ASC 842

Leases

Drew Nagus & Maria Alemian

10.28.2021

BAKER NEWMAN NOYES

Objectives

BAKER NEWMAN NOYES

1. Understand key concepts of ASC 842
2. Learn how to account for an operating lease through a detailed case study
3. Identify provisions in contracts that will impact accounting under ASC 842
4. Understand where public companies faced challenges

ASC 842: *Leases* Case Study

On January 17, 2022, Smith Johnson Williams LLP executed a lease agreement with ABC Properties for 10,000 square feet of office space at 123 Main Street, Boston, MA 02116 Suite #192.

Per the lease agreement, Smith Johnson Williams LLP will take possession of the office space on March 1, 2022, before it begins operations or makes lease payments under the terms of the lease. During this period, Smith Johnson Williams LLP has the right to use the office space for constructing leasehold improvements. Smith Johnson Williams LLP is required to make lease payments only after construction is completed, which is slated to occur on July 1, 2022. The lease expires on June 30, 2027. The lease agreement contains two (2) five (5) year renewal terms at the option of Smith Johnson Williams LLP at rent prices that approximate estimated market rates. Smith Johnson Williams LLC intends to acquire smaller law firms as part of their five-year business plan and hope to integrate all firms within one office space, therefore they expect that they will need a larger office space by 2029. The cost of construction of leasehold improvements is not significant to Smith Johnson Williams LLC. There are no early termination clauses in the lease agreement. There are no purchase options included within the lease agreement.

Per the lease agreement, there are stated annual rent escalations. Additionally, Smith Johnson Williams LLP is required to make payments for their pro rata share of real estate taxes, insurance, and common area maintenance expense. Smith Johnson Williams LLP received no incentives from ABC Properties in connection with the lease agreement. Rent is due on the first day of the month.

As Smith Johnson Williams LLP is not a public business entity, they have made an accounting policy election use the risk-free rate for the initial and subsequent measurement of lease liabilities. The risk-free rate will be determined using a period comparable to the lease term.

Smith Johnson Williams LLP was required to pay $20,000 to their real estate broker upon the closing of the lease agreement. In connection with negotiating the lease agreement, Smith Johnson Williams LLP paid their attorney $30,000.

The building at 123 Main Street, Boston MA recently sold for $900,000,000 on January 1, 2022. Total rentable square feet of the building is 300,000 square feet.

PHONE | 333.378.9946
FAX | 333.378.9945

LEASE ABSTRACT

Property Address:	123 Main Street, Boston, MA 02116
Premises:	Suite #192
Commencement Date:	March 1, 2022
Rent Commencement Date:	July 1, 2022
Termination Date:	June 30, 2027
Rentable Area:	10,000 square feet
Tenants Prorate Share:	3.3% - 300,000 square feet of total building rentable area
Base Rent	7/1/22 – 6/30/23 $100,000 7/1/23 – 6/30/24 $150,000 7/1/24 – 6/30/25 $200,000 7/1/25 – 6/30/26 $250,000 7/1/26 – 6/30/27 $300,000
Lease Term:	64 months
Security Deposit:	$50,000
Renewal Option(s):	Renewal Option 1: 7/1/27 – 6/30/28 $400,000 7/1/28 – 6/30/29 $450,000 7/1/29 – 6/30/30 $500,000 7/1/30 – 6/30/31 $550,000 7/1/31 – 6/30/32 $600,000 Renewal Option 2: 7/1/32 – 6/30/33 $650,000 7/1/33 – 6/30/34 $700,000 7/1/34 – 6/30/35 $750,000 7/1/35 – 6/30/36 $800,000 7/1/36 – 6/30/37 $850,000
Termination Option:	None
Landlord's Notice Address:	ABC Properties Attn: Regional Manager 5000 Harbor Way Boston, MA 02116 ABC Properties Attn: General Counsel 5000 Harbor Way Portsmouth, NH 03801

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Date	1 Mo	2 Mo	3 Mo	6 Mo	1 Yr	2 Yr	3 Yr	5 Yr	7 Yr	10 Yr	20 Yr	30 Yr
01/04/22	0.09	0.09	0.09	0.09	0.10	0.11	0.16	0.36	0.64	0.93	1.46	1.66
01/05/22	0.08	0.09	0.09	0.09	0.10	0.13	0.17	0.38	0.66	0.96	1.49	1.70
01/06/22	0.09	0.09	0.09	0.09	0.11	0.14	0.20	0.43	0.74	1.04	1.60	1.81
01/07/22	0.09	0.09	0.09	0.09	0.11	0.14	0.22	0.46	0.78	1.08	1.64	1.85
01/08/22	0.08	0.08	0.08	0.09	0.10	0.14	0.24	0.49	0.81	1.13	1.67	1.87
01/11/22	0.09	0.08	0.08	0.10	0.10	0.14	0.22	0.50	0.84	1.15	1.68	1.88
01/12/22	0.09	0.08	0.09	0.09	0.11	0.14	0.23	0.50	0.83	1.15	1.68	1.88
01/13/22	0.09	0.08	0.09	0.10	0.12	0.14	0.22	0.48	0.80	1.10	1.63	1.82
01/14/22	0.09	0.09	0.09	0.09	0.10	0.16	0.23	0.49	0.82	1.15	1.69	1.88
01/15/22	0.08	0.09	0.09	0.10	0.10	0.13	0.20	0.46	0.78	1.11	1.66	1.85
01/19/22	0.07	0.09	0.09	0.11	0.10	0.14	0.21	0.45	0.78	1.10	1.65	1.84
01/20/22	0.08	0.08	0.08	0.10	0.10	0.13	0.19	0.45	0.78	1.10	1.65	1.84
01/21/22	0.07	0.09	0.09	0.09	0.10	0.13	0.19	0.45	0.79	1.12	1.68	1.87
01/22/22	0.07	0.08	0.08	0.10	0.10	0.13	0.19	0.44	0.77	1.10	1.66	1.85
01/25/22	0.07	0.08	0.09	0.09	0.10	0.13	0.17	0.42	0.73	1.05	1.61	1.80
01/26/22	0.05	0.07	0.07	0.09	0.09	0.11	0.18	0.42	0.74	1.05	1.61	1.80
01/27/22	0.05	0.06	0.08	0.09	0.09	0.12	0.18	0.41	0.72	1.04	1.60	1.79
01/28/22	0.05	0.06	0.07	0.08	0.08	0.12	0.18	0.42	0.75	1.07	1.63	1.81
01/29/22	0.07	0.07	0.06	0.07	0.10	0.11	0.19	0.45	0.79	1.11	1.68	1.87
02/01/22	0.06	0.07	0.07	0.08	0.08	0.11	0.17	0.42	0.76	1.09	1.66	1.84
02/02/22	0.04	0.05	0.07	0.08	0.08	0.11	0.18	0.45	0.79	1.12	1.69	1.87
02/03/22	0.03	0.04	0.04	0.06	0.08	0.11	0.19	0.46	0.81	1.15	1.73	1.92
02/04/22	0.03	0.04	0.04	0.06	0.07	0.11	0.18	0.46	0.81	1.15	1.75	1.93
02/05/22	0.02	0.03	0.03	0.05	0.06	0.09	0.19	0.47	0.83	1.19	1.79	1.97
02/08/22	0.04	0.03	0.05	0.05	0.07	0.11	0.20	0.48	0.83	1.19	1.78	1.96
02/09/22	0.04	0.04	0.04	0.06	0.07	0.11	0.19	0.48	0.83	1.18	1.78	1.95
02/10/22	0.05	0.04	0.05	0.06	0.07	0.11	0.19	0.46	0.80	1.15	1.75	1.92
02/11/22	0.05	0.05	0.05	0.06	0.07	0.11	0.19	0.46	0.81	1.16	1.77	1.94
02/12/22	0.03	0.04	0.04	0.05	0.06	0.11	0.20	0.50	0.85	1.20	1.83	2.01
02/16/22	0.03	0.04	0.04	0.06	0.08	0.13	0.23	0.57	0.94	1.30	1.92	2.08
02/17/22	0.03	0.04	0.04	0.06	0.07	0.11	0.21	0.57	0.94	1.29	1.92	2.06
02/18/22	0.03	0.03	0.03	0.04	0.06	0.11	0.21	0.56	0.94	1.29	1.91	2.08

