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Franchise Business Network Podcast

**Featuring John Gotaskie of Fox Rothschild,
Jeff Deane of BKD and Jim Powers of Ablak Holdings**

Good morning and welcome to the podcast of the Franchise Business Network in Pittsburgh. We are talking today about new accounting standards which will have a dramatic impact in the field of franchising and specifically their leases. With us today are three distinguished panelists – Jeff Deane of BKD CPAs and Advisors, John Gotaskie of the Fox Rothschild law firm and Jim Powers of Ablak Holdings.

Jeff Deane: Good to be here.

John Gotaskie: Thank you. Good morning.

Jim Powers: Good morning.

Question*: Jeff Deane, I understand that new standards regarding leases have been adopted by the Financial Accounting Standards Board, or FASB for short. These new lease standards change how a franchisee or a franchisor must account for its lease obligations within their financial statements.*

Jeff Deane: Yes. The adoption of the lease standard is going to be a really huge issue for a lot of companies. For someone who has a franchised restaurant or a coffee store or whatever it may be, the leases for the facility and equipment typically in the past have not hit the balance sheet. They've flowed through on the P&L as lease expense or rent expense. What we'll see with the new standard, which is supposed to be effective in 2020 (even though right now the FASB is getting a lot of pressure to push this off one year to 2021, is that for any lease longer than a year, it will be recorded as a liability on financial statements based on the present value of that lease. So if you're leasing a building or a store front and it's a 10-, 20-year lease, you have to work out the math of what is the total future lease payment. Then you have to "present value" that amount and you record that as an asset (a "right to use" asset) and a liability for the obligation on the balance sheet. What we're seeing, and what we expect, is that these numbers are going to be big, and they're going to have material impact and effect on a company's financial statements.

Therefore, what's going to occur is that you're going to have items such as loan agreements that have ratios and covenants such as debt to equity ratios. And all of a sudden, to no fault other than a new accounting change, these companies could be in violation of their covenants, in violation of their debt agreement. If a franchisor owns 15, 20 or 100 locations, now it's even magnified greater with the recording of a liability for all these leases for each one of the properties and equipment packages. So this easily becomes just a huge number.

John Gotaskie: Jeff, I'm sitting here shaking my head. This sounds like it's going to be an accounting nightmare.

Jeff Deane: Yes especially for those with multiple leases. There still will be finance leases – what we used to call capital leases – and operating leases, but now operating leases are going to be treated differently. So companies will need to identify all leases, determine which category

applies (whether it's financing or operating) and determine the adjustment to the opening equity of the financial statements. So the first question after cataloging all of your open leases, is whether each lease is a finance lease or is it an operating lease, ultimately looking at five factors that are used within the standard to determine if it's a finance lease. If not met, then it's an operating lease.

Jim Powers: Jeff of those five criteria, you only have to meet one of those, right?

Jeff Deane: Correct, you only need to meet one of the five lease criteria.

Jim Powers: The key is to categorize and have systems in place. Just like the FASB 606, you need to figure out what's general versus what's specific to figure out what truly is a lease and if so what type. That adds layers of complexity and administration. Over time, we'll get used to that and move ahead.

Question*: John Gotaskie, what are the five finance lease criteria?*

John Gotaskie: Sure, test my memory. The first one is that ownership of an asset transfers to lessee by end of the lease term. Second, the lessee has a purchase option that is reasonably certain to be exercised. Third, the lease term is for a major part of the economic life of an asset, in other words is mostly going to be used up during that lease term. Fourth, the present value of minimum lease payments amounts to, I think the magic words are "at least substantially all," of the fair value of the leased asset. Fifth, it's when the underlying asset is of such a really specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term, which to me, Jeff, sounds an awful lot like using up the economic life of the asset.

Jeff Deane: Very good John, I'm impressed! These five criteria replace what used to be under the old standard as four "bright-line" tests, very similar. The only point that is new is item five, where the underlying asset of the lease 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. Where we see that is with some of our clients – they may have very specialized types of manufacturing. They have dyes that are unique to just them for the products they produce. It may be very expensive to make the dyes. And in the past they have made the leases structured in a way to qualify them as an operating lease, and they did not have to capitalize them. The new standard is saying that if an item is so unique, specific to your company and what you produce, then it automatically qualifies as a finance lease. The same really could apply to specialized equipment used within a franchise system.

Question*: Jeff Deane, tell our listeners more about the impact of new obligations of lease liability sitting on one's balance sheet.*

Jeff Deane: This is really a big issue. What's going to occur is a portion of that lease is going to sit in current, which is going to distort ratios, and a portion will be long-term, similar to debt. And then you will have a right-to-use asset that is considered to be an intangible asset and classified as a long-term asset. The total amount recorded will include the liability plus any initial indirect costs and any prepayments less any incentives. So overall, and this is the big point, the balance sheet is going to look totally different. Dramatically different. For franchisees with many leases, they have to go back and recast those leases and determine what amounts should be booked on the balance sheet. Again as you said, an "accounting nightmare."

John Gotaskie: What I'm worried about is that it's going to impact franchisors when they have to go report to state securities regulators. The regulators are going to want to know why the balance sheets are suddenly looking so different. The other point is, and I'm sure Jim can comment on this, the sales process. Let's not forget that a state like Minnesota now has a searchable databank of all of the FDDs that are used in Minnesota. Someone's going to start looking at these different years and then time before and not be sophisticated when they're looking for a franchise like one of Jim's "hometown heroes" and wonder why the present looks so different, so dramatically different from the past.

Jeff Deane: I think as you said, John, that the statements are going to look dramatically different, and we're already seeing examples of this. Publicly traded companies are adopting this in 2019, in advance of the private companies. We have access to see the impact of this in the notes to their financial statements. One restaurant chain has elected the optional transition method which lets it adopt the new standard in the initial year instead of going back to prior years. And what we're seeing is that the numbers are huge. That restaurant chain expects to record an operating lease liability of $2.7 billion, with a "b." So now all the sudden, nothing changes other than a new accounting pronouncement and their debt to equity ratio has been worsened significantly because they're booking $2.7 billion worth of liabilities that previously were not on their balance sheet.

Question: *Jim Powers, what other issues will franchisors have with their banks as a result?*

Jim Powers: A key thing prior to next year will be for franchisees to forecast what the impact will be, and then approach the lenders and discuss how the accounting standard will change or impact any covenants. Lenders and banks may allow changes and amendments and waiver letters to help franchisees stay in compliance.

John Gotaskie: I agree, Jim, and this is where I believe franchisors can be of assistance to their franchisees. They can be talking to their franchisees about these coming changes and go through the updates to the accounting standards so that everyone knows that it's coming. Now's the time to be thinking about these things and maybe even contacting the banks the lay the groundwork for it.

We're out of time today. Listeners, please check out our companion podcast about how franchise revenue recognition is changing. Again, our thanks to our distinguished panelists today, John Gotaskie of the Fox Rothschild law firm, Jeff Deane of BKD CPAs and Advisors and Jim Powers of Ablak Holdings.

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