



ASC 842, *LEASES*

Key Lease Decision Reference Guide

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Background and Purpose

ASC 842, *Leases*, provides an overhaul of prior lease standards. The new standard updates the definition of a lease and now requires lessees to recognize substantially all leases on their statement of financial position by recording right-of-use asset and lease liability, including for operating leases. In addition, lease-related disclosures have been enhanced.

This Key Lease Decision Reference Guide focuses on the changes to lessee accounting and walks through common aspects of a lease contract that influence how an organization classifies and accounts for the contract. It also includes key decisions that organizations will need to make in the implementation phase of the new standard.

Scope: Assets Excluded from the Lease Guidance in Topic 84

ASC 842 applies to all leases of property, plant, and equipment except for the following items:

Leased Asset	Examples	Scope
Intangible assets	Licenses of intellectual property	Topic 350, Intangibles–Goodwill and Other
Rights to explore or use nonrenewable natural resources	Minerals, oil, and natural gas, including the right to use the land that contains the resources	Topic 930, Extractive Activities–Mining
	Rights to use equipment or rights beyond the exploration and use of the resources are not excluded from ASC 842	Topic 932, Extractive Activities–Oil and Gas
Biological assets	Plants, timber, and livestock	Topic 905, Agriculture
Inventory	Items for production, including raw materials, supplies, or work in process	Topic 330, Inventory
Assets under construction	Buildings under construction	Topic 360, Property, Plant, and Equipment



Accounting Policy Election: Short-term Lease

Short-Term Lease

An organization can make an accounting policy election by class of underlying asset to not record leases with a term of 12 or fewer months on the statement of financial position. The lease term would include renewals that the lessee is reasonably certain to exercise. The lease must not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise. An organization must disclose this policy.

STEP 1: Determine if a Contract Contains a Lease

The new lease standard updates the definition of a lease to include contracts or a part of a contract that conveys the right to control the use of an identified asset for a period of time in exchange for consideration.

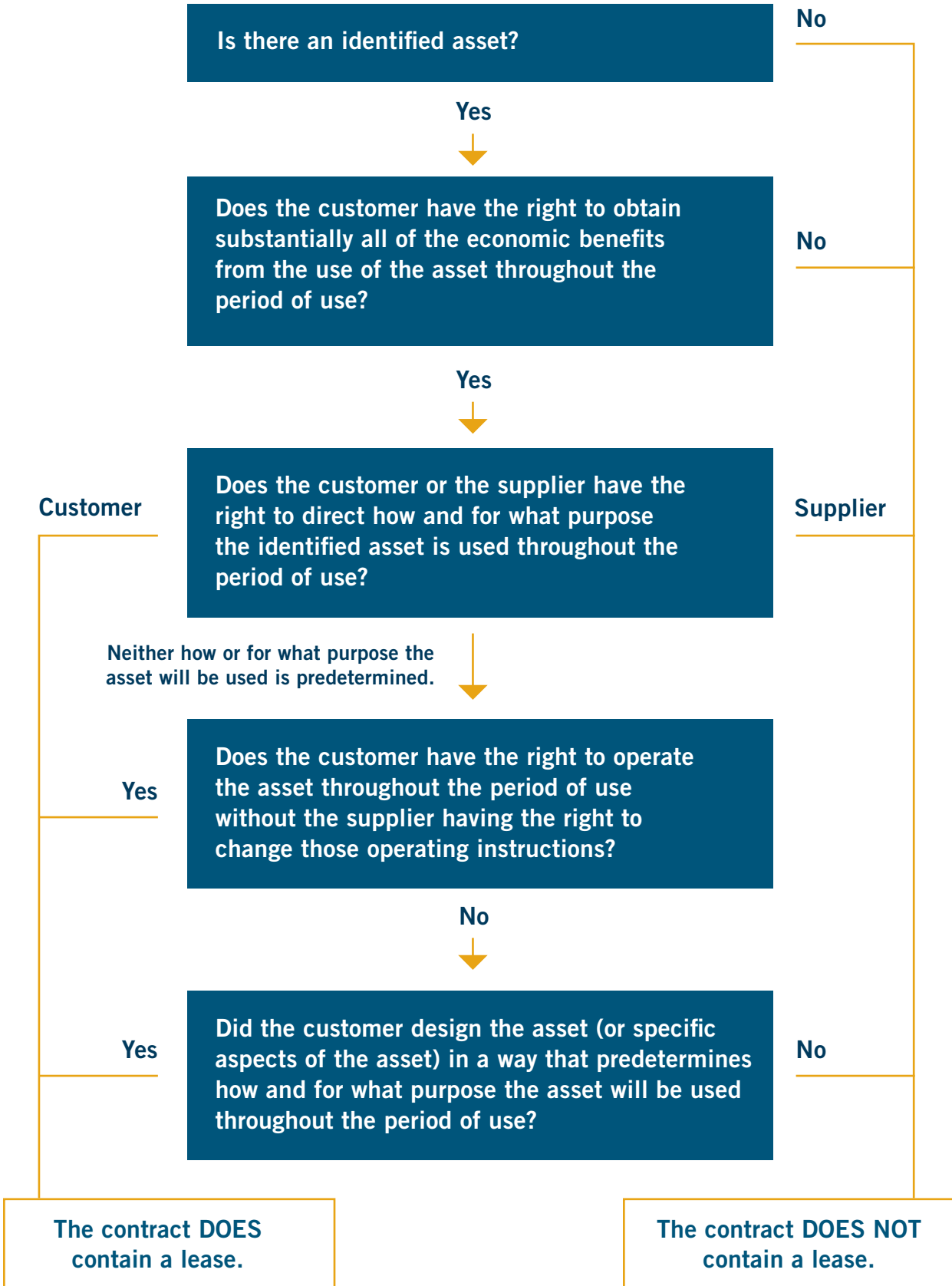
In addition to being described as a set number of days, a period of time may be described in terms of the amount of use of an identified asset (for example, the number of production units that an item of equipment will be used to produce).

