Mastering Lease Accounting: A Recipe for Restaurant Success

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Presenters

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Agenda

- Overview of ASC 842
- Identifying the Lease Portfolio
- Technology solutions
- Internal controls over lease accounting
- Lease classification
- Remeasurement of leases
- Evaluating the right of use asset for impairment
- Frequently asked questions

Save The Date

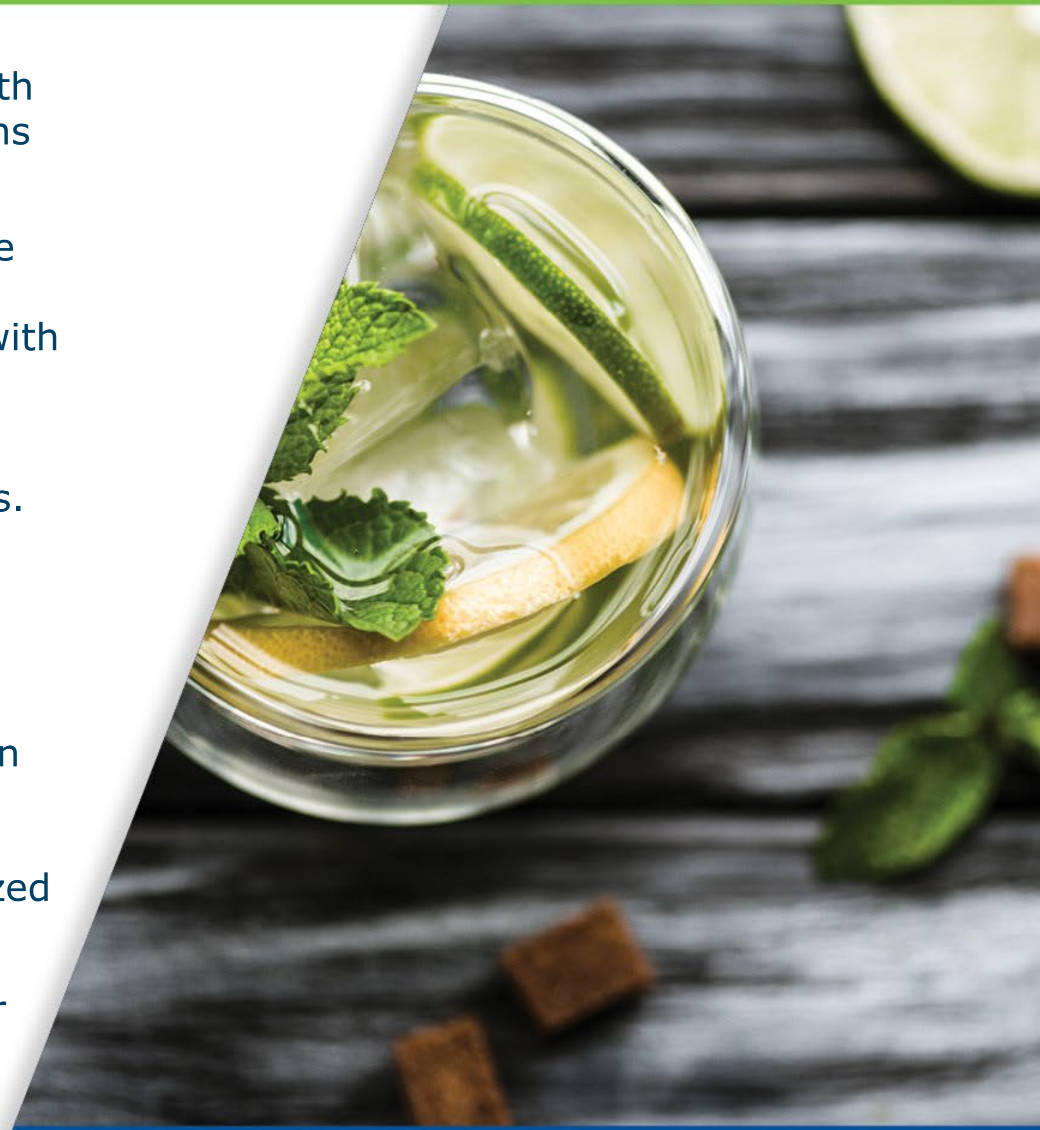
- August 23rd: LeaseCrunch - Preparing for the Next Phase: Ensuring Long-Term Lease Accounting Success

- November 9th: Unveiling Data-Driven Insights for Success Webinar

Visit us online to watch past Restaurant MasterClass webinar recordings.

