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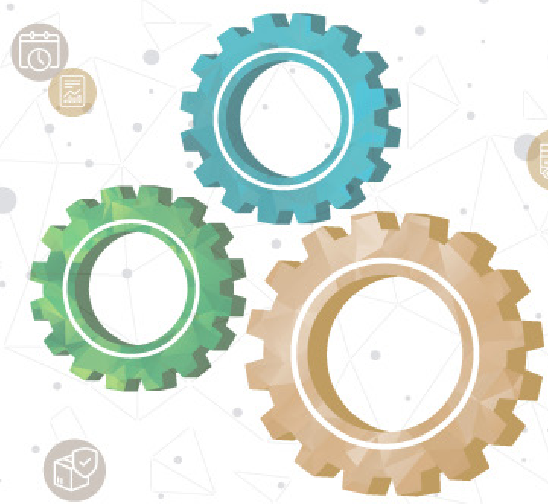

ASC 842: Accounting for Leases

By Mark Sabates

The new lease standard (ASC 842) has completely changed the way a lessee accounts for a lease. Under legacy U.S. GAAP (ASC 840), lessees were mostly concerned whether a lease was an operating or capital lease, as that determinant drove whether a lease was recognized on the balance sheet. In addition, there were no major differences in accounting between an operating lease and service contract that may have contained a lease because both were expensed in a similar fashion. As a result, lessees may not have historically focused on determining whether a service contract was a lease.

Under ASC 842, lessees must now recognize a right-of-use ("ROU") asset and lease liability for each lease on its balance sheet, with exception of a short-term lease. With the adoption of ASC 842, companies will now have to focus on whether a service contract meets the definition of a lease (embedded lease), as that will drive whether it is recognized on the balance sheet. ASC 842 defines a lease as a contract, or part of 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.

ASC 842 will have an impact on manufacturers who enter into contracts with suppliers to outsource some or all of their production. The contract may be structured in a way that allows the manufacturer to control the output (quantity and mix) manufactured during the use of a facility or a production line. As a result, these type of contracts will need to be evaluated to determine if they contain an embedded lease.

In order for a company to determine whether a service contract contains an embedded lease it must determine the following:

1. Is there an identified asset?

   To have an identified asset, a contract must either explicitly or implicitly specify the asset. Examples include a floor of a building, a production facility or a production line within a facility.

2. Does the supplier have a substantive right to substitute the identified asset throughout the period of use?

   Some contracts give the supplier the right to fulfill its obligation using an alternative asset. If the supplier has a substantive right to substitute the identified asset for an alternative asset throughout the period of use, there is no identified asset. The supplier's right to substitute an asset is substantive only if both of the following conditions exists:

   - The supplier has the practical ability to substitute alternative assets throughout the period of use.
   - The supplier would benefit economically from the exercise of its right to substitute the asset (that is,

the economic benefits associated with substituting the asset are expected to exceed the costs associated with substituting the asset).

3. Does the company have the right to control the use of the identified asset?

   Who has control over the right to use the asset and who has decision-making authority differentiates an embedded lease from a service arrangement. A company has the right to control the use of the identified asset when it has both of the following:

   - The right to direct the use of the identified asset. To meet this condition, a company would have to have the right to change how and for what purpose the asset is used. In assessing whether it has that right, the company would consider the decision-making rights that affect the economic benefits to be derived from using the asset.
   - The right to obtain substantially all of the economic benefits from the use of the asset. The economic benefits from using an asset include its primary output and by-products (including potential cash flows derived from these items) and other economic benefits that could be realized from a commercial transaction with a third party.

CONCLUSION

When adopting ASC 842, one of the most challenging aspects can be identifying whether a service contract contains an embedded lease. While it is possible that some contracts may not meet the definition of a lease, it is critical that companies engage in a thoughtful analysis to identify contracts that may contain embedded leases as it can involve significant judgment.

