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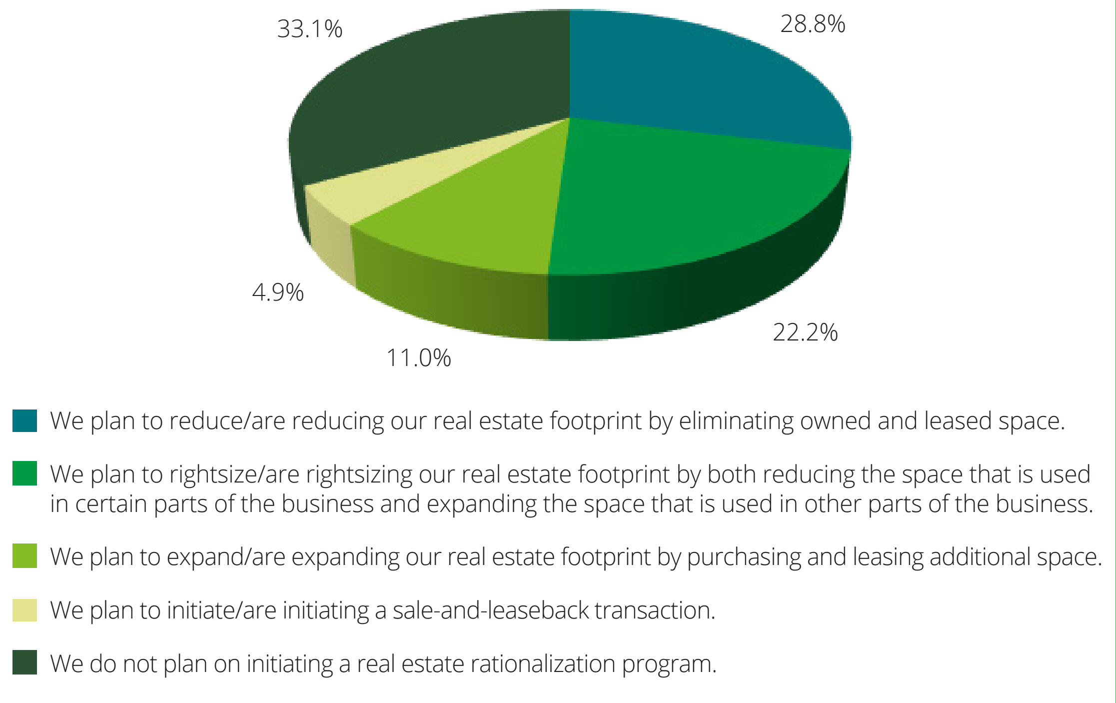
Lease Accounting

Real Estate Rationalization 101: Current Market Trends and the Potential Accounting Implications From a Lessee's Perspective

Background

It has been more than a year since the onset of the coronavirus disease 2019 ("COVID-19") pandemic, which has had a pervasive impact on the global economy and has significantly changed how entities in almost every industry sector are doing business. As a result, many entities are evaluating their current business structures and related models to adapt to the current environment. Two of the more significant areas that many entities are reevaluating include where their employees will conduct their required business activities and to what extent they will rely on the use of brick-and-mortar real estate assets on a go-forward basis. Specifically, many entities have already initiated (or may soon initiate) a real estate rationalization program to reevaluate their organization-wide real estate footprint. The ultimate goal of these entities is to rightsize their real estate portfolios to manage costs while adequately supporting their evolving business needs.

During a March 8, 2021, survey conducted by Deloitte, about 7,700 respondents provided their thoughts on whether and to what extent they plan to initiate or are initiating a real estate rationalization program within their organizations. The chart below depicts the results of the survey.



- We plan to reduce/are reducing our real estate footprint by eliminating owned and leased space.
- We plan to rightsize/are rightsizing our real estate footprint by both reducing the space that is used in certain parts of the business and expanding the space that is used in other parts of the business.
- We plan to expand/are expanding our real estate footprint by purchasing and leasing additional space.
- We plan to initiate/are initiating a sale-and-leaseback transaction.
- We do not plan on initiating a real estate rationalization program.

This *Accounting Spotlight* discusses certain key accounting and financial reporting considerations related to various aspects of an entity's real estate rationalization program. Specifically, this publication focuses on observations and accounting implications associated with (1) deciding to exit leased space before the end of the contract term and potential consequences related to impairment and abandonment, (2) modifying existing lease agreements, and (3) reducing real estate space by executing a sale-and-leaseback transaction.