ASC 842 Crash Course

- The “end game” is to get all leases with service lengths greater than 12 months onto the balance sheet.
- Leases 12 months or less in length are excluded from the guidance and are expensed pro-rata over the contract with no balance sheet impact.
- Operating/capital terminology was replaced with operating/finance leases.
- Finance lease requirements remained relatively unchanged outside of the following:
  - Bargain purchase option reworded to purchase option reasonably certain to be exercised.
  - New 5th category – specialized nature asset that only the lessee can use (i.e., no alternative use to the lessor without significant modification).



Identifying the Lease Portfolio - Tips

- Consider all locations for completeness
- Review recurring expenses for lease payments and keywords (i.e., rent, lease, subscription, contract)
- Examine all types of leases. Real estate, vehicles, and kitchen equipment are expected (see next slide)
- Consider service contracts that may include embedded leases (e.g., A service provider using equipment to deliver wi-fi. The equipment used could qualify.)
- Exclude leases that do not fall under the lease standard
    - Short-term leases (less than 12 months)
    - SAAS software
    - Biological assets
    - Minerals
    - Inventory
    - Assets under construction
- Ask your CPA and business advisors for existing tracking mechanisms

Identifying the Lease Portfolio

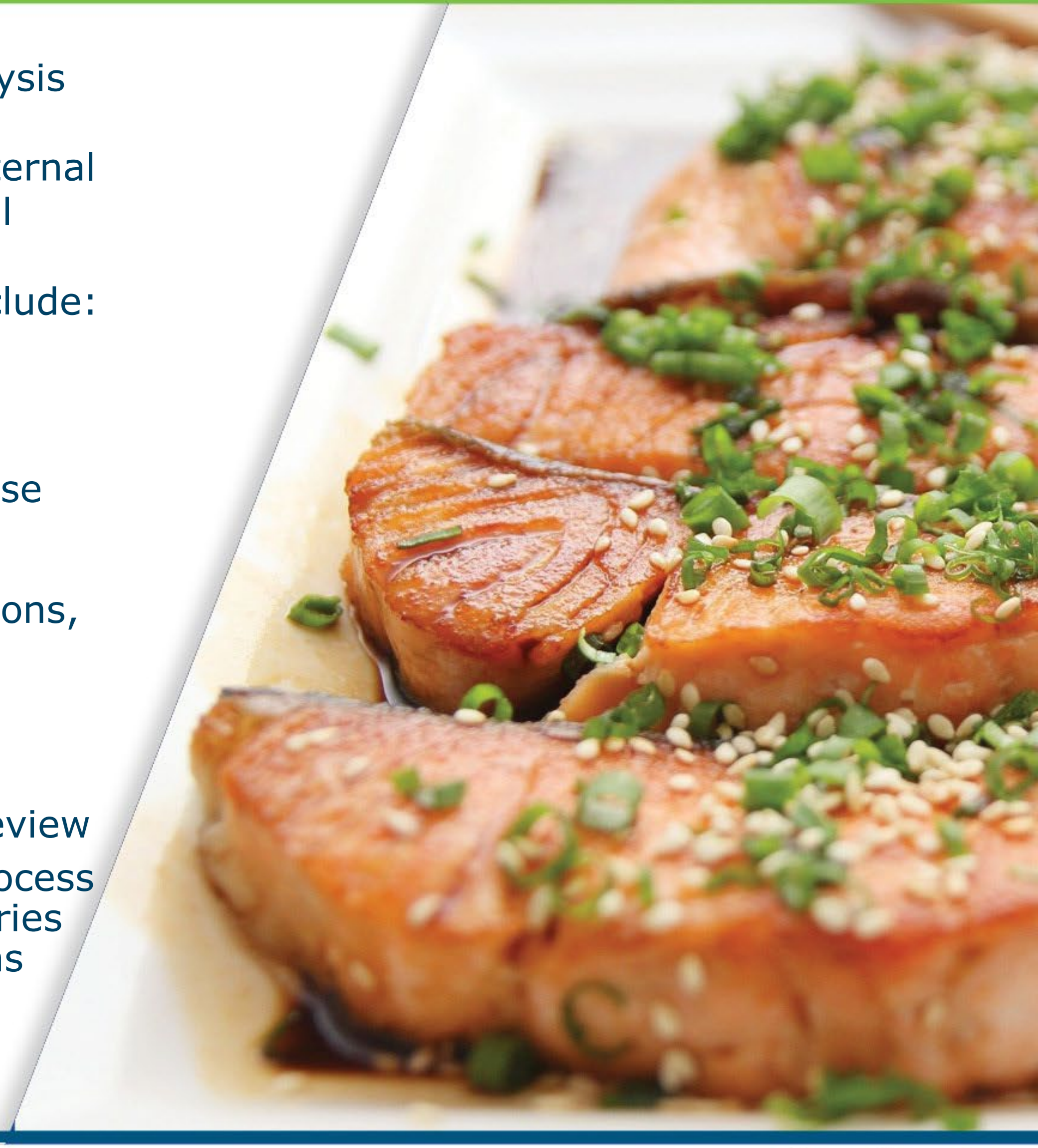
- Common leases in Restaurant
  - Real estate
  - Vehicles
  - Kitchen equipment
  - Vending machines
  - Ice machines
  - ATM
  - Drink dispenser
  - Copiers
  - Security cameras
  - Headsets
  - Satellite dishes
  - POS terminals
  - Generators
  - Trailers
  - Parking
  - Storage
  - Kiosks
  - Dumpster
  - Water cooler
  - Phone systems
  - Laptops
  - Safe
  - Billboards

