Dannible & McKee, LLP

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Navigating the Implementation of the Most Recent Accounting Standards Updates

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Leases

Accounting Standards Update (ASU) 2016-02 – Leases

- Issued on February 25, 2016.
- **Required to be implemented for nonprofit organizations for years beginning after December 15, 2021 (2022 calendar years**).
- The core principle of this ASU is that a lessee should recognize the assets and liabilities that arise from leases that were previously classified as operating leases. Prior guidance only required disclosure of minimum lease payments for operating leases.

Leases

What is a lease under ASC 842?

- A lease is a contract or part of a contract that conveys the right to control the use of identified property, plant or equipment for a period of time in exchange for consideration.

- **Includes** subleases, “embedded leases” and related party leases.
  - If related parties are consolidated for financial statements, leasing activity should be eliminated consistent with current standards.
  - Embedded leases are leases included in larger contracts or agreements (IT Contracts with server leases included).

Leases

What is a lease under ASC 842?

- **Excludes** leases of all intangible assets, biological assets (e.g., timber), inventory and leases to explore for use of mineral oil and natural gas.

- **Month to month leases** – often a related party lease. Need to consider if there is economic incentive/disincentive that make an extension reasonably certain, due to:
  - Costs of relocation / disruption to business
  - Significant investments in Leasehold Improvements
  - Regulatory approvals needed for location

- **Excludes leases with a maximum possible term of 12 months or less**, expense on a straight-line basis.
  - Must consider legally enforceable terms.
  - Must consider expected outcome if unilateral option to cancel or renew.

Leases

How will leases be accounted for under the new guidance?

- Lessees will recognize a **"right-of-use"** asset (non-current) and a liability (current and non-current portions) for their obligation to make lease payments for ***all*** leases.
- Asset and liability are initially measured using the **present value (PV)** of the lease payments using a discount rate.
- Use an **expected-outcome approach:**
  - Contingent rentals and residual value guarantees are part of the right-of-use asset and lease liability if expected to be incurred.
  - Lessee bases its inclusion of rentals for renewal periods in the lease liability on the longest possible term that is more likely than not to occur.
- Initial direct costs are added to the cost of the asset, such as commissions to a broker or costs to prior lessees. Legal and accounting costs are expensed.

Leases

Two elements form basis for PV of lease payments:

1) Lease Term

Noncancellable period for which a lessee has the right to use an underlying asset.

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Any periods covered by an option to:

EXTEND THE LEASE If the lessee is reasonably certain to exercise that option.

TERMINATE THE LEASE If the lessee is reasonably certain they will not exercise that option.

Leases

Two elements form basis for PV of lease payments:

2) Lease Payments - INCLUDED

Fixed Payments
Fixed payments, including in-substance fixed payments, less any lease incentives paid or payable to the lessee.

Transaction Fees
Fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction.

Amounts Owed
Amounts it's probable the lessee will owe under residual-value guarantees.

Purchase Option
The exercise price of an option to purchase the underlying asset, if the lessee is reasonably certain to exercise that option.

Penalty Payments
Penalty payments for terminating the lease, when the lease term reflects the lessee exercising an option to terminate the lease.

Some Variable Payments
Variable lease payments that depend on an index or a rate (i.e. CPI).

Leases

Two elements form basis for PV of lease payments:

2) Lease Payments - EXCLUDED

Certain other variable lease payments
- Real estate taxes
- Building insurance
- Lease payments determined based on a percentage of sales

Amounts allocated to non-lease components
- Common area charges
- Service agreements

Lessees

Lease Classification for Lessees

- Two approaches based on the "lease classification test."
  - ✓ Approach A – Financing Type (Current "Capital Lease")
  - ✓ Approach B – Operating Type

The only difference is how you charge the lease asset and payments to operations.

Lessees

Approach A – Financing Type (Capitalized)

- 5-part test – Financing lease if any of the 5 is met.
  1. Lease transfers ownership.
  2. Lease grants the lessee option to purchase and exercise of the option is reasonably certain.
  3. Lease term is for major part of the remaining economic life (~75% or more).
  4. Present value of future payments plus guaranteed residual value equals or exceeds substantially all of the fair value of the underlying asset (~90% or more).
  5. Asset is specialized in nature and has no alternative use to the lessor.

Lessees

Approach A – Financing Type (Capitalized)

- Separately reflected in P&L.
- Present value the lease liability with interest expense.
- Amortize right of use asset on a straight-line basis.
- Amortize over shorter of the estimated lease term or underlying asset's useful life.
- If significant economic incentive to exercise a purchase option, amortize asset to end of useful life of underlying asset.