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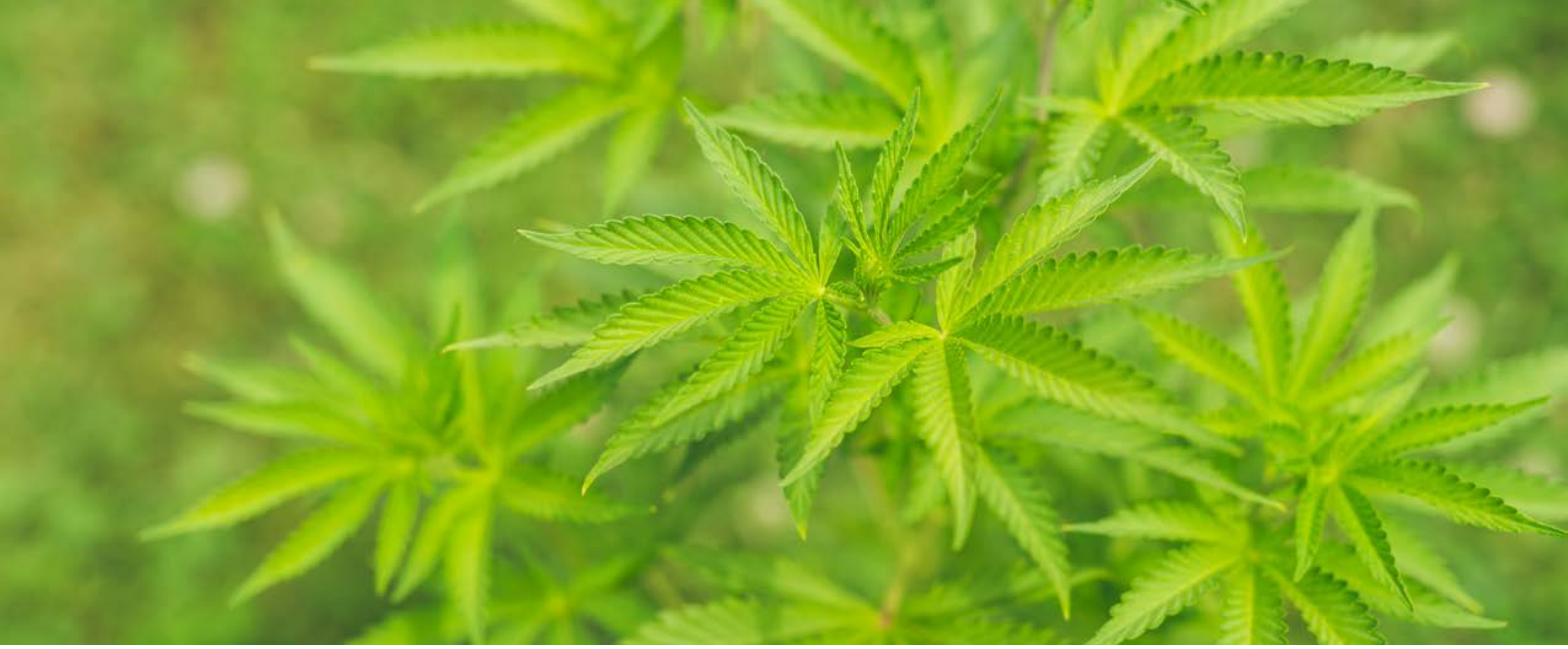


Cannabis — Not a Weed Anymore

By Rick Frimmer

One of the hottest markets in the manufacturing sector today is, believe it or not, cannabis, and its cousin, hemp. In a meteoric recent rise to fame, cannabis is dominating many state legislatures and Congress as well.

It is a total non-sequitur. Cannabis, its manufacture, sale and use, is illegal in the United States, and has been so since 1970. In the 1600s, the King of England encouraged the cultivation of cannabis in the Colonies. It remained legal until 1970, when the Marijuana Tax Act of 1937 was declared unconstitutional, and the Controlled Substances Act ("CSA") was enacted. Marijuana is listed as a Schedule 1 drug under the CSA, thus making it illegal for all federal purposes.

Yet, in a bizarre and unprecedented twist, thirty-six states have now legalized cannabis for medicinal use, for recreational use, or both. This dichotomy between federal illegality and state legality presents a host of problems for industry participants.

In 2014, Assistant Attorney General James Cole issued the now-famous "Cole Memo" which merely set priorities for federal enforcement of illegal cannabis activities. The Cole Memo was echoed by the U.S. Treasury Department in a companion memo. Industry people took the Cole Memo as a "safe harbor" for permissive cannabis activities. At the same time, Congressman Dana Rohrabacher (R-CA) successfully added an "amendment" to the federal budget bill (known as the "Rohrabacher-Farr Amendment") prohibiting the U.S. Justice Department from using federal funds to prosecute medical cannabis businesses and users. The cannabis industry exploded and states started to enact permissive legislation.

In January 2018, Attorney General Jeff Sessions revoked the Cole Memo. The industry barely blinked. Cannabis cultivation, manufacturing and sales exploded in 2018 despite Sessions' attempt to stranglehold the industry. The new Attorney General, William Barr, seems uninterested in prosecuting cannabis.

Nonetheless, the fact of federal illegality keeps U.S. public companies, many private equity funds and others wary of investment. Further, although many states have legalized cannabis activities, federal illegality means that cannabis seeds, plants and products cannot move in interstate commerce. So, everyone has to stay in their own state, or replicate their businesses in every state in which they wish to operate. This is expensive and creates diseconomies of scale.