Identified Asset	Lessee Control
The lease explicitly or implicitly specifies the asset.	The lessee controls the use of the identified asset for a period of time.
The asset is physically distinct.	The lessee has decision-making authority for the asset.
The lessor cannot substitute the asset for another.	The lessee has rights to substantially all the economic benefits.

The change in the definition of a lease focuses on the control of a specifically identified asset. Control of the asset includes the power to have decision-making rights and the benefits of the use of the asset during the lease term. For example, if a customer has a contract for use of a data server, the contract would need to specify a specific server for the customer to meet the definition of a lease. If the supplier has multiple servers and the contract states that the customer has the right to use a server during the lease term, but does not specifically identify which server is for the customer's use, the supplier can determine which one is best suited at any point in time for its own needs.

The ability to control the underlying asset distinguishes a lease from a service contract. In a lease, a customer (lessee) controls an asset when the supplier (lessor) conveys control of the asset to the customer. In a service contract, the supplier does not convey control of an asset to the customer. Instead, the supplier provides a service, and the customer pays only for the services that are performed. While a customer may utilize assets under a service contract, the contract fulfillment generally does not convey the right to control the use of an identified asset for the term of the service contract.

The following flowchart is included in ASC 842 and can be used by an organization to determine whether the contract is or contains a lease:



Perform a Comprehensive Analysis of All Service Contracts to Identify Embedded Leases

An embedded lease is a component within a contract that provides for the use and control of a particular asset by the user. An embedded lease can exist within a contract even though the contract never uses the word “lease,” sometimes making it easy to overlook lease elements.

Under legacy lease accounting, service contracts that contained embedded leases were often treated the same as service contracts without an embedded lease. Since contracts under legacy lease accounting had a similar expense impact for operating leases and service contracts, embedded lease identification may not have been as rigorous at organizations as it needed to be. Organizations should do a comprehensive review of their service contracts to ensure they have identified all embedded leases.

The questions to ask when determining whether a contract contains an embedded lease are the same as when determining whether a contract is or contains a lease. They can be summarized into the following for quick reference:

- 1. Does the contract include the use of one or more specific assets, such as IT devices?** If there is no specified asset, there is no lease. If an asset is explicitly or implicitly identified, then ask the next question.
- 2. Does the supplier have the practical ability to substitute a different asset?** If so, would the supplier benefit economically by doing so? If the supplier can substitute the asset and may benefit economically, there is no lease. If the supplier cannot substitute, then ask the next question.
- 3. Does the customer have control over the use of the asset? Does the control include the decision-making rights?** If the customer does not have control, there is no lease. If the customer does have control, the contract may include a lease.

Common contracts that often include embedded leases include:

- Agreements that bundle a service and a device
- Sales of consumables that include free equipment
- Data center or outsourced IT arrangements that provide exclusive use of assets
- Outsourced manufacturing arrangements that provide exclusive use of space or equipment in a facility

STEP 2: Determine Which Payments are Considered Part of the Lease Calculations

Lease Payments					
Fixed payments (a)	Variable payments based on an index or rate (b)	Exercise price of a purchase option (c)	Payments for penalties for terminating the lease (d)	Residual value guarantees (e)	LESS any incentives paid or payable to the lessee

(a) Includes payments made by the organization prior to the lease term.

(b) Variable payments that depend on an index or rate are calculated based on the rate at the inception of the lease. The organization excludes variable payments that are not based on an index or rate from consideration; these are expensed in the period they are incurred.

