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Gifts that Keep on Giving (Us Headaches)

Navigating Complex Giving Arrangements

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Agenda

- Learning Objectives
- Split Interest Agreements
- Gift Repurposing
- Naming Rights
- Estate Gifts

Learning Objectives

Identify challenges with complex giving arrangements and their implications on organizational finance

Recognize suggested responses and resolve challenges with complex giving arrangements

Identify how to implement processes and procedures to proactively address challenges with complex giving arrangements

Split Interest Agreements

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What are Split Interest Agreements?

Donor transfers assets for benefit of a NFP,

but donor retains partial economic benefit of assets (e.g. future distributions)

Trustees & Custodians

Assets held, invested & administered by:

NFP	Trustee	Fiscal Agent

Term of agreement:

A specified number of years	Perpetuity	Event-driven (e.g. death of donor)

Expiration = remaining assets distributed to or retained by:

NFP	Other beneficiaries

Types of Instruments

Split Interest Agreements

- Charitable Lead Trusts
- Charitable Remainder Trusts
- Perpetual Trusts
- Charitable Gift Annuities
- Pooled Income Funds
- Estate Gifts and Real Estate
- Life Insurance

Enforceability, Recognition & Measurement

Revocable

- Intentions to give
  - Revocable by donor
  - Trustee w/ variance power
- Recognition:
  - Assets received are considered liabilities
- Measurement
  - Fair value when assets received

VS

Irrevocable

- Contributions
- Recognition:
  - Type of agreement
  - Rights & terms of distributions
  - Custodian of assets:
    - NFP
    - Third party
- Measurement
  - Fair value when assets received

NFP Recognition | Asset Custodians

Nonprofit Organization

- Investments
- Contribution
- Refundable Advance (liability)

VS

Third Party

- Beneficial Interest in Assets
- Contribution

Types of Instruments

Split Interest Agreements

- Charitable Lead Trusts
- Charitable Remainder Trusts
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- Life Insurance

Example: Charitable Lead Trust

- Donor creates irrevocable trust
- Trustee = ABC nonprofit
- ABC gets stated $ or % per year until donor passes
- When donor passes, ABC gets 50% and beneficiaries get remaining assets

Creation of Trust	
Debit	**Credit**
Assets Held In Lead Trust	
	Liability (Assets Held for Others)
	Contribution Revenue

Over Life of Trust Adjust for Fair Value of Assets and Liabilities		
	Debit	**Credit**
Distributions to NFP	**Cash**	
		Assets Held In Lead Trust
Gain/Loss on Investments	**Assets Held In Lead Trust**	
		Liability (Assets Held for Others)
PV Amortization & Assumptions Change	**Liability** (Assets Held for Others)	
		Change in SIA (Gain/Loss)

Termination of Trust		
	Debit	**Credit**
Distributions to Others	**Liability** (Assets Held for Others)	
		Assets Held In Lead Trust
Distributions to NFP	**Cash/ Investments**	
		Assets Held In Lead Trust

Types of Instruments

Split Interest Agreements

- Charitable Lead Trusts
- Charitable Remainder Trusts
- Perpetual Trusts
- Charitable Gift Annuities
- Pooled Income Funds
- Estate Gifts and Real Estate
- Life Insurance

Change in Trustee and Custodian!

Example: Perpetual Trust

- Donor creates irrevocable trust
- Trustee = a bank
- XYZ nonprofit gets 50% of annual income on trust assets for perpetuity

Creation of Trust		
	Debit	**Credit**
50% of Fair Value of Trust Assets	**Beneficial Interest in Perpetual Trust**	
		Contribution Revenue

Over Life of Trust Accout for Distributions and Adjust for Fair Value of Assets		
	Debit	**Credit**
Distributions of Annual Income to NFP	**Cash**	
		Investment Income
Remeasurement of 50% of Fair Value of Trust Assets	**Beneficial Interest in Perpetual Trust**	
		Gain on Beneficial Interest in Perpetual Trust

Types of Instruments

Split Interest Agreements

- Charitable Lead Trusts
- Charitable Remainder Trusts
- Perpetual Trusts
- Charitable Gift Annuities
- Pooled Income Funds
- Estate Gifts and Real Estate
- Life Insurance

Example: Charitable Gift Annuity

- Donor gives nonprofit $500k
- Donor will receive $5k per year for life
- Remainder at death goes to nonprofit

Creation of CGA		
	Debit	**Credit**
Record Gifted Assets; Estimated Payment Liability using Life Expectancy & Present Value	**Investments**	
		Gift Annuity Liability
		Contribution Revenue

Over Life of CGA		
	Debit	**Credit**
Distributions	**Gift Annuity Liability**	
		Cash
Gain/Loss on Investments	**Investments**	
		Investment Income
Revaluation of Future Distributions	**Gift Annuity Liability**	
		Change in SIA (Gain/Loss)

