Not-For-Profit Industry Webinar

Preparing for the New Lease Accounting Standard

Dan Bergvall
Manager, Audit & Accounting
Not-For-Profit Industry Group

www.kmco.com

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Agenda

- Understand definition of a lease
- Review lease classification considerations
- Gain understanding of determining lease terms
- Review discount rate considerations to provide more options on the discount rate used
- Review financial statement changes and related banking considerations

Kreischer Miller

Polling Question

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

What is a Lease

- What is a lease?
  - A lease is defined as a contract that conveys the *right to control* the use of identified property, plant or equipment (an identified asset) for a period of time in exchange for consideration.
- *Right to Control*
  - Determination if the customer has both of the following:
    - The right to obtain substantially all of the economic benefits from use of the identified asset.
    - The right to direct the use of the identified asset.

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Embedded Lease – Example

Example – An organization contracts with an information technology service provider to maintain their servers.

Although this arrangement is essentially a service contract, it may include embedded leases if the organization decides when and how the dedicated server is used based on its instructions to the service provider.

Example – An organization pays for advertising on a billboard.

With the sole purpose of the billboard to be an advertisement, the organization is directing the use of that asset with what is specifically advertised on the billboard.

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Polling Question

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Lease Classification

- Finance Lease vs. Operating Lease
  - Finance Lease (if any of the following criteria are met):
    - The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.
    - The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.
    - The lease term is for the major part of the remaining economic life of the underlying asset.
    - The present value of the sum of lease payments and any residual value guaranteed by the lessee equals or exceeds substantially all of the fair value of the underlying asset.
    - The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

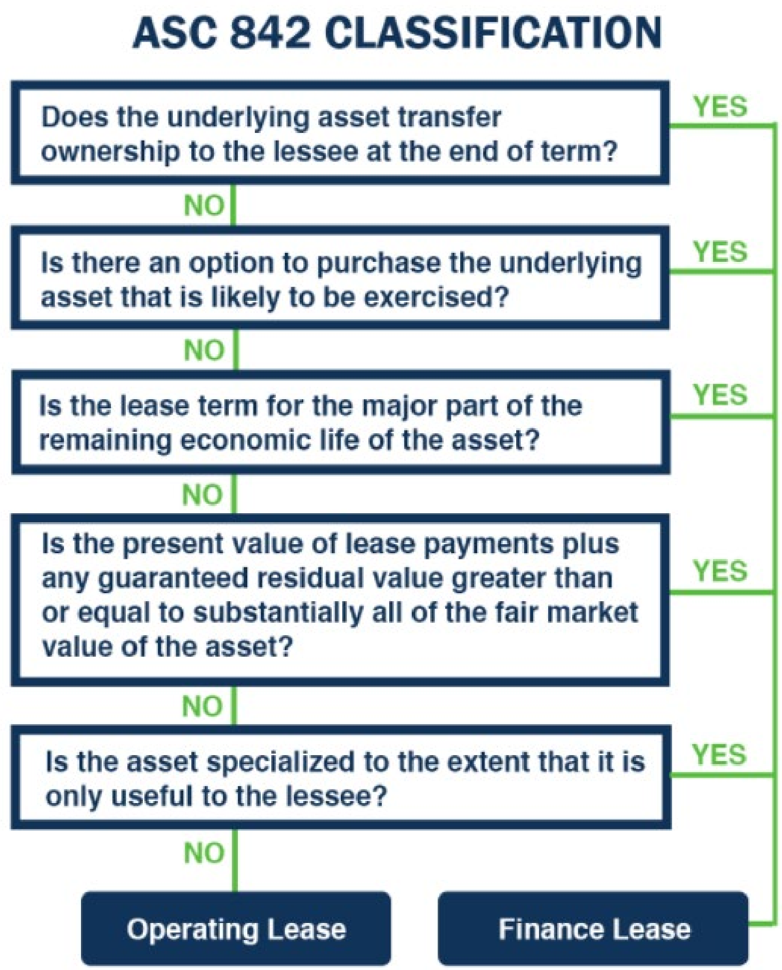
Lease Classification

- Finance Lease vs. Operating Lease
  - Operating Lease
    - When none of the criteria for a finance lease is met, the lessee shall classify the lease as an operating lease.
- Subleases
  - Apply the same criteria