Meanwhile, Canada legalized cannabis for all purposes in 2018. The Canadian Stock Exchange ("CSE") has permitted cannabis enterprises to go public in Canada. Thus, many

Canadian cannabis enterprises have gone public on the CSE and have used their public stock as currency to come to the U.S. and buy up many cannabis businesses. At last count, billions have been invested by Canadian companies in the U.S. cannabis market. Also, U.S.-based companies, such as MedMen, have gone public in Canada on the CSE and used their public stock to expand their U.S. operations. Some experts have reported that cannabis is expected to be a $20 billion market in the U.S. by 2021.

To make matters even more intriguing, cannabis has a cousin – hemp. Hemp is a cannabis plant that tends to produce less of the psychotropic substance THC (tetrahydrocannabinol) than cannabis strains, and more of the other substance in cannabis plants – CBD (cannabidiol). CBD is reported to have many possible medical benefits, so many that Fortune 500 companies are trying to put CBD in drinks and other edibles. Hemp was also illegal for federal purposes until December 2018, when Senator Mitch McConnell (R-KY) successfully appended hemp legalization provisions into the 2018 Farm Bill. Thus, hemp plants which contain less than 0.3% THC are now legal, although technically the FDA has to issue regulations. An entire industry is now born and accelerating at an astonishing pace.

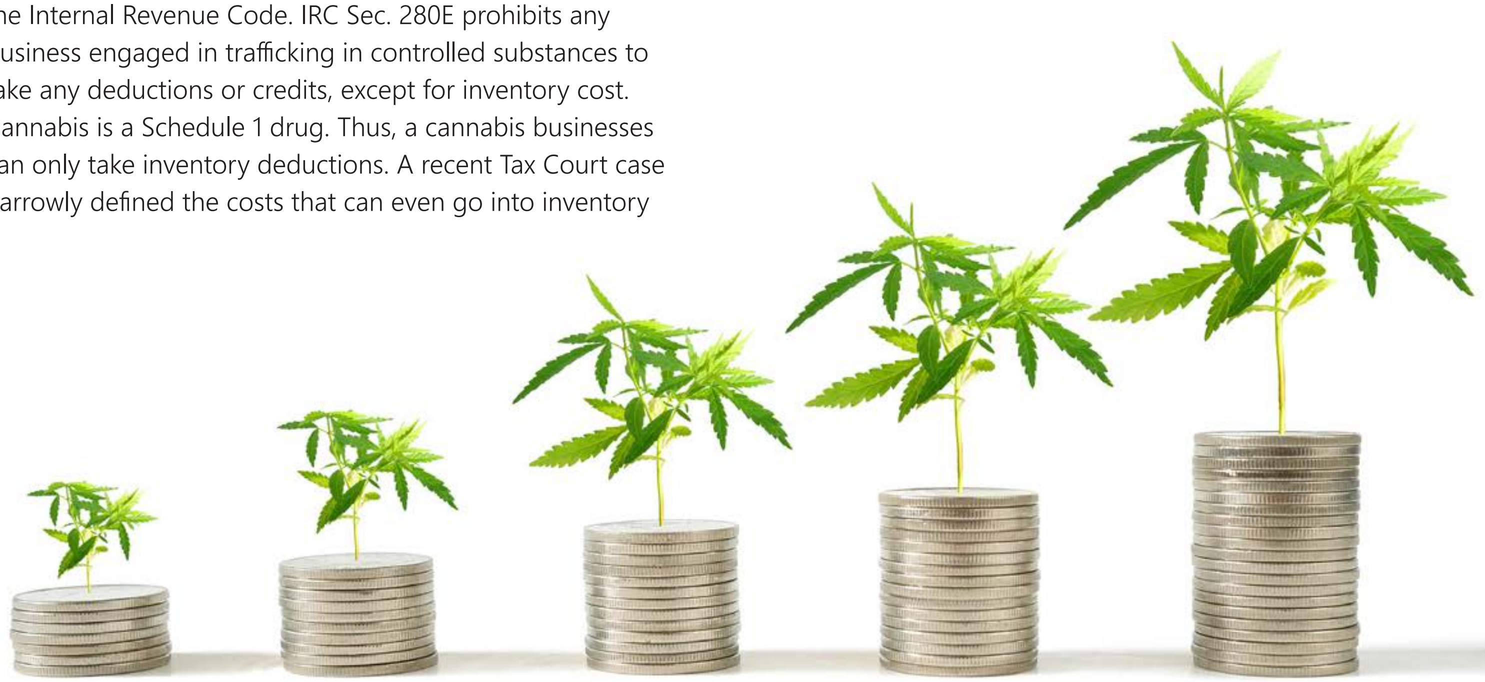
Despite the swelling interest and significant investment, cannabis is far from a simple business. There are many challenges facing cannabis industry participants.

