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Hot Topic: Coronavirus

Lease accounting impacts of COVID-19

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KPMG discusses possible impacts to companies' Topic 842 lease accounting from the economic effects of the COVID-19 pandemic.

Background

The COVID-19 pandemic has had very significant effects on the economies of affected countries and US and international financial markets. These effects have accounting and financial reporting impacts, generally across many areas. For example, the economic and financial markets effects may impact a company's revenue recognition, the valuation of its investments, and its ability to continue as a going concern, among others.

These effects, and a company's actions in responding, may impact the company's lease accounting. In our recent Hot Topics, FASB staff guidance on accounting for COVID-19 rent concessions and Accounting for rent concessions resulting from the coronavirus outbreak and Hong Kong civil unrest, we discuss how Topic 842 applies to rent concessions arising from temporary property closures and other measures taken in response to COVID-19.

In this Hot Topic, we address other possible lease accounting impacts stemming from the economic and financial markets effects of the COVID-19 pandemic.

Key lease accounting impacts

The economic and financial markets effects of the COVID-19 pandemic may impact a company's lease accounting in one or more of the following ways.

Impairment

A lessee's right-of-use (ROU) assets may be impaired if the asset groups to which they belong are impaired. One or more of the aforementioned economic and financial markets effects may trigger a requirement for the lessee to assess one or more of its asset groups that includes an ROU asset for impairment under Topic 360 (property, plant and equipment). For example, the economic effects of the

[1] New guidance or significant updates are indicated with **

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COVID-19 pandemic may result in a 'significant adverse change in…the business climate that could affect the value of the long-lived asset (asset group)'.

Section 6.5.1 of KPMG's Handbook, Leases, discusses lessee impairment considerations around ROU assets in additional detail.

Similarly, lessors may find that some of their underlying assets held for lease are impaired if lessee demand for those assets significantly decreases or rental rates decline precipitously.

KPMG's Hot Topic, Increased risk of impairment of goodwill and long-lived assets, further discusses impairment considerations stemming from the COVID-19 pandemic.

Abandonment

A company may commit to abandon an ROU asset if it concludes it can no longer make use of it as a result of the COVID-19 pandemic, and either cannot or will not sublease it. For example, a company that is leasing overflow fulfillment center space may determine that space is no longer needed because sales have, or are expected to, decline significantly. The company may not have the practical ability to find a sublessee in an economic downturn.

More broadly, lessees that may have already committed to a plan to cease use of an ROU asset or would have done so regardless of COVID-19, and were intending to sublease the underlying asset, may conclude they are not practically able to sublease it, triggering abandonment accounting (i.e. accelerated amortization of the ROU asset).

Section 6.5.2 of KPMG's Handbook, Leases, discusses lessee abandonment of ROU assets in additional detail.

Lessee discount rates**

A lessee's incremental borrowing rate, typically used by lessees as the 'discount rate for the lease', may be affected if interest rates significantly change (e.g. due to central bank monetary stimulus) or its borrowing costs otherwise change (e.g. because its credit rating declines).

An incremental borrowing rate determined during the COVID-19 crisis may appear anomalous to incremental borrowing rates before the crisis or what the lessee forecasts its incremental borrowing rates will be after the crisis. Despite that, we believe it is inappropriate to attempt to 'normalize' an incremental borrowing rate with adjustments the lessee would not otherwise make but for the COVID-19 crisis.

Section 5.6.2 of KPMG's Handbook, Leases, discusses lessee incremental borrowing rates in additional detail.

Lessee reassessments

The effects of the COVID-19 pandemic and a lessee's response(s) thereto may trigger a requirement to reassess and/or remeasure one or more of the lessee's leases. For example: [842-10-35-1, 35-4, 55-28]

— One or more actions a lessee takes in response to the effects of the COVID-19 pandemic may trigger a requirement to reassess the term of the lease, or an option to purchase the underlying asset.

— Economic events such as those arising from the COVID-19 pandemic may trigger a contingency in the lease contract (e.g. with respect to the lease payments or the lease term – e.g. a minimum payment clause or a termination right).

— The expected residual value of an underlying asset may be affected by the economic circumstances, requiring reassessment of the amount it is probable that the lessee will owe under a residual value guarantee.

