KPMG

HOT TOPIC

# Leases

## Topic 842 transition complexities from recent economic conditions

January 24, 2023

## Existing Topic 420 liabilities and the initial application of Topic 360 to ROU assets add complexity for lessees transitioning to Topic 842.

Public companies generally adopted Topic 842 (leases) in 2019. In those implementations we observed companies experience some challenges with:

- applying Topic 360 (property, plant and equipment) impairment and abandonment requirements to previously unrecognized operating lease right-of-use (ROU) assets; and
- understanding how Topic 420 (exit and disposal costs), which previously applied to operating leases under the legacy leases guidance (Topic 840), applies to those leases under and in transition to Topic 842.

These challenges *may* be even more acute for private entities adopting and reporting under Topic 842 for the first time now or in the near term. This is because the economic events and conditions of the last few years – e.g. COVID-19, inflation, rising interest rates and new hybrid or remote working models – may have given rise to new Topic 360 impairments or abandonments or new accounting events under Topic 420. In addition to any long-lived assets impaired or abandoned under Topic 360 during this period, these events and conditions may also have given rise to impairments or abandonments of operating lease ROU assets had Topic 840 required their recognition.

KPMG Handbook, Leases, provides guidance on:

- applying Topic 360 to existing leases in transition to Topic 842;
- accounting for existing, lease-related Topic 420 liabilities in transition to Topic 842; and
- considering applicability of Topic 420 to lease arrangements after Topic 842 adoption.

This Hot Topic compiles specific Questions on these topics from the Handbook (retaining their numbering) into one concise document to assist entities in their initial application of Topic 842. Given the small number of entities that have adopted, or that we expect to adopt, Topic 842 using the ‘comparative transition method’ (discussed in Chapter 13B of the Handbook), only the Questions and Examples related to adopting Topic 842 using the ‘effective date transition method’ (included in Chapter 13A of the Handbook) have been reproduced in this Hot Topic.

The questions included in this Hot Topic may not address all of the issues a lessee could encounter on these topics when transitioning to Topic 842. We encourage entities to discuss these issues with their auditors or other accounting advisors.

## ROU asset impairments and abandonments in transition

### Impairments

After adopting Topic 842 (e.g. on January 1, 2022 for calendar year-end private companies), lease ROU assets are required to be evaluated for impairment under the same Topic 360 framework that applies to the impairment of all other long-lived nonfinancial assets. While the framework to test impairment is therefore familiar to most lessees, incorporating ROU assets into the analysis has proven to be challenging for many entities, particularly on transition to Topic 842.

The following three Questions from the Handbook address applying the Topic 360 impairment guidance in transition to Topic 842.

### Question 13A.3.110

Effects of Topic 360 impairments before the effective date

### What effect do prior impairments under Topic 360 have on the initial recognition of ROU assets for existing operating leases?

**Interpretive response:** None, unless the circumstances discussed in Question 13A.3.130 exist.

At a November 2016 FASB meeting, the Board affirmed the view expressed by the FASB staff that lessees should not begin applying the long-lived asset impairment requirements in Topic 360 (property, plant, and equipment) to new ROU assets until the effective date of Topic 842 (e.g. January 1, 2022 for calendar year-end private companies). This includes ROU assets that are part of an asset group that was previously impaired, except as discussed in Questions 13A.3.90 and 13A.3.130.[1]

The FASB staff believes that it was the Board's intent that, in general, lessees should only adjust the carrying amount of operating lease ROU assets for the following, both of which were applicable to operating leases under Topic 840:

- any liabilities recognized in accordance with the contract termination costs guidance in Topic 420; or
- the sublease loss guidance in paragraph 840-20-25-15. However, see Question 13A.3.90 for sublease liabilities recognized under paragraph 840-20-25-15; we do not believe offsetting of those liabilities against the ROU asset is *required*.

The Board did not intend for lessees to have to go back in time and evaluate what effect operating lease ROU assets would have had on Topic 360 impairment assessments before the effective date (see Question 13A.3.120).

[1] All Question, Example, section and non-ASC paragraph references in the reproduced questions are to the Handbook.

## Question 13A.3.120

Transition impact on prior asset group impairments

### Should a lessee's prior accounting for a long-lived asset subject to impairment under Topic 360 be changed as a result of the transition to Topic 842?

**Background:** The recognition of operating lease ROU assets will increase the number and carrying amount of the long-lived assets in the asset group.