For example, many years ago in response to Pablo Escobar, the infamous drug czar, Congress added Section 280E to the Internal Revenue Code. IRC Sec. 280E prohibits any business engaged in trafficking in controlled substances to take any deductions or credits, except for inventory cost. Cannabis is a Schedule 1 drug. Thus, a cannabis businesses can only take inventory deductions. A recent Tax Court case narrowly defined the costs that can even go into inventory expense. This decreases the EBITDA of cannabis businesses. Interestingly, since hemp is no longer a Schedule 1 substance, hemp businesses are not (since December 2018) subject to IRC Sec. 280E.

Each legalizing state has enacted tax statutes to capture revenue from the explosion of cannabis and hemp-derived CBD sales. State and local governments are collecting various sales and excise taxes from wholesalers, distributors, retailers and consumers. All get added to the price in the store – at least for now.

The legalizing states all have complex licensing, building code, and other regulatory compliance laws that must be dealt with by cannabis enterprises. Some states have limited licenses, both for manufacturing and retail dispensaries alike. California has no less than twelve licensing categories at the state level, and each local government has their own categories as well. It is a virtual compliance nightmare.

There are real estate challenges as well. Zoning laws prohibit cannabis enterprises from operating except in discrete locations. Building codes and environmental laws are complex for cannabis businesses as well. A hoard of expensive and time-consuming issues result.



To make matters worse, there are few banks across the U.S. that will take accounts for cannabis businesses. At last count, around 450 banks, savings and loans, and credit unions across the country will accept deposits. Accepting deposits from cannabis enterprises is not, as one would suspect, illegal. To the contrary, the Federal Reserve has gone out of its way to accommodate cannabis banking. However, the banks deem it too risky, especially since they have to comply with anti-money laundering ("AML") rules and, among other things, file suspicious activity reports ("SARs") for every cash deposit. Since cannabis enterprises cannot get easy access to credit cards, most transactions are in cash. Ergo, banks are forced to file SARs. Most are not willing to establish compliance protocols, and if they do, they charge handsomely for the cannabis clients to bank with them.

Entering and succeeding in the cannabis and hemp business is not for the faint of heart. Significant risks exist at every level. This is the primary reason why so many investors are still on the sidelines.

Yet, the opportunity is tantamount to the fledgling alcohol business after Prohibition ended, gambling in Las Vegas and Atlantic City, and the dot com explosion of the late 1990s. Savvy investors already see the substantial (and quick) upsides. However, not everyone will prosper.

Who will? Those enterprises that have clear market goals and niches. Also, they must surround themselves with quality professionals – attorneys, accountants, consultants, insurance brokers, investment bankers. Why? Because this business is fraught with federal, state and local risks. As the end products becomes commoditized, the weak will fall by the wayside. The strong will dominate the industry.

Rick Frimmer is Group Head, National Cannabis and Hemp Group at EisnerAmper. Questions? He can be reached at 760.579.7356 or rick.frimmer@eisneramper.com..

R&D Tax Credit Opportunities

By Tim Rankins

The manufacturing sector has long been the largest beneficiary of the R&D tax credit, with the industry accounting for over 60% of these credits claimed yearly. Companies can claim credits for R&D activities such as new product development and manufacturing process improvements. In addition, the relatively recent internal-use software regulations have provided additional opportunities for companies to claim internal software development costs. The following offers insight into some of the key considerations taxpayers should be evaluating regarding the R&D tax credit.

THE BASICS – ELIGIBILITY

Qualifying activities must meet a four-part test, which is both activity-based and U.S.-based. First, the work must relate to a new or improved product or process intended to improve at least one of the following product attributes: function, performance, quality or reliability. This test is typically satisfied with new product development activities, with exceptions for reverse engineering, adaptation or specific customer requests. The other consideration on the R&D test is improving a process toward the product development. In cases where a company incurs R&D spend to improve a process, such may qualify for the R&D credit if it meets the improvement criteria noted above.

The next test is whether the activities are technological in nature – meaning the work relies upon the hard sciences such as computer, biological, physical sciences or engineering. Here, taxpayers must be mindful of social sciences that are not considered qualified R&D – such as market research or cosmetics around a product.

The third test is whether there was a technical uncertainty relating to either capability, method or design. In many instances, this is the critical test of whether the activities will end up qualifying for the credit.

The last test is whether a process of experimentation existed (e.g., a systematic process of trial and error). Companies typically work through a product development lifecycle which can serve as primary evidence this test is met.

CONSIDERATIONS FOR MANUFACTURING COMPANIES

Once the above tests are satisfied for qualifying R&D activities, there are several developments and key considerations for evaluation such as:

- Is time being tracked to a project? If so, are all qualifying activities, such as direct support or supervision, being tracked as well? In many cases, the new product development or engineering teams track their time by project. However, support groups such as integrated product teams, or entire departments such as machine shop, tooling, prototyping, quality assurance, marketing and administration will not track their time. Therefore, it's critical to have an understanding of the types of documentation available to support their qualified time.