Lease Tracking Solution

- Options
  - Leveraging software
  - Excel spreadsheet
- Considerations
  - Number of leases to be tracked
  - Complexity of payment terms
  - Frequency of changes to lease agreements
- Software capabilities
  - Automate lease payment process
  - Direct interface with GL system
  - Central depository
  - Lease abstract creation
  - Critical date monitoring (e.g., renewal dates)
  - Real estate market analysis
- Software configuration
  - Testing
  - Training

Internal Controls over Lease Accounting

- Even though your lease portfolio analysis and initial adoption of ASC 842 may already be completed, appropriate internal controls over lease accounting are still imperative. Best practices in lease accounting internal controls would include:
    - Appropriate segregation of duties between data input/review
    - Continued review of the lease portfolio for any additions, changes, potential remeasurements/modifications, etc.
    - To the extent a third-party software solution is utilized, proper ITGCs over logical access and access review
    - Financial reporting close process controls around journal entries recorded, any reconciliations necessary, and financial statement disclosures

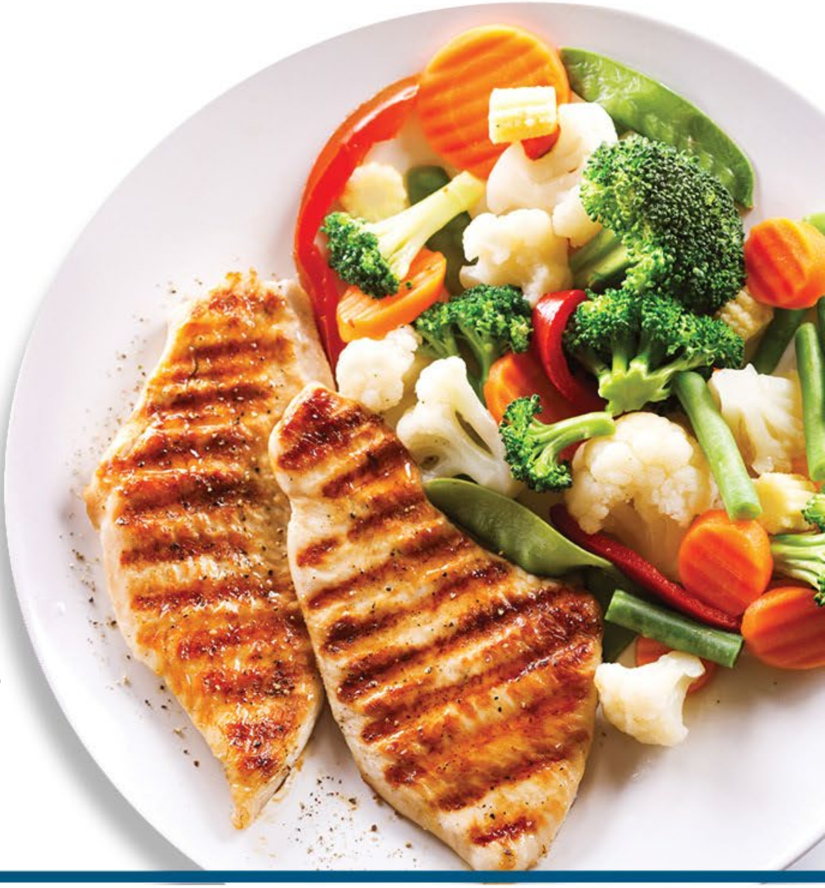


Lease Classification

- Lease classification is governed by five criteria. If any of the five criteria in [ASC 842-10-25-2]() are met, a lessee should classify the lease as a finance lease:

