CohnReznick
Accounting • Tax • Advisory

HOSPITALITY *INSIGHTS*

Forward Thinking Thought Leadership

What Do the New FASB Rules for Leases Mean for Restaurants?

Leasing guidance as we know it has been replaced. In February 2016, the Financial Accounting Standards Board (FASB) issued new guidance on lease accounting, Accounting Standards Update No. 2016-02 (the "ASU"). While the intent of the ASU is to provide greater transparency regarding leasing arrangements, the most significant impact of this new guidance is to move all leases onto the balance sheet. This can have a significant impact on the way your company's financial statements are reported. Are you prepared for those impacts and what it takes to be compliant?

While the ASU impacts the way leases are accounted for in all industries, for some in the restaurant industry, the changes may be especially significant. What do restaurant operators need to focus on in relation to this new standard? They will need to take action in each of the following three ways:

1. **Assess the Volume of Existing Leases.** *Take inventory* of the leases maintained by the company. Multi-unit restaurant operators may have hundreds of leases to assess. This will require time and resources to evaluate, as well as to implement the new processes and policies. *Understand* which agreements have lease components. This could include the leasing of equipment, software, vehicles, real estate property, etc. Determining the volume of existing leases that need to be evaluated will be the first step in establishing the scope of work that needs to be addressed and will help management decide whether it should outsource evaluation of existing leases. Many restaurant entities, especially those with a larger volume of leases, may benefit significantly during transition from adoption of several available practical expedients outlined in the ASU.

2. **Gather the Data Needed for Lease Calculations and Determine Accounting Policies.** Collect information that will be needed for the lease calculations, and may include items such as the economic life of leased assets, the fair value of the underlying assets, lease payments and lease terms, initial direct costs, and appropriate discount rates. A number of *accounting policy determinations* also will need to be made, which will impact lease calculations, both during transition for existing leases and in implementation for new leases and any lease modifications. Certain practical expedients will need to be adopted as accounting policies. Management will need to carefully consider practical expedients it may wish to adopt, which can save significant amounts of time and manpower. This includes practical expedients relating to the election not to reassess expired and expiring leases, and the election to not reassess lease classifications. *Determine* how the company will handle option periods, which may include resolving what is considered to be "reasonably certain" under the ASU.

3. **Understand the Impacts on Financial Statements and Other Agreements.** Bringing leases onto the balance sheet increases assets and liabilities and could *impact covenants* with lenders or others. For example, including leases on the balance sheet will increase the total debt shown, thus modifying leverage ratios. *Higher levels of disclosures* will require organizations to identify the nature of leasing transactions, the lease's rights and obligations, assumptions and estimates used by management, and a summary of maturities. It is also critical to understand the potential impact on covenant calculations. New leases that are determined to be operating leases likely will increase fixed asset balances, which may have an impact on capital expenditure covenants. Lease classification, which affects how the related lease costs are reported, will need to be evaluated to determine the impact on how earnings are reported under these agreements. Changes to categorization of a lease could affect EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization), which is used in many agreements. Lease related costs associated with leases classified as operating leases will continue to be expensed through lease cost expense. Operating lease costs include amortization of the right of use asset as well as interest related to the lease liability. In short, lease costs associated with operating leases will be included in the determination of EBITDA. On the other hand, lease costs associated with finance leases (formally capital leases) are not included in the determination of EBITDA, and instead are reported separately as amortization and interest expense.

Additional lease accounting considerations for restaurants:

- ***Handling lease modifications and reassessments.*** What happens when the terms of the lease change? What happens when the fact and circumstances considered reasonably certain at the initial measurement of the lease have changed? Does the modification qualify as a separate contract?
- ***Implementation of procedures and processes for new leases.*** Restaurant owners may want to consider potential use of a software program to assist with implementation. Each lease will need to be abstracted for key information, in addition to lease calculations, which will need to be completed. The use of software may assist with these areas.

Certain agreements may also include components that need to be accounted for separately as leases. For example, a company may have a service agreement relating to its phone system, where the phone equipment is included as a separate component of the service agreement for the phone service. If the portion of the service agreement related to the use of the phone equipment qualifies as a lease, then a right-of-use asset and a lease obligation related to the phone equipment will need to be recorded regardless of whether the lease is classified as an operating lease or as a finance lease. In the past, the balance sheet impacts resulting from lease classification were more significant and operating leases generally were considered to be more advantageous because the related right-of-use assets and lease obligations were not included on the balance sheet. Another consideration of this type of situation would be the potential impact of the lease classification on EBITDA. Classification of the phone equipment lease as a finance lease could be advantageous based on exclusion of the related lease costs from the determination of EBITDA. Discussions should be had upfront with lenders relating to this standard to ensure that there is no confusion once this standard is in place.

