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FINANCIAL REPORTING

Pandemic alters lease accounting landscape

The coronavirus has led to a likely delay in the effective date of FASB's new lease standard along with other possible consequences.

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In addition to causing enormous disruption to health, safety, and the economy across the globe, the coronavirus pandemic has significantly altered the landscape for CPAs related to lease accounting.

The changes include a potential effective date delay of FASB's new lease accounting standard for certain entities, including private companies; a monumental increase in the number of lease modifications requested by lessees and granted by lessors; and the need for disclosures related to a company's lease accounting decisions in the new environment. Here's a closer look at lease accounting amid the coronavirus pandemic.

LEASE CONCESSIONS

Shelter-in-place, stay-at-home, social distancing, self-quarantine, and other directives have caused significant disruptions to business operations, with many businesses and industries being effectively shut down. This has resulted in record levels of layoffs and unemployment claims, with a potential record number of bankruptcy filings expected over the next few months.

The federal government has taken several actions to provide relief from the devastating economic impact, including enacting the Coronavirus Aid, Relief, and Economic Security (CARES) Act, P.L. 116-136, which provides assistance to small businesses (under 500 employees) through U.S. Small Business Administration loans primarily to support payroll costs for affected businesses. While these loans are for a limited period (up to eight weeks), some or all of the loan may be forgiven.

Despite this government aid, it is anticipated that a significant number of lessees will be looking to negotiate short- or long-term lease concessions or other relief from lessors. On April 10, the FASB staff issued a Q&A (available at tinyurl.com/y9uwfx8v) on FASB ASC Topic 842, *Leases*, and Topic 840, *Leases*, accounting for lease concessions related to the effects of the COVID-19 pandemic.

One topic addressed by the FASB staff is the existing guidance requiring an analysis of whether changed lease agreements provide enforceable rights and obligations for lease concessions. An absence of enforceable rights and obligations can result in lease modification accounting, where the right-of-use asset and lease liability are remeasured using an updated discount rate, and the lease classification as either a finance or an operating lease is reassessed.

The FASB staff concedes that existing guidance did not contemplate the speed and volume of modifications resulting from a major global public health crisis. The FASB staff also acknowledged that absent further interpretative guidance, appropriately analyzing lease modification requirements on the large volume of leases impacted could be costly and complex for both lessees and lessors.

A further complication in determining whether lease concessions are consistent with contract terms rather than a contract modification are the programs implemented or encouraged by governments that permit or require changes to either party's contractual obligations during the period impacted by the COVID-19 pandemic.

The underlying premise of remeasuring a lease is that the economics of the lease are affected for the remainder of the lease term. The FASB staff understands the view that recognizing lease concessions ▸

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related to the effects of the COVID-19 pandemic over the remainder of the lease term may not reflect the economics of those concessions.

ANOTHER ELECTION TO CONSIDER

FASB's staff Q&A provided guidance that it would be acceptable to make an election to account for lease concessions related to the effects of the COVID-19 pandemic as though the lease agreement provides enforceable rights and obligations for lease concessions not requiring lease modification treatment even though the existing agreements do not include such provisions. In making this election, an entity will not need to evaluate whether each applicable lease contains the enforceable rights provisions.

Noted examples include deferred rental payments from three to six months, most initiating in April 2020. Deferred rents are then to be paid back in addition to base rents mandated in the lease agreements, starting in 2021, amortized over a reasonable period. A key point as stated by FASB is that the tenant must be "affected by the economic disruptions caused by the COVID-19 pandemic" and not use the opportunity to take advantage of the general circumstances.

The FASB staff is clear that this guidance can be applied only if lease concessions do not result in a substantial increase in the rights of the lessor or obligations of the lessee. There is an expectation of exercising reasonable judgment in determining that the total payments of a modified lease contract will be substantially the same as or less than the original contract.

When concessions result in the deferral of payments with no substantive changes to contract consideration, the FASB staff indicated that there may be several ways to account for the deferral. With no method identified as preferable, two possible alternatives were presented:

- Deferred payments are accrued, with lessors continuing to recognize income and lessees continuing to recognize expenses; or
- The deferred payments would be accounted for as variable lease payments.

A company's lease accounting software should be able to handle either alternative presented.

Regardless of the method used to account for a lease concession related to the effects of the COVID-19 pandemic, there should be appropriate disclosures about material concessions granted (lessors) or received (lessees) and the related accounting treatment used, so financial statement users can understand the financial impact of lease concessions related to the COVID-19 pandemic.

Should the lease concessions granted result in substantial changes to consideration, treating the changes as a lease modification would be appropriate. The lease liability and right-of-use asset would be remeasured with an updated discount rate, and the lease term may change with an updated evaluation of the "reasonably certain" criteria for extension or early termination options. These changes could result in determination of a different lease classification. There may also be right-of-use asset impairment considerations that could require appropriate attention.

FASB'S DELAY PROPOSAL

In recognition of the business disruptions caused by the new standard, FASB has proposed delaying by one year the effective dates of its lease accounting standard for certain entities. If approved, the delay to Topic 842 would apply to private companies, not-for-profits, and not-for-profit entities that FASB calls public not-for-profits, which have issued or are conduit bond obligors for securities that are traded, listed, or quoted on an exchange or an over-the-counter market and that have not yet issued financial statements.

The delay for private companies and private not-for-profits would make the standard effective for private companies and private not-for-profits for fiscal years starting after Dec. 15, 2021. The effective date for public not-for-profits would be fiscal years starting after Dec. 15, 2019.

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