INSIGHTS FROM THE BDO RETAIL & CONSUMER PRODUCTS PRACTICE

WEBINAR RECAP

TOPIC 842: TOP FAQS FROM RETAILERS AND RESTAURANTS

BDO hosted a webinar on Nov. 21 on Topic 842, New Lease Accounting: Impact on Retail & Restaurants Industries Webinar. The following represents the frequently asked questions from the webinar. Please see below for the questions and answers from our BDO lease accounting specialists. If you need more information, reach out to one of the contacts listed on the last page of this document or check out our other resources on the topic.

Q1: Low value lease arrangements—what is the practical application to these types of leases?

A: The international standard, IFRS 16, provides an exemption for low value leases. Unfortunately, the US standard, ASC 842, does not. However, the basis for conclusions acknowledges that a lessee might apply a recognition threshold similar to PP&E capitalization thresholds, and not recognize lease ROU assets and related liabilities that fall below that threshold. If a company elects to apply that concept, we believe that any such threshold should be consistent with other similar thresholds applied in practice (i.e. the lease recognition threshold should not be higher than the PP&E capitalization threshold), and the company should consider the aggregate impact of not recognizing the lease liabilities on the balance sheet. Remember that under ASC 842, the present value of the remaining lease payments are recorded. While the monthly lease payments may be small, it may be material over time.

Q2: How are leasehold improvements and lease incentives treated under ASC 842?

A: There is a difference between leasehold improvements (LHI) and lease incentives. LHI are the assets that the lessee constructs in, on or around the leased asset. The accounting for LHI is outside the scope of ASC 840 and ASC 842—they should be accounted for under ASC 360, similar to other owned assets. Lease incentives are payments that the lessor makes to or on behalf of the lessee and are often tied to the construction of LHI. Those amounts are treated as a reduction of lease payments when calculating the ROU asset under ASC 842. Upon transition, any liability representing unamortized lease incentives (as well as the straight-line rent balance) is offset against the ROU asset. In other words, at transition the unamortized balance is transferred from the liability side of the balance sheet to a contra-asset.

Q3: How does materiality get applied under ASC842? In the embedded lease example—wouldn't a beverage dispenser be scoped out because it is immaterial?

A: See response to question 1. In our experience, beverage dispensers typically meet the definition of a lease. However, the lease terms are generally based on units consumed, which represents variable lease payments and are recorded in the period incurred.

Q4: Can the financial underperformance of a restaurant that was once considered a strong financial performer trigger a reassessment event?

A: We believe this question relates to the determination of whether a renewal option is reasonably certain of being exercised or not. Consider the example in the webinar whereby the lease term is determined to be the initial lease term plus one renewal term due to the existence of leasehold improvements with a useful live longer than the initial lease term. If at the end of year 3, for example, the company determines that it is no longer reasonably certain that they will exercise the renewal option due to underperformance of the store, that would constitute a reassessment event, and the company would need to reassess the lease term and remeasure the ROU asset and lease liability if the lease term and thus the lease payments change.

Q5: If the lease has three 5-year renewals, why would the term not be 20 years?

A: In the example in the webinar, it was only reasonably certain that the lessee would exercise one of the renewal periods, because the useful life of the leasehold improvements did not extend beyond the end of the first renewal period. In other scenarios, it may be reasonably certain that multiple renewal options will be exercised. It is important to remember, though, that the threshold for including renewal periods in the lease term is whether they are reasonably certain of being exercised, which is based on an economic penalty concept. The fact that management intends to renew the lease, and even has a history of renewing leases, isn't sufficient to conclude that it is reasonably certain if there is no economic penalty if they elect not to renew.

Q6: How is CAM handled in an office lease?

A: CAM is considered a non-lease service component. Therefore, if the lessee follows the guidance in ASC 842-10-15-33 and allocate the consideration in the contract to the lease and nonlease components, they would allocate a portion of the payments to CAM. That amount would not be included in the lease payments for purposes of calculating the ROU asset and lease liability but would be recognized each period directly in expense. Alternatively, if the lessee elects the practical expedient in ASC 842-10-55-37 to not separate lease and nonlease components, then the full amount of lease payments would be included in the calculation of the ROU asset and lease liability. We are seeing most of our clients elect the practical expedient not to separate, as it tends to simplify the accounting, and the added value of the CAM component is generally not significant to the overall lease value.

Q7: How does electing the practical expedient to not separate lease and non-lease components impact the disclosure of lease expense?

A: The disclosures follow the decision to separate or not. So, if a company elects not to separate, then the full amount of the lease payments would be included in the disclosures. However, nothing precludes a company from providing incremental disclosures that explain the make-up of the payments.

Q8: Impairment—would you get a different outcome under the different assessment methods (i.e. netting vs. gross) if your ROU assets were significantly less than the liability due to leasehold incentives?

A: You might, although generally we wouldn't expect that to be the case because if the liability is excluded, then the lease payments are also excluded from the undiscounted cash flows. In other words, the comparison isn't whether the ROU asset and lease liability are similar in amount, but rather whether the lease liability and lease payments are similar in amount, which they will be, by definition (ignoring the discounting factor inherent in the lease liability).

Q9: Regarding the risk free rate of return, is it permissible to use 0% so that a present value calculation is not required?

A: No, unless the risk-free rate of return really is zero, which might be the case in some foreign jurisdictions (such as certain parts of Europe). In the US, the risk-free rate is based on the US Treasury rates, which are currently in the low single digits.

BDO can offer guidance, training, and support as you work your way toward compliance with the new lease accounting standard.

RESOURCES:

Desktop Reference Guide:
Topic 842: A Compliance Checklist for Retailers and Restaurants

Webinar Replay:
New Lease Accounting: Impact on Retail & Restaurants Industries Webinar

White paper:
Topic 842, Leases – A View from the Check-out Lane

FOR MORE INFORMATION:

www.bdo.com/leaseaccounting

www.bdo.com/industries/consumer-business/overview

www.bdo.com/industries/restaurants/overview

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