Section 6.6 of KPMG's Handbook, Leases, discusses lessee reassessments in additional detail.

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Fair values

Multiple aspects of Topic 842 lease accounting depend on fair value (e.g. of underlying assets and ROU assets). The fair value of the *underlying asset* affects lease classification for both lessees and lessors and the accounting for sale-leaseback transactions. The fair value of an *ROU asset* affects whether and how much impairment is recognized on an ROU asset. Fair values may be affected by significant economic events such as the COVID-19 pandemic. [360-10-35-28; 842-10-25-2, 55-3; 842-40-30-1]

KPMG's Q&A, Fair value measurement, discusses fair value in additional detail.

Lease cost and operating lease revenue recognition**

Temporary COVID-19 related measures may significantly curtail the lessee's ability to use, and derive its intended economic benefits from using, the underlying asset. For example, a retail store location in a shopping mall may be closed to the public such that the retailer (lessee) cannot generate sales from the location.

Some lessees and lessors have asked whether it is appropriate to suspend lease cost and operating lease revenue recognition while temporary COVID-19 related measures such as those described in the preceding paragraph are in place. For lessees, this refers to both the single lease cost arising from operating leases and ROU asset (capital lease asset) amortization in finance (capital) leases.

We believe it would be inappropriate to suspend lease cost or operating lease revenue recognition as long as the lessee retains the right to use the underlying asset, even in a significantly curtailed manner. Consider the retail store location example above. Although the retailer cannot sell from the location, if the retailer has not vacated it (e.g. its inventory is still stored there, and its tenant improvements remain in place), the retailer still retains control over the use of the space and is still obtaining economic benefits, albeit limited, from its use.

Lessor revenue recognition – collectibility

The economic effects of the COVID-19 pandemic may adversely affect lessees such that, for some of them, the lessor cannot conclude that collectibility of amounts, or remaining amounts, owed from those lessees are probable of collection. Collectibility issues may exist if lessees request rent payment deferrals or short pay (i.e. pay less than) contractually owed amounts.

Collectibility not probable at commencement

If collectibility of substantially all of the lease payments, plus any amount necessary to satisfy a lessee residual value guarantee, is not probable at the commencement date:

— **Sales-type lease:** The lessor does not recognize any lease revenue, or derecognize the underlying asset, until collectibility becomes probable or one of two specified events occurs (see paragraph 7.5.30 of KPMG's Handbook, Leases). The lessor recognizes lease payments received, including variable lease payments, as a deposit liability until one of those events occur. [842-30-25-3]

— **Direct financing lease:** A lease cannot be classified as a direct financing lease if collectibility is not probable. A lease that would otherwise be classified as a direct financing lease is classified as an operating lease. [842-10-25-3]

— **Operating lease:** The lessor recognizes lease revenue on a cash basis until collectibility becomes probable. [842-30-25-12]

Collectibility probable at commencement

If collectibility *is* probable at the commencement date:

— **Sales-type and direct financing leases:** Collectibility is not reassessed after the commencement date, even for significant events or changes in circumstances such as the COVID-19 pandemic. Subsequent changes in the credit risk of the lessee are accounted for under the impairment

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- guidance that applies to the net investment in the lease (i.e. Topic 326 for companies that have adopted it; Topic 310 for all others). [842-30-25-6, 35-3]
- **Operating leases:** Collectibility is an ongoing assessment that can change, based on facts and circumstances, after the commencement date. See section 7.5.2 of KPMG's Handbook, Leases, for information about a lessor's accounting when this occurs. [842-30-25-13]

Section 7.5 of KPMG's Handbook, Leases, discusses the Topic 842 lessor collectibility requirements in additional detail.

Evolving information

See KPMG's Hot Topics on COVID-19 related rent concessions, FASB staff guidance on accounting for COVID-19 rent concessions and Accounting for rent concessions resulting from the coronavirus pandemic and Hong Kong civil unrest.

For more information about all of the lease accounting requirements in Topic 842, see KPMG's Handbook, Leases.

The potential global and economic impacts of the coronavirus continue to evolve rapidly, and companies should monitor the situation. Companies are encouraged to maintain close communications with their board of directors, external auditors, legal counsel and other service providers as the circumstances progress. Stay informed at read.kpmg.us/coronavirus

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