02/19/22	0.03	0.03	0.04	0.06	0.07	0.11	0.22	0.59	0.98	1.34	1.98	2.14
02/22/22	0.03	0.02	0.03	0.04	0.06	0.11	0.22	0.61	1.00	1.37	2.02	2.19
02/23/22	0.03	0.02	0.04	0.05	0.08	0.11	0.22	0.59	1.00	1.37	2.03	2.21
02/24/22	0.03	0.03	0.03	0.05	0.08	0.12	0.24	0.62	1.02	1.38	2.07	2.24
02/25/22	0.04	0.03	0.04	0.06	0.09	0.17	0.34	0.81	1.23	1.54	2.25	2.33
02/26/22	0.04	0.04	0.04	0.05	0.08	0.14	0.30	0.75	1.15	1.44	2.08	2.17
03/01/22	0.03	0.03	0.05	0.07	0.08	0.13	0.27	$\boxed{0.71}$	1.12	1.45	2.11	2.23
03/02/22	0.04	0.04	0.04	0.06	0.08	0.13	0.26	0.67	1.08	1.42	2.09	2.21
03/03/22	0.04	0.04	0.05	0.07	0.08	0.14	0.29	0.73	1.14	1.47	2.12	2.25
03/04/22	0.03	0.05	0.04	0.07	0.08	0.14	0.32	0.77	1.21	1.54	2.18	2.30
03/05/22	0.04	0.04	0.04	0.07	0.08	0.14	0.32	0.79	1.23	1.56	2.18	2.28
03/08/22	0.04	0.04	0.05	0.06	0.09	0.17	0.34	0.86	1.28	1.59	2.20	2.31

ASC 842

Date	Expense	Lease Liability	Right of Use Asset
12/31/2022	1,878,125	(11,185,112)	9,926,987
12/31/2023	2,253,750	(9,760,428)	7,748,553
12/31/2024	2,253,750	(7,723,640)	5,558,015
12/31/2025	2,253,750	(5,070,387)	3,351,012
12/31/2026	2,253,750	(1,796,278)	1,123,153
12/31/2027	1,126,875	0	(0)

ASC 842 Inputs	
Lease Term (months)	64
Risk-Free Rate 3/1/2022	0.71%
Lease Liability	11,716,493
+ Lease Prepayments	-
+ Initial Direct Costs	20,000
- Lease Incentives Received	-
Right-of-Use Asset	11,736,493

	Date	Payment	PV	S/L Lease	ROU Amort.	ROU Asset	Monthly Accretion	Lease Liability
	3/1/2022					11,736,493		11,716,493
1	3/31/2022	-	-	187,813	180,880	11,555,612	6,932	11,723,425
2	4/30/2022	-	-	187,813	180,876	11,374,736	6,936	11,730,361
3	5/31/2022	-	-	187,813	180,872	11,193,864	6,940	11,737,302
4	6/30/2022	-	-	187,813	180,868	11,012,996	6,945	11,744,246
5	7/31/2022	100,000	99,705	187,813	180,864	10,832,132	6,949	11,651,195
6	8/31/2022	100,000	99,646	187,813	180,919	10,651,213	6,894	11,558,088
7	9/30/2022	100,000	99,587	187,813	180,974	10,470,239	6,839	11,464,927
8	10/31/2022	100,000	99,528	187,813	181,029	10,289,210	6,783	11,371,710
9	11/30/2022	100,000	99,469	187,813	181,084	10,108,126	6,728	11,278,439
10	12/31/2022	100,000	99,410	187,813	181,139	9,926,987	6,673	11,185,112
11	1/31/2023	100,000	99,351	187,813	181,195	9,745,792	6,618	11,091,730
12	2/28/2023	100,000	99,293	187,813	181,250	9,564,542	6,563	10,998,292
13	3/31/2023	100,000	99,234	187,813	181,305	9,383,237	6,507	10,904,800
14	4/30/2023	100,000	99,175	187,813	181,360	9,201,877	6,452	10,811,252
15	5/31/2023	100,000	99,117	187,813	181,416	9,020,461	6,397	10,717,648
16	6/30/2023	100,000	99,058	187,813	181,471	8,838,989	6,341	10,623,989
17	7/31/2023	150,000	148,499	187,813	181,527	8,657,463	6,286	10,480,275
18	8/31/2023	150,000	148,411	187,813	181,612	8,475,851	6,201	10,336,476
19	9/30/2023	150,000	148,324	187,813	181,697	8,294,154	6,116	10,192,592
20	10/31/2023	150,000	148,236	187,813	181,782	8,112,373	6,031	10,048,623
21	11/30/2023	150,000	148,148	187,813	181,867	7,930,505	5,945	9,904,568
22	12/31/2023	150,000	148,061	187,813	181,952	7,748,553	5,860	9,760,428
23	1/31/2024	150,000	147,973	187,813	182,038	7,566,516	5,775	9,616,203
24	2/29/2024	150,000	147,886	187,813	182,123	7,384,393	5,690	9,471,893
25	3/31/2024	150,000	147,798	187,813	182,208	7,202,184	5,604	9,327,497
26	4/30/2024	150,000	147,711	187,813	182,294	7,019,891	5,519	9,183,016
27	5/31/2024	150,000	147,623	187,813	182,379	6,837,511	5,433	9,038,449
28	6/30/2024	150,000	147,536	187,813	182,465	6,655,047	5,348	8,893,797
29	7/31/2024	200,000	196,599	187,813	182,550	6,472,496	5,262	8,699,059
30	8/31/2024	200,000	196,482	187,813	182,666	6,289,831	5,147	8,504,206
31	9/30/2024	200,000	196,366	187,813	182,781	6,107,050	5,032	8,309,237
32	10/31/2024	200,000	196,250	187,813	182,896	5,924,154	4,916	8,114,154
33	11/30/2024	200,000	196,134	187,813	183,012	5,741,142	4,801	7,918,955
34	12/31/2024	200,000	196,018	187,813	183,127	5,558,015	4,685	7,723,640
35	1/31/2025	200,000	195,902	187,813	183,243	5,374,772	4,570	7,528,210
36	2/28/2025	200,000	195,786	187,813	183,358	5,191,414	4,454	7,332,664
37	3/31/2025	200,000	195,671	187,813	183,474	5,007,940	4,338	7,137,003
38	4/30/2025	200,000	195,555	187,813	183,590	4,824,350	4,223	6,941,225
39	5/31/2025	200,000	195,439	187,813	183,706	4,640,645	4,107	6,745,332
40	6/30/2025	200,000	195,324	187,813	183,822	4,456,823	3,991	6,549,323
41	7/31/2025	250,000	244,010	187,813	183,937	4,272,886	3,875	6,303,198
42	8/31/2025	250,000	243,866	187,813	184,083	4,088,803	3,729	6,056,928
43	9/30/2025	250,000	243,722	187,813	184,229	3,904,574	3,584	5,810,511
44	10/31/2025	250,000	243,578	187,813	184,375	3,720,199	3,438	5,563,949
45	11/30/2025	250,000	243,433	187,813	184,520	3,535,679	3,292	5,317,241
46	12/31/2025	250,000	243,290	187,813	184,666	3,351,012	3,146	5,070,387

47	1/31/2026	250,000	243,146	187,813	184,813	3,166,200	3,000	4,823,387
48	2/28/2026	250,000	243,002	187,813	184,959	2,981,241	2,854	4,576,241
49	3/31/2026	250,000	242,858	187,813	185,105	2,796,136	2,708	4,328,949
50	4/30/2026	250,000	242,715	187,813	185,251	2,610,885	2,561	4,081,510
51	5/31/2026	250,000	242,571	187,813	185,398	2,425,487	2,415	3,833,925
52	6/30/2026	250,000	242,428	187,813	185,544	2,239,943	2,268	3,586,193
53	7/31/2026	300,000	290,741	187,813	185,691	2,054,252	2,122	3,288,315
54	8/31/2026	300,000	290,569	187,813	185,867	1,868,386	1,946	2,990,261
55	9/30/2026	300,000	290,397	187,813	186,043	1,682,342	1,769	2,692,030
56	10/31/2026	300,000	290,226	187,813	186,220	1,496,123	1,593	2,393,623
57	11/30/2026	300,000	290,054	187,813	186,396	1,309,726	1,416	2,095,039
58	12/31/2026	300,000	289,883	187,813	186,573	1,123,153	1,240	1,796,278
59	1/31/2027	300,000	289,711	187,813	186,750	936,404	1,063	1,497,341
60	2/28/2027	300,000	289,540	187,813	186,927	749,477	886	1,198,227
61	3/31/2027	300,000	289,369	187,813	187,104	562,374	709	898,936
62	4/30/2027	300,000	289,198	187,813	187,281	375,093	532	599,468
63	5/31/2027	300,000	289,027	187,813	187,458	187,635	355	299,823
64	6/30/2027	300,000	288,856	187,813	187,635	(0)	177	(0)
		12,000,000	11,716,493	12,020,000	11,736,493		283,507	