Entities considering any of these transaction types must carefully consider the accounting and financial reporting implications of their own specific arrangements. When appropriate, entities should discuss any of the potential transactions and the related accounting considerations with their accounting advisers.

Accounting for Changes in the Use of a Property

Observations

In reassessing their real estate needs, some lessees are revisiting their real estate lease portfolios to evaluate whether recognition of an impairment of the leased property is necessary or the acceleration of the right-of-use (ROU) asset amortization is required if a decision to abandon space is made. Given that many ROU assets were recognized for the first time as part of the adoption of ASC 842[1] (i.e., operating leases), the application of the guidance on impairment in ASC 360 is relatively new. We have seen that many lessees are finding the accounting requirements related to this topic challenging to understand and apply. For example, ASC 360-10-35-23 states that the evaluation of a long-lived asset or asset group for impairment should be performed "at the lowest level for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities." In performing this evaluation, a lessee generally must assess all of the cash flows and therefore would consider

[1] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

both cash **outflows** and cash **inflows**. Thus, it would generally not be appropriate to apply the impairment test at the level of the individual ROU asset when this level does not represent the lowest level for which the identifiable cash flows exist. For instance, a leased corporate headquarters building would generally be considered a corporate asset; therefore, it would generally not be appropriate to evaluate impairment at the corporate headquarters level since this is most likely not the lowest level for which there are identifiable cash flows. Such an evaluation generally involves the required allocation of the corporate assets to the relevant asset groups or, in certain cases, at the overall consolidated level that is factored into the test of undiscounted cash flows under ASC 360.

In addition to the challenges associated with applying the impairment testing requirements, some lessees may find it difficult to understand how and when to apply the abandonment guidance in ASC 360 to the ROU asset. Although the abandonment framework generally results in acceleration of the amortization of the ROU asset, an entity may need to use significant judgment in evaluating whether an abandonment has occurred. We have seen some companies assert that they are abandoning the property, even though it is only temporarily idled, or that they may still be using it for minor operational needs or may have the intent and ability to sublease. Under the accounting guidance, the ROU asset in such circumstances **would not** be subject to abandonment accounting under ASC 842 because the lessee would still be planning on obtaining some level of economic benefits from the underlying property. The ROU asset **would** be subject to abandonment accounting when a lessee commits to the decision that it will no longer use the property for any business purposes and concludes that there is no other economic benefit that will be expected from the underlying property at a future date (e.g., there is no intent and ability to sublease the property).

Further, asset groupings may change as a result of real estate rationalization. For example, a leased property may currently be part of a larger asset group (e.g., a satellite corporate office) but the entity may have a plan to exit the facility and sublease it. In such cases, lessees have to use significant judgment to determine when it would be appropriate to revisit their asset group. As a result, lessees may ultimately need to remove ROU assets from a previously identified asset group. Depending on how the liabilities are treated when the impairment assessment is performed, the corresponding lease liabilities for an entire property or part of a property may also need to be removed from the asset group. The determination of when to revisit the asset group and the subsequent accounting may have an impact on the underlying accounting as well as the related impairment considerations.

Overview of the ASC 360 Impairment Model

Under ASC 842, since operating and finance leases are both recorded on a lessee's balance sheet, the ROU assets associated with both types of leases are subject to the impairment guidance on long-lived assets in ASC 360-10-35. A lessee must apply the guidance in ASC 360 on impairment of long-lived assets at an asset group level. The ASC master glossary defines an "asset group" as follows:

> [T]he unit of accounting for a long-lived asset or assets to be held and used, which represents the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities.

When events or changes in circumstances indicate that the carrying amount of the asset group may not be recoverable (i.e., impairment indicators exist), the asset group should be tested to determine whether there is an impairment.

The impairment test consists of the following two steps:

- *Step 1* — An entity compares the carrying value of the asset group with the undiscounted cash flows expected to be generated as a result of the asset group's use and disposal to determine whether the asset group is recoverable (i.e., "the recoverability test"). If the recoverability test fails because the undiscounted cash flows

are less than the carrying value of the asset group, the entity must perform step 2. Conversely, when the undiscounted cash flows exceed the carrying value of the asset group, the asset group is recoverable (i.e., there is no impairment) and therefore there is no need to determine whether the carrying value of the asset group exceeds its fair value.