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Lease Classification – Example



PEOPLE | IDEAS | SOLUTIONS

Separating Components

- Separating Components of a Contract
  - Separate lease and non-lease components (example: equipment and maintenance)
  - Determine relative standalone price of the separate components (should estimate if not readily available)
  - Allocate consideration to the separate lease and non-lease components of the contract
  - Accounting policy election – may elect to not separate lease and non-lease components and account for whole contract as a lease

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Component Example

Consideration	Type	Reasoning	Examples
Fixed payments for use of the asset	Lease component	Rent payments directly transfer the right to use the underlying asset	Base rent to use space in a building or to use a piece of equipment
Variable payments for use of the asset	Lease component	Rent payments directly transfer the right to use the underlying asset	Usage or mileage-based payments on a vehicle or piece of equipment
Common Area Maintenance (CAM)	Nonlease component	Transfers a good or service to the lessee but does not relate directly to the underlying asset	Building HVAC, public space lighting, parking lot maintenance
Other services	Nonlease component	Transfers a good or service to the lessee but does not relate directly to the underlying asset	Security, janitorial services, administrative services
Reimbursement of lessor expenses	Noncomponent	Landlord is required to pay but the lessee does not directly receive a good or service	Property taxes or insurance
Administrative tasks to initiate the lease	Noncomponent	Lessor is not receiving a good or service	Legal fees, contracting costs

Term Considerations

- An entity shall determine the lease term as the non-cancellable period of the lease, together with all of the following:
  - Periods covered by an option to extend the lease if the lessee is *reasonably certain* to exercise that option
  - Periods covered by an option to terminate the lease if the lessee is *reasonably certain* not to exercise that option
  - Periods covered by an option to extend (or not to terminate) the lease in which exercise of the option is controlled by the lessor

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Term Considerations

- How does FASB define "reasonably certain"?
  - Designed to converge language with IFRS
  - High threshold that is consistent with and intended to be applied in the same way as the "reasonably assured" threshold in the previous lease guidance
  - Very high level of likelihood; greater than "probable"

PEOPLE | IDEAS | SOLUTIONS

Term Considerations

- Short Term Leases
  - Lessees can make an accounting policy election and choose not to recognize a right-of-use asset and lease liability for any lease with a term of 12 months or less and does not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise
    - Recognize the lease payments in profit or loss on a straight-line basis over the lease term

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Term Considerations – Example

Non-Cancelable Period + Periods that renewal options will reasonably be exercised + Periods which termination options will not be exercised = Lease Term

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Term Considerations – Example

Lease Term: A term commencing on January 1, 2021 (Commencement Date) and continuing for sixty-six (66) full calendar months. Tenant shall be granted access to the Premises sixty (60) days prior to the Commencement Date to install equipment and furnishings (the "Early Access Period"). Such access shall be subject to all the terms and conditions of this Lease, except that the Commencement Date and the payment of Rent shall not be triggered thereby.

Based on the language above, the lessee should record the lease on November 1, 2020 (or on the date the lessee possesses the asset) under ASC 840, and the lease term is actually 68 months. The 68-month term is the sum of the written lease term of 66 months plus the two additional months between November 1, 2020 and December 31, 2020 when the lessee will control the asset. Under ASC 842, the tenant records the initial ROU asset and lease liability value as of November 1, 2020 also and begins accounting for the lease as of that date, even though the contract explicitly asserts a commencement date of January 1, 2021.

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Term Considerations – Example Related Party

A lessee rents a copier on a month-to-month basis from a related party. The copier will be used over a period that is expected to be two years. One should consider whether there are implicit legally enforceable terms and conditions that would result in the lease term needing to be evaluated as two years as opposed to one month.

Currently, payments on month-to-month copier rental agreements are being expensed. If it is determined that the expected lease term will extend beyond 12 months, this lease will need to be recognized and measured on the balance sheet. The lease term would be the period of time that that the use of and lease is expected to last.