ASC 840

Date	Expense	Deferred Rent Liability
12/31/2022	1,878,125	(1,275,000)
12/31/2023	2,253,750	(2,025,000)
12/31/2024	2,253,750	(2,175,000)
12/31/2025	2,253,750	(1,725,000)
12/31/2026	2,253,750	(675,000)
12/31/2027	1,126,875	-

	Date	Payment	Lease Expense	Amort. of IDC	Deferred Rent
	3/1/2022				
1	3/31/2022	-	187,500	313	(187,500)
2	4/30/2022	-	187,500	313	(375,000)
3	5/31/2022	-	187,500	313	(562,500)
4	6/30/2022	-	187,500	313	(750,000)
5	7/31/2022	100,000	187,500	313	(837,500)
6	8/31/2022	100,000	187,500	313	(925,000)
7	9/30/2022	100,000	187,500	313	(1,012,500)
8	10/31/2022	100,000	187,500	313	(1,100,000)
9	11/30/2022	100,000	187,500	313	(1,187,500)
10	12/31/2022	100,000	187,500	313	(1,275,000)
11	1/31/2023	100,000	187,500	313	(1,362,500)
12	2/28/2023	100,000	187,500	313	(1,450,000)
13	3/31/2023	100,000	187,500	313	(1,537,500)
14	4/30/2023	100,000	187,500	313	(1,625,000)
15	5/31/2023	100,000	187,500	313	(1,712,500)
16	6/30/2023	100,000	187,500	313	(1,800,000)
17	7/31/2023	150,000	187,500	313	(1,837,500)
18	8/31/2023	150,000	187,500	313	(1,875,000)
19	9/30/2023	150,000	187,500	313	(1,912,500)
20	10/31/2023	150,000	187,500	313	(1,950,000)
21	11/30/2023	150,000	187,500	313	(1,987,500)
22	12/31/2023	150,000	187,500	313	(2,025,000)
23	1/31/2024	150,000	187,500	313	(2,062,500)
24	2/29/2024	150,000	187,500	313	(2,100,000)
25	3/31/2024	150,000	187,500	313	(2,137,500)
26	4/30/2024	150,000	187,500	313	(2,175,000)
27	5/31/2024	150,000	187,500	313	(2,212,500)
28	6/30/2024	150,000	187,500	313	(2,250,000)
29	7/31/2024	200,000	187,500	313	(2,237,500)
30	8/31/2024	200,000	187,500	313	(2,225,000)
31	9/30/2024	200,000	187,500	313	(2,212,500)
32	10/31/2024	200,000	187,500	313	(2,200,000)
33	11/30/2024	200,000	187,500	313	(2,187,500)
34	12/31/2024	200,000	187,500	313	(2,175,000)
35	1/31/2025	200,000	187,500	313	(2,162,500)
36	2/28/2025	200,000	187,500	313	(2,150,000)
37	3/31/2025	200,000	187,500	313	(2,137,500)
38	4/30/2025	200,000	187,500	313	(2,125,000)
39	5/31/2025	200,000	187,500	313	(2,112,500)
40	6/30/2025	200,000	187,500	313	(2,100,000)
41	7/31/2025	250,000	187,500	313	(2,037,500)
42	8/31/2025	250,000	187,500	313	(1,975,000)
43	9/30/2025	250,000	187,500	313	(1,912,500)
44	10/31/2025	250,000	187,500	313	(1,850,000)
45	11/30/2025	250,000	187,500	313	(1,787,500)
46	12/31/2025	250,000	187,500	313	(1,725,000)

47	1/31/2026	250,000	187,500	313	(1,662,500)
48	2/28/2026	250,000	187,500	313	(1,600,000)
49	3/31/2026	250,000	187,500	313	(1,537,500)
50	4/30/2026	250,000	187,500	313	(1,475,000)
51	5/31/2026	250,000	187,500	313	(1,412,500)
52	6/30/2026	250,000	187,500	313	(1,350,000)
53	7/31/2026	300,000	187,500	313	(1,237,500)
54	8/31/2026	300,000	187,500	313	(1,125,000)
55	9/30/2026	300,000	187,500	313	(1,012,500)
56	10/31/2026	300,000	187,500	313	(900,000)
57	11/30/2026	300,000	187,500	313	(787,500)
58	12/31/2026	300,000	187,500	313	(675,000)
59	1/31/2027	300,000	187,500	313	(562,500)
60	2/28/2027	300,000	187,500	313	(450,000)
61	3/31/2027	300,000	187,500	313	(337,500)
62	4/30/2027	300,000	187,500	313	(225,000)
63	5/31/2027	300,000	187,500	313	(112,500)
64	6/30/2027	300,000	187,500	313	-
		12,000,000	12,000,000	20,000	

Impact of Adoption and Management Assumptions

Date	Change to P&L	Change to Liabilities	Change to Assets
12/31/2022	-	(9,910,112)	9,926,987
12/31/2023	-	(7,735,428)	7,748,553
12/31/2024	-	(5,548,640)	5,558,015
12/31/2025	-	(3,345,387)	3,351,012
12/31/2026	-	(1,121,278)	1,123,153
12/31/2027	-	0	(0)

ASC 842 Assumptions

1. Practical expedient non-PBE risk-free borrowing rate
2. Company will not exercise renewal options
3. No termination or purchase options
4. No lease prepayments or lease incentives received

Journal Entries

Commencement:	*Dr.*	*Cr.*
Right-of-Use Asset	11,736,493	
Lease Liability		11,716,493
Cash		20,000

March 2022:	*Dr.*	*Cr.*
Lease Expense	187,813	
Lease Liability		6,932
Right-of Use Asset		180,880

July 2022:	*Dr.*	*Cr.*
Lease Expense	187,813	
Lease Liability	93,051	
Right-of-Use Asset		180,864
Cash		100,000

Key Concepts

BAKER
NEWMAN
NOYES

- Does the agreement contain a lease?
- When is the commencement date?
- What is the lease term?
- What is included in lease payments?
- What discount rate should be used?
- What is the lease classification?
- Are there any initial direct costs?
- What is the initial and subsequent measurement of the lease liability?

Case Study

BAKER NEWMAN NOYES

On January 17, 2022, Smith Johnson Williams LLP executed a lease agreement with ABC Properties for 10,000 square feet of office space at 123 Main Street, Boston, MA 02116 Suite #192.

Per the lease agreement, Smith Johnson Williams LLP will take possession of the office space on March 1, 2022, before it begins operations or makes lease payments under the terms of the lease. During this period, Smith Johnson Williams LLP has the right to use the office space for constructing leasehold improvements. Smith Johnson Williams LLP is required to make lease payments only after construction is completed, which is slated to occur on July 1, 2022. The lease expires on June 30, 2027. The lease agreement contains two (2) five (5) year renewal terms at the option of Smith Johnson Williams LLP at rent prices that approximate estimated market rates. Smith Johnson Williams LLC intends to acquire smaller law firms as part of their five-year business plan and hopes to integrate all firms within one office space, therefore they expect that they will need a larger office space by 2029. The cost of construction of leasehold improvements is not significant to Smith Johnson Williams LLC. There are no early termination clauses in the lease agreement.

There are no purchase options included within the lease agreement. Per the lease agreement, there are stated annual rent escalations. Additionally, Smith Johnson Williams LLP is required to make payments for their pro rata share of real estate taxes, insurance, and common area maintenance expense. Smith Johnson Williams LLP received no incentives from ABC Properties in connection with the lease agreement. Rent is due on the first day of the month.