- *Step 2* — An entity determines the fair value of the asset group and recognizes an impairment loss equal to the amount by which the carrying amount of an asset group exceeds its fair value (see ASC 360-10-35-17). Any recognized impairment loss is generally allocated to all of the individual long-lived assets in the asset group on a relative carrying amount basis. However, the impairment loss recorded is limited to the carrying value of the long-lived assets in the asset group, and individual long-lived assets within the asset group cannot be written down below their individual fair values. An entity should determine the fair value in accordance with ASC 820-10 and use the perspective of a market participant.

While an entity's decisions about changing the use of a property subject to a lease may be an impairment indicator, the resulting step 1 recoverability test often will be passed because the undiscounted cash flows for the entire asset group are used for the evaluation. For example, if an entity starts scaling back the use of its corporate headquarters, an impairment indicator for the asset group may exist because "[a] significant adverse change in the extent or manner in which a long-lived asset (asset group) is being used" may have occurred in accordance with ASC 360-10-35-21(b). However, the undiscounted cash flows of the entire asset group would be used for the recoverability test; as a result, the entity may conclude that the asset group (and thereby the ROU asset associated with the corporate headquarters) is not impaired even though the use of the corporate headquarters has been scaled back.

See Q&A 8-12 of Deloitte's Roadmap *Leases* for additional considerations.

Connecting the Dots — Considerations Related to ROU Assets "Held for Sale"

As with other property, plant, and equipment, ROU assets for both operating leases and finance leases are subject to the requirements in ASC 360, including the "held for sale" requirements. An ROU asset would be considered held for sale when (1) the lease is part of a disposal group for which it is expected that the purchaser will assume the lease as part of the purchase of the group or (2) the entity has initiated a "plan" under which it is identifying a third party to assume (acquire) the related lease so that the entity can be relieved of being the primary obligor under the lease. An ROU asset is not considered held for sale when the entity intends to sublease the underlying property.

In addition, since an ROU asset is considered part of a long-lived asset (or disposal group), when a long-lived asset (or disposal group) is characterized as held for sale, the amortization of the ROU asset should cease in accordance with ASC 360-10-35-43, which states:

> A long-lived asset (disposal group) classified as held for sale shall be measured at the lower of its carrying amount or fair value less cost to sell. If the asset (disposal group) is newly acquired, the carrying amount of the asset (disposal group) shall be established based on its fair value less cost to sell at the acquisition date. **A long-lived asset shall not be depreciated (amortized) while it is classified as held for sale**. Interest and other expenses attributable to the liabilities of a disposal group classified as held for sale shall continue to be accrued. [Emphasis added]

If an entity subsequently changes its plans to dispose of the long-lived asset (or disposal group), the asset would be reclassified from "held for sale" back to "held and used" in accordance with ASC 360-10-45-6. Accordingly, ASC 360-10-35-44 requires the entity to adjust the carrying amount of the long-lived asset that is reclassified as "held and used" to the lower of (1) the asset's fair value or (2) the asset's carrying

amount before it was classified as held for sale, adjusted for any depreciation that would have been recorded while the asset was classified as held for sale.

See Q&A 8-12AA of Deloitte's Roadmap *Leases* for more information about the amortization considerations related to ROU assets that are classified as held for sale.

Considerations Related to the Asset Group/Lease Components

As described above, the evaluation, recognition, and measurement of an impairment loss is at the asset group level. A lessee must reassess its identified asset group when there are significant changes in the facts and circumstances associated with **how** the asset or assets in the asset group are used (as opposed to **when** management decides to change how they are used).

Changes in facts or circumstances that **may result** in the need to reevaluate an asset group include:

- The lessee changes how it is using the underlying asset within its business (e.g., it redeploys the property from one business unit to another).
- The lessee executes a sublease of the underlying asset.

In this respect, a lessee must carefully consider the impact of executing a sublease of a property or a portion of a property in the context of the asset group determination. Specifically, when a head lessee/intermediate lessor subleases a property or a portion of a property, the determination of the asset group for ROU asset impairment testing could be affected (i.e., the sublease of the property or a portion of the property may now meet the definition of an asset group).

