L-shaped recession**, or depression, occurs when an economy has a severe recession and does not return to trend line growth for many years.

- Not all companies will exhibit the same recovery

Valuation Process

Discounted Cash Flow Method Example

	Year 1	Year 2	Year 3	Year 4	Year 5
Distributable Net Cash Flow	$ 5,000,000	$ 5,500,000	$ 5,940,000	$ 6,296,400	$ 6,611,220
Present Value Factor @ 18.0%	0.9206	0.7801	0.6611	0.5603	0.4748
Present Value of Distributable Cash Flow	$ 4,602,873	$ 4,290,814	$ 3,927,186	$ 3,527,811	$ 3,139,154

Present Value of Cash Flows (Years 1 to 5)	$ 19,487,838
Present Value of Residual Cash Flow	25,354,703
Enterprise Value	44,842,541
Rounded	**$ 44,800,000**

Year 5 Cash Flow	$ 6,611,220
Multiplied by: 1 + Growth Rate	1.05
Residual Cash Flow	6,941,781
Discount Rate	18.0%
Less: Residual Growth Rate	-5.0%
Capitalization Rate	13.0%
Residual Cash Flow Value	53,398,315
Present Value Factor	0.4748
PV of Residual Cash Flow	$ 25,354,703

Valuation Process

Market Approach

- **Premise:** The value of a business can be estimated based on comparisons to similar businesses

- **Guideline Public Company Method**
  - Stock market is the best and most accurate source of valuation data; it is the source of rate of return data in income approach
  - Compare fundamentals of subject company and peer group of publicly traded companies
  - Current valuation multiples are extremely volatile… use caution!

- **Guideline Transaction Method**
  - Identical to public company approach, except use transaction multiples from M&A deals as basis for valuation
  - Information about each transaction is typically limited since deals often involve private companies
  - Current company performance may not be the best indicator of long-term performance… look heavily at "sustainable" performance

Impairment Considerations

History

Pre-2001 (APB Opinion 17): Goodwill amortized over 40-year period.

2001-2008 (SFAS 142 & later ASC 350): Goodwill tested for impairment

- Testing at the reporting unit level
- Tested annually, or when a triggering event occurs
- Tested using a 2-step valuation process
- SFAS 141 also implemented, which outlined how intangible assets (including goodwill) should be originated in business combinations

2011-2013: In an effort to reduce costs, a new qualitative approach (i.e., "Step Zero") may be used to test for impairment prior to a quantitative approach (i.e., Step One), with a "more likely than not" standard for moving to Step One.

2014-2016: In another effort to reduce costs, the FASB's Private Company Council introduced an alternative to accounting for goodwill available only for private companies and not-for-profit companies, including:

- Goodwill may be amortized over a period of 10 years or less
- Impairment testing is only performed when there is a triggering event
- Impairment testing can be done at enterprise or reporting unit level

2017-Now: The "Step Two" calculation for goodwill impairment is eliminated

Impairment Considerations

Triggering Event

- U.S. GAAP requires an entity to consider whether an interim "triggering event" has occurred in between the dates of its annual impairment testing
- Determining whether a triggering event has occurred requires an assessment of the totality of events or circumstances such as the following:
  - Macroeconomic conditions such as a deterioration in general economic conditions, limitations on accessing capital, fluctuations in foreign exchange rates or other developments in equity and credit markets
  - Industry and market considerations such as a deterioration in the environment in which an entity operates, an increased competitive environment, a decline in market-dependent multiples or metrics (consider in both absolute terms and relative to peers), a change in the market for an entity's products or services or a regulatory or political development
  - Cost factors such as increases in raw materials, labor or other costs that have a negative effect on earnings and cash flows
  - Overall financial performance such as negative or declining cash flows or a decline in actual or planned revenue or earnings compared with actual and projected results of relevant prior periods
  - Other relevant entity-specific events such as changes in management, key personnel, strategy, or customers; contemplation of bankruptcy; or litigation
  - Events affecting a reporting unit such as a change in the composition or carrying amount of its net assets, a more-likely-than-not expectation of selling or disposing of all, or a portion, of a reporting unit, the testing for recoverability of a significant asset group within a reporting unit or recognition of a goodwill impairment loss in the financial statements of a subsidiary that is a component of a reporting unit
  - If applicable, a sustained decrease in share price (consider in both absolute terms and relative to peers)

Impairment Considerations

Sequencing

- In light of the current conditions brought on by the COVID-19 pandemic, most businesses are likely to conclude that a triggering event has occurred, which will likely result in the need for asset impairment testing.

- As businesses consider the financial reporting impacts of COVID-19 and whether assets are impaired, they will need to carefully consider the rules regarding the sequence in which impairment testing is to be performed.