Termination of CGA		
	Debit	**Credit**
Final Distribution	**Gift Annuity Liability**	
		Cash
Close Accounts	**Gift Annuity Liability**	
		Change in SIA (Gain/Loss)

Challenges: Split Interest Agreement

Lack of information & identifying type of arrangements	• Obtaining copies of agreements • Determining fair value of assets held by third-party trustee
Varied accounting treatment	• Complexity • Type of agreement • Trustee & Custodian vs Beneficiary
Assumptions and calculations	• Present value discount • Life expectancy determination • Adjusted measurement: changes in value of assets
Trustee & custodian administration	• Donor distributions • Donor communications • Beneficiary distributions • Beneficiary communications

Solutions: Split Interest Agreement

Standardized controls: templates and checklists

- Initial & ongoing trustee communications (e.g. fair value of assets)
- Identify type and accounting determination checklist
- Chart of accounts, reconciliations, journal entries
- Search for unrecorded – consistent gifts from same source (esp. trustee)

Split-interest agreement calculators

- Internally developed
- Externally developed & purchased
- Consider outsourcing function based on volume and complexity

Gift acceptance policies

- Limit volume: gift amount minimum if NFP is trustee & custodian

Standardized periodic reporting for donors and beneficiaries:

- Communications
- Statements

Gift Repurposing

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What is Gift Repurposing?

Donor Restriction:

- A donor stipulation that specifies a use for a contributed asset that is more specific than broad limits resulting from the following:
  - The nature of the nonprofit entity,
  - The environment in which is operates,
  - The purposes specified in its organizing documents

When a donor restricted gift is repurposed for a use that deviates from the original donor restriction

Common Example: Gift Repurposing

A religious organization raised funds 10 years ago to fund a childcare facility for before and after school childcare program.

Due to staffing issues, high costs, and aging members the religious organization has decided to end its childcare program and would like to repurpose its childcare facility.

Potential Remedies:

- Obtain permission from original donor to remove or change restriction
- If impractical, seek court permission to repurpose gift & restrictions

Challenges: Gift Repurposing

Existing donor restricted funds

- Maintaining original donor restriction records
- Tracking overly restrictive & unused donor restricted funds
- Long-term donor contact & communication regarding use of funds
- Inability to use resources to carry out programs and mission

Repurposing donor restricted funds

- Return of funds to donors
- Deterioration to donor relationships
- Damage to organizational reputation
- Legal and court fees for gift or restriction repurposing

Solutions: Gift Repurposing

Gift policies

- Establish a floor for restricted giving

Fundraising Campaign Design - Include budgets:

- “Funds raised above a campaign budget of $500,000, will be used to support the organization’s mission”
- “Unused funds after xx/xx/xx can be used towards any of the Organization’s programs”

Variance Power via Bylaws or Gift Agreements

- Unilateral power to redirect the use of transferred assets
- “Donor agrees that the board shall have the organization shall have the power to modify any restriction of this gift is in the sole judgment of the board that such restriction becomes unnecessary or inconsistent with the charitable needs of the community.”

Donor Advised Funds managed by 501c3 Organizations

- Donors can recommend use of funds, but receive immediate tax deduction and typically grant variance power

Naming Rights

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What are Naming Rights?

A form of sponsorship where a funder receives the exclusive right to name an asset, space, venue or area.

Naming rights can have the following revenue recognition:

- Entirely contribution
- Entirely exchange transaction
- Partially contribution and partially exchange transaction

Naming Rights Recognition

Exchange if: Funder receives significant value from the public recognition of the naming opportunity

Valuation: Exchange portion valued first; remainder (if any) recognized as contribution

Measurement: Exchange portion reported at fair value, which can be difficult to determine.

Difficulty of measurement is not a reason for failing to report the exchange portion of the transaction separately from the contribution portion.

Common Example 1: Naming Rights

- ABC Co. pays $50,000 to museum to support an exhibit. Museum includes acknowledgment in exhibit catalog: “This exhibit was brought to you by the generosity of ABC Co.”
- No other assets, rights, or privileges are transferred
- Is this a contribution, exchange transaction, or both?
- Answer: Contribution
- Recognition: $50k should be recognized when promise is received

Common Example 2: Naming Rights

- Thomason Tech is a firm located in the same town as the University. University is constructing a new class & lab building. The Firm agrees pay $5M to University with these terms:
  - Building to be named the Thomason Tech Center for 10 years
  - Building name will use the same font as the Firm's logo
  - Name will be on all sides of the building and lit at night
  - Firm can rename the building if desired
  - No other entity's name may be placed on the building's exterior
- Is this a contribution, exchange transaction, or both?
- Answer: Entirely Exchange, or partially exchange and partially contribution