In addition to asset group considerations, a head lessee's/intermediate lessor's sublease of a portion of a larger asset (e.g., one floor of a 10-floor office building) may indicate that the subleased portion of the larger asset should be treated as a separate lease component in the head lease. This would be the case irrespective of whether the various lease components in the contract were formally identified and separated into separate lease components at the inception of the lease. For example, assume that the head lessee/intermediate lessor initially accounted for the 10-floor building lease as a single lease component or unit of account and, accordingly, recorded one ROU asset and lease liability for the arrangement. We believe that the head lessee in a sublease arrangement should generally reconsider whether the subleased asset should be deemed a separate lease component under the head lease upon the execution of the sublease. As a result, there may be a need to allocate the ROU asset and lease liability to two or more separate lease components in order to apply the appropriate accounting (e.g., the ROU asset and lease liability may need to be bifurcated between the subleased asset and the remaining portion of the initial ROU asset).

If, after revisiting the asset group or reevaluating the lease components in a contract, an entity determines that the property (or a portion of the property subject to a sublease) represents a separate asset group, it may then be subject to an ASC 360 impairment assessment since, in accordance with ASC 360-10-35-21, such a change could represent "[a] significant adverse change in the extent or manner in which a long-lived asset (asset group) is being used." In this scenario, the impairment analysis may need to be performed at the level of the individual ROU asset (if the underlying property is subleased or ceases to be used).

See Q&A 8-12A of Deloitte's Roadmap *Leases* for additional considerations.

Applying Abandonment Accounting

In addition to being subject to the ASC 360 impairment requirements, ROU assets are subject to its abandonment guidance. ASC 360-10-35-47 and 35-48 provide guidance on abandonment and state:

> For purposes of this Subtopic, a long-lived asset to be abandoned is disposed of when it ceases to be used. **If an entity commits to a plan to abandon a long-lived asset before the end of its previously estimated useful life, depreciation estimates shall be revised in accordance with paragraphs 250-10-45-17 through 45-20 and 250-10-50-4 to reflect the use of the asset over its shortened useful life (see paragraph 360-10-35-22).**
>
> Because the continued use of a long-lived asset demonstrates the presence of service potential, only in unusual situations would the fair value of a long-lived asset to be abandoned be zero while it is being used. When a long-lived asset ceases to be used, the carrying amount of the asset should equal its salvage value, if any. The salvage value of the asset shall not be reduced to an amount less than zero. [Emphasis added]

Unlike the impairment requirements, which are applied at the asset group level, the abandonment requirements are applied at the level of the individual lease component (regardless of whether the separate lease components were accounted for separately at lease commencement — see discussion above).

In the context of a real estate lease, when a lessee decides that it will no longer need a property to support its business requirements (i.e., will cease using the property immediately or at some designated future date) but is still contractually obligated under the underlying lease, it needs to evaluate whether the ROU asset has been or will be abandoned, as a result of which such assets would be subject to abandonment accounting. Abandonment accounting only applies when the underlying property subject to a lease is no longer used for **any** business purposes, including storage. By contrast, even if an entity has fully vacated the space, the asset would not be considered abandoned if the lessee expects to continue to obtain the economic benefits from using the underlying asset (i.e., the underlying asset is viewed as temporarily idled, as contemplated in ASC 360-10-35-49). This would be the case if the lessee intends to use the space at a future time or when it has the **intent** and **ability** to sublease the property. This guidance is consistent with ASC 842-10-15-17, which states, in part:

> **A customer can obtain economic benefits from use of an asset directly or indirectly in many ways, such as by using, holding, or subleasing the asset.** The economic benefits from use of an asset include its primary output and by-products (including potential cash flows derived from these items) and other economic benefits from using the asset that could be realized from a commercial transaction with a third party. [Emphasis added]

In our experience, establishing management's intent regarding subleasing involves judgment and depends on various facts and circumstances, such as the remaining lease term, the nature of the property, and the level of demand in the rental market. For example, it may be reasonable to conclude that an ROU asset is subject to abandonment accounting when the remaining lease term is shorter and the rental market is, and is expected to remain, weak. On the other hand, it may be more challenging to conclude that management has forgone the opportunity to sublease if the remaining lease term is longer given the increased uncertainty about the level of demand in the rental market over a longer time horizon. Reaching such a conclusion may be particularly difficult in the current environment given the uncertainties related to the duration of the pandemic and its impact on the real estate strategy of other market participants going forward. There are no bright lines regarding the duration of the remaining lease term in this analysis, and the exercise could differ by rental market. We would also expect specialized properties to be more difficult to sublease than more generic properties such as retail shopping units and office space. Entities should carefully evaluate their specific facts and circumstances when determining whether the ASC 360 abandonment accounting applies to the ROU asset.

