COVID-19's Impact on ASC 842 — What Accountants Need to Know

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Wednesday, Aug. 11 | 1-2 p.m. ET

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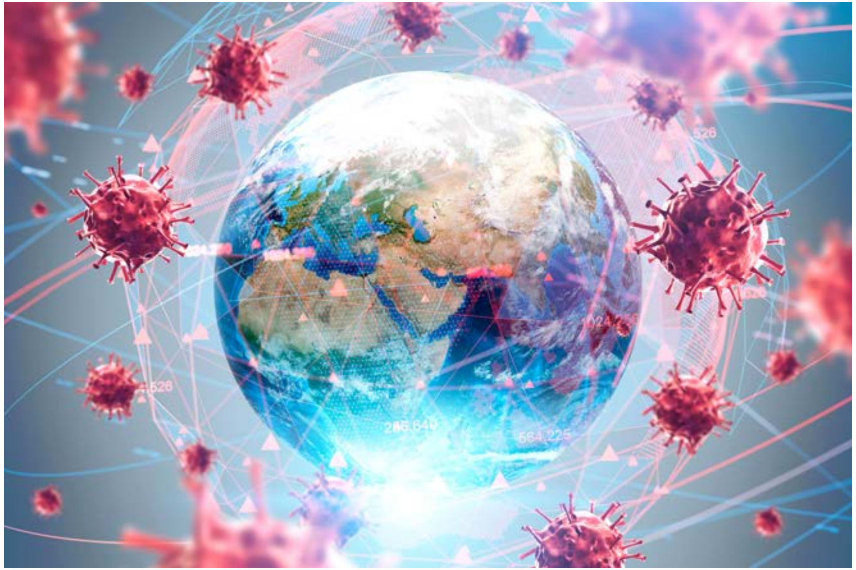
Lynn Fountain has over 38 years of experience spanning public accounting, corporate accounting and consulting. 20 years of her experience has been working in the areas of internal and external auditing and risk management. She is a subject matter expert in multiple fields including internal audit, ethics, fraud evaluations, Sarbanes-Oxley, enterprise risk management, governance, financial management and compliance.

Introduction



- The pandemic has and will continue to impact major economic/financial markets, and virtually all industries/governments are facing challenges.
- As the the pandemic continues and the Delta variant spreads, entities are experiencing conditions associated with a general economic downturn.
- In our last few Lunch & Learns we discussed impacts on financial statement disclosures, revenue recognition and internal controls.
- This month we will focus specifically on the new leasing standard ASC 842.

Impacted Topics

There continue to be many accounting and FR issues that should be on the radar of accounting professionals. These include (but are not limited to):

