



Hot Topic: ASC 842

Accounting for rent concessions resulting from the coronavirus outbreak and Hong Kong civil unrest



March 12, 2020 (updated April 13, 2020¹)

This Hot Topic addresses the application of ASC 842 to rent concessions arising from temporary coronavirus and Hong Kong civil unrest property closures.

FASB staff guidance^{**}

On April 8 and April 10, 2020, the FASB staff provided guidance on the accounting for rent concessions arising from the coronavirus (COVID-19) outbreak. In discussions on April 8, the SEC staff provided guidance consistent with that of the FASB staff. KPMG's Hot Topic, [FASB staff guidance on accounting for COVID-19 rent concessions](#), outlines this guidance.

The guidance that follows in the remainder of this Hot Topic continues to apply to rent concessions arising from circumstances other than the coronavirus outbreak, including the civil unrest in Hong Kong. It also continues to apply to companies that elect not to apply the optional guidance provided by the FASB staff.

Background and key impacts

Background

In certain countries, the outbreak of novel coronavirus (COVID-19) in early 2020 has forced the temporary closure, or changes to the operating hours, of shopping centers, office buildings, theatres and restaurants, among other types of buildings. Similar closures and changes have arisen in Hong Kong as a result of recent civil unrest. These temporary measures have often been involuntary and mandated by national or local governments.

Some landlords have announced that tenants are not obligated to pay rent, or the entirety of the contractual rent, for the period affected by those measures, which may range from a few days to a month or more. Other landlords are offering concessions in the form of decreased rent in future periods (e.g. for the next 12 months after the end of the temporary measure, assuming it has ended)

¹ New guidance or significant updates added are indicated with * (added March 26, 2020) or ** (added April 13, 2020)

or interest-free rent deferrals. Lessees are also seeking rent concessions where not proactively offered by their landlords to lessen their economic burden from these measures.

Generally speaking, lease contracts do not include clauses for rent concessions specific to the coronavirus or the civil unrest in Hong Kong. Therefore, and also because ASC 842 is a relatively new accounting standard, questions have arisen about how lessees and lessors should account for these rent concessions.

Key impacts*

Accounting for these rent concessions under ASC 842, regardless of whether proactively offered by the landlord or negotiated by the tenant, depends on the enforceable rights and obligations of the parties under the original lease contract, and the nature of any changes agreed by the parties to the terms and conditions of that contract.

- If a rent concession under these circumstances is required by the original lease contract (e.g. by a force majeure clause). If the concession is for reduced rent, it will generally be accounted for as a negative variable lease payment.
- In contrast, if the lessor is under no obligation to grant a rent concession, the lessor's agreement to grant one should be accounted for as a lease modification.

When ascertaining the enforceable rights and obligations of the parties under the original lease contract, it is important to remember that it is not required that those rights and obligations be written in the contract; they may arise from the laws of the jurisdiction governing the lease contract.

If, in response to these recent events, a lessee 'short pays' the amount it owes under a lease – e.g. pays only 50 percent of the contractually required rent payment – without being entitled to do so, both parties' accounting should generally continue to follow the original contract's terms and conditions, unless and until the lessor agrees to accept (1) rent that is less than that to which it is entitled, and/or (2) late/deferred rent payment. As an exception, the lessor may need to adjust its accounting even before a modification is approved if it concludes that the lessee's short payment raises questions about the collectibility of the lease payments.

Applicability

While this Hot Topic was written to address questions about rent concessions granted as a result of measures taken for the coronavirus and the civil unrest that has occurred in Hong Kong, the guidance herein may apply to other similar situations. For example, in addition to possible future outbreaks like that of coronavirus or other instances of civil unrest elsewhere, temporary measures resulting in rent concessions could arise from a natural disaster or other unforeseen event.

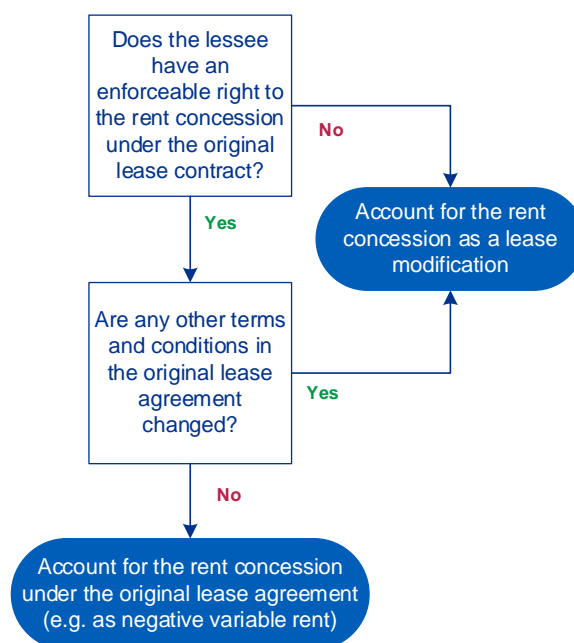
Variable lease payments or lease modification?