1. Does the lease transfer ownership by the end of the lease?
2. Does the lease grant the lessee an option to purchase an underlying asset that the lessee is reasonably certain to exercise?
3. Is the lease term for a major part of the remaining economic life of the underlying asset?
4. Is the present value of the sum of the lease payments and any residual value guaranteed by the lessee, that is not otherwise included in the lease payments, substantially all of the fair value of the underlying asset?
5. Is the underlying asset of such a specialized nature that it is expected to have not alternative use to the lessor at the end of the lease term?

- Any "YES" answer above is considered a Finance Lease



Lease Accounting – Practice Issues and "Day 2" Considerations

Lessee (Finance & Operating) – Subsequent Accounting

	Finance Leases		Operating Leases	
	ROU Asset	Lease Liability	ROU Asset	Lease Liability
Balance Sheet	Typically amortized on a straight-line basis to the earlier[1] of the end of its useful life or lease term	Increases to reflect interest using the effective interest method and decreases for lease payments made	Amortize based on the difference between periodic straight line lease cost (including amortization of initial direct costs) and the periodic interest accretion	Increases to reflect interest using the effective interest method and decreases for lease payments made
Income Statement	Recognize amortization expense[2]	Recognize interest expense on the lease liability and any variable lease payments incurred	Recognize straight-line rent expense and any variable lease payments incurred and not included in the lease liability[2]	

1) If the lease transfers ownership of the underlying asset to the lessee or the lessee is reasonably certain to exercise an option to purchase the underlying asset, the lessee amortizes the right-of-use asset to the end of the useful life of the underlying asset.
2) If the ROU asset is impaired under ASC 360, an impairment loss is also recognized. For operating leases, recognition in the income statement post-impairment <u>no longer is on a straight-line basis</u> (but still recognized as a single lease cost).

Day 2 Remeasurements (Excluding Modifications)

<table>
<tr><th>Remeasurement Event</th><th>Accounting Applicable to All Remeasurement Events</th><th>Update the Discount Rate?</th><th>Reassess Lease Classification?</th></tr>
<tr><td>A change in the lease term or the assessment of whether the lessee is reasonably certain to exercise a purchase option</td><td rowspan="3">- Remeasure the lease payments and the consideration in the contract,
- Reallocate the consideration to the lease and nonlease components (unless the practical expedient not to separate is elected), and
- Remeasure the lease liability and recognize the remeasurement amount as an adjustment to the ROU asset.
  - However, if the carrying amount of the ROU asset is reduced to zero, the remaining amount is recognized in profit or loss.</td><td>Yes, unless the discount rate already reflects a lessee’s extension, termination or purchase option</td><td>Yes</td></tr>
<tr><td>A contingency upon which some or all of the variable lease payments in the lease are based is resolved such that those payments become fixed</td><td>No</td><td>No</td></tr>
<tr><td>A change in the amount probable of being owed to the lessor under a residual value guarantee</td><td>No</td><td>No</td></tr>
</table>

Day-2 Change in Lease Term & Assessment of Purchase Option

A significant event or change in circumstances within the lessee's control directly affects whether the lessee is reasonably certain to exercise (or not to exercise) an option

There is an event written into the contract that obliges the lessee to exercise (or not to exercise) an option to extend or terminate the lease

The lessee elects to exercise an option even though the entity had previously determined that the lessee was not reasonably certain to do so

The lessee elects not to exercise an option even though the entity had previously determined that the lessee was reasonably certain to do so

Examples of significant events or changes in circumstances within the lessee's control include:

- Constructing leasehold improvements that are expected to have significant value when the option becomes exercisable;
- Making significant modifications or customizations to the underlying asset;
- Making a business decision that is directly relevant to the ability to exercise an option such as extending the lease of a complementary asset; and
- Subleasing the underlying asset for a period beyond the exercise date of the option.