In applying the abandonment model in ASC 360, a lessee would shorten the remaining useful life of the ROU asset to equal the amount of time remaining before the planned abandonment

date. In a manner consistent with the discussion in paragraph BC255 of ASU 2016-02,[2] it is expected that the ROU asset should be zero as of the abandonment date. Paragraph BC255 of ASU 2016-02 states, in part:

> **In the Board's view, it would be inappropriate to continue to recognize a right-of-use asset from which the lessee does not expect to derive future economic benefits (for example, a right to use a building that the lessee has abandoned)** or to recognize that asset at an amount the lessee does not expect to recover. [Emphasis added]

While the ROU asset is affected by the entity's decision to abandon an asset, the corresponding lease liability is not affected because the lessee is not relieved of its obligations under the lease.

The guidance in ASC 842 is not clear on **how** an entity should amortize the ROU asset over the shortened remaining useful life in the event of an abandonment plan. Two alternative views have emerged in practice. Some believe that this scenario should be viewed similarly to an impairment, resulting in the need to fully amortize the ROU asset on a straight-line basis over the remaining shortened useful life. This amortization profile for the ROU asset, when coupled with the interest accretion on the liability (which, in the absence of an early termination of the lease, continues to be recognized by using an effective interest method throughout the entire remaining lease term), will result in a front-loaded expense profile in a manner similar to that for a finance lease. Others believe that, in the absence of an impairment, a lessee should be allowed to retain an overall straight-line expense profile for the period between (1) the date on which a decision is made regarding the abandonment and (2) the actual abandonment date. This would be accomplished by "plugging" the ROU asset amortization amount in each period to achieve an overall straight-line expense recognition profile for the period up to the cease-use date, ensuring that the ROU asset is fully amortized by that date.

After the cease-use date, the only lease cost that would be recognized is that related to the liability accretion.

See Q&A 8-11A of Deloitte's Roadmap *Leases* for additional considerations.

Connecting the Dots — Revisiting Conclusions About Renewal and Termination Option

The lease term, as defined, includes the noncancelable period plus periods covered by renewal options whose exercise is reasonably certain and periods covered by termination options whose exercise is not reasonably certain. This assessment is based on the facts and circumstances that exist as of the lease commencement date.

A lessee must reassess the lease term when, among other things, there is a significant event or a significant change in circumstances that (1) is within the lessee's control and (2) directly affects whether the lessee is reasonably certain to exercise or not to exercise an option to extend or terminate the lease. ASC 842-10-55-28(c) notes that one such example would be "[m]aking a business decision that is directly relevant to the lessee's ability to exercise or not to exercise an option (for example, extending the lease of a complementary asset or disposing of an alternative asset)."

A lessee's decision to early exit a property, while potentially an impairment indicator, **would not** be considered a lease term reassessment event because a "change in management intent" is not considered a business decision that is directly relevant to the lessee's ability to exercise or not exercise an option. Rather, the reevaluation of the lease term is based on factors specific to the lease (not any other business decision). For example, management's **decision** to close a retail location at the end of the noncancelable period because of poor performance would not be considered a lease term reassessment event as this is a business decision that could be changed

[2] FASB Accounting Standards Update (ASU) No. 2016-02, *Leases*.

if the economic performance of the store improves. ASC 842-10-55-28 provides examples of significant events or significant changes in circumstances that may result in the need to reassess the lease term and purchase options.

Changing Lanes — Applying the ASC 420 Requirements Under Legacy Lease Accounting

Unlike ASC 842, ASC 840 requires entities to account for the early exit of a property/part of a property that is subject to an operating lease in accordance with ASC 420. Specifically, ASC 420-10-25-12 and 25-13 require that a liability for the costs of terminating a contract before the end of its term be recognized when the entity terminates the contract in accordance with the contract terms. Specifically, a lessee recognizes a liability for the costs of terminating a contract before the end of its term at fair value when the entity terminates the contract in accordance with the contract terms (i.e., when the entity gives written notice to the counterparty within the notification period specified by the contract or has otherwise negotiated a termination with the counterparty).

