Leases: Impact of ASC 842 on the retail and restaurant sector

RSM’s industry insiders break down the answers to five key questions on how ASC 842 may affect the retail and restaurant sector.

Accounting Standard Codification Topic 842, Leases (ASC 842) is a revolutionary change in lease accounting that will affect entities across all industries, but there are specific aspects that retailers and restaurant operators should consider. To understand these considerations the first step is to understand the full inventory of all contracts that would fall under the new definition of a lease. Understanding the financial reporting and operational impact is imperative also to the middle market.

For example, companies may be thinking of engaging in early conversations with their lenders to understand the debt covenant implications as the financial metrics on the balance sheet will be affected significantly upon the adoption of the new standard. From both strategic and forward-looking perspectives, companies should also be thinking about the implications of lease renewal terms as well as contingent rental agreements. Under the standard and from a financial planning perspective, common renewal terms (e.g., at the end of five years) need to be considered because of their potential impact on the balance sheet.

Furthermore, as the retail landscape continues to evolve, major malls and commercial establishments are being faced with unexpected vacancies in high traffic areas. The new standard introduces the concept of recognizing an asset as “the right to use” which in turn must also be evaluated for impairment in situations where retail and restaurant companies are being faced with the impact of internet sales, lower traffic due to the Amazon effect, mobile orders, or even relocation options within a commercial establishment.

Given the impact of ASC 842 on retail and restaurants, five unique questions have arisen

Question 1: How will the new lease standard affect my company’s debt covenants?

The amount of long-term debt or long-term assets on a balance sheet has a direct impact on selected key financial ratios used by lenders and other users of financial statements. The most significant change arising from the new standard will be the recognition of historical operating leases as right-of-use (ROU) assets with a corresponding lease liability. The liability will initially be measured at the present value of the lease payments to be made over the lease term (see question 2 for what “term” means). The initial ROU asset will be measured at the amount of the initial liability recorded, adjusted for any lease payments made to the lessor at or before the commencement date, net of any lease incentives received by the lessee, as well as any initial direct costs incurred by the lessee.
Under the new standard, a lease will be classified as an operating lease or a finance lease. The subsequent accounting for the lease liability is the same for both finance and operating leases and, at the end of each period, the balance of the lease liability should be equal to the present value of the lease payments not yet paid. One of the differences between the finance and operating lease accounting models is how the accretion of the lease liability is treated from a cost perspective. The accretion of the lease liability is treated as an interest cost under the finance lease accounting model, while it is treated as part of total lease costs under the operating lease accounting model. Thus, in the context of EBITDA, the classification would affect certain debt covenant ratios that add back any interest.

The subsequent accounting for the ROU asset under a finance lease is to amortize the remaining lease costs over the remaining term on a straight-line basis, with adjustments for the recognition of payments made or payment received from the lessor before the lease’s commencement date as well as any initial direct costs incurred by the lessee. This generally results in front-loaded expense. Under an operating lease, the ROU asset is subsequently remeasured at the amount of the remeasured lease liability. This generally results in straight-line expense.

As an example of the impact of recognition of a ROU asset and corresponding lease liability on common financial ratios, the following shows the impact on the current ratio and the debt-to-equity ratio:

<table>
<thead>
<tr>
<th>Financial ratios</th>
<th>Impact</th>
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<tbody>
<tr>
<td>Current ratio</td>
<td>Increase in short-term liabilities with lead to a decrease in this ratio</td>
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<tr>
<td>Debt to equity</td>
<td>Significant increases to long-term debt will lead to an increase in this ratio</td>
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<tr>
<td>Debt service coverage</td>
<td>Inclusion of operating liabilities as debt without an offset of the lease expense included in the operating cash flow will lead to this ratio being substantially skewed</td>
</tr>
<tr>
<td>Basic fixed charge coverage</td>
<td>If operating liabilities are included in the cash on hand calculation this can dramatically impact a companies’ borrowing capabilities</td>
</tr>
<tr>
<td>EBITDA</td>
<td>Should remain relatively unchanged; ROU asset will affect amortization expenses and interest portion of the liability will affect interest expense</td>
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Other financial ratios that may be affected by the changes of ASC 842 are shown in the following chart:
**Question 2: How will renewal options or contingent rental agreements in a lease contract be considered under the new lease standard?**

If an option to extend a lease rests with the lessee, the period covered by the option is included in the lease term if the lessee is reasonably certain to exercise it. In contrast, if the option to extend a lease rests with the lessor, the periods covered by the option should be included in the lease term regardless of the likelihood of the lessor exercising the option. This is a change from the current accounting practice and will affect strategic considerations on a contract negotiation given the impact on some of the financial ratios as outlined on question 1 above.

The factors that should be considered in determining whether a lessee is reasonably certain to exercise an option include the following:

- How do the lease payments in the period covered by an option to extend the lease compare to current market rates? If lease payments in the period covered by an option to extend the lease are significantly less than current market rates, then the likelihood that the lessee will exercise the option would increase.
- Has the lessee constructed significant leasehold improvements that will still have economic value to the lessee during the period covered by an option to extend the lease? If so, then the likelihood that the lessee will exercise the option would increase.
- How important is the underlying asset to the lessee’s operations? If the underlying asset is critical to the lessee’s operations, then the likelihood that the lessee will not exercise an option to terminate the lease, or will exercise an option to extend the lease, would increase.