Remeasurement Example

- Fact Pattern
  - Term 1/1/2022 – 12/31/2026
  - $600,000 PV of future payments at 1/1/2022
  - Payments of $125,000 annually
  - Risk free rate of 1.37% was used at lease inception
  - Classifies as an operating lease
  - Journal entries during year 1 are as follows

LEASE COMMENCEMENT

	Debit	Credit
ROU Asset	$ 600,000	
Lease Liability		$ 600,000

YEAR ONE ENTRY

	Debit	Credit
Lease Expense	$ 125,000	
Lease Liability	$ 116,738	
ROU Asset		$ 116,738
Cash		$ 125,000

Remeasurement Example

- Now assume that the lease contained a 5 year renewal option at the end of the original 5 year period on 12/31/2026. This was not originally expected to be exercised due to the store being underperforming. Due to an approved construction plan as of 1/1/2023 for significant leasehold improvements, the exercise of this renewal option is now deemed probable.
- Classification assessment results in continued classification as an operating lease. However, the remeasurement requires an update of the discount rate. The rate updates to 3.79% (risk-free rate for the 9 year term including the renewal period).
- Rent during the renewal period is $140,000 annually

Lease Liability at 1/1/23	$	483,262
New lease liability based on remeasurement	$	1,013,939

JOURNAL ENTRY REQUIRED

ROU Asset	$	530,677		
Lease Liability			$	530,677

Day-2 Modification Considerations

Does the modification grant the lessee an additional right of use not included in the original contract[1]?

No → Modification is not accounted for as a separate contract. See table below for accounting.

Yes ↓

Is the increase in lease payments commensurate with the additional right of use's standalone price, adjusted for the contract's circumstances[2]?

No → Modification is not accounted for as a separate contract. See table below for accounting.

Yes ↓

Account for the lease modification as a separate contract. Accounting for original contract is not affected.

[1] A modification that increases the lease term does not grant the lessee an additional right-of-use. Rather, it changes an attribute of the original right of use that the lessee already controls. Accordingly, this question should be answered 'No' for a modification that increases the lease term.

[2] The lease payments could be adjusted for the circumstances of the contract. For example, the standalone price for the lease of one floor of an office building in which the lessee already leases other floors in that building may be different from the standalone price of a similar floor in a different office building. This is because it was not necessary for a lessor to incur costs that it would have incurred for a new lessee.

Day 2 Modifications Accounting

<table>
<tr><th>Type of Modification</th><th>General Accounting</th><th>Additional Guidance</th></tr>
<tr><td>Grants the lessee an additional right-of-use not included in the original contract and the lease payments are not commensurate with standalone price</td><td rowspan="4">▸ Remeasure the lease payments and the consideration in the contract,
▸ Reallocate the remaining consideration to the lease and nonlease components (unless the practical expedient to not separate is elected),
▸ Update the discount rate for the lease,
▸ Remeasure the lease liability, and
▸ Reassess lease classification and update the subsequent accounting for the lease accordingly.</td><td rowspan="3">▸ Recognize the remeasurement amount of the lease liability as an adjustment to the right-of-use asset.
▸ However, if the carrying amount of the right-of-use asset is reduced to zero, the remaining amount is generally recognized in profit or loss.</td></tr>
<tr><td>Extends or reduces the term of an existing lease, other than through exercise of an option in the original contract</td></tr>
<tr><td>Changes the consideration in the contract only</td></tr>
<tr><td>Fully or partially terminates an existing lease (for example, reduces the assets subject to the lease)</td><td>▸ Decrease carrying amount of ROU asset on a basis proportionate to full or partial termination. Any difference between the reduction in lease liability and proportionate reduction in ROU asset is recognized as a gain or loss at the modification's effective date.</td></tr>
</table>

Day 2 Right-of-Use Asset Impairment Considerations

- A lessee determines whether an ROU asset is impaired and recognizes any impairment loss by applying ASC 360-10-35 on impairment or disposal of long-lived assets.
- Under ASC 360-10-35, an asset group is tested for impairment when events or changes in circumstances indicate that the asset group may not be recoverable.
- Impairment assessment is performed at the asset group level, which is the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities
- An entity may choose to include or not include <u>operating</u> lease payments and liabilities in its estimate of future undiscounted cash flows and carrying amount of the asset group, but it must be consistent.
  - **Remember: If operating lease ROU asset is impaired, recognition in the income statement post-impairment no longer is on a straight-line basis (but still recognized as a single lease cost)**
- Abandonment & sublease of an asset considerations
  - **Reassess lease term?**
  - **Indicator of impairment?**
  - **ROU asset its own asset group for purposes of testing for impairment?**
  - **Update estimate of remaining useful life of ROU asset and other PP&E?**

Day 2 Right-of-Use Asset Impairment Considerations (Cont.)