For example, an asset group with 50 long-lived assets that have an aggregate carrying amount of $1 million at the date a previous asset group impairment was recorded may have had 65 long-lived assets with an aggregate carrying amount of $1.2 million if the operating lease ROU assets had been recognized in the past. This may have affected either or both:

- the amount of the impairment that was recorded – e.g. the amount of the impairment may have been limited to the amount that would reduce the carrying amount of the long-lived assets in the group to zero; if additional long-lived assets (ROU assets) were in the asset group, the impairment charge may have been greater (see Question 13A.3.130).
- the allocation of the impairment to the long-lived assets in the asset group – i.e. even if the total amount of the impairment did not change, the amount of the impairment allocated to each asset in the group would differ if there were additional assets in the group.

**Interpretive response:** No. At a November 2016 FASB meeting, the Board affirmed the view expressed by the FASB staff that lessees should not alter their previous accounting for long-lived assets as a result of transitioning to Topic 842.

This means that impairment amounts previously allocated to a long-lived asset (e.g. an item of property, plant or equipment or a finite-lived intangible asset), and subsequent accounting resulting from the amount of that impairment (e.g. depreciation or amortization of the long-lived asset), should not be changed as a result of initially applying Topic 842.

## Question 13A.3.130

Recognizing 'hidden' ROU asset impairments at the effective date

### Can a 'hidden' impairment of an ROU asset arising from a Topic 840 operating lease be recognized through equity at the effective date?

**Background:** A 'hidden impairment' refers to either:

- where a Topic 360 asset group was fully impaired before the effective date (i.e. all of the long-lived assets in the group were written down by the maximum allowable amount under Topic 360 at the time of the impairment) and an additional impairment charge would have been recorded on that asset group before the effective date had the operating lease ROU asset(s) been recognized at that date; or

- where a Topic 360 asset group would have included only one or more ROU assets that were not recognized under Topic 840, and an impairment charge would have been recorded on that asset group before the effective date had the operating lease ROU asset(s) been recognized under Topic 840.

**Interpretive response:** Based on the FASB staff views outlined in Questions 13A.3.110 and 13A.3.120, we believe it would be acceptable for a lessee not to consider the impairment guidance in Topic 360 as it relates to newly recognized ROU assets until the effective date of Topic 842 and to recognize any impairment that exists as of that date, including any 'hidden impairment', and regardless of whether the condition or event giving rise to that impairment occurred before the effective date, as a charge to adoption-year income or loss.

However, the FASB staff has expressed the view that it would be acceptable to recognize a hidden impairment of an ROU asset arising from an existing operating lease at the effective date. In that case, the amount of the additional impairment (i.e. the hidden impairment plus any additional amount of impairment that presently exists at the effective date) would be taken through an adjustment to equity at the effective date, with a corresponding reduction to the carrying amount(s) of the ROU asset(s). Note that no amount of past hidden impairment should be taken at the effective date if the asset group to which the ROU asset belongs is not impaired at the effective date based on an effective date Topic 360 analysis.

We believe this interpretation does not conflict with the responses to Questions 13A.3.110 and 13A.3.120 because it (1) would not affect any prior accounting for other long-lived assets and (2) reflects a unique circumstance where this adjustment is effectively the result of a past impairment assessment and preexisting conditions of impairment, rather than one triggered primarily by the recognition of new operating lease ROU assets.

### Abandonment

Like all other long-lived assets within the scope of Topic 360, lease ROU assets may be abandoned. If a lessee commits to a plan to abandon an ROU asset before the end of the lease term, it should shorten the useful life of the ROU asset to ensure that the to-be-abandoned ROU asset is amortized to its salvage value over the period of its remaining expected use. Questions 6.5.50, 6.5.55 and 6.5.70 in the Handbook address identifying and accounting for ROU asset abandonments.

The following Question from the Handbook addresses transition accounting for an ROU asset abandoned before the effective date.

## Question 13A.3.60
ROU asset abandoned before the effective date

### Should a lessee recognize an ROU asset in transition if it has already abandoned the asset before the effective date?

**Background:** A lessee may have abandoned an ROU asset arising from an existing operating lease before the effective date of Topic 842. Despite this, following the transition requirements for the initial measurement of the ROU asset could result in the lessee recognizing the abandoned ROU asset. This is because the transition guidance does not address abandoned ROU asset scenarios and derives the ROU asset for existing operating leases from the lease liability (which will not be zero, even in an abandonment scenario).

