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Featured Articles

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Coincidentally FASB's New Leases Rules Hit Just Before an Unprecedented Pandemic

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by Denise Lugo

Summary: *Twitter lit up on October 9, 2020, after Microsoft announced it would let its employees work from home permanently – a new trend emerging in the marketplace stemming from the coronavirus pandemic. For the accounting field, this new shift for businesses has brought the FASB's new lease accounting standard upfront and on center stage, especially for reporting partial lease terminations, which is a complex issue. The FASB's planned simplifications could help ease reporting costs.*

Twitter lit up on October 9, 2020, after Microsoft Corp. announced it would let its employees work from home permanently, the implications being apparent to most people. "Microsoft has over

150,000 employees! I wouldn’t want to own a bunch of commercial real estate [right now],” one person tweeted.

The tech giant’s announcement is the latest among a slew of other companies that decided to stick mostly with remote work post the coronavirus-pandemic, finding it a nimble, cost cutting move. And employees like it!

This new business trend has brought the FASB’s new lease accounting standard upfront and on center stage, especially in the area of partial lease terminations. Reporting partial lease terminations, i.e. reducing the number of floors rented in a building, can be complex, accounting practitioners said.

“Under ASC 842, as currently written, when a partial lease termination occurs, the accounting is not as simple as, say, writing off the portion of the right of use asset that corresponds to the portion of the leased space given up – and reducing the lease liability for the present value of the future rent savings,“ Scott Ehrlich, President of Mind the GAAP, LLC, in West Chester, Pennsylvania, said.

Instead, lessees will typically have to re-evaluate the classification of the lease, Ehrlich said. “It’s possible that in doing so, the lease may flip from operating to capital, or vice versa,” he said.

The reevaluation of the lease classification requires the lessee to arrive at all new assumptions as of the partial termination date, including a new estimate of the discount rate (usually, a lessee’s incremental borrowing rate), the fair value and remaining economic life of the residual underlying leased asset, whether the lessee is likely to exercise purchase or renewal options, etc. “These are not easy items to evaluate in many cases, and the cost/time of doing so could be significant,” Ehrlich said.

Another complication is as of the modification date the lessee may need to reallocate the revised consideration being paid to the lessor between lease and nonlease components, and will have to remeasure its lease liability based on current discount rates. “Again, this is a time-consuming exercise. Perhaps most importantly, many lease accounting systems are not currently equipped to handle this type of lease modification very well,” Ehrlich said.

The FASB plans to issue a proposal this month with three targeted revisions on the leases standard, including one that could simplify the accounting for partial lease terminations in a lease contract. Under the potential change, when a separate lease component within a contract is terminated and the economics of the remaining lease components remain the same as before the partial termination of that contract, a lessee or lessor would not apply lease modification accounting to the remaining lease components. That potential change could simplify the accounting for partial terminations for both lessees and lessors.

Lease Accounting Rules Timely

In addition to Microsoft, Google and its parent Alphabet Inc., Facebook, Inc., Apple Inc., and Amazon.com, Inc., among many others said they would either extend remote work options for employees, or keep them permanent.

The leases standard is timely. When the FASB issued Accounting Standard Update (ASU) No. 2016-02, *Leases (Topic 842)*, in 2016, with an effective date of 2019 for public companies, no one could have foreseen how important that timing was as the coronavirus-pandemic hit a year later. Companies in March were forced to shift their workforce to remote work after a nationwide shutdown was put in place to help stem the spread of COVID-19, a respiratory disease caused by a novel coronavirus. The virus has had huge economic impact – business closures, millions of job losses, and more than 200,000 deaths to date in the U.S.

According to a July study conducted by research and advisory firm Gartner, 80 percent of executives said their companies plan to permit employees to work remotely at least part-time post COVID-19. This means leases terminations or modifications.

Topic 842, *Leases*, requires companies to bring—for the first time in history—the full magnitude of their long-term lease obligations on the balance sheet. The standard puts an end to what the SEC and others identified as one of the largest forms of off-balance sheet accounting. The SEC said more than $1.25 trillion of leases were kept off balance sheet.

The old lease accounting model was criticized as failing to meet the needs of investors and other users of financial statements because it does not always provide a faithful representation of leasing transactions.

The new rules under Topic 842 will enable investors to see the footprint of a company's lease holdings more clearly in light of new trends.

The leases standard requires disclosures to help investors gain better insight in the amount, timing, and uncertainty of cash flows arising from leases. These disclosures include qualitative and quantitative requirements, providing additional information about the amounts recorded in the financial statements.

"If you talk to real estate people they're in the middle of this," Peter Vinci, an accounting consultant in North Carolina, said. "I know companies are struggling with it. It requires some work that's not something that accountants do every single day, but it has implications," he said.

Vinci said some companies third quarter (Q3) results will include lease asset write-offs. "You're going to see some companies that couldn't hold off to do the annual goodwill impairment test in Q4 also, which is when they normally do it, being mandated to do it now. You're going to see companies that are potentially getting close to breaching their debt covenants, have cash flows issues. The leasing is a big piece of it," he said.

A Game Changer

Accountants said the pandemic is not only a game changer but brings with it a measure of uncertainty that leave more questions than answers. “Because as time goes on we’re all starting to realize that we’re at least in this pandemic until next summer,” Drew Nagus, Assurance and Advisory Principal at Baker Newman Noyes in Woburn, Massachusetts, said. “And then what if there’s another one?” he said.

“ Because as you think about it look at in a high-rise building that has 40 floors of office space and all of a sudden nobody wants it, what do you do with it? It is mostly in the sky, it’s fiscal footprint on the ground is pretty small compared to its overall footprint. I don’t know – do you make it apartments? do you make it condos? would people even want to live in that close proximity anymore because of the environment? who knows, there are a lot of unanswered questions,” he said. “And if you just knock the building down the square footage of the plottable land isn’t that big, what do you do with it? you certainly wouldn’t get the same level of investment that you got on that high rise. The economic impact of that is even more complex.”

One thing companies need to be mindful of is staying on top of the rule changes and tweaks the FASB makes to help them navigate the pandemic, practitioners said. Be mindful, for example, not to confuse the FASB’s rent concessions guidance, made to ease the accounting woes brought on by coronavirus, with what they have to do related to partial lease terminations.

Partial lease terminations are about actually physically changing the asset within the lease, Nagus explained. “And once it gets into more complex business scenarios with multiple places leased, multiple amounts of square feet, maybe multiple floors or locations, etc. this results in having multiple variables to consider,” he said.

Additionally, there may be non-lease components within the agreements and “all of this immensely magnifies the complexity of the accounting requirements,” said Nagus. “Especially when you get into lease and nonlease components mixed together in the same agreement which requires two different sets of guidance to be followed as well as the need to allocate arrangement consideration between the lease and non-lease components. Once you modify or change that agreement you have to reevaluate all the terms and conditions again, resulting in reevaluating everything – the discount rates, the liability, the right of use asset, incremental costs, etc. under [Topic] 842 or other relevant guidance for non-lease components,” he said.

A company has to determine if the changes made resulted in a new separate lease, or they are changes to the existing lease and there is not a new separate lease component. “In the case of COVID-19 and the reduction of space and the reduction of asset within the lease,” said Nagus, “it’s very likely that you would get to the conclusion, that it’s a new separate lease which makes it a change to an existing lease resulting in you having to reevaluate everything.”

The FASB has placed the leases standard under post-implementation review (PIR), a process to evaluate whether a standard is achieving its objective by providing financial statement users with relevant information in ways that justify the cost of providing it. The rules take effect in 2022 for private companies.

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