    1) Indefinite-Lived Intangible Assets (ASC 350-30);

       Receivables and inventory under the applicable guidance;

       Equity method investments under ASC 323-10; and

       Investments in equity securities and available-for-sale securities under ASC 321-10 and ASC 326-10, respectively

    2) Long-lived assets, such as property, plant and equipment (PP&E), finite-lived intangible assets and asset groups under ASC 360-10

    3) Goodwill of a reporting unit containing any of the above assets under ASC 350-20

Impairment Considerations

Long-Lived Assets (ASC 360)

- Once indefinite-lived intangible assets have been tested for impairment and any necessary impairment loss has been recognized, an entity should consider whether long-lived assets, including finite-lived intangible assets should be tested for impairment.
- These assets (asset groups) are tested for impairment whenever events or changes in circumstances indicate that an impairment may have occurred (i.e., a triggering event).
- If a triggering event occurs, the carrying amount of the asset (asset group) is tested for recoverability.
- The recoverability test is performed by comparing undiscounted cash flows attributable to the asset (asset group) to the carrying amount of that asset (asset group).
- If the recoverability test indicates that the carrying amount of the asset (asset group) is recoverable, no impairment should be recognized.
- If the recoverability test indicates that the carrying amount of the asset (asset group) is not recoverable, the fair value of the asset (asset group) should be determined and an impairment loss should be recognized if the carrying amount of the asset (asset group) is greater than the fair value of the asset (asset group).

Impairment Considerations

Goodwill (ASC 350-30)

- The Step 1 test is an enterprise valuation, typically performed using valuation methodologies such as:
  - Discounted Cash Flow Method
  - Guideline Public Company Method
  - Guideline Transaction Method

- Impairment exists when carrying value (i.e., book value) exceeds fair value

- The concluded Fair Value should reflect an Exit Price
  - Would the likely exit be in the form of a stock deal or asset deal?
  - The tax benefit of intangible asset amortization should be considered
  - "Market participant" control premiums should be considered

Impairment Considerations

Goodwill (ASC 350-30) (cont.)

- As a result of the pandemic, many auditors are requiring additional scenario-based analysis
- For example, multiple forecasts based on various recovery scenarios which are then assigned probabilities.
- Many companies are already engaging in scenario planning as they develop their strategies to manage the impact of the crisis on their business. Modeling for impairment testing purposes should leverage these plans.
- For both private and public companies, quantifiable and measurable support for any discount rate adjustments is recommended. Corroborative analysis — instead of making arbitrary discount rate adjustments — can help avoid overconfidence in the resulting conclusion. For example, reconciling the value calculated from an adjusted discount rate with a value derived from explicit adjustments to the cash flow assumptions without a discount rate adjustment will improve the reliability of, and visibility into, key value drivers.

Other Financial Reporting Considerations

ASC 805 – Business Combinations

- While COVID-19 has dramatically decreased deal flow, the transactions that have occurred likely require additional scrutiny
- Within 1 year of a business combination, an acquirer shall recognize all identified assets acquired *(including previously unrecorded intangible assets)* and liabilities assumed at the acquisition date fair value
- The fair value of the purchase price shall include the fair value of any contingent consideration, equity interests, and debt assumed
- Identifiable intangible assets must meet the contractual-legal or separability criteria to be recognized separately from goodwill
- Assembled workforce is <u>not</u> an identifiable intangible asset and is subsumed in goodwill
- Allocations must be at the "reporting unit" level

Other Financial Reporting Considerations

ASC 805 – Business Combinations (cont.)

1. Determine Fair Value of Purchase Price

- Must include all forms of consideration
- Assess whether purchase price is fair value (vs bargain purchase)
- Can test by computing IRR of transaction (i.e., "solving" for IRR given financial forecast and purchase price, and then comparing IRR to WACC for consistency with "market participant" assumptions)
- May require independent valuation is some cases

2. Assess Fair Value of all Tangible and Intangible Assets

- Most involved part of PPA assignment
- Details to follow

3. Assess Fair Value of all Liabilities

- Typically equal to book value
- Certain liabilities (e.g.. Deferred revenue) will require valuations

4. Solve for Residual Goodwill & test for Reasonableness

- Does remaining goodwill make sense?
- Assess values of expected synergies and assembled workforce

Other Financial Reporting Considerations

Bargain Purchases

- A bargain purchase exists when the fair value of the acquired enterprise exceeds the purchase price.
- Bargain purchases should be very rare.
- Prior to ASC 805, the "negative goodwill" associated with bargain purchases was recorded as a pro-rata reduction of non-current assets acquired.
- Currently, under ASC 805, all acquired assets and liabilities are recorded at their fair values (regardless of the purchase price), and any excess is recorded as an immediate gain on the income statement.
- Most often, bargain purchases may occur in the following situations:
  - The selling company was distressed prior to the sale
  - There was no competitive bidding for the selling company prior to the sale
  - The selling owners were highly motivated to sell

Questions

THANK YOU!

- Contact any of our presenters if you have any questions on the topics discussed today.
- All registrants will receive a follow-up email that will include the presentation recording, materials and CPE evaluation survey link.
- Please allow up to two weeks for CPE certificates to be issued due to the amount of attendees.

GBQ