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Polling Question

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Discount Rate

- Accounting Standards Update (ASU) 2021-09
  - Discount Rate for Lessees that are not Public Business Entities
    - Topic 842 currently provides lessees with a practical expedient that allows them to elect to use a risk-free rate as the discount rate for all leases
    - The amendments in the newest update allows the risk-free rate election to be by class of underlying asset, rather than at the entity-wide level
      - Must disclose which asset classes elected to apply a risk-free rate
      - Amendments require that when the rate implicit in the lease is readily determinable for any individual lease, the lessee must use that rate, regardless of whether it has made the risk-free rate election
  - Currently effective for 12/31/2021 year-ends

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Discount Rate – Deeper Dive

There are three options for determining the discount rate

1. Implicit Rate (IR)

This is defined as the interest rate on a given date that generates the aggregate present value of the lease payments, and the amount a lessor expects to derive from the underlying asset following the end of the lease term.

In practice, it is not likely that the lessee will have the inputs required for this calculation readily available. You would need to know the fair value of the asset leased and the residual value.

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Discount Rate – Deeper Dive

There are three options for determining the discount rate

2. Incremental Borrowing Rate (IBR)

This is defined as the interest rate a lessee would have to pay to borrow, on a collateralized basis, an amount equal to the lease payments over a similar term and in a comparable economic environment.

Among the ways to calculate an IBR are using your rate on existing debt or recent loan; the borrowing rate of similar entities with comparable credit risk; or an interest rate quoted by your lender if you were to borrow funds to purchase a similar asset.

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Discount Rate – Deeper Dive

There are three options for determining the discount rate

3. Risk-Free Rate (RFR)

The RFR is the rate of a zero-coupon U.S. Treasury instrument using a period comparable with the lease term. This provides a practical expedient alternative for private companies.

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Polling Question

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Recognition

- Recognize the assets and liabilities that arise from leases at lease commencement
  - Recognize a right-of-use asset, representing its right to use the underlying asset for the lease term, initially measured at the lease liability amount, adjusted for lease prepayments, incentives and initial direct costs (such as commissions)
  - Recognize a liability to make lease payments, initially measured at the present value of lease payments (using the rate implicit in the lease when readily determinable, or the risk-free rate)

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Recognition – Example

Pike Enterprises, Inc. leases a machine for three years on 1/1/year 1. The machine has a fair value of $75,000, a 10-year economic life, and alternative expected uses to the lessor after the lease term. The lease calls for annual lease payments of $10,000 on 12/31 of each year, and the implicit interest rate known to Pike is 5%. The lease conveys no ownership at the end of the lease term, contains no purchase option, and requires no guarantee of residual value. Because this lease does not meet any of the 5 criteria for a finance lease it an operating lease under the new standard, but the lease term is greater than 12 months so the new standard requires balance sheet presentation.

Present value factor for ordinary annuity for 3 years at 5%:	2.72325
Known implicit interest rate:	5%

The present value of the lease payments is calculated as follows:

Annual Lease Payment:	$	10,000
Present value factor for an ordinary annuity for 3 years at 5%:		× 2.72325
Present value of the lease payments:	$	27,233

Recognition – Example

Amortization Table for the Operating Right-of-Use Asset and Operating Lease Liability

Date	Lease Payment		"Interest" on the Operating Liability at 5%		Amortization of Operating Lease Right-of-use Asset and Lease Liability	Account Balances for the Operating Lease Right-of-Use: Asset	Liability
1/1/year 1						$27,233	$27,233
12/31/year 1	$ 10,000	=	$1,362	+	$8,638	18,595	18,595
12/31/year 2	10,000	=	930	+	9,070	9,525	9,525
12/31/year 3	10,000	=	475	+	9,525	–	–
Totals	$ 30,000	=	$2,767	+	$27,233		

Lease expense includes both interest and amortization of the right-of-use asset; thus, the operating lease shows lease expense on a straight-line basis, similar to operating leases under the current standard.

The amortization amounts for the right-of-use asset and the lease liability offset one another; therefore, each account has the same year-end balance.

Recognition – Example

The first year's journal entries would be:

1/1/year 1	Operating Lease Right-of-Use Asset	27,233	
	Operating Lease Liability		27,233

To record the operating right-of-use asset and related liability at the PV of the lease payments.

12/31/year 1	Lease Expense	10,000	
	Operating Lease Liability	8,638	
	Cash		10,000
	Operating Lease Right-of-Use Asset		8,638

To record annual lease payment and expense, and the amortization of the operating lease liability offset against the operating right-of-use asset.