Costs that will continue to be incurred under a contract after a property is vacated (i.e., as of its cease-use date) will be accrued as of the cease-use date. ASC 420-10-30-8 states that for an operating lease, "the fair value of the liability at the cease-use date shall be determined based on the remaining lease rentals, adjusted for the effects of any prepaid or deferred items recognized under the lease, and reduced by estimated sublease rentals that could be reasonably obtained for the property, even if the entity does not intend to enter into a sublease. Remaining lease rentals shall not be reduced to an amount less than zero."

ASC 420 does not address the accounting for the costs of terminating a contract that is a capital lease accounted for under ASC 840 since capital leases are subject to the impairment and abandonment guidance in ASC 360.

Rules of the Road

Lessees observing changes in the use of properties subject to leases — either through deteriorating market conditions or because of a shift in business strategy — need to fully understand the applicable accounting guidance and related interpretive views:

- ROU assets, including those related to real estate leases, are subject to the ASC 360 impairment requirements, which are applied at the asset group level. While the decision to vacate a property may be an impairment indicator under ASC 360, the impairment recoverability test is performed at the asset group level, which would take into account the cash flows for all of the assets in the asset group. Properties subject to a lease that do not have separately identifiable cash **inflows** and **outflows** would most likely need to be evaluated at a level higher than the level of the individual ROU asset.
- Whether a property lease should remain in an asset group would be revisited only when there is an actual change in the facts and circumstances related to how the asset(s) will be used, as opposed to a change in managements' intent for how the assets will be used in the future. Examples of such changes in facts and circumstances would include (1) a change in how the lessee is using the underlying asset within its business (e.g., redeploying the property from one business unit to another) or (2) the lessee's execution of a sublease of the underlying asset.
- Abandonment accounting only applies when management commits to no longer use the underlying property subject to a lease for **any** business purposes, including storage. In addition, the lessee must not have both the **intent** and **ability** to sublease the property when the cease-use date occurs. When assessing whether it has the intent and ability to sublease the property, a lessee will need to consider a number of

factors, including the remaining lease term, the nature of the property, and the level of demand in the rental market. This assessment may be challenging since it can involve considerable management judgment.

When appropriate, entities should discuss any changes involving their planned use of properties subject to a lease and the related accounting considerations with their accounting advisers.

Modifying Existing Lease Arrangements[3]

Observations

As part of their real estate rationalization program, some lessees are working with their landlords to modify existing lease agreements to rightsize their real estate portfolios to meet their existing and future needs. Such modifications include (1) eliminating or scaling back office space and (2) expanding the leased space as a result of considerations related to social distancing and open floor plans. The accounting for a lease modification under ASC 842 depends on whether the modification is accounted for as a separate contract as well as the nature of the modification.

A number of observations have been made regarding the application of the ASC 842 lease modification framework in such circumstances. For example, in some cases, the determination of whether a contract amendment represents a separate contract or a change to the existing agreement is challenging. In other cases, applying the ASC 842 modification framework when the amendment results in multiple changes to an arrangement or affects different lease components can introduce unexpected complexity (e.g., reducing the term of one floor and extending the term of another). The ASC 842 modification guidance is new to U.S. GAAP and has presented certain challenges (e.g., applying the guidance on the reduction in lease term as opposed to that on the reduction in the lease scope, accounting for termination penalties).

The discussion below is based on the current modification framework in ASC 842. The FASB considered making a targeted change to the modification framework in an October 2020 proposal. (See Deloitte's November 2, 2020, *Heads Up*, and the FASB's February 11, 2021, FASB meeting minutes for additional discussion.) Ultimately, the Board decided not to move forward with the targeted change but did acknowledge the possibility of a broader look at the lease modification framework in the future. The Board directed the staff to study this issue and come back with recommendations. No date has been set for further discussion, and it remains unclear whether or, if so, how the model may change.

Core Principles Related to Applying the ASC 842 Modification Model

When a real estate lease is modified, a lessee must assess whether the modification should be accounted for as a separate contract.

A modification would be considered a separate contract only if (1) the modification grants the lessee an additional right of use not included in the original lease (e.g., additional space) and (2) the lease payments associated with the additional right of use are consistent with its stand-alone price. A modification that includes multiple changes (e.g., a lease modification that provides additional leased space while also changing the term or payments for other components) would not be accounted for as a separate contract. If a modification is accounted for as a separate contract, the lessee would account for the agreement as two separate contracts: (1) the original, unmodified contract and (2) a separate contract for the additional right of use that is accounted for in a manner similar to the accounting for a new lease.