- Should the taxpayer use the ASC730 safe harbor as a basis for calculating the R&D tax credit? There is a safe harbor available to large companies that book R&D for financial reporting purposes under ASC730. The safe harbor allows those costs as the basis for calculating the credit and does not require documentation to be accumulated to support the credit claim. This can be an extremely useful tool for large taxpayers that are fatigued with spending significant time documenting how each project meets the four-part test.
- Is the taxpayer a qualified small business? For new taxpayers (those in existence for five years or less), there is an opportunity to use the credits against future payroll tax expense. This option can be a tremendous benefit for new start-up companies. Qualified small businesses are companies with less than $5,000,000 in receipts in their current tax filing year; and zero receipts prior to a five-year look-back period. For example, a company filing a 2018 tax return needs to have zero receipts prior to 2014. Receipts include interest in this determination. Further, companies need to be mindful of the control-group rules in determining eligibility.
- IRC Section 174 Pilot Models. The Treasury released regulations broadly defining pilot models and their eligibility under IRC Sec. 174. Consequently, taxpayers have been able to qualify significantly more supply costs associated with pilot models. Defining the business component and pilot model is critical to taxpayers in how much supply costs can be eligible for the credit.
- State Credit Incentives. Many states offer similar R&D tax credit incentives. Some of these incentives are transferrable, enabling taxpayers to monetize the credits if they are in a loss position. Other states use application processes where the deadline does not align with the taxpayers' tax filing. The New Jersey R&D tax credit was recently updated to include a simplified credit method, for example. Other states have adopted a similar approach in recent years, such as Massachusetts.

In summary, there are several R&D credit opportunities and considerations available to taxpayers in this industry. It is vital to review existing activities and ensure you are taking advantage of all the opportunities available. If R&D spend is material, it is a good practice to consider an analysis or tax study performed by a professional. Not only would this be good documentation to support an R&D credit, but acts as a strong defense if challenged by tax authorities.

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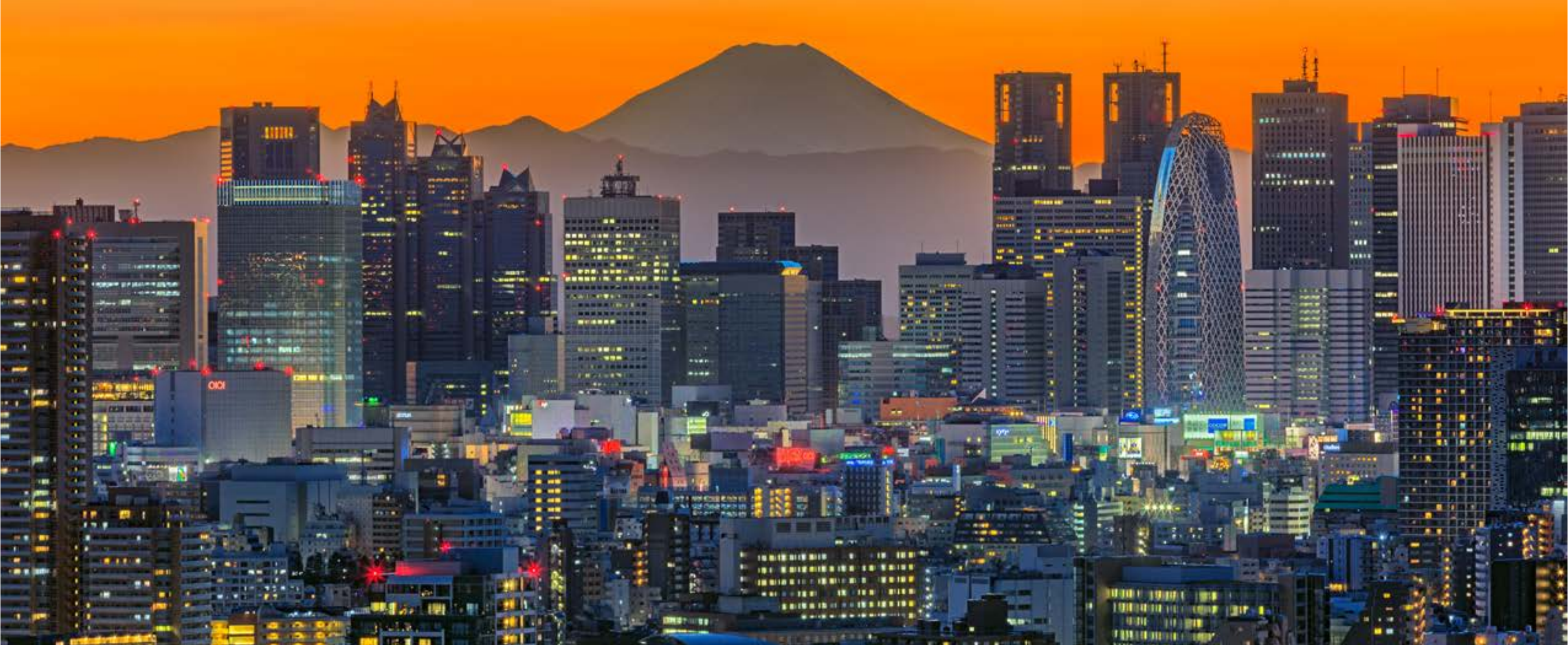

