Q&A

Lease Accounting Standards' Impact on the Restaurant Industry

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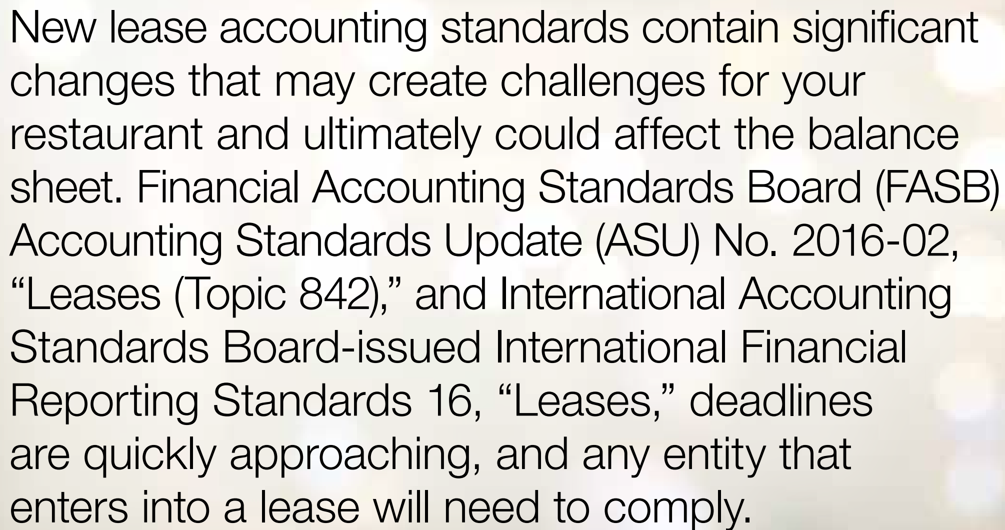


New lease accounting standards contain significant changes that may create challenges for your restaurant and ultimately could affect the balance sheet. Financial Accounting Standards Board (FASB) Accounting Standards Update (ASU) No. 2016-02, “Leases (Topic 842),” and International Accounting Standards Board-issued International Financial Reporting Standards 16, “Leases,” deadlines are quickly approaching, and any entity that enters into a lease will need to comply.

To discuss the new standards' impact on the restaurant industry, Laura Michaels, managing editor of Franchise Times, sat down with Bill Watts, leader of the restaurant industry practice at Crowe, to address questions that may be of concern to you.

Laura Michaels
Franchise Times

Bill Watts
Crowe

LAURA MICHAELS: What we want to start with is what sort of contract review processes are in place to help identify the lease information that someone will need for accounting and compliance?

BILL WATTS: We have seen many organizations struggling with understanding the location of all of their leases and the information in their lease agreements. As a result, organizations are wrestling with what process or approach to take to gather and understand their population of leases. While many organizations can informally account for most general leases, the challenges come with looking at embedded leases. An embedded lease could be a lease that is part of a contract for services or something similar to that.

Two criteria are important for embedded leases: One, the contract has to identify the asset involved. So, the contract has to make it clear that this is the asset you're using. And two, it has to clearly state that you have the right to use the asset for a period of time. Those two components are some of the information that you need in the review process for embedded leases.

We're also finding that there may be many leases in the population that could be unrecorded, or what we call hidden leases. In the past, under Accounting Standards Codification (ASC) 840, you really didn't have to worry about having leases on your balance sheets, so various departments or areas would enter into leases that were never accounted for as a lease by the corporate accounting function. As long as the expense recognition was similar to that of a lease, contracts were not further examined. As organizations struggle with understanding where all the leases are, they are recognizing a need to put together very formalized processes around educating everyone involved with contracts, surveying them, and asking questions in order to understand where leases exist.

Data analytics has come into play to help analyze various expense accounts or general ledger accounts. By leveraging analytics, companies can look for potential hidden leases where employees may have entered into a lease in a more decentralized location, and, as such, the accounting organization may not be aware of it. This analysis approach can help you look for anomalies of consistent dollar amounts throughout certain periods of time and potentially find an outlier that is a lease. Companies are really looking to have a complete picture in understanding where all their leases originate. With this in mind, it's critical to have review processes in place to ensure not only that you identify where all of your leases are but also that you understand the various components of your contracts – for example, the embedded leases I mentioned earlier.

LAURA MICHAELS: Absolutely, and that is some great information. Thank you for covering that. For our next question – and I know there is some relatively new information on this – what do companies or organizations need for this first comparative period that begins Jan. 1, 2019?

BILL WATTS: While adoption of this new leasing standard isn't really required until Jan. 1, 2019, for public companies and certain not-for-profit entities and benefit plans, and then 2020 and thereafter for private organizations, there still may be a need for a two-year look-back period for some entities. There is a clear definition in the FASB standard as to the transition method being a modified retrospective transition to provide accurate and comparable pro forma information. This means that you may have to accumulate all the necessary lease data available for the comparable reporting periods, which means 2017 for some organizations.

But as you mentioned, in November of 2017, the FASB proposed an ASU revision within the standard, which would provide another optional transition method. If finalized, this proposal will give companies more relief in how they transition. It gives companies the option to use the effective date of ASC 842 as the date of the initial application on the transition.

The proposed option doesn't require companies to do the comparative look back from 2017 forward. Instead, the proposal allows companies to apply the provisions of ASC 842 with a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption.

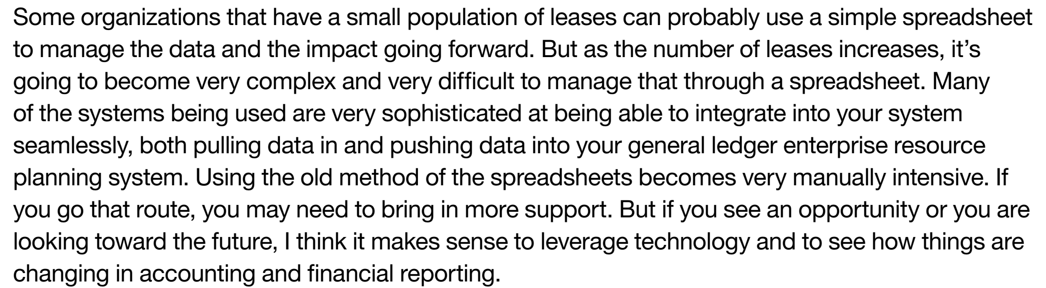
Many organizations are very excited about this because in some industries, or based upon your strategy, it's not important for your investors or your stakeholders to see that comparative information. In these situations, the proposed optional transition method could facilitate a much more effective and efficient transition. The proposed transition option also may reduce the time and effort invested in calculating the impact from the accounting angle. This was a really nice relief that the FASB has proposed, and we're seeing many organizations think through it and look at how they can leverage this going forward.

LAURA MICHAELS: I'm sure there are a lot of people that will appreciate that with everything else they have to deal with. So, as one of those things, this next question will be of particular interest to our audience here: Will organizations need to increase head count or implement new systems as a result of these new standards?

BILL WATTS: With any major change in an organization comes the potential for people or system changes. We've seen that – very similar to revenue recognition – this will have a major impact, not only on the accounting for leases or accounting for a new type of transaction in the organization, but also on the processes, the potential systems, and the people involved. It's really going to depend on a couple different elements: One is the number of leases you have, so the volume of leases not only moving forward, but also what you have to date. The other element is the complexity of those leases.

Many companies will not be able to transition to the new standard with spreadsheets alone with the current staff because of two challenges: One, the standard is very complex and so someone should have some very strong and deep knowledge of it. This may entail hiring someone with that level of understanding or contracting with a third party to bring that knowledge in-house. Second – as I mentioned before – because traditionally many leases really weren't required to be on the balance sheet, there wasn't a lot of impact on the organization. As such, many leases could be tracked through simple spreadsheets because it was more of an income expense impact versus a balance sheet impact. Under the new standard, almost all leases will now go on the balance sheet. The type of lease – financing or capital leases – will determine the extent of information needed, and the analysis will cause great complexity in calculation and tracking. Many of the available software systems in the market are built for these needs and can handle them. This might make for a more efficient and effective approach and save on manual labor and cost. This depends, once again, on the number of leases you have and the complexity. Fewer leases and low complexity may allow for a spreadsheet with manual management, but we have seen most organizations needing additional help.

It's key that your team isn't caught in that tight spot when this new standard is implemented. That could mean that you don't really have a full understanding of the standard, and you're getting pressure from your external auditors on approach, or you're really not fully prepared for it from a spreadsheet perspective. Many of the systems that we see out there today are very adept at handling the new standard from both an accounting and a lease management perspective. They are making things very efficient and effective for organizations – even those with a small number of leases – to quickly understand, implement, and manage their leases going forward.



Some organizations that have a small population of leases can probably use a simple spreadsheet to manage the data and the impact going forward. But as the number of leases increases, it’s going to become very complex and very difficult to manage that through a spreadsheet. Many of the systems being used are very sophisticated at being able to integrate into your system seamlessly, both pulling data in and pushing data into your general ledger enterprise resource planning system. Using the old method of the spreadsheets becomes very manually intensive. If you go that route, you may need to bring in more support. But if you see an opportunity or you are looking toward the future, I think it makes sense to leverage technology and to see how things are changing in accounting and financial reporting.