(c) Include only if reasonably certain that the organization will exercise.

(d) Include only if the lease term reflects the lessee exercising an option to terminate the lease.

(e) Include the amount that is probable a lessee will owe under residual value guarantees.

Identify Components of the Contract

Components are items or activities that transfer a good or service to the lessee. A contract can include the right to use one or multiple assets (lease components) as well as services provided by the lessor, such as maintenance of the asset (nonlease components). A contract that contains a lease coupled with an agreement to purchase or sell other goods or services has a nonlease component. A contract with multiple leases may contain one or more lease components.

A lease contract may also include costs such as administrative tasks to set up the lease and reimbursement of the lessor's costs. Since these do not transfer a good or service to the lessee, they are not a component of the contract.

Organizations are required to isolate and account separately for the lease components in a contract. After isolating, a lessee needs to allocate the consideration in the contract to the separate lease and nonlease components, including variable payments. If an item is not a component of a contract, the lessee does not receive an allocation of the consideration in the contract.

A lessee allocates the consideration in the contract to the separate lease and nonlease components by determining the following:

- The relative standalone price of the lease and nonlease components, if available.
- If observable standalone prices are not readily available, the lessee shall estimate the standalone prices, maximizing the use of observable information.
- A residual estimation approach may be appropriate if the standalone price for a component is highly variable or uncertain.

The consideration that is allocated to the lease components is recorded on the statement of financial position as a right-of-use asset and lease liability; nonlease component consideration is expensed as incurred. Consideration attributable to nonlease components is not a lease payment and, therefore, is not included in the measurement of lease assets or lease liabilities.

Lease Components

- The right to use an asset
- If multiple assets, each underlying asset should be a separate lease component when both of the following criteria are met:
 - The lessee can benefit from the right of use either on its own or together with other resources that are readily available to the lessee
 - The right of use is neither highly dependent on nor highly interrelated with the other right to use underlying assets in the contract

Non-Lease Components

- Lessor-provided services
- Examples:
 - Service contracts for leased assets (e.g., maintenance, supply of utilities)
 - Common-area maintenance

Not a Separate Component

- Items that do not transfer goods or services to the lessee
- Examples:
 - Administrative tasks to set up a contract or initiate the lease
 - Reimbursement or payment of the lessor's costs

Organizations are required to isolate and account separately for the lease components in a contract.

Lessees may make an accounting policy election by class of underlying asset not to separate lease components from nonlease components. If an entity makes that accounting policy election, it is required to account for the nonlease components together with the related lease components as a single lease component.

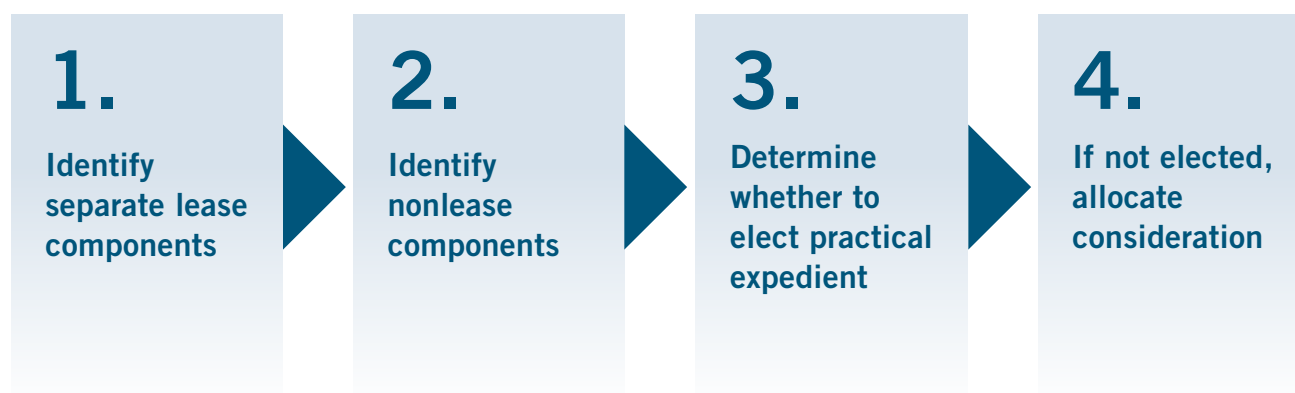
The determination to apply the accounting policy election is a trade-off between the convenience of eliminating the consideration allocation process versus a higher recognized lease liability.

For many asset types, this election can eliminate administrative burden, especially if the service component is a small portion of the contract, for example, a copier lease and the related service component. However, a contract with a large nonlease component in relation to total consideration would have greater financial implications, so an organization must carefully consider this election. The lessee must apply the practical expedient to overall classes of underlying assets; it cannot elect it by individual lease agreements.