Japanese Sarbanes-Oxley Compliance Services

By Brian Ferrara

Japan's version of Sarbanes-Oxley (SOX) is incorporated in its Financial Instruments and Exchange (FIE) Act enacted in 2006. The J-SOX requirement is the Japanese equivalent to U.S. SOX in relation to Sections 302 "Corporate Responsibility for Financial Reports" and 404 "Management Assessment of Internal Controls." Both regulations are aimed at evaluating internal control systems relating to financial reporting, assuring the proper expression of external financial reporting with the requirement of financial-report certifications by the CEO and CFO and preventing the recurrence of investor deception.

Not unlike the U.S., the J-SOX regulatory initiative was also in response to a number of scandals in the Japanese markets, including Seibu Railway in October 2004, Kanebo in September 2005, and Livedoor in January 2006. There are a number of similarities and differences which need to be addressed by companies, especially with subsidiaries located in both Japan and the U.S. Overall, J-SOX requirements require a broader initiative than U.S. SOX. The Internal Control Reporting System in Japan looked to avoid both the burden and confusion surrounding U.S. SOX when developing the standards.

J-SOX SPECIFICS

- Internal controls over financial reporting will include not only the financial statements and their footnotes, but also items that are disclosed in other areas of Securities Reports.
- Evaluation of certain controls at affiliates accounted for in accordance with the equity-method of accounting.
- Evaluation of entity-level internal controls including book closing and financial reporting processes at all business units.
- Companies are to focus on processes related to the closing of the books and reporting, sales, accounts receivable, inventory and the significant processes related to the business objectives of the company.
- There are only two types of deficiencies based on quantitative and qualitative factors:
  - Deficiency
  - Material weakness
- A material weakness is reported if the effect of the misstatement is greater than 5% of consolidated pre-tax income.

Other specifics for J-SOX in reporting and evaluation of internal controls over financial reporting, distinguishing the standards from U.S. SOX, are as follows:

J-SOX OVERALL

- Internal control assessment reports will be audited and certified by independent accountants, who will attest to the reports' reliability or lack thereof. Under U.S. SOX requirements, in addition to assessing a company's management-generated internal control assessment reports, the certifying accountants must also perform an audit of the effectiveness of the company's financial reporting-related internal control system.
- The managers of a company are responsible for designing and implementing an internal control system, and they must assess the effectiveness of that system.
- Management reports on the accuracy of disclosures and the company's internal controls.
- J-SOX does not restrict consulting roles offered by external auditors to the same client.

INFORMATION SUBJECTED TO THE RULES

- Consolidated financial statements and their footnotes in the financial section of the Securities Report.
- Disclosures that have a significant impact on the reliability of financial statements in other sections of the Securities Report.

J-SOX INTERNAL CONTROL FRAMEWORK:

- J-SOX framework includes an objective of "preservation of assets" in addition to three Committee of Sponsoring Organization (COSO) objectives: operations, reporting and compliance.
- J-SOX framework includes an element of "Response to IT" in addition to five COSO elements: control environment, risk assessment, control activities, information and communication, and monitoring activities.

EVALUATION STEPS FOR J-SOX

- Determine the scope by reasonably considering the materiality of the quantitative and qualitative impacts to the financial reporting.
- Evaluate company-level internal controls. The list of elements is similar to COSO, with the addition of "Response to Information Technology."
- Evaluate process-level internal control over financial close and reporting. Controls are divided into company-level controls and process-level controls. The company-level controls should be evaluated at all business units.
- Process-level controls related to sales, AR and inventory should be considered as significant processes for manufacturing companies.
- All other high-risk business processes should be evaluated.

FOUR-PHASE APPROACH

It is imperative for Japanese companies to recognize the issues in order to evaluate and establish effective internal controls and to be prepared for the compliance due date. We have developed a four-phase approach which will provide guidance for successful compliance of J-SOX requirements within your organization.

Planning & Scoping:

- Evaluate and compare J-SOX to U.S. SOX requirements on a company level.
- Establish materiality threshold metrics.
- Assess risk at the company and process level with emphasis on safeguarding of assets and IT control environment.