As Smith Johnson Williams LLP is not a public business entity, they have made an accounting policy election to use the risk-free rate for the initial and subsequent measurement of lease liabilities. The risk-free rate will be determined using a period comparable to the lease term.

Smith Johnson Williams LLP was required to pay $20,000 to their real estate broker upon the closing of the lease agreement. In connection with negotiating the lease agreement, Smith Johnson Williams LLP paid their attorney $30,000.

The building at 123 Main Street, Boston MA recently sold for $900,000,000 on January 1, 2022. Total rentable square feet of the building is 300,000 square feet.

Determining Whether an Arrangement Contains a Lease

BAKER NEWMAN NOYES

- Is there an identified asset?
- Does the customer have the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use?
- Does the customer or the supplier have the right to direct how and for what purpose the identified asset is used throughout the period of use?
  - If neither because how and for what the purpose the asset will be used is predetermined consider the following additional steps:
  - (1) Does the customer have the right to operate the asset throughout the period of use without the supplier having the right to change those operating instructions? – If no continue to second consideration below.
  - (2) Did the customer design the asset (or specific aspects of the asset)in a way that predetermines how and for what purpose the asset will be used throughout the period of use?

IF YES TO THE DECISION TREE ABOVE FOR EACH STEP THEN THE CONTRACT CONTAINS A LEASE

Case Study: Identified Asset

BAKER NEWMAN NOYES

“On January 17, 2022, Smith Johnson Williams LLP executed a lease agreement with ABC Properties for 10,000 square feet of office space at 123 Main Street, Boston, MA 02116 Suite #192.”

Commencement Date of the Lease

- **Commencement Date** – The date on which the lessor makes an underlying asset available for use by a lessee.
  - **Note:** The timing of when lease payments begin under the contract does not affect the commencement date of the lease.
  - **Master lease agreements** that specify minimum number of units or dollar value of equipment is not a lease modification for delivery of these at different times. There may be multiple commencement dates resulting from a master lease agreement.

Case Study: Commencement Date

BAKER NEWMAN NOYES

"On January 17, 2022, Smith Johnson Williams LLP executed a lease agreement with ABC Properties for 10,000 square feet of office space at 123 Main Street, Boston, MA 02116 Suite #192.

Per the lease agreement, Smith Johnson Williams LLP will take possession of the office space on March 1, 2022, before it begins operations or makes lease payments under the terms of the lease. During this period, Smith Johnson Williams LLP has the right to use the office space for constructing leasehold improvements. Smith Johnson Williams LLP is required to make lease payments only after construction is completed, which is slated to occur on July 1, 2022."

Commencement Date:	**March 1, 2022**
Rent Commencement Date:	**July 1, 2022**

Lease Term

- **Lease Term** includes the following:
  - Any noncancelable periods
  - Periods covered by an option to extend the lease if the lessee is *reasonably certain* to exercise that option
  - Periods covered by the option to terminate the lease if the lessee is *reasonably certain* not to exercise that option
  - Periods covered by an option to extend (or not terminate) the lease in which the exercise of the option is controlled by the lessor
- Purchase options should be assessed in the same way as options to extend the lease term or terminate the lease
- A lease is no longer enforceable when both the lessee and the lessor each have the right to terminate the lease without permission from the other party with no more than an insignificant penalty

Case Study: Lease Term

BAKER NEWMAN NOYES

"Per the lease agreement, Smith Johnson Williams LLP will take possession of the office space on March 1, 2022, before it begins operations or makes lease payments under the terms of the lease. During this period, Smith Johnson Williams LLP has the right to use the office space for constructing leasehold improvements. Smith Johnson Williams LLP is required to make lease payments only after construction is completed, which is slated to occur on July 1, 2022. The lease expires on June 30, 2027.The lease agreement contains two (2) five (5) year renewal terms at the option of Smith Johnson Williams LLP at rent prices that approximate estimated market rates. Smith Johnson Williams LLC intends to acquire smaller law firms as part of their five-year business plan and hope to integrate all firms within one office space, therefore they expect that they will need a larger office space by 2029. The cost of construction of leasehold improvements is not significant to Smith Johnson Williams LLC. There are no early termination clauses in the lease agreement. There are no purchase options included within the lease agreement."

Commencement Date:	March 1, 2022
Rent Commencement Date:	July 1, 2022
Termination Date:	June 30, 2027

Case Study: Lease Term

BAKER NEWMAN NOYES

ASC 842 Inputs	
Lease Term (months)	64
Risk-Free Rate 3/1/2022	
Lease Liability	
+ *Lease Prepayments*	
+ *Initial Direct Costs*	
- *Lease Incentives Received*	
Right-of-Use Asset	-

Lease Payments

BAKER NEWMAN NOYES

- Fixed payments less lease incentives
- Variable payments based on index or rate
- Exercise price of purchase option
- Penalties for terminating the lease
- Amounts owed under residual value guarantees
- Fees paid to owners of special-purpose entities for structuring the transaction

Fixed Payments Less Lease Incentives

BAKER NEWMAN NOYES

- Includes in-substance fixed payments such as:
  - 1% of sales subject to a minimum sales amount
  - Sometimes CPI adjustments when designed to make sure a cap is always reached
- Deduct lease incentives that are payable to the lessee at lease commencement such as:
  - Up front cash payment to incentivize the lessee to sign the lease
  - The lessor assuming the lessee's preexisting lease with a third party
  - The lessor paying the lessee's moving expenses
  - Reimbursement for construction costs for leasehold improvements
- ASC 842 does not provide guidance for lease incentives neither paid nor payable at lease commencement. Reasonable approaches are:
  - If there is a maximum level of reimbursement and the lessee is reasonably certain to incur the costs, deduct from lease payments
  - Once qualified reimbursable costs are incurred, adjust the lease liability and ROU asset
    - Reduction of ROU asset recognized prospectively over the remaining lease term
    - Reduction of ROU asset recognized as a cumulative catch-up adjustment to expense

Variable Lease Payments Based on an Index or Rate

BAKER NEWMAN NOYES

- Variable lease payments that depend on an index or a rate are included in the lease payments and are measured using the prevailing index or rate at the measurement date (lease commencement)
- Despite the uncertainty, the payments meet the definition of a liability to the lessee because they are unavoidable
- Changes to the index or rate are recognized in the P&L in the period of change (similar to other variable lease payments)
- Examples:
  - CPI
  - LIBOR
  - Prime interest rate
  - Treasury rates (with or without a spread)
  - Payments that depend on market rental rates

Purchase Options, Terminations, and Residual Value Guarantees

BAKER NEWMAN NOYES

- Include exercise price of purchase options if the lessee is *reasonably certain* to exercise the option.
- Include payments for penalties for terminating a lease if the lessee is *reasonably certain* to exercise an option to terminate the lease
- Include amounts it is *probable* that lessee will owe under residual value guarantees

Case Study: Lease Payments

BAKER NEWMAN NOYES

"Per the lease agreement, there are stated annual rent escalations. Additionally, Smith Johnson Williams LLP is required to make payments for their pro rata share of real estate taxes, insurance, and common area maintenance expense. Smith Johnson Williams LLP received no incentives from ABC Properties in connection with the lease agreement. Rent is due on the first day of the month."