Lessees can make an accounting policy election to treat both lease and nonlease elements as a single lease component.

	Treatment of Nonlease Components	Fixed Nonlease Components	Variable Nonlease Components
Elect practical expedient	Lease component	Included in lease liability	Variable lease expense
Do not elect practical expedient	Nonlease component	Expensed (not as lease expense)	Expensed (not as variable lease expense)

The key steps in accounting for the components of a contract are as follows:





STEP 3: Determine The Lease Term

NONCANCELABLE PERIOD

The lease term includes the noncancelable period specified in the contract. This is the period for which the lessee cannot cancel its right to use the underlying asset.

The lease term includes any lessor-provided rent-free periods.

OPTIONAL PERIOD BY LESSEE

The lease term includes any optional or cancelable periods for which the lessee controls the exercise of the option and is reasonably certain to exercise.

Optional periods include renewal options to extend the lease and the periods occurring after a lessee's optional early termination date.

OPTIONAL PERIOD BY LESSOR

The lease term includes any similar optional periods under the lessor's control.



STEP 4: Determine the Discount Rate

A lessee must determine the relevant discount rate based on information available at the commencement date to compute the present value of the lease payments. The higher the discount rate, the lower the lease liability will be.

The lessee must use the rate implicit in the lease when it is able to readily determine the rate. When the lessee is not able to readily determine the rate implicit in the lease, it must use its incremental borrowing rate. An implicit rate is considered readily determinable when all material inputs are themselves readily determinable by the lessee, including:

- a. Fair value of the underlying asset
- b. Amount lessor expects to derive from the underlying asset at the end of the lease term
- c. Lessor's initial direct costs

As a lessee, the implicit rate will be almost impossible to determine if it is not explicitly stated in the contract.

An organization's incremental borrowing rate is the rate of interest that the lessee would have to pay on a collateralized loan with similar terms in a similar economic environment. A lessee may apply a single discount rate to a portfolio of leases, assuming the result would not be significantly different from individual discount rates.

As amended by ASU 2021-09, a nonpublic business entity can elect an accounting policy to use a risk-free discount rate for a lease instead of its incremental borrowing rate. All not-for-profit organizations are considered nonpublic business entities, including those that have public conduit debt securities. The risk-free rate should be determined using a period comparable to that of the lease term. An organization makes this election by class of underlying asset. An organization must disclose this policy and the classes of underlying assets to which it has been applied.

A nonpublic business entity can make an accounting election to use a risk-free discount rate by class of underlying asset.

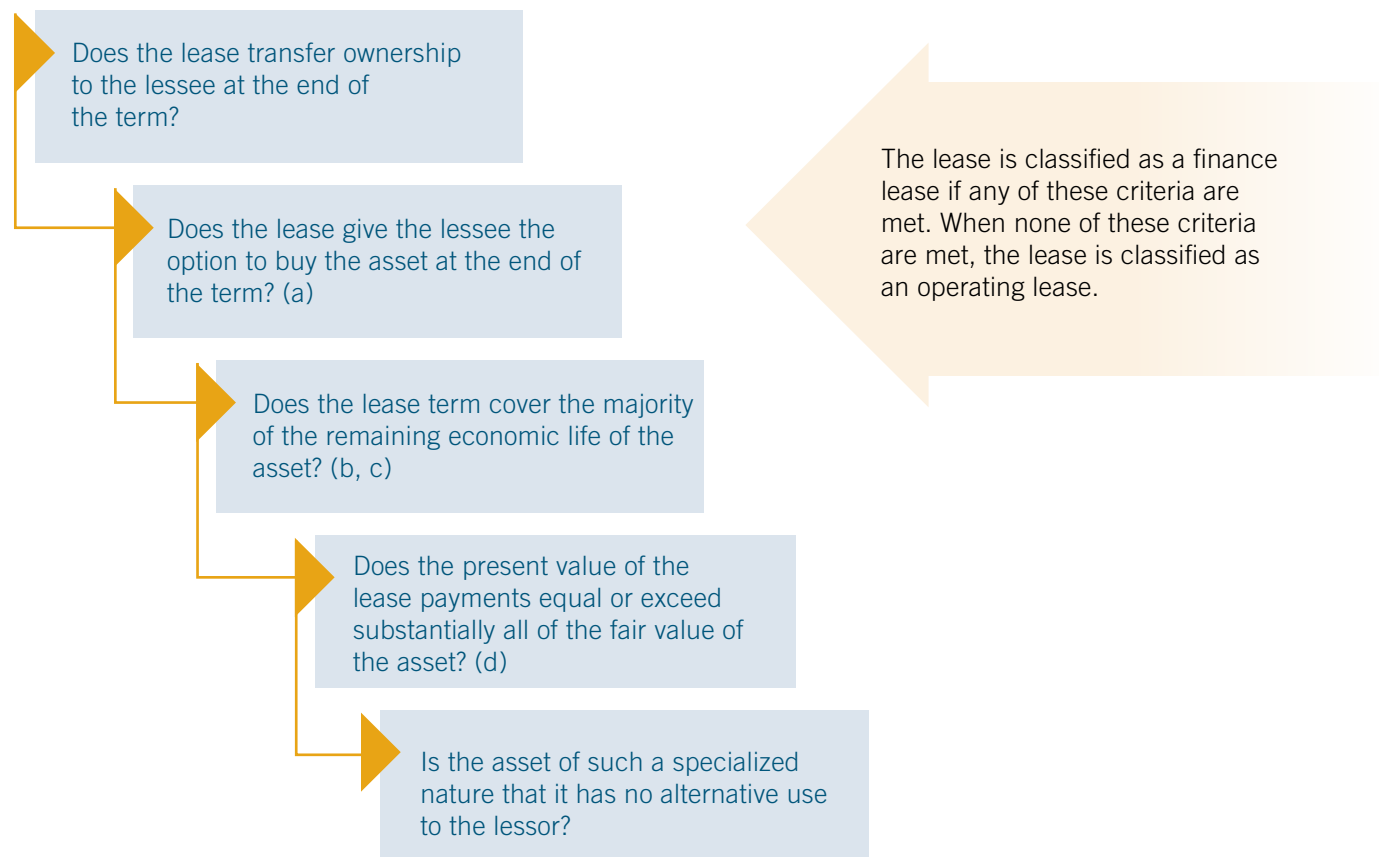
This election would typically result in a higher recorded lease liability. Organizations will need to weigh the administrative benefits of this election against the higher financial liabilities and consider which classes of assets to apply it to. Factors to consider include the amount and frequency of the lease payments.