The following table represents how each lease classification would be reflected on the company balance sheet and income statement under the ASU:

	OPERATING LEASE	FINANCE LEASE
Balance Sheet	Right to Use Asset Lease Liability	Right to Use Asset Lease Liability
Income Statement	Lease Cost	Amortization Expense Interest Expense

Following are two simplified scenarios on how the new guidance could affect a company:

Scenario 1

ABC Company has adopted the new lease guidance. The company has 25 restaurant locations subject to existing lease agreements, each of which are classified as operating leases under existing guidance. The company currently has financial statement covenants that limit the amount they can spend on capital expenditures during the year and a required minimum EBITDA. How will this new guidance affect the company? How would this affect their loan covenants?

Key Considerations – Based on this scenario, the company has 25 existing leases to evaluate, which may take a significant amount of time. While they can adopt the practical expedients so that they do not need to evaluate lease classification type for the existing leases, they will still need to record right-of-use assets and lease obligations for all 25 leases. Monthly amounts of amortization related to the right-of-use assets and interest related to the outstanding lease obligations will be reported on a straight-line basis as a single lease cost in the income statement. Based on this scenario, the company should consider whether recording the right-of-uses assets under the existing leases in accordance with the ASU will be considered a violation of its capital expenditure loan covenant provisions. While the company may not be in violation of the EBITDA covenant in this example, management should also assess any potential impacts.

LEASE ACCOUNTING RESOURCE CENTER

The CohnReznick *Lease Accounting Resource Center* presents regular updates with our latest thinking around lease accounting changes, helping middle-market companies gain insight and practical implementation guidance. Visit the portal and download CohnReznick's in-depth resource publication, *INSIGHTS: New Lease Accounting Standard Impacts and Implementation*, to better understand the revised standards, determine how to assess the impact on an organization, and develop an action plan to implement required business process and financial system changes.

Scenario 2

XYZ Company has adopted the new lease guidance. The company currently has financial statement covenants that limit the amount they can spend on capital expenditures during the year and a required minimum EBITDA. The company currently has the exact required minimum EBITDA on the income statement. They have just completed the negotiations on a new lease of restaurant equipment. How would the new lease affect their loan covenants if the company determines the new lease should be classified as an operating lease? How would the new lease affect their loan covenants if the company determines the new lease should be classified as a financing lease?

Key Considerations – Based on this example, assuming the company determines that the new lease should be classified as an operating lease, both a right-of-use asset and a corresponding lease liability would be recorded on the balance sheet. Additionally, monthly lease costs composed of amortization of the right-of-use asset and interest on the lease liability would be reported on a straight-line basis in the income statement. These lease costs would also be included in the determination of EBITDA, which could negatively impact the company's compliance with its existing loan covenant. Additionally, the right-of-use asset recorded under the lease could negatively impact the company's compliance with the capital expenditure covenant under the loan.

Alternatively, assuming the company determines that the new lease should be classified as a finance lease, both a right-of-use asset and corresponding lease liability would be recorded on the balance sheet. However, unlike the operating lease example above, monthly lease costs would be reported differently. Amortization expense related to the right-of-use asset and interest expense related to the lease obligation would be reported separately in the income statement. However, these lease costs would not be included in the determination of EBITDA and, therefore, should have no negative impact on the company's compliance with its existing loan covenant in this regard. However, it could be in violation of the capital expenditure covenant.

For public companies, the new lease accounting guidance is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. For all other organizations, the ASU is effective for fiscal years beginning after December 15, 2019, and for interim periods within fiscal years beginning after December 15, 2020. Early application is permitted.

Learn More

For further understanding of how the lease accounting revisions will impact restaurant owners, and for guidance on implementation, please contact Kelly O'Callaghan, Partner, at 973-618-6221 or kelly.ocallaghan@cohnreznick.com, or Tina Janevski, Senior Manager, at 973-618-6244 or tina.janevski@cohnreznick.com.

June 2017

cohnreznick.com