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Financial Statement Impact

ABC Test Company, Inc.	
Balance Sheet	
As of December 31, 2018	
Assets	
Current Assets	
Cash and Equivalents	6,500,000
Accounts Receivable	1,358,610
Prepaid Expenses	150,000
Other Current Assets	25,000
Total Current Assets	8,033,610
Long Term Assets	
Fixed Assets - Net	1,750,000
Total Assets	**9,783,610**
Liabilities & Equity	
Current Liabilities	
Accounts Payable	860,000
Accrued Expenses	450,000
Short-Term Deferred Revenue	2,650,000
Other Current Liabilities	300,000
Total Current Liabilities	4,260,000
Long Term Liabilities	
Long-Term Deferred Revenue	1,250,000
Deferred Rent	23,610
Total Long Term Liabilities	1,273,610
Equity	
Members Capital	3,000,000
Retained Earnings	1,100,000
Net Income	150,000
Total Equity	**4,250,000**
Total - Liabilities & Equity	**9,783,610**

ABC Test Company, Inc.	
Balance Sheet	
As of December 31, 2018	
Assets	
Current Assets	
Cash and Equivalents	6,500,000
Accounts Receivable	1,358,610
Prepaid Expenses	150,000
Other Current Assets	25,000
Total Current Assets	8,033,610
Long Term Assets	
Fixed Assets - Net	1,750,000
Operating ROU Asset	2,046,217
Total Assets	**11,829,827**
Liabilities & Equity	
Current Liabilities	
Accounts Payable	860,000
Accrued Expenses	450,000
Short-Term Deferred Revenue	2,650,000
Short-Term Lease Liability	233,672
Other Current Liabilities	300,000
Total Current Liabilities	4,493,672
Long Term Liabilities	
Long-Term Deferred Revenue	1,250,000
Long-Term Lease Liability	1,836,155
Deferred Rent	-
Total Long Term Liabilities	3,086,155
Equity	
Members Capital	3,000,000
Retained Earnings	1,100,000
Net Income	150,000
Total Equity	**4,250,000**
Total - Liabilities & Equity	**11,829,827**

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Implementation Considerations

- Develop an implementation strategy – Type 1 or Type 2 Modified retrospective transition method of adoption is required to be adopted by lessors and lessees for all existing leases.
  - Identify available resources and a champion for the project
  - Evaluate existing leases and service agreements to identify all operating leases and finance leases
  - Evaluate software considerations
  - Consider accounting policy elections, including available practical expedients
  - Determine transition year financial statement presentation
  - Evaluate terms for new leases and upcoming lease renewals

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Implementation Considerations – Practical Expedients

#1 Lease classification is grandfathered

If a lease was classified as a capital lease under 840, it remains a capital lease.

#2 No re-evaluation of embedded leases

If you were accounting for leases embedded in service and outsourcing contracts appropriately under the old standards, then you don't need to re-evaluate.

#3 You do not have to reassess initial direct costs

Under 840 you could allocate a portion of your internal expenses to initial direct costs. For instance, you could allocate a percentage of the salaries for internal real estate or legal staff. Under 842, initial direct costs are defined as costs you would not have incurred had you not signed the lease – typically external costs, such as broker fees or external legal fees. This expedient states that you don't need to reassess those costs.

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Contact the Presenter

Daniel Bergvall
Manager, Audit & Accounting
dbergvall@kmco.com

Dan has a wide range of experience providing audit and accounting services to a variety of businesses, including construction, not-for-profit, consulting, and manufacturing. Dan also provides business advisory services such as contract compliance, FASB ASC 606 (*Revenue from Contracts with Customers*) evaluations, and public company accounting services.

Dan is an active member of Kreischer Miller's Construction and Not-for-Profit Industry Groups.

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

About Kreischer Miller

Kreischer Miller is an accounting, tax, and business advisory firm that has been serving clients since 1975. We've built our firm to respond to the unique needs of growth-oriented private companies, helping you smoothly transition through growth phases, business cycles, and ownership changes. The companies we work with need to be able to quickly adapt and respond to changing market opportunities and challenges. That's why our focus is on being responsive, decisive, and forward-thinking. We're up to the challenge—always looking at the road ahead, not in the rear-view mirror. **Learn more at www.kmco.com.**

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS