



October 2018

Serving Up the New Lease Guidance

Restaurant and retail considerations
for the new lease accounting standard

An article by Simon J. Little, CPA; Lindsay R. Sellers, CPA; and William C. Watts



A new lease accounting standard, Accounting Standards Update No. 2016-02, “Leases (Topic 842),” issued by the Financial Accounting Standards Board (FASB) in 2016, is effective in 2019 for public companies, not-for-profit entities that have issued securities that are traded on an exchange, and employee benefit plans filed with the Securities and Exchange Commission. All other entities must adopt in 2020. The new standard will affect any entity that enters into a lease.

Areas of potential impact

As restaurants and retail organizations familiarize themselves with the new standard, they may find themselves focusing on three areas in particular that could potentially have a greater impact for them than for organizations in other industries. These areas are 1) the identification of embedded leases, 2) the determination of the lease term, and 3) the proper accounting for variable lease payments.

Embedded leases. The new lease standard applies to not only distinct lease contracts but also contracts with embedded lease components. Consequently, organizations need to look beyond their more obvious leases (for example, facilities or retail locations) when implementing the new standard. In particular, organizations also need to determine whether any significant service contracts contain embedded leases. For example, a restaurant may obtain the right to use a “free” dishwasher as part of a contract to purchase a certain quantity of cleaning agents. Such a contract will need to be evaluated to determine whether the right to use the dishwasher over the period of the service contract is an embedded lease.

Lease term. The new lease standard requires organizations to record a lease liability on their balance sheet equal to the present value of future cash flows over the remaining term of a lease contract. The lease term includes the initial noncancelable period plus any periods covered by renewal options that an entity is reasonably certain to exercise. In determining whether it is reasonably certain to exercise a renewal option, an organization must consider all relevant economic factors, including factors such as the significance of leasehold improvements made or the impact of switching costs (for example, lost business or moving expenses). In certain situations, organizations may know up front they will exercise a certain number of renewal options. Given the impact of the lease term on the measure

of the lease liability, organizations need to carefully evaluate renewal options and have a process for determining the renewal options they intend to exercise, using the resulting period in the measurement of their lease liability. This will require a high level of coordination between the lease operations and accounting functions that previously may not have existed to provide for a full understanding of the economic factors that may affect the lease’s term.

Variable lease payments. Under the new lease standard, variable lease payments are included in the measure of the lease liability only in certain circumstances. Variable lease payments based on an index or rate – such as the consumer price index (CPI) – are included in the measure of the lease liability using the spot rate of the index or the rate at lease commencement. In contrast, variable lease payments that are based on changes in an index or rate (for example, year-over-year changes in the CPI) are not included in the lease liability. Instead, they are recognized in the period the obligation for payment is incurred. Similarly, variable lease payments based on something other than an index or rate (for example, percent of sales) are not included in the lease liability unless there is a base minimum amount payable. Given the different treatments for variable lease payments, organizations will need to establish a process to identify and distinguish between variable lease payments – or portions thereof – that should be included in the lease liability and variable lease payments that are recognized when incurred.



Additional realizations

Many organizations implementing the new standard also have come to realize the following:

1. Substantially all leases will be reported on the balance sheet. The new standard requires organizations to reflect substantially all leases – including operating leases – on the balance sheet to give users of the financial statements more transparency into the future commitments of an organization. This change requires organizations to know not only the composition of their entire lease population but also the status of each lease. As a result, aspects of an organization's leases that typically were the concern only of those initiating the lease now must be communicated to accounting. For example, accounting must be made aware of events or circumstances that affect a lease's term and relevant discount rates.

Organizations will need to assess whether their existing processes easily allow them to identify their total lease population. If they do not, and help is needed, organizations should begin now to reassess their lease initiation, administration, and modification processes and consider whether these processes should be redesigned and/or centralized.

Training will be another consideration in gathering the required information. As simple as it may seem, many of the individuals given authority to procure

resources for an organization may not know they have entered into a lease. This may be because they don't know how to identify an embedded lease or simply because they misunderstand what a lease is for accounting purposes. For example, some nonaccountants may not realize that day-to-day rentals (such as of equipment or vehicles) and long-term leases (such as of real estate) both are treated as leases for accounting purposes.

2. Organizations with more than a small number of leases likely will need software to assist in the accounting under the new lease standard. For a very small business that leases office space, a few copiers, and a company car, maintaining the required lease information on spreadsheets still might be possible, at least theoretically. But even such a small lease portfolio would require constant monitoring and manual updating – with all the opportunities for error that provides. In reality, even many small businesses are at the point where lease administration or accounting software is a necessity. Software can help with the requirement to have a lease amortization table for each lease, handling the ongoing calculations and reducing the risk of misstatement from manual calculations. With that in mind, organizations should assess the potential costs of software solutions so they can include those costs in their budgets for this year, far ahead of the standard's effective date.

As with any software implementation, organizations should consider what functionality they want in their software. For example, they should examine the complexity of their lease contracts (such as embedded leases, option periods, variable lease payments, and foreign currency translation issues). Additionally, they should consider the impact of the software on their business processes. Do they want to train multiple groups in a decentralized process or centralize the process in one group? Similar to what many companies experienced with the implementation of the revenue recognition standard, in order to implement the new lease standard, companies may need to make major changes to their accounting processes and practices. The budgeting process should start immediately.

Implementation of the standard

Similar to the revenue recognition standard, the new lease standard is 300-plus pages and does not always provide organizations the clear-cut answers they want. Implementation of the lease standard may require additional resources to gather and analyze contracts. Organizations should consider bringing in outside help from professional services firms that can assist with evaluating processes and identifying the portions of the standard that will affect them the most.

As organizations have learned through their experiences with other recent accounting changes, it is important to start the implementation of a standard sooner rather than later.



Learn more

Simon Little
+1 214 777 5235
simon.little@crowe.com

Lindsay Sellers
+1 214 777 5231
lindsay.sellers@crowe.com

William Watts
Principal
+1 614 280 5227
william.watts@crowe.com

crowe.com

"Crowe" is the brand name under which the member firms of Crowe Global operate and provide professional services, and those firms together form the Crowe Global network of independent audit, tax, and consulting firms. "Crowe" may be used to refer to individual firms, to several such firms, or to all firms within the Crowe Global network. The Crowe Horwath Global Risk Consulting entities, Crowe Healthcare Risk Consulting LLC, and our affiliate in Grand Cayman are subsidiaries of Crowe LLP. Crowe LLP is an Indiana limited liability partnership and the U.S. member firm of Crowe Global. Services to clients are provided by the individual member firms of Crowe Global, but Crowe Global itself is a Swiss entity that does not provide services to clients. Each member firm is a separate legal entity responsible only for its own acts and omissions and not those of any other Crowe Global network firm or other party. Visit www.crowe.com/disclosure for more information about Crowe LLP, its subsidiaries, and Crowe Global.

The information in this document is not – and is not intended to be – audit, tax, accounting, advisory, risk, performance, consulting, business, financial, investment, legal, or other professional advice. Some firm services may not be available to attest clients. The information is general in nature, based on existing authorities, and is subject to change. The information is not a substitute for professional advice or services, and you should consult a qualified professional adviser before taking any action based on the information. Crowe is not responsible for any loss incurred by any person who relies on the information discussed in this document.
© 2018 Crowe LLP.