Lease liabilities - performing Step 1 (recoverability test) and Step 2 (fair value of asset group)

- Finance leases – Always exclude.
- Operating leases – Potential approaches (apply consistently):

	Approach A	Approach B	Approach C
Step 1 - carrying amount of asset group	Exclude operating lease liability	Include operating lease liability	Include operating lease liability
Step 1 - undiscounted cash flows	Exclude lease payments	Include lease payments - But exclude interest accretion	Include lease payments - And include interest accretion
Step 2 – fair value (DCF approach)[a, b]	Same approach as Step 1 above	Same approach as Step 1, but include total lease payments	Same approach as Step 1 above

a. Use market participant assumptions (Step 2) rather than entity specific assumptions (Step 1)

b. In allocating the impairment loss to the long-lived assets (i.e., pro rata allocation and FV limitation), consider the ROU asset without the lease liability.

GBQ

Impairment

- The ROU assets recorded on a lessee's balance sheet under ASC 842 are subject to the ASC 360-10 impairment guidance applicable to long-lived assets. When events or changes in circumstances indicate that the carrying amount of the asset group may not be recoverable (i.e., impairment indicators exist), the asset group should be tested to determine whether an impairment exists through a recoverability test.
- Common impairment indicators
    - Significant changes in the operation (i.e. store closure) or expected future cash flows of the asset
    - Legal proceeding that could impact an asset's future use or value
    - Adverse changes in the economy or business climate.
- Recoverability test involves comparing undiscounted cash flows to the NBV of the asset
    - Expected undiscounted future cash flows > NBV of the asset = "recoverable" and no further assessment is necessary
    - NBV of asset > expected undiscounted future cash flows = "not recoverable" and further evaluation is required
- Potential need to reassess the lease term if reassessment events in ASC 842-10-35-1 have occurred simultaneously with the impairment indicator.

Impairment Recoverability Test

- ABC Company has an underperforming store with 5 years remaining in the lease term. Based on the underperformance of the store and low operating cash flows, a recoverability test was triggered.
- Total ROU assets and total leasehold improvements are as follows:

	Carrying Amount
ROU Assets	$ 700,000
Leasehold Improvements	100,000
	$ 800,000

- Total associated lease liabilities were $750,000
- No variable lease payments are expected. Total fixed lease costs are $173,000 per year and are excluded from the recoverability test as Approach A is being utilized. Expected cash inflows and outflows are as follows over the remainder of the lease term:

Impairment Recoverability Test

- Undiscounted cash flow analysis

	2023	2024	2025	2026	2027	Total
Sales	$ 600,000	$ 550,000	$ 500,000	$ 450,000	$ 450,000	$ 2,550,000
Total Costs	(450,000)	(450,000)	(400,000)	(400,000)	(350,000)	(2,050,000)
Total Cash Flows	$ 150,000	$ 100,000	$ 100,000	$ 50,000	$ 100,000	$ 500,000
Discounted at 5%	$143,000	$91,000	$86,000	$41,000	$79,000	$ 440,000

- As the total undiscounted cash flows of $500,000 are < the carrying value of $800,000, further evaluation is required.
- Cash flows are discounted at a rate a market participant would use which was determined to be 5%.
- Impairment loss was determined to be $360,000 based on this assessment.

Carrying Amount of Asset Group	$ 800,000
Fair Value of Asset Group	(440,000)
Impairment Loss	$ 360,000

Impairment Recoverability Test

- As there were both ROU assets and leasehold improvements at the store level, the impairment loss would be allocated between the two asset groups based on their respective percentage of the total book value pre-impairment.