Lessees

Approach B – Operating Type, Straight-line Approach.

- For all leases **not** meeting the Financing criteria above.
- Amortize the "right-of-use" asset each period as a balancing figure such that the total lease expense would be recognized on a straight-line basis regardless of timing of lease payments.
- Recognize lease expense **as a single cost in the income statement**.
- Combine effective interest on lease liability with amortization of ROU asset so that the remaining cost of lease is allocated over remaining lease term equally on a straight-line basis.

Lessees

Approach A – Financing Type (Capitalized)

- To amortize a 5-year lease at $20,000 / year with a 3% escalation ($106,183 total payments) using a 6% incremental borrowing rate.

Finance Lease						
	A	B	C	D	E - B	E
Year	Payment	Interest	Principal	Remaining	Asset Amortization	Total Expense
				$ 86,727		
1	$ 20,000	$ 6,071	$ 13,929	72,798	$ 17,345	$ 23,416
2	20,600	5,096	15,504	57,294	17,345	22,441
3	21,218	4,011	17,207	40,086	17,345	21,356
4	21,855	2,806	19,049	21,038	17,345	20,151
5	22,510	1,473	21,038	-	17,345	18,818
	106,183	19,456	86,727		86,727	106,183

- Note that the **asset amortization is static** from year to year.

Lessees

Approach B – Operating Type, Straight-line Approach.

- To amortize a 5-year lease at $20,000 / year with a 3% escalation ($106,183 total payments) using a 6% incremental borrowing rate.

Operating Lease						
	A	B	C	D	E - B	E
Year	Payment	Interest	Principal	Remaining	Asset Amortization	Total Expense
				$ 86,727		
1	$ 20,000	$ 6,071	$ 13,929	72,798	$ 15,166	$ 21,237
2	20,600	5,096	15,504	57,294	16,141	21,237
3	21,218	4,011	17,207	40,086	17,226	21,237
4	21,855	2,806	19,049	21,038	18,431	21,237
5	22,510	1,473	21,038	-	19,764	21,237
	106,183	19,456	86,727		86,727	106,183

- Note that the **total expense is static** from year to year.

Leases

Donated Rent and Below-Market Leases

- Unconditional promises to give the use of long-lived assets (such as a building or other facilities) for a specified number of periods in which the donor retains legal title may be similar to leases but have **no** lease payments.

- Under the new lease ASU, a lease is defined as a contract, or part of a contract, that conveys the right to control the use of identified property and equipment for a period of time in exchange for consideration.

- As a result, such promises are not within the scope of the ASU.

Leases

Donated Rent and Below-Market Leases

- In other instances, organizations may receive below-market leases.

- When calculating the ROU assets and lease liabilities, organizations should not include the fair value rental value of donated use of facilities that is in excess of the stated lease payments.

- Therefore, only the portion of the lease requiring the payment of consideration will be accounted for under the new lease ASU.

- The below market portion (donated rent) would be recorded as a contribution and expense.

Leases

Donated Rent and Below-Market Leases

- An organization that receives a contribution of the use of property or facilities, in which the donor retains legal title to the assets, should record the fair value of the use of the property as contribution revenue in the period in which the contribution is received and expense in the period the property or facilities are used.

- If the contributed assets are being provided for a specified number of periods, the unconditional promise is recorded as revenue and as a contribution receivable for the difference between the fair value of the property and the stated amount of the lease payments, if any.

- The revenue would be donor-restricted due to time and the restriction released as the contributed assets are used each period.

Leases

Fully Donated Lease Example

- A donor unconditionally promises to provide NFP A with the free use of warehouse space for three years, beginning January 1, 20X7. NFP A does not pay the insurance or taxes nor any non-cash considerations to the lessor. The unconditional promise to provide the space is considered to be fully collectible.

- The undiscounted fair value of the free rent totals $69,000 ($20,000 for 20X7, $23,000 for 20X8, and $26,000 for 20X9). Under guidance, this contribution to be received in future periods needs to be discounted. Discounted at 5% or $62,370. NFP A is responsible for utilities.

- The contributed use of the warehouse space increases net assets with donor restrictions because the space can only be used in future periods.

Leases

Fully Donated Lease Example

- Since there is no consideration paid, NFP A determined that this transaction is not a lease and therefore the new lease ASU does not apply.