Risk Assessment & Control Design:

- Evaluate company and process-level internal controls over high risk areas related to financial reporting and close, sales, accounts receivable, inventory and purchasing
- Determine and rate the inherent risk.
- Review internal control system designed and implemented by management.
- Align the control activities to the risk at the company and process level.
- Identify key controls.

Testing & Evaluating Controls:

- Develop test plans based on the significance and type of control.
- Review test plans with management with consideration of implemented internal control system.
- Perform test execution.

Deficiency Assessment & Conclusion Report:

- Evaluate identified control deficiencies.
- Communicate identified control deficiencies to management.
- Prepare conclusion report.
- Provide response to IT.

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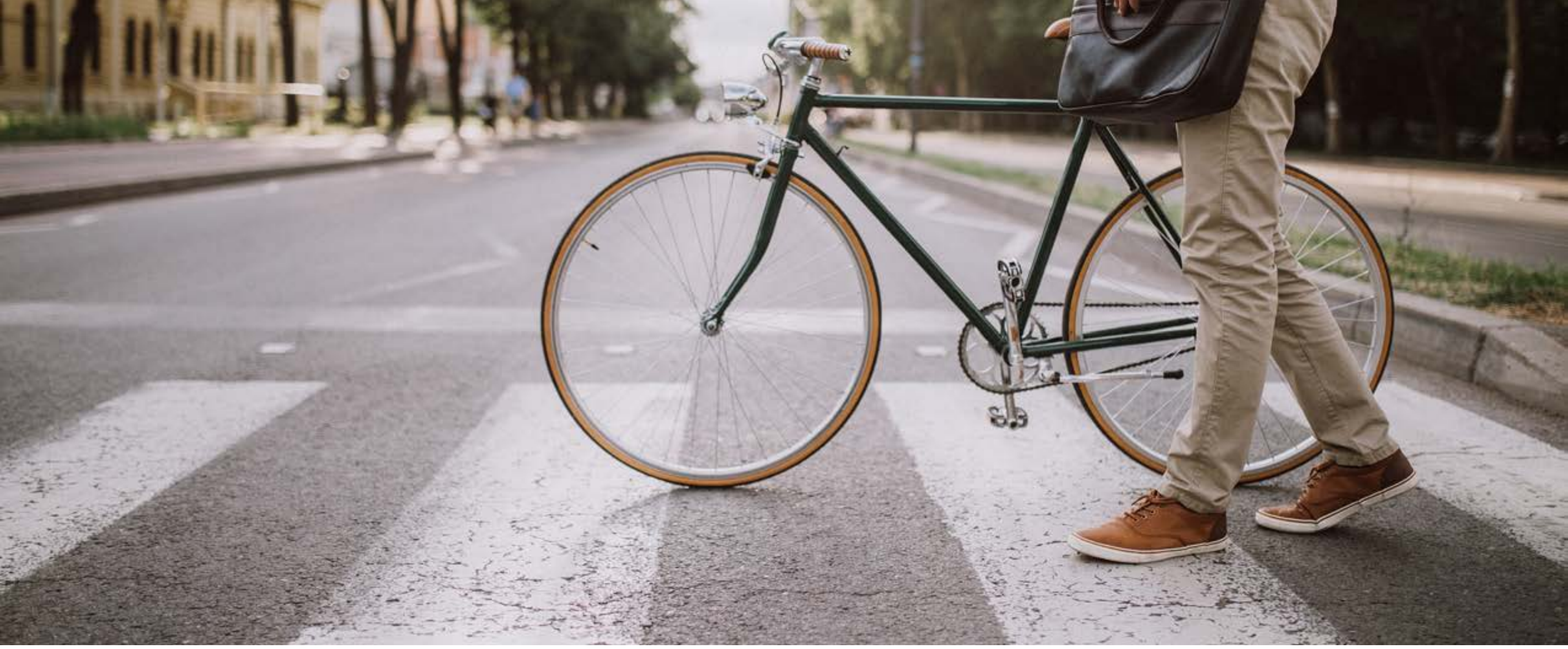

EisnerAmper Q&A with Arnold Kamler, CEO, Kent International

By Elana Margulies-Snyderman

Kent International is an American bicycle supplier based in Parsippany, New Jersey that imports and distributes bicycles and bicycle parts. EisnerAmper sat down with Arnold Kamler, CEO of the company, who shared the company's story and how it has been instrumental in importing bikes from China, bringing manufacturing back to the U.S., adapting to Chinese tariff increases, future plans and more.

EisnerAmper: Tell us about Kent International.

Kamler: My family has been in the bike business since 1907 when my grandfather, Abraham Kamler, who emigrated from Poland, opened a bike shop in New York City. In 1915, he and the family moved to Newark, New Jersey where they opened up a new shop.