**Interpretive response:** No. An ROU asset should not be recognized on transition if it was abandoned before the Topic 842 effective date. If an abandoned ROU asset is measured at an amount greater than zero after applying the transition guidance, a further adjustment should be recorded through equity to reduce the carrying amount of that ROU asset to zero as of the effective date.

## Topic 420 and Topic 842 interaction

### Applicability of Topic 420 after Topic 842 adoption

Before adopting Topic 842, lessees were sometimes required to recognize a liability under Topic 420 for (1) costs to terminate an operating lease before the end of its term and/or (2) other costs associated with the operating lease that will continue to be incurred without economic benefit to the entity.

After adopting Topic 842, costs to terminate all leases (operating and finance) are outside the scope of Topic 420. However, Topic 420 continues to apply to non-lease components of a lease contract as outlined in the Question from the Handbook that follows. [420-10-05-2(b), 15-3(b)]

### Question 6.5.100
Topic 420 and non-lease component costs

### Should non-lease component costs be accrued under Topic 420 when the lessee ceases use of the underlying asset?

**Background:** Costs to terminate a lease are outside the scope of Topic 420 (exit or disposal cost obligations) after the adoption of Topic 842. [420-10-05-2(b), 15-3(b)]

Before the adoption of Topic 842, a lessee in an operating lease that ceased use of the underlying asset would accrue the remaining lease payments as of the 'cease-use date' (the date the entity ceased using the right conveyed by the contract), net of amounts it could obtain from a sublessee if it chose to sublease the asset. The lessee's accrual included other fixed and estimated variable costs connected to the lease (e.g. future property tax, insurance and maintenance costs) that would continue to be incurred after the cease-use date without remaining economic benefit to the lessee.

**Interpretive response:** It depends on whether the lessee has elected the practical expedient to not separate lease and non-lease components (see section 4.4.1).

#### Lessee elects the non-separation practical expedient

When a lessee elects the non-separation practical expedient, the lease component and the combined non-lease components are accounted for as a single *lease* component (see paragraph 4.4.30). Therefore, all lease component, non-lease component and non-component (e.g. property tax and insurance) costs are accounted for as fixed or variable *lease* costs.

As outlined in the background, after the adoption of Topic 842, costs to terminate a lease are outside the scope of Topic 420. This includes costs related to the lease that will continue to be incurred without economic benefit to the lessee, such as property tax, insurance or common area maintenance costs. Therefore, none of those costs are accrued at the cease-use date after adopting Topic 842.

#### Lessee does not elect the non-separation practical expedient

Costs to terminate a non-lease component (e.g. a service or the delivery of a supply of goods) remain in the scope of Topic 420. Therefore, at the cease-use date the lessee will accrue:

- fixed costs allocable to the non-lease component; and
- estimated variable payments allocable to the non-lease component.

Allocation of fixed and variable payments to the lease and non-lease components in this context occurs on the same basis as the 'consideration in the contract' was allocated to those components.

Fixed costs and the portion of estimated variable payments allocable to the lease component are outside the scope of Topic 420, and are *not* accrued at the cease-use date.

Example 6.5.60 in the Handbook illustrates this accounting.

### Topic 420 liabilities in transition

The ROU asset for a lease existing at the Topic 842 effective date is measured as follows. [842-10-65-1(m)]

Lease liability + Unamortized initial direct costs + or − Prepaid/ (accrued) lease payments − Unamortized balance of lease incentives received − Any Topic 420 lease liability

Section 13A.9 of the Handbook addresses additional considerations if the lease was acquired in a business combination.

The explicit guidance in Topic 842 on how to account for existing Topic 420 liabilities in transition results in any existing Topic 420 liability at the effective date reducing the initial measurement of the lease ROU asset regardless of whether the lease is classified as an operating or finance lease under Topic 842. [842-10-65-1(m) – 65-1(n)]

The following Questions address two common issues that arise when applying the Topic 842 transition guidance to existing lease-related Topic 420 liabilities.

## Question 13A.3.70

Executory costs that are part of Topic 420 liabilities on transition

### Are amounts for lessee executory costs (e.g. property taxes) in a Topic 420 liability netted against the ROU asset established on transition?

**Background:** Before transition to Topic 842, Lessee LE provided legal notice that it will terminate its operating lease of a facility before the conclusion of the contract term.