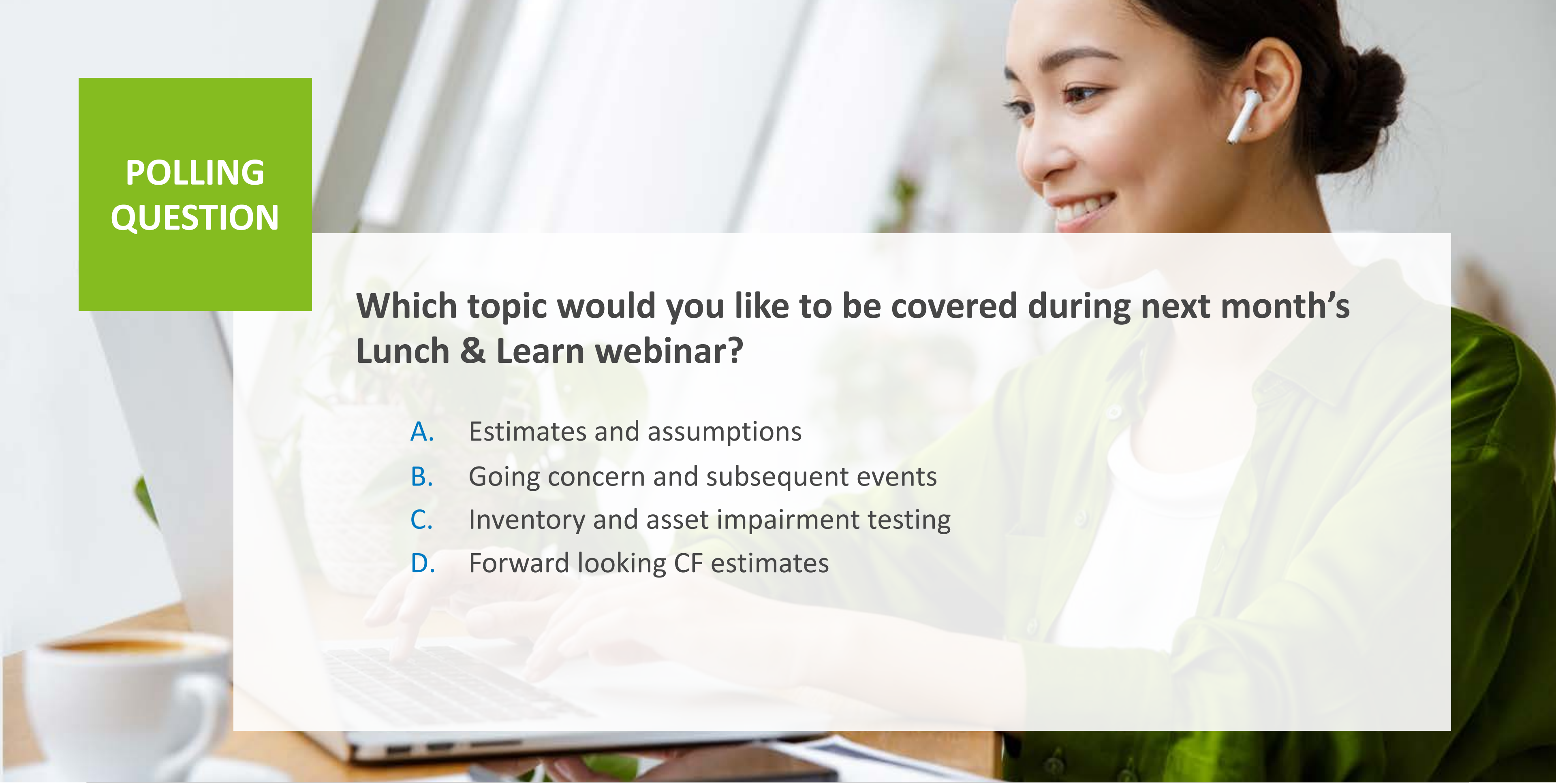
Forward looking CF estimates	Impairment testing and recoverability of impairment of assets	Indefinite lived intangible assets other than goodwill and LLA	Accounting for financial assets: • Inventory, • Equity method investments, • **Revenue recognition**
Leases	Goodwill	Subsequent Events	Going Concern
Disclosures	**ICFR**	Exist or Disposal Costs	Loss Contingencies
Future Operating Losses	Insurance Recoveries	Government Grants	

Bolded topics have been discussed in recent lunch and learns.

Agenda

- Examine the current status of the effective date of the updated lease standard ASC 842 considering COVID-19.
- Review the most significant impacts of ASC 842 in accounting for leases.
- Discuss any considerations, considering COVID-19, that could impact lease accounting and disclosures.

- Finding additional resources in CCH® Accounting Research Manager®



POLLING QUESTION

Which topic would you like to be covered during next month's Lunch & Learn webinar?

A. Estimates and assumptions
B. Going concern and subsequent events
C. Inventory and asset impairment testing
D. Forward looking CF estimates

Leases

ASC 842

- The purpose of the new standard is to close a major accounting loophole in ASC 840 that dealt with off-BS operating leases.
- The core principle of the new standard (Topic 842) is as follows:
  - *A lessee should recognize the assets and liabilities that arise from leases.*
- This requirement, compared with legacy lease accounting, primarily changes the accounting for lessees, requiring lessees to record assets and liabilities on the BS for almost every lease.
  - This significantly differs from legacy accounting for operating leases, under which they were viewed as executory contracts not recognized for accounting purposes — in other words, they were off BS.

Effective Date

- The standards original effective dates were prior to 2019.
  - In April 2020, due to COVID-19, FASB voted to defer the effective date for ASC 842 for private companies and certain NFP’s for one year.
  - For private companies and private NFPs, the leasing standard will be effective for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022.
  - For public companies the leasing standard will be effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years.

COVID-19

- The economic/financial markets effects of the COVID-19 outbreak may have one (more) impact on a company’s lease accounting:
  - Impairment of a lessee’s ROU assets and lessor’s owned assets held out for lease
  - Abandonment of ROU assets
  - Lessee discount rates
  - Lessee reassessments
  - Fair values
  - Lease cost and operating lease revenue recognition
  - Lessor revenue recognition — collectability

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 economic/financial markets effects may trigger a requirement for the lessee to assess its asset groups that include an ROU asset for impairment under Topic 360 (property, plant and equipment). Example:
    - The economic effects of the pandemic may result in a 'significant adverse change in the business climate that could affect the value of the long-lived asset (asset group).
        - Lessors may find some underlying assets held for lease are impaired if lessee demand for assets significantly decrease or rental rates decline.