Common Example 2: Naming Rights Rev Rec

Agreement makes clear that Firm sees strategic advertising value in naming the building and is protecting that value

University should determine advertising value — it’s possible to conclude entire $5M payment is an exchange transaction

Exchange portion would be recognized over the agreement's term — 10 years

Contribution portion (if any) would be recognized in the year the agreement is executed, unless the contribution is subject to conditions not yet satisfied

Challenges: Naming Rights

Establishing nature of agreement: contribution vs exchange

Negotiating acceptable agreement terms

- E.g. Donor pledges $1.5B for construction of a windowless dorm

Determining the value of return benefit

Taxability considerations

- Contribution = deduction for donor
- Return benefit ≠ deduction for donor
- Advertising = unrelated business income for nonprofit

Revocation of naming rights if donor’s reputation is tainted (e.g Ponzi schemes)

Solutions: Naming Rights

Standardize naming rights contracts by type

- Contribution
- Exchange transaction
- Contribution & Exchange

Collaboration of accounting and development department on contracts

- Establish fair value of exchange-related contracts
- Determine revenue recognition for standardized and major contracts

Limit term of contracts to several years

Articulate naming right revocation clauses for contracts

Specify protocol and responsible party for name change costs

Estate Gifts

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What are Estate Gifts?

Gifts of deceased donor’s remaining assets to a beneficiary via a will, insurance policies, beneficiary designation, etc.

Revenue Recognition:

- Estate gifts only recognized as a contribution when probate court declares the will to be valid

- After will is declared valid, a nonprofit should recognize the bequest using the executor's estimate of:

- Estate's assets and liabilities,
- Expected disbursement amount interest in the estate,
- Expected timeframe for disbursement

Common Example: Estate Gift

- In 2010: donor notifies Church she has remembered the church in her will and provides a written copy of the will
- In 2020: donor dies
- In 2021:
  - donor's last will and testament enters probate and the probate court declares the will valid
  - executor informs Church the will has been declared valid and it will receive 40% of the individual's estate, after satisfying the estate's liabilities and specific bequests
  - executor provides estimate of the estate's assets and liabilities and the expected amount ($6m) and time (2023) for payment of Church's interest in the estate
- In 2022: Church receives a partial payment of $5m
- In 2023: Church receives updated estimate its total expected interest is $7m, not $6m
- In 2024: Church receives final payment of $2m
- When should the Church recognize estate gift revenue?

Common Example: Estate Gifts

- **The 2010 communication between donor and Church is an intention to give**
  - The ability to modify a will at any time prior to death is well established, thus in 2010 Church did not receive a promise to give and did not recognize a contribution received.
  - When the probate court declares the will valid, Church would recognize a receivable and revenue for an unconditional promise to give at the fair value of its interest in the estate.
- **Revenue Recognition:**
  - Contribution revenue and receivable of $6m should be recorded in 2021, when will is declared valid by probate court
  - Additional contribution revenue of $1m recorded in 2024 when Church receives updated estimate
  - Revenue **should not** be recorded based on cash payments
  - Difficulty of obtaining information is not a valid reason to not record revenue on an accrual basis

Challenges: Estate Gifts

Ascertain type of gift	Valuation	Timeline of estate distributions	Lack of information and responsiveness from estate executers
Specific bequest (specified dollar amount or percentage)	Volatility (assets with unstable values)	Liquidation of real property can take years	Notification of will declared valid by probate
Residual bequest (remainder of estate)	Valuation can change over time	Multiple, unanticipated payments	Executer a relative of donor
Contingent bequest (certain conditions satisfied)	Specific real property gifted (working farm)	Beneficiary disputes	Limited formal reporting on assets and liabilities

Solutions: Estate Gifts

Initial estate gift requests

- Establish a significance threshold
- Contact estate executors
  - Copy of official last will and testament
  - Copy of probate court notice
  - Estimated assets and liabilities of estate
  - Composition of assets and liabilities
  - Distribution timeline

Ongoing estate gift requests

- Establish a significance threshold
- Period close checklist
- Contact estate executors
  - Create template for information requests
  - Updated remaining assets and liabilities
  - Updated distribution timeline
- Maintain documentation to support outstanding estate gift estimates

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Questions?

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FASB Update

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Learning Objectives

- Describe new accounting guidance affecting nonprofits and how it could impact your organization
- Identify upcoming accounting standards and recognize important items to consider when implementing the standards
- Recognize changes to audit standards that may impact audit engagements

ASU 2016-13

Measurement of Credit Losses on Financial Instruments

ASU 2016-13: Financial Instruments – Credit Losses

What? Immediate Recognition of the estimated expected credit loss over the life of the financial instrument

When? Effective date: Fiscal years beginning after December 15, 2022

Who? The ASU is relevant for all organizations.