Commencement Date:	March 1, 2022	
Rent Commencement Date:	July 1, 2022	
Base Rent:	7/1/22 – 6/30/23	$100,000
	7/1/23 – 6/30/24	$150,000
	7/1/24 – 6/30/25	$200,000
	7/1/25 – 6/30/26	$250,000
	7/1/26 – 6/30/27	$300,000

Case Study: Lease Payments

BAKER NEWMAN NOYES

	Date	Payment	PV	S/L Lease	ROU Am ort.	ROU Asset	Monthly Accretion	Lease Liability
	3/1/2022							
1	3/31/2022	-						
2	4/30/2022	-						
3	5/31/2022	-						
4	6/30/2022	-						
5	7/31/2022	100,000						
6	8/31/2022	100,000						
7	9/30/2022	100,000						
8	10/31/2022	100,000						
9	11/30/2022	100,000						
10	12/31/2022	100,000						
11	1/31/2023	100,000						

BAKER NEWMAN NOYES

Discount Rate

- Rate implicit in the lease (if known)
- Incremental borrowing rate (IBR)
  - The rate of interest that a lessee would have to pay to borrow on a collateralized basis over a similar lease term an amount equal to the lease payments in a similar economic environment
  - Complex calculation that will vary company to company, therefore the determination process, key inputs, and judgments made should be well documented
  - Consider:
    - Credit quality of the company
    - Secured/collateralized cost of borrowing
    - Cost to borrow over an equivalent term
    - Foreign subsidiaries may not default to parent company's credit standing
    - Foreign currency and political risks inherent in the jurisdiction should be considered

- Risk-free rate (private companies only)
  - Easier method of determining the discount rate
  - Choosing this can cause a significant difference to the calculated lease liability when compared to using IBR

Case Study: Discount Rate

BAKER NEWMAN NOYES

"As Smith Johnson Williams LLP is not a public business entity, they have made an accounting policy election to use the risk-free rate for the initial and subsequent measurement of lease liabilities. The risk-free rate will be determined using a period comparable to the lease term."

U.S. DEPARTMENT OF THE TREASURY

Resource Center

Daily Treasury Yield Curve Rates

Date	1 Mo	2 Mo	3 Mo	6 Mo	1 Yr	2 Yr	3 Yr	5 Yr	7 Yr	10 Yr	20 Yr	30 Yr
03/01/22	0.03	0.03	0.05	0.07	0.08	0.13	0.27	$\boxed{0.71}$	1.12	1.45	2.11	2.23

Case Study: Discount Rate

BAKER NEWMAN NOYES

ASC 842 Inputs	
Lease Term (months)	64
Risk-Free Rate 3/1/2022	0.71%
Lease Liability	
+ *Lease Prepayments*	
+ *Initial Direct Costs*	
- *Lease Incentives Received*	
Right-of-Use Asset	

Lease Classification

BAKER NEWMAN NOYES

- A lessee shall classify a lease as a finance lease if any of the following criteria are met:
  - The lease transfers ownership of the underlying asset to the lessee by the end of the lease term
  - The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise
  - The lease term is for the major part of the remaining economic life of the underlying asset (unless commencement date falls at or near the end of the economic life)
  - The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments equals or exceeds substantially all of the fair value of the underlying asset
  - The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term
- When none of the aforementioned criteria are met the lessee shall classify the lease as an operating lease

Case Study: Lease Classification

- The lease transfers ownership of the underlying asset to the lessee by the end of the lease term

  No transfer of ownership based on case study excerpt and lease abstract

- The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise

  No purchase option based on case study excerpt and lease abstract

Case Study: Lease Classification

BAKER NEWMAN NOYES

- The lease term is for the major part of the remaining economic life of the underlying asset (unless commencement date falls at or near the end of the economic life)

Company Policy: If the lease term is greater than 75% of the remaining economic life, the lease is a finance lease.

Lease term	5 years	
Remaining economic life	30 years	
Lease term as a % of remaining economic life	17%	*Does not meet criteria*

Case Study: Lease Classification

BAKER NEWMAN NOYES

- The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments equals or exceeds substantially all of the fair value of the underlying asset

"The building at 123 Main Street, Boston MA recently sold for $900,000,000 on January 1, 2022. Total rentable square feet of the building is 300,000 square feet."

Company Policy: If the present value of lease payments (and residual value guarantee) is greater than 90% of the fair value of the underlying asset, the lease is a finance lease.

Square Feet of Suite #192	10,000	
Square Feet of Building	300,000	
Proportion of Building	3.3%	
Value of Building	$900,000,000	
Value of Suite #192	$30,000,000	
PV Lease Payments	$11,736,493	
PV of Lease Payments as a % of the Value of Suite #192	39%	*Does not meet criteria*

Case Study: Lease Classification

BAKER NEWMAN NOYES

- The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term

  Not specialized in nature. The lessor can lease the office space at the end of the lease term.

OPERATING LEASE

Initial Measurement of Lease Liability & Right-of-Use Asset

BAKER NEWMAN NOYES

- **Lease Liability** = Present value (using discount rate determined on the commencement date) of lease payments to be made over the lease term
- **Right-of-Use Asset** = Lease Liability + Lease Prepayments + Initial Direct Costs – Lease Incentives Received

Case Study: Lease Liability – Initial Measurement

BAKER NEWMAN NOYES

	Date	Payment	PV	S/L Lease	ROU Am ort.	ROU Asset	Monthly Accretion	Lease Liability
52	6/30/2026	250,000	242,428					
53	7/31/2026	300,000	290,741					
54	8/31/2026	300,000	290,569					
55	9/30/2026	300,000	290,397					
56	10/31/2026	300,000	290,226					
57	11/30/2026	300,000	290,054					
58	12/31/2026	300,000	289,883					
59	1/31/2027	300,000	289,711					
60	2/28/2027	300,000	289,540					
61	3/31/2027	300,000	289,369					
62	4/30/2027	300,000	289,198					
63	5/31/2027	300,000	289,027					
64	6/30/2027	300,000	288,856					
		12,000,000	11,716,493					

ASC 842 Inputs	
Lease Term (months)	64
Risk-Free Rate 3/1/2022	0.71%
Lease Liability	11,716,394
+ Lease Liability	
+ Initial Direct Costs	
- Lease Incentives Received	
Right-of-Use Asset	

Initial Direct Costs

BAKER NEWMAN NOYES

- Includes incremental cost of a lease that would not have been incurred if the lease had not been obtained
  - Commissions
  - Payments made to an existing tenant to incentivize that tenant to terminate its lease
- Does *not* include costs to negotiate or arrange a lease that would have been incurred regardless of whether the lease was obtained
  - General overheads (depreciation, occupancy and equipment costs, unsuccessful origination efforts, idle time)
  - Costs related to activities that occur before the lease is obtained (tax and legal advice, negotiating lease terms and conditions)

Case Study: Initial Direct Costs

BAKER NEWMAN NOYES

"Smith Johnson Williams LLP was required to pay $20,000 to their real estate broker upon the closing of the lease agreement. In connection with negotiating the lease agreement, Smith Johnson Williams LLP paid their attorney $30,000."

Case Study: Initial Direct Costs

ASC 842 Inputs	
Lease Term (months)	64
Risk-Free Rate 3/1/2022	0.71%
Lease Liability	11,716,493
+ *Lease Prepayments*	
+ *Initial Direct Costs*	20,000
- *Lease Incentives Received*	
Right-of-Use Asset	

Case Study: Right-of-Use Asset – Initial Measurement

BAKER NEWMAN NOYES

ASC 842 Inputs	
Lease Term (months)	64
Risk-Free Rate 3/1/2022	0.71%
Lease Liability	11,716,493
+ *Lease Prepayments*	-
+ *Initial Direct Costs*	20,000
- *Lease Incentives Received*	-
Right-of-Use Asset	11,736,493

Case Study: Lease Liability and Right-of-Use Asset – Initial Measurement

BAKER NEWMAN NOYES

Journal Entries		
Commencement:	Dr.	Cr.
	11,736,493	
Right-of-Use Asset		11,716,493
Lease Liability		20,000
Cash		

Case Study: Lease Liability & Right-of-Use Asset – Subsequent Measurement

BAKER NEWMAN NOYES

	Date	Payment	PV	S/L Lease	ROU Am ort.	ROU Asset	Monthly Accretion	Lease Liability
	3/1/2022					11,736,493		11,716,493
1	3/31/2022	-	-	187,813	180,880	11,555,612	6,932	11,723,425
2	4/30/2022	-	-	187,813	180,876	11,374,736	6,936	11,730,361
3	5/31/2022	-	-	187,813	180,872	11,193,864	6,940	11,737,302
4	6/30/2022	-	-	187,813	180,868	11,012,996	6,945	11,744,246
5	7/31/2022	100,000	99,705	187,813	180,864	10,832,132	6,949	11,651,195
6	8/31/2022	100,000	99,646	187,813	180,919	10,651,213	6,894	11,558,088
7	9/30/2022	100,000	99,587	187,813	180,974	10,470,239	6,839	11,464,927
8	10/31/2022	100,000	99,528	187,813	180,029	10,289,210	6,783	11,371,710
9	11/30/2022	100,000	99,469	187,813	180,084	10,108,126	6,728	11,278,439
10	12/31/2022	100,000	99,410	187,813	180,139	9,926,987	6,673	11,185,112
11	1/31/2023	100,000	99,351	187,813	181,195	9,745,792	6,618	11,091,730
12	2/28/2023	100,000	99,293	187,813	181,250	9,564,542	6,563	10,998,292