STEP 5: Determine the Classification of a Lease

Under the new standard, lease classification no longer determines whether a lease will be recorded as an asset and liability on the statement of financial position, since all leases are recorded. Lease classification is determined at

the commencement date and affects the amount and timing of lease expense. The evaluation between an operating and a finance lease focuses on whether control of the asset is effectively transferred to the lessee.

The following flowchart is used to determine classification:

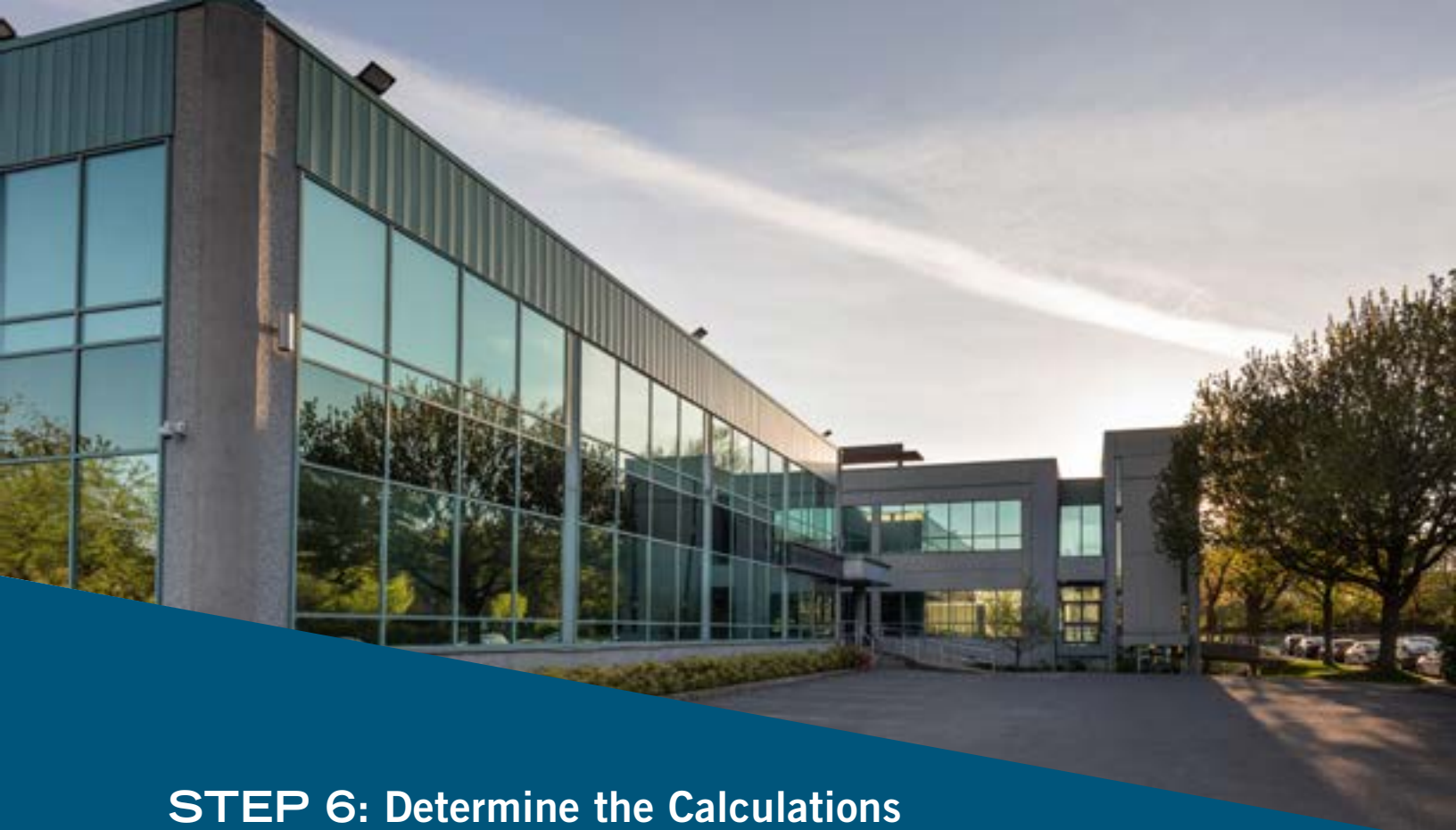


(a) And the lessee is reasonably certain to exercise the right to buy.

(b) 75% or more of the remaining economic life of the underlying asset can be used to determine whether it is a major part of the remaining economic life of that underlying asset.

(c) If the commencement date falls at or near the end of the economic life of the underlying asset, this criterion shall not be used for purposes of classifying the lease. A commencement date that falls within the last 25% of the total economic life of the underlying asset can be used as a basis for determining whether the contract falls at or near the end of the economic life of the underlying asset at the commencement date.

(d) 90% or more of the fair value of the underlying asset can be used as a basis for determining whether it amounts to substantially all the fair value of the underlying asset.



STEP 6: Determine the Calculations for Recognition and Initial Measurement

A lessee must recognize a lease liability and right-of-use asset for all leases. Recognition and measurement of a lease occur at the commencement date. The lease commencement date is the date the lessor makes the asset available for use by the lessee.

▶ CALCULATION OF INITIAL LEASE LIABILITY

Present value of future lease payments

▶ CALCULATION OF INITIAL RIGHT-OF-USE ASSET

Initial lease liability



Prepaid lease payments made to the lessor



Initial direct costs incurred by the lessee



Lease incentives receivable

Right-of-use asset

The lease asset will be equal to the lease liability at the start of the lease, adjusted for any prepaid rent, initial direct costs, and lease incentives. The initial right-of-use asset and lease liability will be the same for operating leases and finance leases.