We’re not seeing a lot of significant head count additions at this point. Once organizations begin leveraging outside parties for education, information, and advisory support, many get through the initial orientation and really start looking for that technology tool to be the gap-filler for the process. As we mentioned before, your process may change: It may become more centralized, because you will need to manage these leases as they are all now on your balance sheet. Or, if you remain decentralized, you need a more efficient, effective, tied-down process through a technology tool to allow your people to remotely manage the information in leasing standards and contracts in that regard.

LAURA MICHAELS: Wonderful. That is definitely encouraging to hear, and certainly Crowe has plenty of those resources that you mentioned. We encourage our audience to take advantage of that.

Bill, I'm wondering if you think software is really necessary. What if someone was planning to use spreadsheet software for an organization with about 150 leases and was going to set up a template to compute everything for each lease. What are your thoughts on that?

BILL WATTS: That's been a challenge from the beginning. We actually started looking at this new standard almost three years ago, and we looked at what was available to help make this an efficient and effective process. We first looked at Excel as it's kind of the workhorse of the business world, and we saw many challenges in terms of the ability to manage large, complex amounts of data. Really we saw it kind of fall down around three areas: the ability to collect and manage data, to qualify or analyze data, and finally to report that data. One of the things we saw cause some serious concern – from what we'll call the stakeholder world – is the ability to maintain viability of the data, prevent it from being susceptible to error or fraud, things of that nature. I think Excel will be very good with a limited number of leases, but it's not very adaptable to the leasing standard, and it's not suitable for multiple users. So, if you are highly decentralized, it becomes a little more difficult to manage it on a consolidated basis – as you are probably already aware from just general usage in the business world. And I think, once again, the inability to track audit trails and limitations on built-in controls – it's not that you can't use it, but I think that's why a lot of technology tools have come forward, because of their ability to more easily adapt to and make things efficient.

One other point I'll just make quickly is we had one client ask us, "Should we pay for technology, or should we pay for people? Should we hire additional people that can help manage this?" And we said, "When you look at the cost of software in today's environment, it's coming down pretty rapidly." Generally, most of these tools range anywhere from in the low tens-of-thousands of dollars up to $100,000. But, if you try to bring on a full-time equivalent or two to help you manage this process, the cost can run in that same range or even higher. Technology tools allow for usage just when you need it versus hiring somebody who may be dedicated to this process 100 percent of the time, thus either freeing up current resources or allowing new hires to work on various areas outside of leasing.

Just look at that balance of your return on investment in this area. As I mentioned, there are some very nice tools out there that are fairly inexpensive from an investment perspective. So we encourage our clients to take a good hard look at that.

LAURA MICHAELS: Lots of considerations. Is there any specific software that Crowe would recommend that would be ideal for tracking higher volumes of leases?

BILL WATTS: There are many great tools in the market, and they do a variety of things depending on your needs. It would be difficult to point to any one or a number of them at this point. Like many decisions in life, it is dependent on what is important to you and your situation. We'd be more than willing to have a separate call with interested parties to discuss what we know is out there. As a starting point, we categorize in three buckets: what we call basic, moderate, and advanced. Obviously, you can imagine as you go further up the scale that the cost, features, and functionality can increase.

As I mentioned, there are some very nice, basic tools out there. We generally look at the number of leases you are going to have, the complexity of the types of leases, and structure – decentralized versus centralized. We have found that revenue is not always a clear indication of software needs either, as we have seen some very large global organizations in terms of revenue and assets that don't have very many leases, and we've seen some small organizations with many leases.

There are a lot of variables involved. I would say talk with a Crowe professional or others to get a better understanding because there are a lot of choices out there.

LAURA MICHAELS: How will the additional leases on the balance sheet affect blending?

BILL WATTS: I think there was some confusion early on when the standard came out about whether or not we were creating more debt on the balance sheet. This is not additional debt, but rather it is additional operating liabilities. Many companies have debt arrangements and credit arrangements with borrowing facilities or banks, and often these agreements have loan covenants that depend on various aspects of the business in terms of financial ratios. Unfortunately, it's going to depend on how your particular lender views the increase in operating liabilities, or how the debt covenants you have in place read. It is important to look at whether or not this will trigger any issues or may challenge you to get additional financing or loans.

Please ensure you are educated on the new standard before you talk to your lender, as lenders may not be as informed, or may have a unique perspective on the impact of the new standard. The challenge is making sure that lenders are educated that this isn't debt but operating liabilities and that they understand how this could potentially affect both current debt covenants as well as what they'll be expecting under new or future lending.

Learn More

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