Case Study: Lease Liability & Right-of-Use Asset – Subsequent Measurement

BAKER NEWMAN NOYES

Journal Entries		
March 2022:	Dr.	Cr.
Lease Expense	187,813	
Lease Liability		6,933
Right-of-Use Asset		180,880

July 2022:	Dr.	Cr.
Lease Expense	187,813	
Lease Liability	93,051	
Right-of-Use Asset		180,864
Cash		100,000

Finance Lease

BAKER NEWMAN NOYES

- Initial measurement of the lease liabilities and ROU assets for finance leases are the same as for operating leases
- Subsequent measurement:
  - Reduce the lease liability by cash payments less interest expense
  - Amortize the ROU asset on a straight-line basis

Finance Lease

The journal entries for a finance lease with otherwise the same fact pattern as our case study would be the following:

	Dr.	Cr.
Commencement:	*Dr.*	*Cr.*
Right-of-Use Asset	11,736,493	
Lease Liability		11,716,493
Cash		20,000

March 2022:	*Dr.*	*Cr.*
Amortization Epense	183,383	
Interest Expense	6,932	
Lease Liability		6,932
Right-of-Use Asset		183,383

July 2022:	*Dr.*	*Cr.*
Amortization Expense	183,383	
Interest Expense	6,949	
Lease Liability	93,051	
Right-of-Use Asset		183,383
Cash		100,000

Lease Provisions to Consider

BAKER NEWMAN NOYES

- Lease and nonlease components
- Lease incentives and improvements
- Evergreen leases
- Related-party leases
- Variable lease payments
- Embedded leases
- Lease modifications

Lease & Non-Lease Components

BAKER NEWMAN NOYES

- Many contracts contain a lease coupled with an agreement to purchase or sell other goods or services (non-lease components)
- The non-lease components are identified and accounted for separately from the lease component in accordance with other US GAAP (except when a lessee or lessor applies the practical expedient to not separate lease and non-lease components)
- Some contracts contain items that do not relate to the transfer of goods or services by the lessor to the lessee (e.g. fees or other administrative costs that a lessor charges a lessee). These items should not be considered separate lease or non-lease components, and the lessee and lessor do not allocate consideration in the contract to these items.

Lease Incentives and Improvements

BAKER NEWMAN NOYES

- Must evaluate whether improvements made to the leased property are lessee or lessor assets because it affects:
  - Which entity recognizes the asset
    - Lessee improvements are capitalized by the lessee and lessor improvements are capitalized by the lessor
  - Whether a lessor payment to the lessee for the improvements is a lease incentive or a reimbursement of costs
    - Lessee improvements are a lease incentive and lessor improvements are a reimbursement of costs
  - The lease commencement date
    - If the lessor provides access to the space so that the lessee can begin to construct its own leasehold improvements the commencement date is the date the lessor made the underlying asset available for use

Lease Incentives and Improvements

- Factors to consider in the evaluation:
  - What happens to the improvements at the end of the lease term (removed or preserved for landlord)
  - Whether the improvements are unique (décor and logo of a national retail chain or general purpose improvements)
  - Which party is supervising construction (is the lessee acting as an agent during the construction period or are they actively involved in the design)
  - Which party bears all costs of improvements (including the risk of cost overruns)
  - Which party owns the improvements
- It is improper to recognize a partial asset
- The determination should be consistent across various aspects of the guidance

Evergreen Leases

BAKER NEWMAN NOYES

- Also referred to as:
  - Month-to-month
  - Cancellable
  - At-will
  - Perpetual
  - Rolling
- ASC 842 applies to these leases if they create enforceable rights and obligations
  - Not enforceable if both the lessee and the lessor each have the right to terminate the lease without permission from the other party and with no more than an insignificant penalty
- Any noncancelable periods in contracts that meet the definition of a lease are considered part of the lease term
  - The likelihood of a lessor exercising the termination option is not considered in evaluating the lease term
  - If only a lessee has the right to termination it is an option that is considered in determining the lease term
- These leases will not automatically meet the short-term lease practical expedient and the lease term must be evaluated

Related-Party Leases

BAKER NEWMAN NOYES

- ASC 842 significantly modifies the treatment of related-party leases
  - ASC 840 – substance over form in evaluating a lease
  - ASC 842 – acknowledges that many related-party transactions are not at an arm's length and should be evaluated based on the legally enforceable terms and conditions of the lease
- Inappropriate to ignore any facts and circumstances not written in an agreement that create enforceable rights and obligations
  - For example a lease term may be stated at 6 months, but factors outside the contract indicate that the lease term is longer
  - May need to consult legal counsel
- Leases between related-parties should be disclosed and should not imply that the transaction is at an arm's length

Variable Lease Payments

BAKER NEWMAN NOYES

- A lessee should recognize costs from variable lease payments before the achievement of the specified target that triggers the variable lease payments, provided that achievement of that target is considered *probable*, and should be reversed at such a time that it is *probable* that a specified target will not be met
- Probable = the future event or events are likely to occur
- Examples:
  - Additional payment if machine hours exceed maximum
  - Percentage of sales
- Do not impact lease classification, lease liability, or ROU asset unless they depend on an index or rate

Embedded Leases

BAKER NEWMAN NOYES

- Leases contained within larger arrangements
  - All leases are not necessarily structured as a lease in their legal form
- While the concept is not new, the impact of failing to identify an embedded lease is more significant under ASC 842 as nearly all leases are reported on the balance sheet
- Leading practices to identify embedded leases:
  - Meet with other departments to understand the types of service contracts that exist
  - Perform a risk assessment to identify areas where embedded leases are more likely to exist
  - Review expense activity for recurring payments
  - Examine contracts

Lease Modifications

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- (1) Is the modified contract a lease, or does it contain a lease? – If no treat as a lease termination
- (2) Does the modification result in a separate contract?
  - If yes account for two separate contracts
  - If no:
    - Remeasure and reallocate the remaining consideration in the contract
    - Reassess the classification of the lease at the effective date of the modification
    - Account for any initial direct costs, lease incentives and other payments made to or by the lessee

Lessons Learned from Public Company Adoption

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- Many did not start to plan for adoption early enough
- Challenges in getting a complete population of leases
- Overlooked the volume of increased disclosures
- Overlooked how complex the calculation of incremental borrowing rates can be
- Did not consider the impact on debt covenant compliance (debt to earnings ratio) and bank capital compliance (bank capital ratios)
- Maintaining ASC 842 continues to be a challenge even after adoption

Things to Consider “Talk to Your BNN Advisor”

- Lessor Accounting
- Sublease Agreements
- Sale Leaseback Transactions
- Accounting for Leases in a Business Combination
- Application of Transition Guidance
- Build to Suit Arrangements

Questions?

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NOYES

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NOYES

Thank You!

Buying and Selling

Post-2020

Scott McKenzie & Josh Lapierre

10.28.2021

BAKER
NEWMAN
NOYES

Who We Are

BAKER NEWMAN NOYES

Our experienced transaction advisory services team works with investors, private equity and venture capital firms, and shareholders to manage transactions and provide real time advice. Our experience allows us to move efficiently according to our clients' timelines, help reduce risks, and deliver value.

Scott McKenzie

Transaction Advisory Managing Director

smckenzie@bnncpa.com

Josh Lapierre

Tax Principal

jlapierre@bnncpa.com

Agenda

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1. What We Are Seeing
2. What You Should Be Thinking About
3. How to Add Value to Your Business

What We Are Seeing

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- Active market
- Deals are taking longer
- Process shortcuts
- Capacity Issues for professional service providers
- COVID Impact
  - Pre- and Post-COVID Financial Impact
  - Lookback Comparisons
  - Projections

What Should You Be Thinking About?

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- Operations
  - Outside looking in
  - Improvements
- Reasonable expectations of timing
  - Seller preparation and preparedness: Proactive vs Reactive
  - Buyer Due Diligence
- Value Creation
  - Competitive Advantage today and tomorrow
  - Environmental Challenges
  - Political Challenges

How to Add Value to Your Business?