ASU 2016-13: Background

Why did the FASB issue this update?

- In the wake of the 2008/2009 financial crisis
- Potential overstatement of assets
- Accurate and timely recognition of loss reserves

ASU 2016-13: Restrictions under existing GAAP

Previous Loss Incurred Model
Bad Debt Expense/Allowance for Doubtful Accounts
Losses recorded when probable and incurred
No indication of a loss, no allowance recorded
Based mainly on historical information
Allowance typically applied to past-due trade receivables

ASU 2016-13: Updated GAAP

Current Expected Loss Model
Credit Loss Expense/Allowance for Credit Losses
Recognize all expected credit losses over life upon initial recognition
Allowance for credit losses is required, even if risk is remote
Based on reasonable and forecasted info about total expected credit losses (historical, current & future)
Allowance applied to all balances, including current due amounts

ASU 2016-13: **What Is Included in Scope?**

- Financial Instruments include:
  - Trade receivables
  - Financing receivables
  - Held to maturity debt securities
  - Loan receivables
  - Net investment in leases
  - Any right to receive settlement in the form of cash
  - Contract Assets

ASU 2016-13: **What Is Excluded?**

- Pledges receivable
- Operating lease receivables
- Loans and A/R between entities under common control
- Financial assets measured at fair value
- Available for sale debt securities
- Loans to participants of DC benefit plans
- Insurance entity policy loans receivable

ASU 2016-13 Financial Instruments Credit Losses

- Assets measured at amortized cost
  - Present net of a valuation allowance at net amount expected to be collected
  - **Allowance:** incorporate relevant information about past events, historical experience, current conditions and reasonable and supportable forecasts
  - Standard does not specify a method for measuring expected credit losses
    - Apply methods that reasonably reflect its expectations

ASU 2016-13: Potential Impacts

- Depends on current reserving methodologies
- Diversity in practice in application of “incurred loss” models
- **Less Impact going forward:** Reasonable & supportable future expectations may have been incorporated
- **More Impact going forward:** Reserve methodology based on backward looking data and excluded future expectations
- Understand rationale for changes – beware unsupportable changes in methodologies that may indicate bias

ASU 2016-13: Measuring CECL

- **Step 1:** Pooling receivables with similar risk characteristics:
  - Historical or expected Loss patterns
  - Geographical Location
  - Effective interest rate
  - Collateral type
  - Credit score or ratings
- **Step 2:** Adjust historical loss rates for current conditions and reasonable/supportable forecasts
- **Step 3:** Apply adjusted loss rates to the amortized cost to estimate CECL

ASU 2016-13: Measuring CECL (Aging)

Past-Due Status	Amortized Cost Basis	Historical Credit Loss Rate	Expected Credit Loss Rate	Expected Credit Loss Estimate
Current	$ 7,501,892	0.23%	0.25%	$ 18,755
1–30 days past due	$ 547,637	7.65%	8.42%	$ 46,111
31–60 days past due	$ 329,431	24.50%	27.00%	$ 88,946
61–90 days past due	$ 143,236	46.50%	51.00%	$ 73,050
More than 90 days past due	$ 98,929	65.75%	72.50%	$ 71,724
	$ 8,621,125			**$ 298,586**

ASU 2016-13: Measuring CECL (Geography)

Geography	Region	Current	1–30 days past due	31–60 days past due	61–90 days past due	More than 90 days past due
North America	USA	$X	$X	$X	$X	$X
	Canada	$X	$X	$X	$X	$X
World	Europe	$X	$X	$X	$X	$X
	Others	$X	$X	$X	$X	$X

ASU 2016-13: **SOFP & SOA Impact**

	Assets Measured at Amortized Cost
Balance Sheet Presentation of the Receivable	Amortized Cost
Allowance for Credit Losses Presentation	Presented in a **separate line** as a contra-asset deducted from the asset's amortized cost **(See Note Below)**
Income Statement Presentation	Credit Loss Expense

Note: Presentation of the net (of the allowance) amount of the amortized cost on one line in the balance sheet (with the allowance amount disclosed in parentheses following the balance sheet caption) for assets measured at amortized cost may be acceptable **if the impact on the financial statements is not material.**

ASU 2016-13: **Net Asset Impact**

- Record a cumulative effect adjustment as of the beginning of the first reporting period in which the guidance is effective.
  - Difference between pervious loss incurred model vs. CECL
- If impact is not material to beginning net assets, a passed adjustment is allowed.