When a lessor grants a rent concession in connection with an event such as the coronavirus outbreak or the business interruptions caused by the civil unrest in Hong Kong, we believe the first step is to determine whether the concession constitutes a lease modification or, instead, is a variable lease payment. We believe the evaluation is the same for both lessees and lessors.

To make this evaluation, both parties must consider whether:

- the lessee had an enforceable right, and the lessor an enforceable obligation, to grant the rent concession under the circumstances; and
- if the answer to the first consideration is ‘yes’, the terms and conditions of the lease contract were changed other than as required under the original contract.

The following diagram illustrates the evaluation and its result on a company’s accounting.



Enforceable right to the rent concession under the original lease contract

If the lessee did not have an enforceable right to the rent concession under the agreement, but the lessor still agreed to grant one, the rent concession constitutes a lease modification.

KPMG observation: Enforceable rights

Many lease agreements contain rent suspension or ‘force majeure’ clauses that apply in the event that unforeseen circumstances prevent the parties to the lease agreement from fulfilling their obligations under the contract. These clauses may provide for free or reduced rent for the period of time until the unforeseen circumstances are remedied, after which rent payments return to the normal amounts as specified under the original lease agreement. Alternatively, they may provide for prospective rent abatements that are intended to recompense the lessee for the effect of the unforeseen circumstances. Such clauses may apply and provide a lessee with the contractual right to free or reduced rent in situations where there have been forced closures – e.g. because of the coronavirus outbreak or the civil unrest in Hong Kong.

Even if not written into the original lease contract, a lessee may still have an enforceable right to, and the lessor an enforceable obligation to grant, a rent concession based on the laws in the jurisdiction that apply to the lease agreement. Whether a suspension or ‘force majeure’ clause applies to the coronavirus outbreak or the Hong Kong civil unrest, or whether a lessee otherwise has an enforceable right to a rent concession, is ultimately a legal question that must be answered based on applicable law (i.e. in the jurisdiction governing the lease contract) and the facts and circumstances giving rise to the evaluation. Companies should work with their legal counsel to determine whether an enforceable right (lessee)/obligation (lessor) to a rent concession exists.

Concession required but amount uncertain

In some cases, both the lessee's right to a rent concession and the amount thereof may be determinable under the contract, or the relevant laws or regulations of the applicable jurisdiction. For example, if the landlord's shopping center is required to be closed entirely for the month, the contract or laws of the governing jurisdiction may be clear:

- that a concession is required; and
- about the amount of that concession.

However, in other cases, it may be that the parties conclude the lessee has an enforceable right to a rent concession under the circumstances, but that the amount to which the lessee is entitled is uncertain. That is, neither the contract, nor the laws of the relevant jurisdiction, clearly articulate how to calculate the required concession. In the scenario of reduced operating hours for a shopping center, it may be unclear how the rent abatement should be calculated – e.g. pro rata based on the decreased number of operating hours as compared to normal, or potentially on some other basis if the changed operating hours disproportionately affect low- or high-traffic times, such as dinner hours for a restaurant in a shopping center food court.

We believe it frequently will be appropriate to conclude that reaching agreement about the amount of the rent concession is not a lease modification. However, facts and circumstances, including considerations about changes to other terms and conditions of the original lease contract (see next section), may affect this evaluation and should be taken into account.

Changes to other terms and conditions

If the lessee has a contractual, or otherwise enforceable, right to the rent concession, a lease modification may still result if other terms and conditions of the original lease contract are changed in connection with communicating or agreeing the amount of the rent concession.

Because the two parties will be communicating, they may take the opportunity to agree other changes to the terms and conditions of the contract. For example, the parties may agree a change to the lease term and/or changes to the lease payments, including variable payment terms, for periods unaffected by the temporary closure or other measures.

In general, changes to the terms and conditions of the contract (which can be written, verbal or otherwise) other than merely communicating or agreeing the amount of a rent concession for the affected periods of the lease will result in a lease modification, even if the impetus for the negotiation was the force majeure event (e.g. the coronavirus or civil unrest countermeasures).

Careful consideration should be given to the rent concession. Even if no other terms and conditions are explicitly changed, if the substance of the rent concession is that it is clearly not related solely to the affected periods (e.g. the amount of the concession is more than the contractual rent for those periods or is significantly disproportionate to the effect of the temporary measures taken), a lease modification has likely occurred; for example, an additional concession might be offered to induce the lessee to extend or not to terminate the lease.

Rent deferrals*

Agreement by the lessor to defer contractually owed lease payments or variable lease payments is a rent concession. Consistent with rent abatement concessions, if the lessee does not have an enforceable right to the rent deferral, granting of this concession by the lessor is a lease modification. The rent deferral both changes the scope of, and the consideration for, the lease. It changes:

- the scope of the lease by, in effect, adding a new financing element to the lease in the form of the lessee's new right to defer its contractually owed lease (or variable lease) payments for a period of time; and
- the consideration for the lease by the interest element of the rent deferral.



Accounting for the rent concession

Lease modification

If the rent concession is itself a modification, or if as a result of other changes to the terms and conditions of the contract in connection with granting the rent concession there is a modification, lessees and lessors will account for the modification consistent with any other modification, which is generally on a prospective basis.