The standard requires a comprehensive review of relevant factors that create an economic incentive for the lessee to exercise the options, including market-, asset-, entity- and contract-based factors. This will affect decision-making when opening new retail locations, or when facing questions regarding relocation options as the retail landscape continues to transform itself.

Variable lease payments that vary after the commencement date for reasons other than a change in an index or rate are not included in lease payments within the contractual term. Other than balance sheet recognition, this is similar to current practice with respect to disclosures of future obligations under the lease contract. Under the new standard, the obligation has been incurred in the period in which it becomes probable that the specified variable lease payments will be made. Also, some lease agreements include payments that are described as variable or may appear to contain variability, but are in-substance fixed payments because the contract terms require the payment of a fixed amount that is unavoidable (e.g., a lease that requires a lessee to pay percentage rent equal to 1 percent of its sales, subject to a minimum sales figure to be used).

**Question 3: As retail continues to reinvent itself, what impact will this have on leases when the ROU asset is declining in fair market value?**

ROU assets recognized as a result of the application of ASC 842 are subject to the long-lived asset impairment testing guidance prescribed by ASC 360, Property, Plant and Equipment. Under existing GAAP, operating leases are not classified as long-lived assets and are accordingly excluded from an asset group when testing for recoverability (i.e., possible impairment). However, the related lease payments are included in the determination of undiscounted cash flows for purposes of the recoverability test. Upon application of the new lease standard, the recoverability test will require an entity to include the ROU assets (and related lease liabilities) as part of the asset group and to consider how to appropriately determine the cash outflows associated with their lease portfolio. Under this scenario, cash outflow would mean the overall profitability of the business as a unit. One acceptable alternative is to include the entirety of the operating lease payments in the calculation, an approach similar to the current recoverability testing model. Another acceptable alternative is to include only the cash outflows associated with the principal portion of the operating lease payments when determining the asset group’s undiscounted cash flows.
Middle market companies may want to think about having specific contract clauses that would adjust the rental payments in extreme circumstances of a decline in fair value to lessen the financial burden of this impact by having the right to renegotiate the remaining contractual term and its liability.

Multi-unit operators of retail and restaurants have long dealt with the provisions of ASC 360 when evaluating long-lived assets for impairment. While the applicable impairment guidance has not changed, the adoption of the new lease standard will affect the recoverability testing process and should be considered when evaluating the overall impact of ASC 842 on a company’s financial statements.

**Question 4: What factors should be considered when analyzing relocation options under a lease contract?**

When a lessee is offered a relocation option in today’s retail environment, the change of terms and conditions may result in a new lease, or simply a modification of the original contract previously recorded on the balance sheet. This business practice is evolving as major retail stores are merging or relocating as a result of overall retail disruption and consequently affecting traffic considerations of the original agreement. In addition to impairment considerations, as the traffic on a retail property changes, opportunities may arise to either renegotiate or relocate to other areas within the same commercial establishment.

A lease modification refers to a change (or changes) to the original terms and conditions of a contract. A lessee should recognize a lease modification as a separate agreement when the following two conditions are met:

1) The modification grants the lessee an additional ROU not included in the original agreement
2) The lease payments increase commensurate with the standalone price for the additional ROU

The majority of rental agreements within a retail commercial establishment could have the option of relocation and such terms would be part of the original agreement (thus, not meeting condition 1 above).

If the above two conditions are not met, there is a new contract altogether. As part of the new contract evaluation, a lessee evaluates the contract to determine if it is (or contains) a lease. The lessee would reassess the classification for the new lease (operating or finance) as of the date of the modification. In most cases in which the lessee receives an additional ROU (e.g., more square footage) or even changes the consideration in the agreement, the lessee would remeasure the lease liability as an adjustment to the ROU asset with no income statement impact.

On the other hand, in instances in which the modification substantially or fully terminates the existing lease (e.g., significant reduction of its fair market value or space), the lessee would reduce the ROU asset and any difference between the asset and the liability (absent of any protection clause) would be recognized in the income statement.

**Question 5: Are there additional items that are covered by the new lease standard beyond explicit and contractual lease arrangements?**

It is likely that explicit and contractual lease arrangements will have the most significant impact on a company’s financial statements when implementing ASC 842. However, the definition of a lease extends beyond traditional lease agreements and careful consideration should be given to other contracts that could potentially provide a company with the right to use an asset. The definition of a lease in ASC 842 is “a contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration.” The concept of an “embedded lease arrangement” within a contract did not originate in ASC 842 (as existing accounting guidance requires a similar evaluation); however, the accounting consequences of these arrangements are potentially more important under ASC 842.

Consider a restaurant chain that executes a contract with a third party to provide in-restaurant wireless internet hotspots for its customers. While this agreement has characteristics of a service contract, an evaluation of the arrangement could result in the determination that the contract does in fact convey the right to control the use of the related equipment and would qualify for recognition as an embedded lease arrangement. Alternatively, a retailer may enter into a logistics contract with a third party that specifies the use of dedicated warehouse space within the company’s distribution footprint. This arrangement will also require further evaluation to determine if it contains a lease under ASC 842. Depending on the nature of the company’s contractual arrangements, determining if a contract contains a lease will require exercising a significant amount of judgment. As such, great care should be taken in understanding the terms of a contract and applying the definition of a lease to that contract.