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- Value is usually attributable to a dollar amount
  - When you decide to add a new product or service you would run scenarios to determine if there is value to add the new product/service

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NOYES

How to Add Value to Your Business?
(Continued)

- How can you add value to your business without adding a new product or service
  - Operations
    - Understand your business's key performance indicators
    - Review legal documents to be sure everything is properly prepared
  - Financial
    - Review of internal controls
    - Forecasting process
  - Tax
    - Sellers: Pre-Tax Planning
    - Buyers: Structure Considerations
    - Tax in the future

Questions?

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NOYES

BAKER NEWMAN NOYES

Thank You!

COVID Relief Programs

An Accounting Primer

Joseph Jalbert

10.28.2021

BAKER NEWMAN NOYES

Overview

1. Paycheck Protection Program (PPP)
2. Employee Retention Credit (ERC)
3. Miscellaneous Grant Programs

PPP – How Did We Get Here?

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March 27, 2020
- CARES Act signed into law
- Act introduces PPP
- $349 billion earmarked for PPP

April 3, 2020
- SBA opens program to prospective applicants. The floodgates open

April 16, 2020
- SBA announces program funds have been exhausted (13 days!)

April 24, 2020
- due to overwhelming popularity of PPP, Congress approves additional $320 billion

June 30, 2020
- with program due to expire at midnight and funds remaining, Congress approves extension of program to August 8

August 8, 2020
- No further extension of program (yet), approximately $134 billion remains

December 21, 2020
- Congress passes Consolidated Appropriations Act, 2020 (CAA)
- Additional $284 billion earmarked for PPP (includes $134 billion previously earmarked and unspent)
- Introduces “second draw” loans

January 11, 2021
- SBA re-opens program

March 30, 2021
- Application deadline extended from March 31, 2021 to May 31, 2021

May 5, 2021
- SBA announces PPP funds have been exhausted

Accounting for PPP Loans

- ASC 470 Debt Model (Option #1)
  - Can be used regardless of circumstances
  - Carried as debt until borrower is legally released as primary obligor (i.e. SBA has approved forgiveness or loan has been paid off)
  - Longer derecognition timeline (but, most objective)
  - Interest accrues in accordance with terms of agreement
  - Once legal release obtained, record as gain on extinguishment of debt

Accounting for PPP Loans (Continued)

- ASC 958-605 Conditional Contribution Model (Option #2)
  - Although written for not-for-profits, for-profit entities may apply as well
  - Derecognize liability as qualifying expenses incurred and when program conditions substantially met
    - Cannot project whether conditions will be met
  - Satisfaction of conditions/derecognition can be in stages
  - Need to consider all conditions and whether substantially met
    - Emphasis on most restrictive condition (e.g. headcount/compensation conditions)
  - Initially record as refundable advance
  - Recognize contribution revenue as expenses incurred
  - Accrue interest on portion expected to be repaid

Accounting for PPP Loans (Continued)

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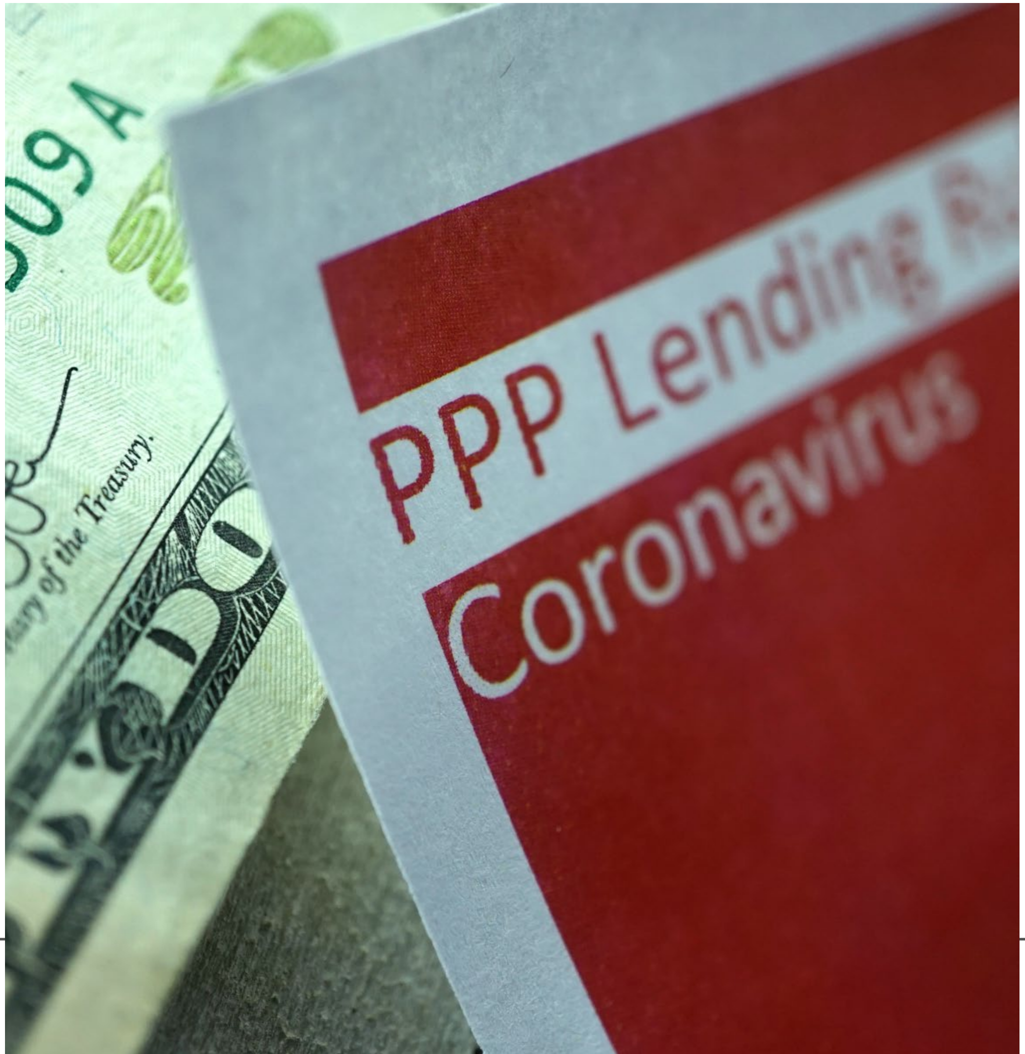

- ASC 450-30 Gain Contingency Model (Option #3)
  - Initially recorded as a liability
  - Realization of gain (i.e. derecognition of liability) cannot occur until realized or realizable
  - In case of PPP, no gain recognized until all forgiveness uncertainties resolved (i.e. close to when formal forgiveness takes place)
  - <u>Not</u> appropriate for not-for-profit entities
  - Provides less specificity on disclosure, measurement and recognition requirements
    - As a result, not the preferred accounting policy

Accounting for PPP Loans (Continued)

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- IAS 20 Government Grant Model (Option #4)
  - Treated as a government grant when reasonable assurance entity will meet terms for forgiveness
    - "Reasonable assurance" analogous to "probable" in U.S. GAAP
  - Ability to project likelihood of meeting conditions for forgiveness
  - Initially record as deferred income liability
  - Recognize in P/L on systematic basis over periods related expenses are recognized
    - Present as "other income" or as reduction of related expenses
  - Earlier derecognition timeline (but, more subjective)
  - <u>Not</u> appropriate for not-for-profit entities

Accounting for PPP Loans (Continued)

BAKER NEWMAN NOYES

- Disclosure considerations
  - Which accounting method was applied?
  - Program terms
  - Where do items and amounts appear in the financial statements?
  - Conditions not substantially met

Accounting for PPP Loans (Continued)

BAKER NEWMAN NOYES

Sample footnote disclosure (ASC 470):

Paycheck Protection Program Loan

On June 2, 2020, the Company entered into a promissory note for an unsecured loan in the amount of $5,000,000 through the Paycheck Protection Program (PPP) established by the *Coronavirus Aid, Relief, and Economic Security* (CARES) Act and administered by the U.S. Small Business Administration (SBA). The PPP provides loans to qualifying businesses for amounts up to 2.5 times the average monthly payroll expenses of the qualifying business. The loan and accrued interest had original terms that were forgivable as long as the borrower used the loan proceeds for eligible purposes, including payroll, benefits, rent and utilities, and maintains its payroll levels for an eight-week period or a 24-week covered period, as defined. The amount of loan forgiveness would be reduced if the borrower terminated employees or reduced salaries during the covered period. Certain modifications to PPP loan terms were signed into law in June 2020 and October 2020 that changed the forgiveness, covered period, deferral period and forgiveness periods. The PPP loan was made for the purpose of securing funding for salaries and wages of employees that may have otherwise been displaced by the outbreak of the coronavirus (COVID-19) and the resulting detrimental impact on the Company's business. The loan bears interest at 1.0%, with principal and interest payments deferred until the date the SBA remits forgiveness to the lender or ten months following the end of the covered period. After that, the loan and interest would be paid back over a period of two years, if the loan is not forgiven under the terms of the PPP. BNN Bank (the Lender) processed and funded the PPP loan.