STEP 7: Determine the Ongoing (or Subsequent) Measurement

Finance leases will result in greater expense in the early years of the lease term and a lesser expense in the later years. Conversely, operating leases will result in a single straight-line lease expense throughout the lease term, unless another pattern

is more representative of the lessee's anticipated consumption of the asset's future economic benefits. The following summarizes the financial statement impact of operating and finance leases:

Operating Lease

Statement of Financial Position	Right-of-use asset: Measured at the current lease liability +/- prepaid lease payments, unamortized initial direct costs, and the remaining balance of any lease incentives received.	Operating lease liability: Measured at the present value of remaining lease payments using the discount rate established at the beginning of the lease term.
Statement of Activities	Single lease expense recognized on a straight-line basis. If the payments vary over the lease term, the lease expense should be straight-lined over the lease term.	
Statement of Cash Flow	Cash paid for lease payments (operating activities).	

Finance Lease

Statement of Financial Position	Right-of-use asset: Amortized over the lease term. Amortized over the useful life of the underlying asset if the lease transfers ownership and the lessee is reasonably certain to exercise an option to purchase the asset.	Finance lease liability: Measured at the initial lease liability, plus interest on the liability less payments made.
Statement of Activities	Amortization expense: Amortization of the right-of-use asset. Interest expense: Interest on the finance lease liability.	
Statement of Cash Flow	Cash paid for principal payments (financing activities). Interest payments (supplemental disclosure). Cash paid for interest (operating activities and supplemental disclosure).	

EXAMPLE 1:

Operating Lease

A lessee signs an agreement to lease a building for five years with no renewal options. The annual lease payment is \$117,088, due at the end of the year. The incremental borrowing rate is 5.5%. The lease is determined to be an operating lease.