ASU 2016-13: **Income Statement Impact**

	2023		
	Without Donor Restrictions	With Donor Restrictions	Total
CHANGES IN NET ASSETS	2,000,000	50,000	2,050,000
Net Assets - Beginning of Year	23,000,000	1,500,000	24,500,000
Cumulative Affect of Application of FASB No. 2016-13 (Note 1 and 10)	**(100,000)**	**-**	**(100,000)**
Net Assets- Beginning of Year as Restated (Note 1 and 10)	22,900,000	1,500,000	24,400,000
NET ASSETS - END OF YEAR	$ 24,900,000	$ 1,550,000	$ 26,450,000

ASU 2016-13: Required Disclosures

- **Changes in accounting policies**
- **Loss allowance methodology:** Disclose their loss allowance methodology, including the inputs, assumptions, and models used to estimate expected credit losses
- **Significant Inputs/Assumptions**

ASU 2016-13: Required Disclosures (Continued)

- **Sensitivity analysis:** Provide sensitivity analysis of loss allowance estimates to changes in assumptions and economic conditions.
- **Portfolio segmentation:** Segmentation of the portfolio by risk characteristics, such as credit rating, loan type, and industry.
- **Reconciliation of loss allowance balances:** Reconciliation of the opening and closing balances of their loss allowance account.

ASU 2016-13: Disclosure Example 1

<u>Adoption of CECL - Disclosure Example for Trade Accounts Receivable</u>

At the beginning of 2023, the Company adopted FASB ASU 2016-13, Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments, as amended, which modifies the measurement of expected credit losses. The Company adopted this new guidance utilizing the modified retrospective transition method. The adoption of this Standard did not have a material impact on the Company's consolidated financial statements but did change how the allowance for credit losses is determined.

The Company is a wholesale distributor to retail entities whose invoices are due within 60 days. The Company uses historical loss information based on the aging of receivables as the basis to determine expected credit losses for receivables and believes that the composition of trade receivables at year-end is consistent with historical conditions as credit terms and practices and the customer base has not changed significantly. However, the current unemployment rate is higher than in prior years, and reasonable and supportable forward-looking information shows deteriorating economic conditions and an increasing unemployment rate. Based on this information, management believes the Company is likely to experience 10% higher credit losses than historically experienced. As such, management increased the credit loss percentages in each aging category by 10% to calculate expected credit losses.

ASU 2016-13: Disclosure Example 2

- NOTE 6—ALLOWANCE FOR CREDIT LOSSES [Excerpt from Checkpoint]

The Company hosts virtual courses and in-person workshops for individuals looking for certification in a specialized area of study. Students register in advance and are billed in arrears. The Company records tuition receivable and contract liabilities for its students upon the start of the term or program. An allowance for credit losses related to tuition receivable from students is established based upon historical collection rates by age of receivable and adjusted for reasonable expectations of future collection performance, net of estimated recoveries. The Company periodically assesses its methodologies for estimating credit losses in consideration of actual experience, trends, and changes in the overall economic environment.

The Company's tuition receivable and allowance for credit losses were as follows as of December 31, 20X9 and March 31, 20X0 (in thousands):

	December 31, 20X9	March 31, 20X0
Tuition receivable	$ 82,454	$ 79,429
Allowance for credit losses	(30,931)	(38,094)
Tuition receivable, net	$ 51,523	$ 41,335

ASU 2016-13: Rollforward of CECL Balance

Changes in the allowance for credit losses for the year ended December 31, 20xx were as follows:	
	12/31/20xx
Balance, beginning of the period	**$ 175,000**
Impact of the adoption of the new credit loss standard	25,000
Provisions	5,000
Write-offs, net of recoveries	(15,000)
Balance, end of period	**$ 190,000**

ASU 2016-13: Practical Example

- **Overview:**
  - NFP bills membership dues at the start of each membership term (1 year term)
  - Balances typically due within 30 days
- **Step 1:** Determine Risk Characteristics
  - Aging Schedule
- **Step 2:** Compile historical loss rate & update for current/future forecasts
  - Additional 10% loss due to rising inflation and potential recession
- **Step 3:** Apply the loss rate against each risk characteristic pool
- **Step 4:** Determine impact to opening net asset balance
  - Modified retrospective approach

ASU 2016-13: Practical Example

*Trade accounts receivable consists of amounts billed to members for membership charges. Accounts receivable are presented net of an allowance for credit losses, which is an estimate of amounts that may not be collectible. The NFP separates accounts receivable into **risk pools based on their aging.** In determining the amount of the allowance as of the balance sheet date, the NFP develops a **loss rate for each risk pool**. This loss rate is based on management's historical collection experience, adjusted for management's expectations about current and future economic conditions. On June 30, 20X4, the NFP increased its historical loss rates for each aging **category by 10% due to rising inflation and indicators of a potential recession.***