Abandonment

- A company may commit to abandon a ROU asset if it concludes it can no longer make use of it due to COVID-19, and either cannot/will not sublease it.
  - Example: Company leasing overflow fulfillment center space may determine the space is no longer needed because sales have decline significantly.
    - 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.

Lessee discount rates

- A lessee's IBR, typically used by lessees as the 'discount rate for the lease', may be affected if interest rates significantly change (due to central bank monetary stimulus) or its borrowing costs otherwise change (because its credit rating declines).
- An IBR determined during COVID-19 crisis may appear anomalous to IBR's before the crisis or what the lessee forecasts its IBR will be after the crisis.
  - Experts believe it is inappropriate to attempt to 'normalize' an IBR with adjustments lessee would not otherwise make but for the COVID crisis.

Lease Re-Assessments

- The effects of the COVID-19 pandemic and a lessee's response(s) may trigger a requirement to reassess and/or remeasure one or more of the lessee's leases.
  - One or more actions a lessee takes in response to the effects of COVID may trigger a requirement to reassess the term of the lease, or an option to purchase the underlying asset.
    - Economic events 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 RV of an underlying asset may be affected by the economic circumstances, requiring reassessment of the amount probable the lessee will owe under a RV guarantee.

Fair Values

- Multiple aspects of Topic 842 lease accounting depend on FV (e.g. of underlying assets and ROU assets).
  - The FV of the *underlying asset* affects lease classification for both lessees and lessors and the accounting for sale-leaseback transactions.
  - The fair value of a *ROU asset* affects whether and how much impairment is recognized on a ROU asset.
- Fair values may be affected by significant economic events such as the COVID-19 pandemic.

Lease Cost/Operating Lease Revenue Recognition

- Temporary COVID measures may curtail the lessee's ability to use, and derive its intended economic benefits from using, the underlying asset.
  - Example: a retail store location in a shopping mall may be closed to the public and the retailer (lessee) cannot generate sales from the location.
- Some lessees/lessors have asked if it is appropriate to suspend lease cost and operating lease RR while temporary COVID measures 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.

Lease Cost/Operating Lease Revenue Recognition *(cont'd)*

- Experts believe it would be inappropriate to suspend lease cost or operating lease RR 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.
    - 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 some economic benefits.

POLLING QUESTION

Has your organization considered some of the elements we have discussed related to leases when assessing your current lease commitments?

A. Yes
B. No
C. Not Applicable

Lessor — Revenue Recognition Collectability

- Economic effects of COVID may adversely affect lessees such that the lessor cannot conclude collectability of amounts owed from those lessees are probable of collection.
    - Collectability issues may exist if lessees request rent payment deferrals or short pay (i.e. pay less than) contractually owed amounts.

Collectability not probable at commencement

- If collectability of substantially all the lease payments, plus any amount necessary to satisfy a lessee RV guarantee, is not probable at the commencement date.

Lessor — Revenue Recognition Collectability *(cont'd)*

- **Sales-type lease:** The lessor does not recognize any lease revenue, or derecognize the underlying asset, until collectability becomes probable or one of two specified events occurs (per ASC 842).
  - The lessor recognizes lease payments received, including variable lease payments, as a deposit liability until one of those events occur.
- **Direct financing lease:** A lease cannot be classified as a direct financing lease if collectability is not probable.
  - A lease that would otherwise be classified as a direct financing lease is classified as an operating lease.
- **Operating lease:** The lessor recognizes lease revenue on a cash basis until collectability becomes probable.

Collectability Probable at Commencement

- If collectability *is* probable at the commencement date:
  - **Sales-type and direct financing leases:** Collectability is not reassessed after the commencement date, even for significant events or changes in circumstances such as the COVID-19 pandemic.
    - Subsequent changes in credit risk of lessee are accounted for under the impairment guidance that applies to net investment in lease.
  - **Operating leases:** Collectability is an ongoing assessment that can change, based on facts/circumstances, after the commencement date.

Summary

- Ongoing review of your organization's leases and the related conditions is important to properly complying with the new lease standard under current economic conditions.

POLLING QUESTION

Would you like additional resources to help you comply with the new lease standard by receiving a free trial to CCH ARM?

A. Yes, sign me up!
B. No, I already have a CCH ARM subscription
C. No, I'm not interested

Additional Answers in CCH® Accounting Research Manager®

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Beth Patrick is a Field Sales Executive at Wolters Kluwer and has over 20 years' experience serving Accounting Professionals. She works with both CPA firms and Corporations sharing best practices to ensure they are utilizing CCH Accounting Research Manager to its fullest.

POLLING QUESTION

Would you like a more in-depth demo of the tools and content available on CCH Accounting Research Manager?

A. Yes

B. No

Thank you for attending

Financial Accounting Impacts due to COVID-19: Focus on Leases

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