In general, if a modification occurs, the resulting change in the lease cost (lessee) and lease income (lessor) will be recognized over the remainder of the post-modification lease term. For example, if the concession is in the form of a rent abatement, the amount of the rent concession, whether (1) paid immediately or over time or (2) paid in cash or in the form of reduced future payments, will be recognized as a reduction to lease cost for the lessee and, if an operating lease, a reduction to lease income for the lessor over the remainder of the post-modification lease term.

The following sections of KPMG's Handbook, [Leases](#), provide additional guidance on accounting for lease modifications:

- Section 6.7: Lease modifications – Lessee
- Section 7.6: Lease modifications – Lessor

Variable lease payments

As illustrated in the diagram earlier in this Hot Topic, when the lessee has the enforceable right to a rent concession for the affected period(s) and there are no other changes to the terms and conditions of the original lease contract, we believe that there is no lease modification. The parties should each continue to account for the lease under the original contract, treating the rent concession as a variable lease payment (negative), resulting in negative variable rent in the affected period(s).

This is generally consistent with the accounting for a co-tenancy clause; in a co-tenancy scenario, the contract similarly stipulates a rent concession for the period affected by the specified event (i.e. the co-tenancy event). Questions 6.6.60 (lessees) and 7.6.10 (lessors) in KPMG's Handbook, [Leases](#) discuss and illustrate the accounting for co-tenancy clauses.

Consistent with the analysis in those Questions, we do not believe the triggering of the force majeure or other clause of the contract giving rise to the lessee's enforceable right to the rent concession:

- meets any of the remeasurement requirements in paragraph 842-10-35-4, including the triggering event in paragraph 842-10-35-4(b) related to the resolution of a contingency for the lessee; or
- triggers lease modification accounting for the lessor.

Concession required but amount uncertain

As discussed earlier, there may be situations where the lessee has an enforceable right to a rent concession, but the amount of the concession for the affected period (e.g. an affected month) is uncertain at the period's end. In these cases, the question arises about what amount of negative variable rent cost (lessee) / income (lessor) should be recognized in the period-end financial statements.

For lessees, we believe the negative variable rent cost amount for the period should only be recognized to the extent of the amount that is probable and estimable of being conceded. We do not believe lessees should take a current period expense benefit for amounts in excess of that. Similarly, lessors should recognize any probable and estimable concession amount in the period to which the concession relates.

For both lessees and lessors, we believe usual subsequent events considerations apply. In general, this means that if the probable and estimable amount of the concession changes between the affected period-end and the date the financial statements for, or that include, the affected period are issued (or available to be issued), that amount should be reflected in the financial statements.

Short payment of rent*

Some lessees may decide, or be forced by their cash flow circumstances, to make rent payments that are less than the amount that is contractually owed (i.e. 'short pay'). In these cases, similar to the topics discussed previously herein, the accounting by the lessee and lessor depends on whether the lessee was entitled to short pay based on its enforceable rights under the original lease contract. If the lessee was entitled to short pay, the accounting by both parties will generally follow the same variable lease payment accounting model outlined in the preceding section. If the lessee was not entitled to short pay, both parties will continue to account for the lease under its original terms and conditions unless and until the lessor agrees to modify the contract by accepting the short payment or some amount other than what it is entitled to under the original contract. This means that, in general:

- **For a lessee**, lease cost will not change for the periods of short payment, and no remeasurement of the lease liability will occur, before the modification is approved.
- **For a lessor:**
 - In an *operating* lease, lease income will continue to reflect the rental payments to which the lessor is entitled. However, an exception arises if the lessor concludes that the lessee's short payment makes it no longer probable that it will collect at least substantially all of the lease payments to which it is entitled under the original contract. See KPMG's Hot Topic, [Lessor accounting for operating lease receivables](#), for information about a lessor's accounting when this occurs. [842-30-25-13]
 - In a *sales-type* or *direct financing* lease, while the lessor will continue to account for the lease under its original terms and conditions, the carrying amount of the net investment in the lease and interest income related thereto will be affected by the lessee's short payment. Collectibility is not reassessed after the commencement date for these leases, even for significant events or changes in circumstances such as the coronavirus outbreak or civil unrest. Subsequent changes in the credit risk of the lessee are accounted for under the impairment guidance that applies to the net investment in the lease (i.e. ASC 326 for companies that have adopted it; ASC 310 for all others). See KPMG's Hot Topics, [COVID-19 impacts on the accounting for financial instruments](#) and [Potential impacts of economic disruption on expected credit losses under ASC 326](#). [842-30-25-6, 35-3]

Evolving information**

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 boards of directors, external auditors, legal counsel and other service providers as the circumstances progress. Stay informed at read.kpmg.us/coronavirus

For more information about the effects of the COVID-19 outbreak on lease accounting, see KPMG's Hot Topic, [Lease accounting impacts of the COVID-19 virus](#).

For more information about the lessee and lessor accounting requirements in Topic 842, see KPMG's Handbook, [Leases](#).

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