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Operating Lease Assets: Enter the Impairments

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Background

ASC 842, Leases, is a new accounting standard that went into effect in 2019.

- Firms must report cost of operating leases on balance sheet as liabilities, and also report a corresponding **right-of-use (ROU) asset** on asset side of balance sheet. This is the first time firms have reported ROU assets.
- Like any other asset, **ROU assets can be impaired**. The impairments would then be deducted from pre-tax income and reduce earnings per share (EPS) — although impairments do **not** reduce actual cash the firm has.
- Several firms have begun reporting ROU impairments, usually reported in the footnotes or as part of other charges.
- A firm with a high ratio of ROU to total assets and low EPS **could see large negative swings in EPS** even with small (1 percent) impairments.

Testing an Asset for Impairment

An asset is impaired when its market value is confirmed to be less than its book value recorded on the balance sheet. The value is marked down to current market price, and the size of that mark-down is the impairment.

U.S. GAAP has a two-step test for impairment:

- **Step 1:** Is the asset's book value higher than undiscounted cash flows expected from continued use of the asset? If so, **the asset is unrecoverable**. Then…
- **Step 2: Calculate the impairment loss** as asset's book value – asset's fair value.

For ROU assets, firms should assess changes in market price, economic conditions, or physical condition of the asset to decide whether an impairment test is necessary. There is no specific requirement on the frequency of testing.

Where Impairments Get Reported

An impairment is deducted from net income and reported as a charge on the income statement, so it always results in a hit to earnings. ROU asset impairments are sometimes reported as part of a larger impairment charge, and tagged 'OperatingLeaseImpairmentLoss.'

Examples from Q3 2019 include…

- **Hi-Crush** ($HCR) declared a $76.3 million impairment related to its use of railcars to ship its sand and related mining products.
- **Tapestry Inc.** ($TPR) declared a $35.8 million impairment related to leased assets and included those costs in the SG&A line on the income statement.
- **L Brands** ($LB) reported a $30 million operating lease impairment on 6 Dec. 2019, stemming from poor sales in its Victoria Secrets line of stores.

Example: Hi-Crush

16. Asset Impairments

During the nine months ended September 30, 2019, we saw a significant decrease in the price of our common stock resulting in an overall reduction in our market capitalization, and our recorded net book value exceeded our market capitalization as of September 30, 2019. In addition, as a result of the current demand for frac sand and related logistics services and continued pricing pressure for both Northern White and in-basin sand during the third quarter of 2019, we completed an impairment assessment of certain long-lived assets, including right-of-use assets, based on current market conditions and the current and expected utilization of the assets.

Asset impairments for the three and nine months ended September 30, 2019 totaled $346,384 and was comprised of the following assets:

Augusta facility, including work-in-process inventory	$	109,747
Whitehall facility		105,727
Terminal facilities		5,972
Railcar operating lease right-of-use assets		76,308
Goodwill		35,657
Intangible assets associated with FB Industries acquisition		12,973
Asset impairments	$	346,384

Hi-Crush reported a total of $346.4 million in impairments in Q3 2019. More than $76.3 million of that amount related to leased railcars (highlighted in blue at left), now worth less amid declining demand for Hi-Crush sand and other aggregate mining products.

Example: Tapestry Inc.

Period Ending: 9/28/2019 | **From: 10-Q Filed On: 11/7/2019** | **Tapestry, Inc. (TPR)** | **Leases**

The following table summarizes the composition of net lease costs, primarily recorded within SG&A expenses on the Company's Condensed Consolidated Statement of Operations for the three months ended September 28, 2019:

	Three Months Ended September 28, 2019 (millions)
Finance lease cost:	
Amortization of right-of-use assets	$ 0.2
Interest on lease liabilities(1)	0.2
Total finance lease cost	0.4
Operating lease cost	111.8
Short-term lease cost	1.7
Variable lease cost(2)	51.0
Operating lease right-of-use impairment	35.8
Less: sublease income	(5.4)
Total net lease cost	$ 195.3

Tapestry Inc., owner of brands such as Kate Spade and Coach, reported a $35.8 million impairment to operating leases in Q3 2019, recorded within the Sales, General & Administrative line on the income statement.

Example: L Brands

In the third quarter of 2019, the Company concluded that the negative operating results for certain of its Victoria's Secret stores were an indicator of potential impairment of the related store asset groups. The Company determined that the estimated undiscounted future cash flows were less than the carrying values and, as a result, determined the estimated fair values of the store asset groups using estimated discounted future cash flows. Accordingly, the Company recognized a loss equal to the difference between the carrying value of an asset group and its estimated fair value but did not impair any individual store asset below its estimated fair value. For leasehold improvements and store-related assets, the Company recognized impairment charges of $188 million. Impairment charges of $151 million related to stores in Greater China, the U.K. and Ireland, and impairment charges of $37 million related to stores in the U.S. and Canada. For operating lease assets, the Company recognized impairment charges of $30 million. Impairment charges of $26 million related to stores in the U.K., and impairment charges of $4 million related to stores in the U.S.

L Brands decided in Q3 2019 that poor operating results in its Victoria's Secret line of stores warranted an impairment test, and ultimately recorded a $30 million ROU impairment as part of a larger $218 million charge.

Measuring Impairment Sensitivity

A firm's impairment sensitivity — that is, how much EPS would suffer if an impairment to goodwill or ROU assets were recorded — can be measured. Note the total value of goodwill and ROU assets; next, model what net income would look like after a hypothetical impairment. Then recalculate the lower EPS. Examples are below.

Company	Q3-19 EPS actual	Goodwill & ROU assets	EPS at 1% impairment	EPS at 5% impairment	EPS at 10% impairment
Macy's	$0.01	$6,493,000,000	($0.20)	($1.04)	($2.08)
MGM Resorts International	$0.01	$2,727,421,000	($0.04)	($0.25)	($0.51)
Fidelity Nat'l Info. Services	$0.30	$52,411,000,000	($0.70)	($4.70)	($9.70)
Nisource	$0.02	$1,751,600,000	($0.03)	($0.22)	($0.45)
Willis Towers Watson	$0.62	$12,146,000,000	($0.32)	($4.06)	($8.73)

How Much Do Impairments Matter?

Impairments reduce reported earnings per share, but they do **not** reduce the actual cash a firm has on hand. This raises the question: how much do impairments matter, really? Well...

- While impairments don't reduce cash, they do reduce assets while liabilities remain steady, which means the book value of the company is reduced. A decline in assets may also affect debt covenants or other contracts the business has.
- The effects of impairment even out over time. An impairment does hurt EPS in one period, but lease assets amortize over a set schedule. If the asset is impaired today, future amortization per quarter will be *lower*, thus making future quarters look *better*.
- Lease-related gains are also possible. If a lease is impaired or negotiated down, and the firm then gets out of the lease in the future, it would recognize a 'gain on modification from lease' — which would be a one-time boost EPS.

Other Ways Calcbench Can Help

Balance sheet displays. Our Company-in-Detail database lets you see what a specific firm reports on its balance sheet for impairment, including comparables to prior periods.

Standardized leasing metrics. Our Multi-Company database lets you search ‘operating lease right-of-use asset’ or ‘operating lease liability’ to see reported numbers for one or more firms.

Footnote disclosures. Our Interactive Disclosure database lets you search for any disclosures related to impairments (often listed as ‘impairment of long-lived assets’) or for specific text related to leasing operations as well.

Impairment sensitivity template. Our Excel template can measure impairment sensitivity automatically. Have ticker symbol, will calculate!

Also see our Analysis Guide for Operating, Finance, and Capital Lease Disclosures.


Thank you, that’s all!
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