ASC 2023-08

Intangibles- Goodwill and Other-Crypto Assets

ASU 2023-08 Intangibles – Goodwill and Other-Crypto Assets

- Accounting for crypto assets
- Crypto Assets must meet all the following:
  - Meet the definition of *intangible asset* as defined in the Accounting Standards Codification Master Glossary
  - Do not provide the asset holder with enforceable rights to, or claims on, underlying goods, services, or other assets
  - Are created or reside on a distributed ledger based on blockchain or similar technology
  - Are secured through cryptography
  - Are fungible
  - Are not created or issued by the reporting entity or its related parties

ASU 2023-08 Intangibles – Goodwill and Other-Crypto Assets

Current guidance – crypto assets are intangible assets

- Account for as cost less impairment
- Recognize impairment for declines in value
- Do not recognize subsequent recoveries in value

This ASU requires measurement at fair value

- Consider volatility and impact on earnings

ASU 2023-08 Intangibles – Goodwill and Other-Crypto Assets

Statement of Financial Position

- Crypto assets separate from other intangible assets measured using other measurement bases

Statement of Activities

- Gains and losses in net income separate from amortization and impairment of other intangible assets

Cash Flow

- Classify cash flows from crypto assets received in ordinary course of business or as a contribution and converted nearly immediately into cash as operating activities
- If received with **donor-imposed restrictions for long-term or capital use,** required to classify the activity as cash flows from **financing activities**

ASU 2023-08 Intangibles – Disclosure Requirements

- **Roll forward:** Activity in the reporting period for crypto asset holdings, including additions (with a description of the activities that resulted in the additions), dispositions, gains, and losses
- For dispositions, the difference between disposal price and cost basis and a description of activities leading to the disposal
- If gains and losses are not separately presented, the line item in which they are presented
- Method for determining the cost basis of Crypto assets

ASC 842 (Leases)

Steps: Lease Analysis and Accounting

Lease Determination (Completeness)

Lease | Non-lease

Lease Classification & Subsequent Measurement

Operating lease | Financing lease

Initial Measurement

Contract components | Discount rate** | Lease Term

Lease & Non-lease Contract Components; Fixed and Variable Consideration

Lease Determination

An identified asset

- Can be explicitly or implicitly specified
- Supplier has no practical ability to substitute
- Supplier receives no economic benefit from substituting

The right to control the use during the lease term

- Decision making authority over the use of the asset
- Ability to obtain substantially all economic benefits from the use of the asset

Leases Financial Statement Impact – Balance Sheet

Finance Lease

- Right-of-Use Asset
- Lease Liability

Operating Lease

- Right-of-Use Asset
- Lease Liability

Lease Liability – Initial Measurement

Present value of the lease payments

- Discount rate**
  - IBR, Implicit rate, Risk free rate

+

Real estate taxes and insurance

- Fixed (included)
- Variable (excluded)

=

Lease liability

Lease Right of Use Asset – Initial Measurement

- ROU asset =
  - Initial measurement of lease liability
  - Plus: lease pre-payments
  - Plus: lessee initial direct costs
  - Minus: lease incentives received

Lease Financial Statement Impact - Income Statement

Finance Lease

- Amortization Expense
- Interest Expense

Operating Lease

- Lease Expense

Lease Financial Statement Impact - Cash Flow Statement

Finance Lease

- Operating:
  - Amortization of ROU Asset
  - Change in lease liability
- Financing:
  - Principal Payments

Operating Lease

- Operating:
  - Amortization of ROU Asset
  - Change in lease liability

Example – Operating Lease

- 3-year lease term
- Annual rent of $100, escalating $3 annually
- 7% interest rate

Example – Operating Lease

- Initial Recognition:

  Dr. ROU Asset 270
  Cr. Lease Liab 270

- Year 1 Entry:

  Dr. Lease Exp 103 A
  Dr. Lease Liab 81 D
  Cr. Cash 100 B
  Cr. Accum Amort 84 A-C

- NOTE: No amortization expense is recorded! It is a component of the lease expense!

	Expense	Liability			Asset
		Payment	Interest	Principal	Amortization
Year	A	B	C	D	A-C
1	103	100	19	81	84
2	103	103	13	90	90
3	103	106	7	99	96
	309	309	39	270	270

Example – Finance Lease

3-year lease term

Annual rent of $100, escalating $3 annually

7% interest rate

Example – Finance Lease

- Initial Recognition:

  Dr. ROU Asset 270

  Cr. Lease Liab 270

- Year 1 Entry:

  Dr. Interest Exp 19 C

  Dr. Amort Exp 90 A

  Dr. Lease Liab 81 D

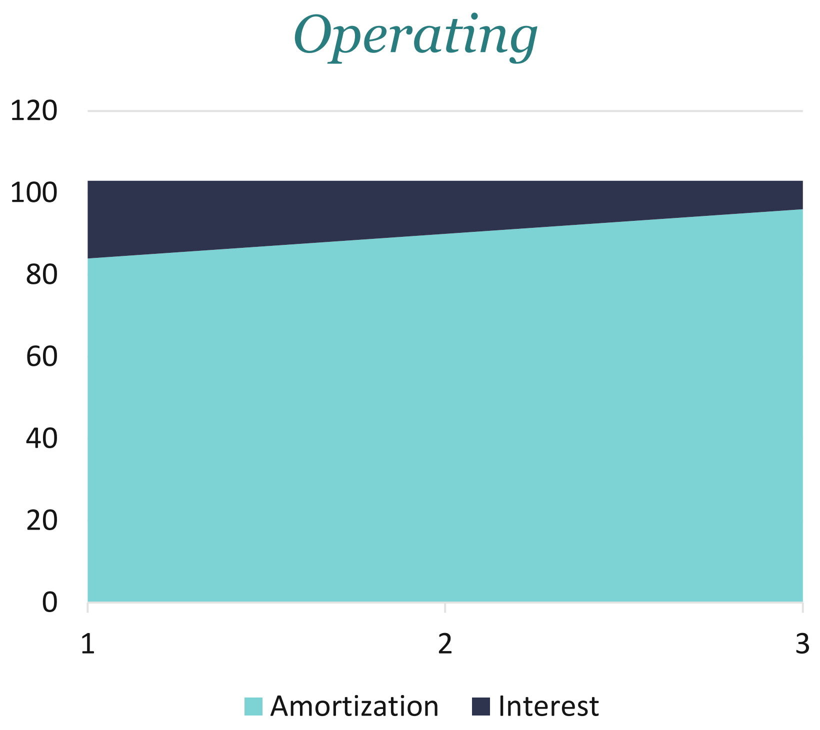
  Cr. Cash 100 B

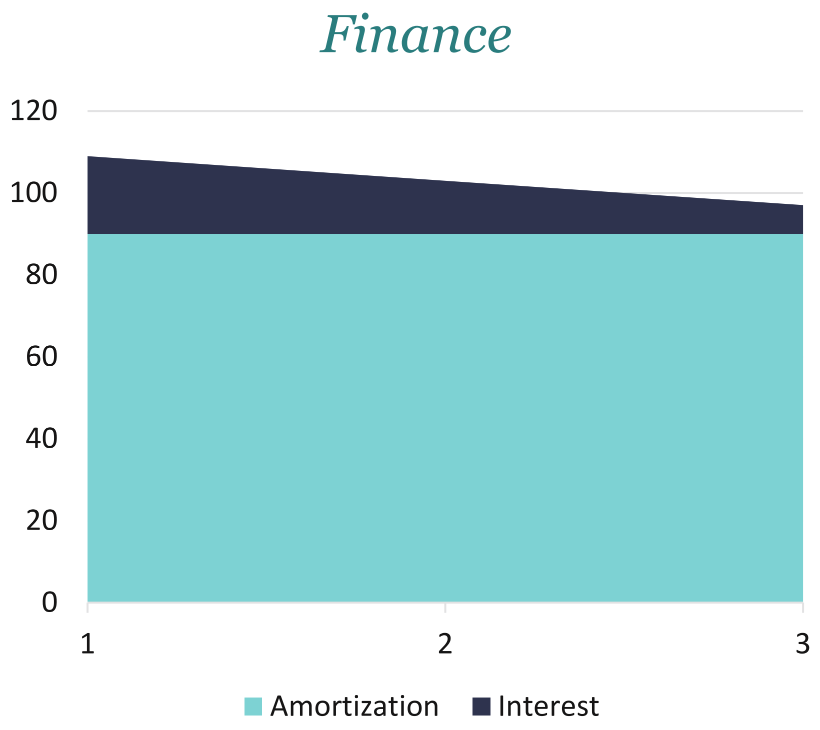
  Cr. Accum Amort 90 A

- NOTE: No lease expense is recorded. Each component is recorded.