- NFP A calculated the amount to be recognized as a contribution receivable as follows:

Contribution receivable	Year 1	Year 2	Year 3
Contribution receivable, beginning	$ 69,000	$ 45,490	$ 24,760
Beginning discount	(6,630)	N/A	N/A
Amortization of discount	3,120	2,270	1,240
Minus fair rental value of donated lease	(20,000)	(23,000)	(26,000)
Contribution receivable, ending	$ 45,490	$ 24,760	$ -

Leases

Fully Donated Lease Example

The impact on net assets with donor restrictions would be as follows:

	Year 1	Year 2	Year 3
Net assets with donor restrictions, beginning	$ 62,370	$ 45,490	$ 24,760
Amortization of discount	3,120	2,270	1,240
Release from restriction	(20,000)	(23,000)	(26,000)
Net assets with donor restrictions, ending	$ 45,490	$ 24,760	$ -

The following initial and annual entries for 20X7, 20X8, and 20X9 would be recorded in connection with the donated warehouse space:

Initial entry to record the donated warehouse asset:		
Contribution receivable, warehouse	$62,370	
Contribution revenue with donor restrictions		$62,370

Leases

Fully Donated Lease Example

Annual entries to record periodic use on a fair rental value basis:	Year One		Year Two		Year Three	
Occupancy expense	20,000		23,000		26,000	
Contribution receivable, warehouse		20,000		23,000		26,000

Annual entries to record release from time restriction and amortization of discount:	Year One		Year Two		Year Three	
Net assets released from restrictions, net assets with donor restrictions	20,000		23,000		26,000	
Net assets released from restrictions, net assets without donor restrictions		20,000		23,000		26,000
Contribution receivable, warehouse (unamortized discount)	3,120		2,270		1,240	
Amortization of discount (Contribution revenue with donor restrictions)		3,120		2,270		1,240

Leases

Below-Market Financing Lease Example

- This example will assume the same details as the previous fully donated lease example except for the following:
- The donor is providing the space to NFP A for a below-market rate of $5,000 per year and the donor has committed to transferring the warehouse to NFP A at the end of the lease term.
- The new lease ASU is applicable to the portion of the arrangement for which consideration is paid and would result in the recognition of a ROU asset and a lease liability.
- Since the property will transfer to NFP A at the end of the lease, the lease is recognized and measured as a finance lease.

Leases

Below-Market Financing Lease Example

- The lease liability would be amortized using the effective interest method based on the contractual terms in the lease.
- Since NFP A does not know the lessor's rate implicit in the lease, NFP A uses its incremental borrowing rate to determine the present value of the lease liability. Therefore, the undiscounted value of the lease liability is $15,000 discounted at 5% to $13,620.
- The remainder (the difference between the fair value rental and the consideration paid) will be recorded using the contribution accounting as demonstrated in the previous example. ($69,000 less $15,000 = $54,000 would be the donated rent)

Leases

Below-Market Financing Lease Example

Assuming there are no initial direct costs, NFP A could calculate the amount to be recognized as a ROU asset and lease liability for the portion of the agreement with consideration as follows:

Lease liability	**Year 1**	**Year 2**	**Year 3**
Lease liability, beginning	$ 13,620	$ 9,290	$ 4,750
Plus amortization, treated as interest expense	670	460	250
Minus lease payment	(5,000)	(5,000)	(5,000)
Net lease liability, ending	$ 9,290	$ 4,750	$ -

Right of use asset	**Year 1**	**Year 2**	**Year 3**
ROU asset, beginning	$ 13,620	$ 9,080	$ 4,540
Less amortization	(4,540)	(4,540)	(4,540)
Right of use asset, ending	$ 9,080	$ 4,540	$ -

Leases

Below-Market Financing Lease Example

The initial entries to record the ROU asset and the related lease liability is as follows:

ROU asset, leased warehouse (net of discount)	$13,620	
Lease liability		$ 13,620

The annual entries to record the related activity are as follows:

	Year One		Year Two		Year Three	
Annual entry to record cash lease payment of $5,000 and periodic use:						
Interest expense	$ 670		$ 460		$ 250	
Lease liability	4,330		4,540		4,750	
Cash		5,000		5,000		5,000
Annual entry to record amortization of ROU asset:						
Amortization of ROU asset	4,540		4,540		4,540	
ROU asset		4,540		4,540		4,540

Leases

Below-Market Operating Lease Example

- This example will assume the same details as the previous Below-Market Financing lease example except for the following:

- Since the property will **NOT** transfer to NFP A at the end of the lease, nor did the lease contain any of the other four criteria that would cause it to be classified as a financing lease, the lease is recognized and measured as an operating lease.

- Note, that the initial entry to record the ROU asset and related liability is the same regardless of whether the lease is treated as financing or operating.

Leases

Below-Market Operating Lease Example

Assuming there are no initial direct costs, NFP A could calculate the amount to be recognized as a ROU asset and lease liability for the portion of the agreement with consideration as follows:

Lease liability	**Year 1**	**Year 2**	**Year 3**
Lease liability, beginning	$ 13,620	$ 9,290	$ 4,750
Plus amortization, treated as lease expense	670	460	250
Minus lease payment	(5,000)	(5,000)	(5,000)
Net lease liability, ending	$ 9,290	$ 4,750	$ -

Right of use asset	**Year 1**	**Year 2**	**Year 3**
ROU asset, beginning	$ 13,620	$ 9,290	$ 4,750
Less amortization (lease expense)	(4,330)	(4,540)	(4,750)
Right of use asset, ending	$ 9,290	$ 4,750	$ -

Leases

Below-Market Operating Lease Example

The initial entries to record the ROU asset and the related lease liability is as follows:

ROU asset, leased warehouse (net of discount)	$13,620	
Lease liability		$ 13,620

The annual entries to record the related activity are as follows:

	Year One		Year Two		Year Three	
Annual entry to record cash lease payment of $5,000 and periodic use:						
Lease expense	5,000		5,000		5,000	
Lease liability	4,330		4,540		4,750	
Cash		5,000		5,000		5,000
ROU asset		4,330		4,540		4,750

Leases

Presentation for Lessees

Balance sheet

- Either present separately or combine with appropriate class of assets and liabilities with proper disclosure.

- No co-mingling of *Approach A* (financing) and *Approach B* (operating) leases, either present separately or disclose separately.

Income statement

- No change to how capital leases and operating leases are currently being charged to expense.

Leases

Adoption and Implementation

- Classification, measurement, and recognition are all done at adoption.
  - Not required to re-assess classification for existing leases.
- Measurement is done using remaining lease payments as of the date of application.
- 2 optional modified retrospective methods of adoption:

1) Comparative Date Method **(Not recommended)**
   - Date of initial application is at the beginning of the earliest comparative period (ex: 1/1/21 for a 2022 calendar year-end private entity).
   - Restate comparative periods presented.
   - ASC 842 disclosures required for all periods presented.

Leases

Adoption and Implementation

- 2 optional methods of adoption (continued):

  2) Effective Date Method **(recommended)**
     - Date of initial application is the effective date (ex: 1/1/22 for a 2022 calendar year-end private entity).
     - No requirement to adjust comparative periods or provide comparative period disclosures.
     - Make disclosures under ASC 840 for comparative period and ASC 842 disclosures for post-adoption period.

- Full retrospective method is ***not*** allowed (i.e. going back to beginning of each lease).

Leases

Disclosures

- Information about lease assets by class of asset, including cash flows.
- Maturity analysis of lease liabilities.
- Description of extension and termination options.
- Basis on which variable lease payments are determined.
- Quantitative table of lease cost, cash flows, and remaining balances for finance leases and separately for operating leases.
- Cumulative effect of the change on net assets, if any.
- Nature & reason for the change.
- Effect on income from net income or any other line item.
- Lease descriptions & terms.

Leases

What should you be doing now?

- Review and evaluate now.
- Take inventory & gather documentation for all leases – centralized location.
- Assign "champion" or lead personnel for the project.
- Maintain written policies on the thresholds to be used & any "reasonable" approaches to be used.
- Determine accounting treatment for each lease.
- Talk with bank or lenders if this new accounting will affect debt agreements or covenants.
- Review lease software options – Find what is right for you / your client.
  - There are over 30 different lease software solutions in the market today – various price points, industry focuses, implementation difficulties, features & benefits.
- Apply the policies consistently for all leases.

Gifts-in-kind Presentation and Disclosure Standards

In September 2020, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2020-07, Not-For-Profit Entities (Topic 958): Presentation and Disclosures By Not-for-Profit Entities For Contributed **Nonfinancial** Assets. This ASU is effective for fiscal years beginning after June 15, 2021. (Calendar year ending 2022).

Early adoption is permitted.

The amendments are applied on a retrospective basis.

Gifts-in-kind Presentation and Disclosure Standards

Transition disclosures are required in the first period of adoption, which include:

- The nature of, and reason for, the change in accounting principle and
- The method of applying the change, including:
  - A description of the prior period information that has been retrospectively adjusted, if any; and
  - The effect of the change on relevant financial line items.

Gifts-in-kind Presentation and Disclosure Standards

The objective of ASU 2020-07 is to increase transparency about gifts-in-kind, including how they are valued and utilized through enhanced presentation and disclosure. This is meant to address concerns about nonprofits inflating the fair value measurements of gifts-in-kind, which would thereby increase a nonprofit's revenue and program expenses and make it appear larger and more efficient in its use of resources than other nonprofits.

Gifts-in-kind Presentation and Disclosure Standards

Examples of contributed **nonfinancial** assets include:

- Food
- Used clothing and household items
- Materials and supplies
- Pharmaceuticals
- Medical equipment
- Intangibles
- Land and buildings
- Use of long-lived assets
- Contributed services

Gifts-in-kind Presentation and Disclosure Standards

Contributed securities and other **financial** assets are outside the scope of ASU 2020-07. The FASB decided not to include these types of contributions within the scope of this ASU because contributed financial assets other than cash are typically monetized immediately and used similarly to cash, rather than directly in a nonprofit's programs or other activities.

Gifts-in-kind Presentation and Disclosure Standards

New Presentation Requirement

Under ASU 2020-07, nonprofits are required to show in-kind revenues as a separate line item on the statement of activities, apart from contributions of cash and other financial assets.

Gifts-in-kind Presentation and Disclosure Standards

New Presentation Requirement, continued

	Without Donor Restrictions	With Donor Restrictions	Total
Contributions of cash and investments	$300,000	$175,000	$475,000
Contributions of nonfinancial assets	715,450	35,000	750,450
Contributed services	260,750	-	260,750
Investment return, net	40,000	60,000	100,000
Other revenues	22,000	-	22,000
Total revenues and gains	$1,338,200	$270,000	$1,608,200

Gifts-in-kind Presentation and Disclosure Standards

New Disclosure Requirements, continued

What has not changed…

- The new standards do not change the existing standards for valuing gifts-in-kind or the prior disclosures for contributed services.

- Contributions of gifts-in-kind must be reported at fair value when received in accordance with FASB ASC 958-605, Not-for-Profit Entities – Revenue Recognition.

Questions

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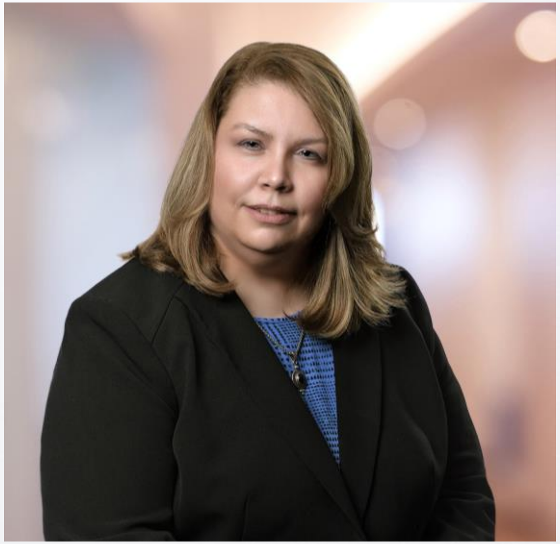

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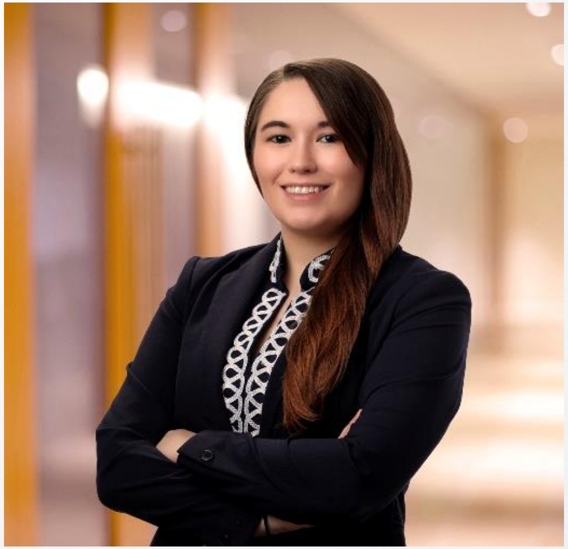

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