The Company applied for full forgiveness during 2021, as it believed it used the proceeds for purposes consistent with the PPP. On December 22, 2021, the Company received approval for full forgiveness from the SBA. The Company had accounted for the PPP loan in accordance with FASB ASC Topic 470 and included the full $5,000,000 as a component of long-term debt until forgiveness was received. Upon receiving full forgiveness during the year ended December 31, 2021, the Company recorded a gain on extinguishment of long-term debt for the full $5,000,000 on the accompanying 2021 consolidated statements of revenues and expenses.

ERC Overview

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- Introduced March 2020 under the CARES Act
- Allowed organizations that experienced suspension of operations resulting from government orders limiting business activities due to COVID-19, or significant decline in gross receipts, to apply for tax credits
  - Note: ERCs are payroll tax credits, not income tax credits
- Expanded applicability and amounts of credits available under legislation subsequent to the CARES Act (CAA, American Rescue Plan Act)
  - Enabled employers that received a PPP loan to take advantage of ERCs (not previously allowed under the CARES Act), significant questions as to the programs' interplay followed

Accounting for ERCs

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- For-profit entities should apply ASC 958-605 or IAS 20
- ASC 958-605 (Conditional Contribution Model)
  - Record current liability for credits received until conditions necessary to earn credit are substantially met
  - Refunds receivable should be presented as a current asset
  - As conditions are met, for-profit entities can record as grant revenue or other income
    - Netting of grants against qualifying costs not permitted
    - Similar to PPP, determining whether conditions substantially met requires judgment
  - Present change in balance of receivable or unearned advance as change in current assets or liabilities in operating activities section of statement of cash flows

Accounting for ERCs (Continued)

BAKER NEWMAN NOYES

- IAS 20 (Government Grant Model)
  - Requires estimation of amount of credit expected to be retained
    - Is there “reasonable assurance” of compliance with program conditions?
  - If uncertain as to compliance with program conditions as of reporting period end, any credits received should be recorded as a liability until reasonable assurance met
  - When reasonable assurance met, related amounts received reported either -
    - Net of related expenses, or
    - On a gross basis (i.e. other income)
    - Develop accounting policy election
      - If employer applied this accounting model to PPP loan(s), should apply consistent policies to both programs

Accounting for ERCs (Continued)

BAKER NEWMAN NOYES

- Disclosure considerations (either ASC 958-605 or IAS 20 applied)
  - Which accounting method was applied?
  - Program terms
  - Where do items and amounts appear in the financial statements?
  - Conditions not substantially met

Accounting for ERCs (Continued)

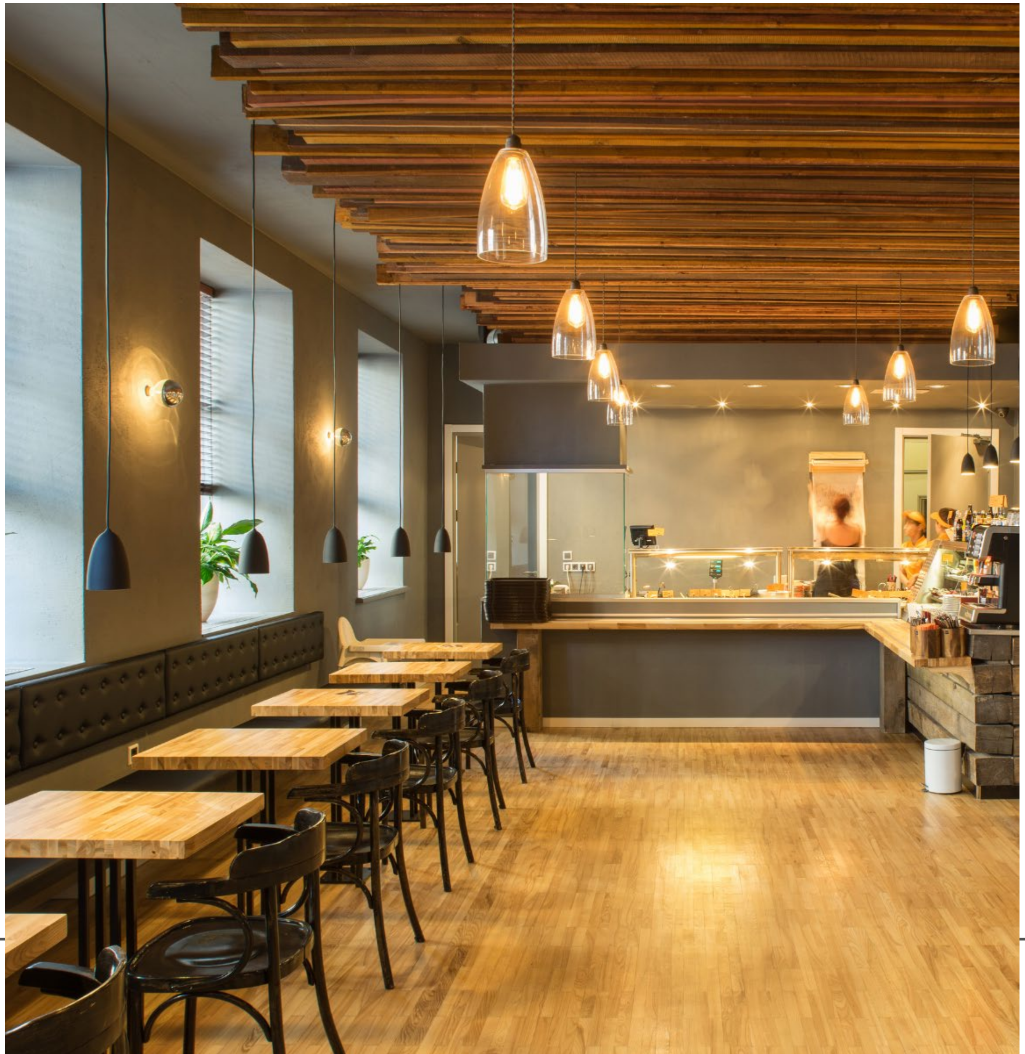
BAKER NEWMAN NOYES

Sample footnote disclosure (IAS 20):

<u>*Payroll Taxes*</u>

The Company determined it was eligible in 2020 for the Employee Retention Credit established by the *Coronavirus Aid, Relief, and Economic Security Act* (CARES Act). The Employee Retention Credit is a fully refundable payroll tax credit, estimated at $200,000 by the Company, based on qualified wages paid after March 12, 2020 and before January 1, 2021. In addition, the Company also deferred the payment of its employer share of the Social Security tax allowed under the CARES Act beginning with payroll periods after March 27, 2020 through December 31, 2020. The total amount deferred at December 31, 2020 is $100,000. The Company is accounting for these credits in accordance with IAS 20. The Company expects to receive the Employee Retention Credit net of its deferred payroll taxes in 2021 and these amounts are included in prepaid expenses and other current assets on the accompanying balance sheet at December 31, 2020.

Miscellaneous Grant Programs



- Shuttered Venue Operators Grant
- Restaurant Revitalization Fund
- Generally accounted for under one of the following models:
  - ASC 958-605
  - IAS 20
  - ASC 450-30

Questions?

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NOYES

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NOYES

Thank You!