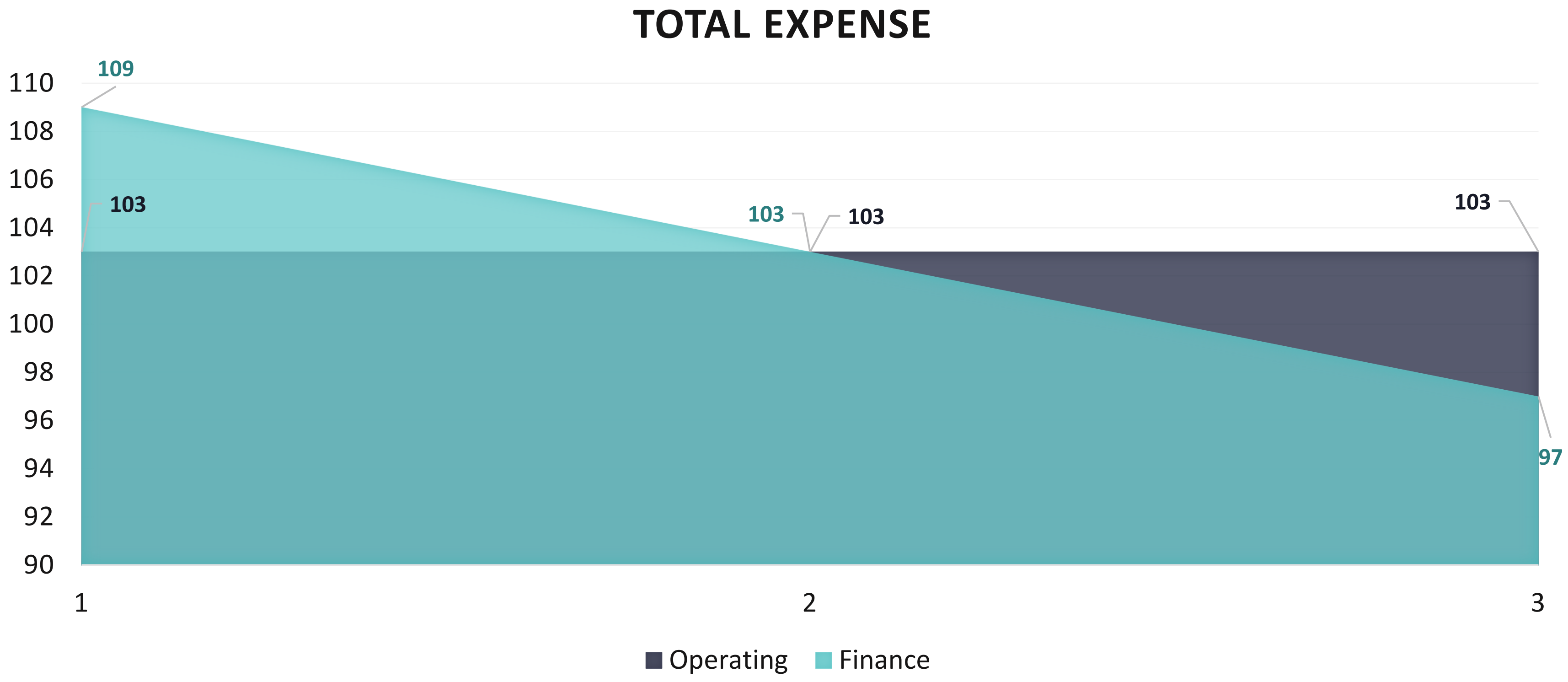
	Asset	Liability			Expense
	Amortization	Payment	Interest	Principal	
Year	A	B	C	D	A+C
1	90	100	19	81	109
2	90	103	13	90	103
3	90	106	7	99	97
	270	309	39	270	309

Total Expense – Operating Lease Vs Finance Lease





Total Expense – Operating Lease Vs Finance Lease



Contract Components

- Separate lease components from non-lease components
- Allocate the consideration on a relative standalone basis
  - Use observable standalone prices wherever available
- May elect practical expedient to not separate the non-lease component
  - Accounting policy

Contract Components – Example 1

- Payments for taxes and insurance are included in a contract
- Annual lease payments are fixed at $10,000 per year
- Real estate taxes and insurance payments are variable and will be billed to the lessee each year

Contract Components – Example 1

- Are the real estate taxes and insurance components of the contract?
- Contract contains a single lease component
    - The right to use the building
- Lessee payments are a reimbursement of the lessor's costs
    - Not a payment for goods or services in addition to the right to use the building

Contract Components – Example 2

- Payments for taxes and insurance are included in a contract
- Annual lease payments are fixed at $13,000 per year
- Contract components are itemized
  - $10,000 for rent
  - $2,000 for real estate taxes
  - $1,000 for insurance

Contract Components – Example 2

- Are the real estate taxes and insurance components of the contract?
- Contract contains a single lease component
    - The right to use the building

Contract Components – Example 3

- Payments for taxes, insurance, and common area maintenance are included in a contract
- Annual lease payments are fixed at $17,000 per year and include rent, taxes, insurance, and building maintenance

Contract Components – Example 3

- Real estate taxes and insurance are still not components of the contract
- What about the common area maintenance?
- Lessee receives a service from the lessor
  - A second component of the contract (non-lease component)
  - Consideration is allocated among the two components
  - CAM payments are not included in lease liability
    - Unless the practical expedient is selected

Questions?

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Thank You!

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