	Old Carrying Amount	Allocation	Allocated Loss	New Carrying Amount
ROU Assets	$ 700,000	87.5%	$ 315,000	$ 385,000
Leasehold Improvements	100,000	12.5%	45,000	55,000
	$ 800,000		$ 360,000	$ 440,000

	Debit	Credit
Impairment Loss	$ 360,000	
ROU Asset		$ 315,000
Leasehold Improvements		$ 45,000

Impairment Recoverability Test

- After a ROU asset is impaired, the remaining ROU asset is amortized into expense on a straight-line basis over the remaining lease term. The associated lease liability is accreted using the interest method over the remainder of the lease term. The interest rate utilized in this calculation would be the same interest rate utilized in the initial lease liability calculation at either lease commencement or adoption of ASC 842.

	2023	**2024**	**2025**	**2026**	**2027**	**Total**
Lease Expense	114,500	107,725	100,611	93,142	84,022	500,000
ROU Asset	(77,000)	(77,000)	(77,000)	(77,000)	(77,000)	(385,000)
Lease Liability	135,500	142,275	149,389	156,858	165,978	750,000
Cash	(173,000)	(173,000)	(173,000)	(173,000)	(173,000)	(865,000)

Frequently Asked Questions

Many questions have arisen since the implementation of ASC 842. Common areas of FAQ's will be discussed in further detail and are as follows:

- Tenant improvement allowances
- Closed store lease accounting
- Sublease rentals
- Sale-Leaseback accounting
- Related party leases

Tenant Improvement Allowances

- **FAQ:** I had a tenant improvement allowance recorded under the previous lease accounting standard. What is the treatment of tenant improvement allowance at transition to ASC 842 and going forward?

- **GBQ Response:** Upon implementation, the ROU asset is calculated by reducing it for any unamortized TI allowances that existed on the balance sheet. Additionally, for new leases entered into subsequent to the implementation date, any tenant improvement allowances received will reduce the ROU asset upon recording on the commencement date.

Closed Store Accounting

- **FAQ:** Do I still need to track closed store reserves separately under ASC 842 accounting?

- **GBQ Response:** The answer is no. Under ASC 842, the closed store liability is no longer required to be recorded separately as a lease obligation will be recognized. The existing closed store reserve will offset the ROU asset calculated on Day 1. Lease obligations related to closed store operations are evaluated for impairment at cease use date and considering sublease contractual arrangements. ASC 842 revised ASC 420 to remove lease obligations within the scope of termination costs. However, if a policy was elected to separate lease and non-lease components, a reserve for non-lease components may be necessary under ASC 420.

Sublease Rentals

- **FAQ:** How do I handle a sublease arrangement under ASC 842?

- **GBQ Response:** Original lease and sublease arrangements are accounted for separately so long as the primary obligation still exists under the original lease by the lessee. Follow lessee accounting for the original lease with ROU asset and lease obligation.

- For sublease arrangement, lessor accounting is followed:
    - Sublease follows original lease classification
    - Rental revenue is recognized on a straight-line basis
    - Use unbilled rent receivable for any difference between cash rent paid and GAAP rental income recognized

Sale-Leaseback Accounting

- **FAQ:** Has the accounting for Sale-Leaseback Transactions changed under ASC 842?
- **GBQ Response:** Yes, the sale-leaseback accounting has changed under ASC 842. Upon the implementation date, the company should recognize any deferred gain or loss not resulting from off-market terms as a cumulative adjustment to equity. For transactions post-implementation date, the company should recognize any deferred gain or loss **not resulting from off-market terms** in earnings in the period the sale occurred.
    - Deferred Loss: Any deferred loss recognized resulting from the consideration for the sale of the asset not being at fair value or the lease payments not being at market rates as an adjustment to the leaseback right-right-of-use at the later of the transition date and the date of the sale of the underlying asset.
    - Deferred Gain: Any deferred gain recognized resulting from the consideration for the sale of the asset not being at fair value or the lease payments not being at market rates as a financial liability at the later of the transition date and the date of the sale of the underlying asset.