My father, Philip, grew up in the apartment located on the second floor right above the bike shop. Unfortunately in 1946, his father had a heart attack and he left his job at Price Waterhouse to help the family business. He quickly realized he didn't like the retail bike business and therefore opened up a wholesale bike business called Philkam Cycle Supply Company in Newark, New Jersey in 1950. In 1958, he decided to take a chance and import bikes from Europe to take advantage of the low cost of labor and that was when Kent International launched. Kent International has imported bikes and bike parts since then.

In 1978, we also began manufacturing bikes in Kearny, New Jersey; which we did until 1991 when it became cost-prohibitive. Ultimately, we became one of the largest bike suppliers in the U.S and currently we produce between 2.5 and 3 million bikes a year.

In 1992, we relocated to Parsippany, New Jersey, our current headquarters. In 2014, we opened up our bike factory in Manning, South Carolina. Approximately three years ago, we acquired a custom designs bicycle cruiser company called Villy Customs in Dallas. In addition, we own our own brand of prestigious bikes called Van Dessel Cycles specific for racing. Kent International has 205 employees across all branches.

EisnerAmper: For many years Kent imported bikes from China. Please tell us how your company has been instrumental in bringing bike and bike accessories manufacturing back to the U.S. through your location in South Carolina.

Kamler: We started manufacturing in South Carolina in 2014 following a conference we attended where Walmart was pushing to bring manufacturing to the U.S. At the conference, former South Carolina Governor Nikki Haley was a strong advocate for Kent to launch a location in the State. After we conducted a feasibility study in other states including Georgia and Florida, and considering the fact that we wanted to stay on the East Coast, we came to the conclusion that South Carolina presented an attractive opportunity to open a location. Today, our production there accounts for approximately 15% of our business.

EisnerAmper: Discuss Kent's success selling bikes on Amazon and at Walmart and other well-known places of commerce.

Kamler: We try to sell to all of the large companies, although there are not that many left. Walmart sells 60% of the bikes sold in the U.S. Having a substantial business at Walmart is critical to become a big player in the business. It's a lot of hard work getting to know the businesses of Amazon and Walmart. Bicycles and bike accessories are price sensitive and we do our hardest work to create products at various price points. With Amazon and Walmart.com and other retailers, business is changing quickly and you have to be constantly innovating; what you did last year probably won't work this year. We act as a drop ship vendor (DSV) where the customer sends his or her order to us and we bill them and ship it to the consumer, even though the consumer thinks it is coming from Amazon or other e-commerce platform. In 2018, we shipped more than 3,000 shipments per day from mid-November to mid-December and this year we are ready and expecting the number to be in the neighborhood of 7,000-8,000 shipments per day.

EisnerAmper: With President Donald Trump's recent Chinese tariff increases, how has Kent International had to adapt and change its immediate and longer-term plans?

Kamler: This is the most challenging period in our company's history. We have been able to deal over the years with price increases but with the tariff increases, we don't know if they are temporary or permanent. For the long term, the cost in China will become prohibitive; therefore, we will expand our U.S. production and are working with our supplier in China to develop a bike factory in Cambodia. Meanwhile, in the short term, we have to pass the increased price of bikes and bike parts onto our customers. This trade war is painful at times, and it doesn't seem to be going away anytime soon.

EisnerAmper: What is needed to help stimulate manufacturing and distribution in the United States?

Kamler: I have met with the Department of Commerce to discuss this exact topic. The idea was the U.S. bike industry was wiped out by China in 1990s. Now, we have to import bike parts from various countries. As a result, we have an aggressive plan and have formed a coalition called the American Bicycle Reshoring Coalition. The concept is duty free treatment of all imported parts for five years which would give any company in the U.S. a big advantage. It would further stimulate competitors to follow suit and open up here and also would be the motivation for companies to start manufacturing bicycles parts again in the U.S.

EisnerAmper: Innovation is a key to continuing successful businesses. Are there are any new product lines you are working on to evolve and grow your business?

Kamler: We have entered in an agreement with Panasonic to grow the pedal-assisted bike market in the U.S. Panasonic has been doing this in Japan for 40 years and the idea would be to do this in our South Carolina location by the fourth quarter.

Earlier this year, we launched a higher end line called Univega USA, featuring lighter materials for the frames and parts.

EisnerAmper: Talk about your company's succession plan and what you hope for the future.

Kamler: I'm planning to live until 148! But in all seriousness, my son, Scott, joined the company in 2010 and is now President. We are poised to continue the growth but the challenge is dealing with an environment where retailers are condensing. We will have to revamp our marketing plan and leverage social media to get consumers to purchase directly from our website so we can sell at retail profit margins instead of wholesale. It will be up to Scott to take it to another level and I am confident we are in a good position for the future.

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