Commencement Date

	Debit	Credit	
Right-of-use asset	500,000		<i>To record the right-of-use asset at the lease commencement date.</i> (a) Lease liability at commencement: present value of five payments of \$117,088 at 5.5%
Lease liability (a)		500,000	

Year 1 Entries

	Debit	Credit	
Lease liability	117,088		<i>To record the periodic rent payment to the lessor.</i>
Cash		117,088	
Lease expense	117,088		<i>To record the periodic lease expense, amortization of the right-of-use asset, and accreted interest on lease liability.</i> (b) Accreted interest on lease liability: \$500,000 x 5.5% = \$27,500
Lease liability (b)		27,500	
Right-of-use asset		89,588	

Lease liability after Year 1 payment: $\$500,000 - \$117,088 + \$27,500 = \$410,412$

Right-of-use asset after Year 1 payment: $\$500,000 - \$89,588 = \$410,412$

Year 2 Entries

	Debit	Credit	
Lease liability	117,088		<i>To record the periodic rent payment to the lessor.</i>
Cash		117,088	
Lease expense	117,088		<i>To record the periodic lease expense, amortization of the right-of-use asset, and accreted interest on lease liability.</i> (c) Accreted interest on lease liability: $\$410,412 \times 5.5\% = \$22,573$
Lease liability (c)		22,573	
Right-of-use asset		94,515	

Lease liability after Year 2 payment: $\$410,412 - \$117,088 + \$22,573 = \$315,897$

Right-of-use asset after Year 2 payment: $\$410,412 - \$94,515 = \$315,897$

EXAMPLE 2:

Finance Lease

A lessee signs an agreement to lease equipment for 15 years with no renewal options. The annual lease payment is \$24,734, due at the end of the year. The incremental borrowing rate is 4.0%. The lease is determined to be a finance lease.

Commencement Date

	Debit	Credit	
Right-of-use asset	275,000		<i>To record the right-of-use asset at the lease commencement date.</i> (a) Lease liability at commencement: present value of 15 payments of \$24,734 at 4.0%
Lease liability (a)		275,000	

Year 1 Entries

	Debit	Credit	
Interest expense (b)	11,000		<i>To record the periodic rent payment to the lessor and interest expense on lease liability.</i> (b) Interest expense on lease liability: \$275,000 x 4% = \$11,000
Lease liability	13,734		
Cash		24,734	
Amortization expense (c)	18,333		<i>To record the amortization expense.</i> (c) Amortization expense: \$275,000 / 15 years = \$18,333
Right-of-use asset		18,333	

Lease liability after Year 1: $\$275,000 - \$13,734 = \$261,266$

Right-of-use asset after Year 1: $\$275,000 - \$18,333 = \$256,667$

Year 2 Entries

	Debit	Credit	
Interest expense (d)	10,451		<i>To record the periodic rent payment to the lessor and interest expense on lease liability.</i> (d) Interest expense on lease liability: $\$261,266 \times 4\% = \$10,451$
Lease liability	14,283		
Cash		24,734	
Amortization expense (e)	18,333		<i>To record the amortization expense.</i> (e) Amortization expense: $\$275,000 / 15 \text{ years} = \$18,333$
Right-of-use asset		22,573	

Lease liability after Year 2: $\$261,266 - \$14,283 = \$246,983$

Right-of-use asset after Year 2: $\$256,667 - \$18,333 = \$238,334$

STEP 8: Effective Date and Additional Standard Clarifications

Effective Date for Nonprofit Organizations

For nonprofits, the new standard is effective as follows:

- Fiscal years beginning after December 15, 2021 (calendar 2022 year-end; fiscal years ending in 2023)
- If the organization has conduit debt or securities that are traded, listed, or quoted on an exchange or an over-the-counter market and have not issued their December 31, 2019, financial statements, fiscal years beginning after December 15, 2019 (calendar 2020 year-end; fiscal years ending in 2021)

Accounting Standards Update (ASU) 2023-01

On March 27, 2023, FASB issued ASU 2023-01, which amends certain provisions of ASC 842 that apply to arrangements between related parties under common control. Specifically, the ASU:

- Provides a practical expedient for nonprofits that are not conduit debt obligors to use the written terms and conditions (as opposed to the enforceable rights and obligations) to determine whether a lease exists in common control arrangements and, if so, the accounting and classification for that lease. This practical expedient can be applied on an arrangement-by-arrangement basis. However, if no written terms exist, an entity is not allowed to adopt the practical expedient and must apply ASC 842 in a manner consistent with other arrangements.
- Amends the accounting for leasehold improvements to allow amortization over the useful life of the leasehold improvements to the common control group (regardless of lease term) as long as the lessee controls the use of the asset through the underlying lease. This is in contrast to recording amortization over the shorter of the lease term or the useful life of the asset.