Based on the terms of the lease contract, in addition to making fixed rental payments, LE is required to make variable property tax payments. Under Topic 420, at the cease-use date, LE recognized a liability for the remaining rental payments and the property tax payments it expected to make over the remaining term for which it will receive no economic benefit.

**Interpretive response:** Yes. Paragraph 842-10-65-1(m) does not envisage separation of a Topic 420 operating lease liability into components – e.g. a component associated with the contractual rental payments and a component related to one or more executory costs, such as an obligation to pay property taxes on the underlying asset. Therefore, the entire Topic 420 liability is netted against the effective date ROU asset, including any portion attributable to expected executory costs for which the lessee will receive no economic benefit, as long as the carrying amount of the ROU asset will not be reduced below zero subsequent to that action (see Question 13A.3.80).

## Question 13A.3.80

Transition guidance for Topic 420 liabilities results in negative ROU asset carrying amount

### If netting the existing Topic 420 liability on transition would result in a negative initial measurement of the ROU asset, how is that excess credit accounted for?

**Background:** The carrying amount of a lessee's Topic 420 liability immediately before the Topic 842 effective date for an existing operating lease may exceed the amount that will be recognized for the lease liability at the effective date. Consequently, measuring the ROU asset in accordance with paragraph 842-10-65-1(m) may result in a negative ROU asset carrying amount.

For example, the Topic 420 liability might include estimated executory costs (e.g. for property taxes or insurance) that the lessee expects to pay over the remaining lease term for which it will receive no economic benefit. However, the lease liability does not include such amounts – either because the costs are variable or because the lessee has historically followed Approach B in Question 13A.3.10.

**Interpretive response:** If netting the Topic 420 liability would create a negative ROU asset carrying amount, we believe the lessee should reduce the carrying amount of the ROU asset to zero and then do one of the following with the remaining amount of the Topic 420 liability:

- **Derecognize the 'excess' Topic 420 liability.** The corresponding entry is an adjustment to equity at the effective date. The costs underlying that excess amount will be recognized through the income statement as they are incurred after the effective date.

  Under this approach, the lessee will recognize those costs through the income statement twice: once when the Topic 420 liability was established before the effective date, and again when those costs are actually incurred after the effective date. Operating lease costs are no longer in the scope of Topic 420 from the effective date of Topic 842; therefore, this approach takes the perspective that there is no longer a basis in Topic 420 to recognize the excess amounts.

  Proponents of this approach believe that paragraph 842-10-65-1(d) would instruct the lessee to take the excess credit to equity on the effective date and account for the lease-related costs underlying that excess liability that will be incurred after the effective date in the same manner as such costs will be accounted for after the effective date for new leases. [842-10-65-1(d)]

- **Continue to recognize the 'excess' Topic 420 liability.** Under this approach, the excess credit is accounted for after the effective date in the same manner as before the effective date. Proponents of this approach note that the FASB stated its intent for lessees to be able to 'run off' existing leases in accordance with the requirements in previous GAAP (other than recognizing new ROU assets and lease liabilities for existing operating leases) – see paragraph 13A.2.120. Therefore, it would be inconsistent with that intent to require a lessee to derecognize the excess Topic 420 liability and recognize those costs through the income statement a second time. Proponents further note that it would appear to be inconsistent with the intent of the new standard to *derecognize* existing liabilities when its principal goal was the recognition of previously unrecognized lease liabilities. [ASU 2016-02.Summary, ASU 2016-02.BC390]

Topic 842 does not provide guidance on this type of scenario; therefore, in the absence of additional guidance from the FASB or the SEC staff, we believe either of the above approaches is acceptable as an accounting policy election applied to all of the entity's leases for which it is a lessee.

## For further information

For more information about applying Topic 842, see KPMG Handbook, Leases. Chapters 13A (effective date transition method) and 13B (comparative transition method) specifically discuss transition. Section 6.5 discusses lease ROU asset impairment and abandonment and the interaction of Topic 420 and Topic 842.

For more information on the Topic 360 impairment guidance, including considerations during a period of economic uncertainty, refer to KPMG Handbook, Impairment of nonfinancial assets, and the related KPMG Hot Topic, Impairment: Nonfinancial asset impairment in a period of economic uncertainty.

**This document is part of a series to highlight implementation issues that are discussed in KPMG Handbook, Leases.**

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