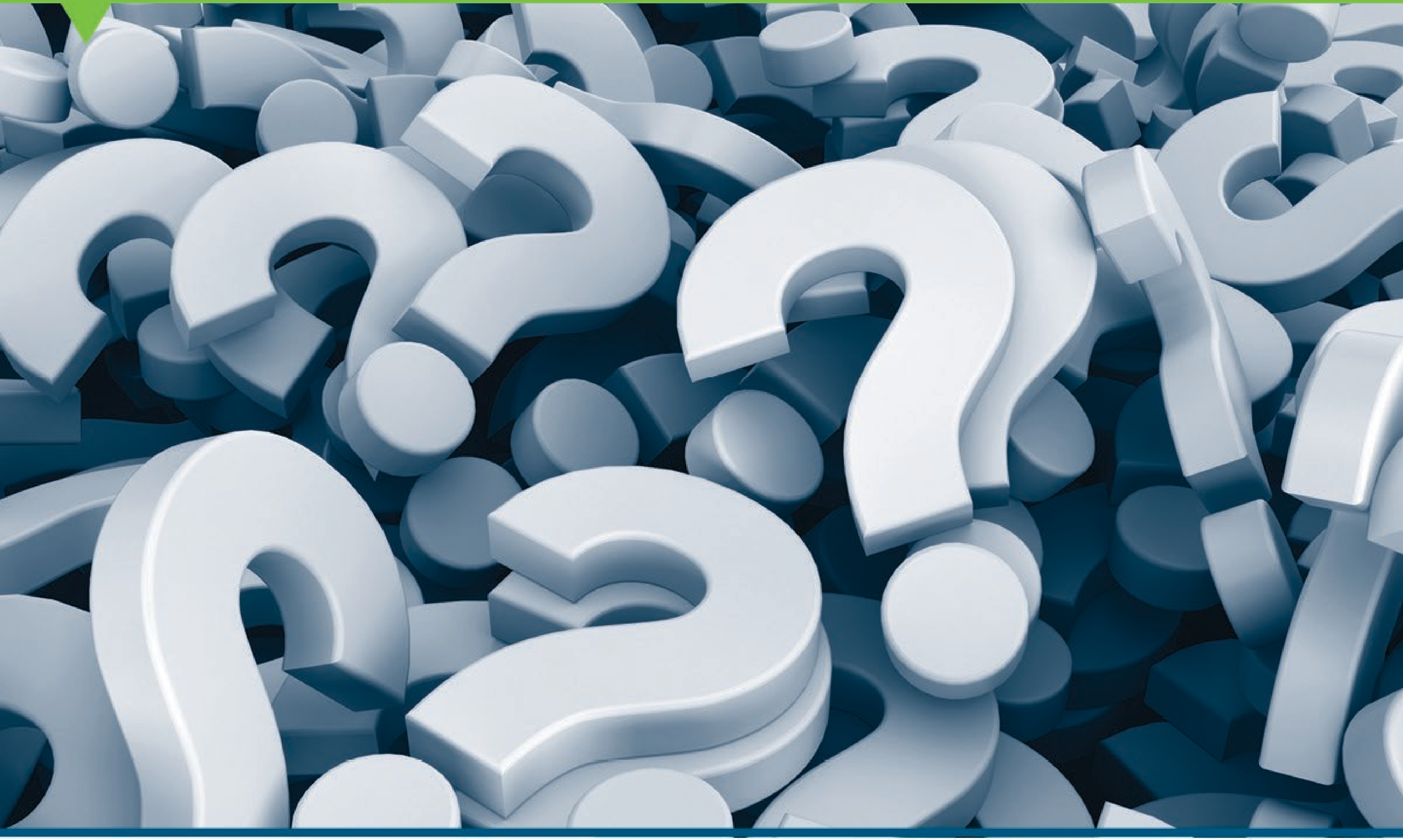
Related Party Leases

- **FAQ:** Are related party leases within the scope of ASC 842?

- **GBQ Response:** The answer is yes. All related party leases should be recorded based on the legally enforceable provisions. There is a practical expedient from the FASB to loosen the requirement of legally enforceable provisions as related party leases can be verbal or not well documented to be legally enforceable. The short answer is that all related party leases need to be recorded, and now is a great time to formalize your related party leases to be legally enforceable.

- ASU 2023-01 – *Common Control Arrangements* – was issued by the FASB in early 2023 to give relief for leasing arrangements under common control. Even though the expectation may be that the lease will continue in perpetuity due to the common control, ASU 2023-01 allows private companies to utilize the written terms of a lease vs expectation when determining the classification and accounting of a lease (e.g. lease term considerations).

Questions



Resources

- View GBQ's Restaurant Service's webinar recording library by clicking here.
- Let us be your "host" in serving your business's unique needs. Visit us online.
- We'll keep you informed on the latest accounting and tax guidance impacting the restaurant industry and provide solutions and tools to ease the challenges you face. Subscribe to our Table Talk newsletter today.

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