Appendix:

Disclosure Summary

Statement of Financial Position

Right-of-use assets and lease liabilities should be appropriately classified as current and noncurrent in a classified statement of financial position. Operating lease right-of-use assets and finance lease right-of-use assets cannot be presented in the same line item in the statement of financial position.

Similarly, operating lease liabilities and finance lease liabilities are prohibited from being presented in the same line item in the statement of financial position. If these are not presented separately from other assets and liabilities in the statement of financial position, the line items in which they are included need to be disclosed in the notes to the financial statements.

Statement of Activity

For finance leases, interest expense on the lease liability and amortization of the right-of-use asset should be presented in the statement of activities consistent with the presentation of other interest expense and amortization or depreciation of similar assets. Interest expense on the lease liability and amortization of the right-of-use asset are not required to be presented as separate line items in the statement of activities.

Statement of Cash Flow

- Classify repayments of the principal portion of the finance lease liability with financing activities
- Classify interest on finance lease liability according to the requirements related to other interest paid
- Classify payments from operating leases as operating activities
- Classify variable lease payments and short-term lease payments not included in the lease liability with operating activities

Notes to the Financial Statements

Qualitative and quantitative information should be disclosed about:

1. The organization's leases;
2. Significant judgments that were made in applying GAAP related to leases; and
3. The related amounts recognized in the financial statements.

Consideration should be given to the level of detail needed to satisfy the disclosure objective and the degree of emphasis placed on each requirement. Disclosures should be aggregated or disaggregated to ensure that useful information is not obscured by including a large amount of detail that is not significant or by aggregating items with differing characteristics. The disclosures allow users to assess the amount, timing, and uncertainty of cash flows from leases.



Qualitative Disclosures

- Nature of leases, as well as any subleases, including:
 - A general description of the leases.
 - The basis and terms and conditions on which variable lease payments are determined.
 - The existence and terms and conditions of options to extend or terminate the lease. A lessee should provide narrative disclosure about the options that are recognized as part of its right-of-use assets and lease liabilities and those that are not.
 - The existence and terms and conditions of residual value guarantees provided by the lessee.
 - The restrictions or covenants imposed by leases, e.g., those relating to dividends or incurring additional debt.
- Information about leases that have not yet commenced but that create significant rights and obligations for the lessee, including the nature of any involvement with the construction or design of the underlying asset.
- Significant assumptions and judgments, including:
 - The determination of whether a contract contains a lease.
 - The allocation of the consideration in a contract between lease and nonlease components.
 - The determination of the discount rate for the lease.
- Lease transactions between related parties.
- If the lessee has made the accounting policy election for short-term leases:
 - Disclose that it has made the election.
 - Disclose the amount of its short-term lease commitments if the short-term lease expense for the period does not reasonably reflect the lessee's short-term lease commitments.
- If the lessee has made the accounting policy election to treat both lease and nonlease components as a single lease component, disclose that it has made the election and the class or classes of underlying assets on which the practical expedient was applied.
- If the lessee has made the accounting policy election to use a risk-free discount rate instead of its incremental borrowing rate, disclose that it has made the election and the class or classes of underlying assets on which this election was applied.

Quantitative Disclosures

- For each period presented in the financial statements, a lessee shall disclose the following amounts relating to a lessee's total lease cost, which includes both amounts recognized in the change in net assets or capitalized as part of the cost of another asset, and the cash flows arising from lease transactions:
 - Finance lease cost, segregated between the right-of-use amortization and interest on the lease liabilities.
 - Operating lease cost (including cash paid for operating leases).
 - Short-term lease cost, excluding expenses relating to leases with a lease term of one month or less.
 - Variable lease cost.
 - Sublease income, disclosed on a gross basis, separate from the finance or operating lease expense.
 - Net gain or loss recognized from sale and leaseback transactions.
 - Amounts segregated between those for finance and operating leases for the following items:
 - Cash paid for amounts included in the measurement of lease liabilities, segregated between operating and financing cash flows.
 - Supplemental noncash information on lease liabilities arising from obtaining ROU assets.
 - Weighted-average remaining lease term.
 - Weighted-average discount rate.
- Maturity analysis of breaking out finance and operating lease liabilities separately, showing the undiscounted cash flows on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years. A lessee shall disclose a reconciliation of the undiscounted cash flows to the finance and operating lease liabilities recognized in the statement of financial position.

Questions?

CapinCrouse is here to help. Please reach out to your engagement team or [contact us](#) to learn more about how we can assist you with implementing the lease standard.

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