[3] The guidance and interpretive views in this section are based on the lease modification guidance in ASC 842 and do not take into account the relief detailed in the FASB staff Q&A on concessions that lessors have provided to lessees in response to the effects of the COVID-19 pandemic. Modifications eligible for that relief would be subject to additional considerations. See Deloitte's *Heads Up* "FASB Decides to Defer Certain Effective Dates and Provides Guidance on COVID-19" for more information.

Lease modifications that do not qualify as a separate contract are accounted for together with the original contract (i.e., are not accounted for as a separate contract). ASC 842 includes various types of modifications that are not accounted for as a separate contract and, in certain cases, multiple types of modifications may exist when a contract is amended. The broad categories include modifications that:

- Extend or reduce the lease term of an existing lease (other than through exercise of an option).
- Grant the lessee an additional right of use not included in the original contract and that is not accounted for as a separate contract.
- Only change the consideration in the contract.
- Decrease the scope of the lease through a full/partial termination.

In each of these scenarios, when a lease is modified, the lessee should reassess the classification of the lease as of the effective date of the modification by using the modified terms and conditions. In all of the scenarios, with the exception of one in which there is a full or partial termination of the leased space, the lessee would remeasure the lease by using the updated lease payments and discount rate to remeasure the lease liability and would recognize any difference between the new lease liability and the old lease liability as an adjustment to the ROU asset. When accounting for a full termination, the lessee would derecognize the lease liability and ROU asset and recognize any difference as a gain/loss through earnings. With respect to a partial termination, the lessee would adjust the lease liability by using the revised lease payments and an updated discount rate, derecognize a proportionate amount of the ROU asset, and recognize any difference as a gain/loss through earnings. A lease modification would generally not have an income statement impact, with the exception of a modification that decreases the scope of the lease through a full or partial termination.

Note that when a contract is amended, it is subject to the **entire ASC 842 modification framework**. Accordingly, an entity would first evaluate whether the contract is or contains a lease and then determine whether the modification would be accounted for as a separate contract. For modifications that are not accounted for as a separate contract, the lessee would then (1) identify the separate components in the contract, (2) remeasure and reallocate the consideration in the contract, (3) reassess the lease classification for each separate lease component, and (4) remeasure the lease by using updated assumptions. This principle applies irrespective of whether the amendment affects all of the lease components in the contract or just one lease component.

Lease Modifications That Involve More Than One Change

When a contract is amended and the resulting lease modification involves more than one change to the contract, a lessee's approach to applying the modification framework will typically depend on the nature of the changes and whether they would individually lead to different accounting treatments upon remeasurement of the lease liability (i.e., recognition of all adjustments on the balance sheet versus the potential for gain or loss in the income statement).

Our view — as detailed in Q&A 8-15B of our Roadmap *Leases* — is that a lessee should account for each change included in the modification in accordance with the guidance applicable to that change rather than considering one change as predominant (i.e., a lessee would not simply adjust the ROU asset for the total remeasurement in the lease liability by using the modification guidance applicable to the most significant change). To properly account for each change, it may be helpful for a lessee to bifurcate the original lease into the portions that are subject to the different remeasurement rules in ASC 842-10-25-12 and 25-13.

For example, when dealing with a modification involving an immediate termination of part of a lessee's right of use coupled with a lease term extension for the remaining right of use, it would be reasonable for the lessee to first bifurcate the existing lease liability and ROU asset on the basis of the portion of the lease affected by each change. The bifurcation between the two portions should be based on the relative stand-alone prices. Once the lease liability and ROU asset have been allocated between the two portions, the lessee would apply the modification guidance in ASC 842-10-25-11 through 25-13 to the balances allocated to each portion. The lessee would thus derecognize the balances allocated to the terminated portion of the lease (with a corresponding gain or loss) and would remeasure the lease liability allocated to the retained portion of the lease (with a corresponding adjustment to the ROU asset) by using updated assumptions, such as those about the lease term, lease payments, and discount rate, all of which are determined as of the effective date of the modification. The lessee would also reassess the classification of the lease as of the effective date of the modification.

This represents one approach to the accounting for lease modifications that involves more than one change. We are aware that there are other practical approaches to accounting for these scenarios that result in a similar accounting outcome.

See Q&A 8-15B of Deloitte's Roadmap *Leases* for additional considerations.

Example

Lessee has an existing lease for 5,000 square feet of office space with a remaining lease term of three years. Lessee and Lessor agree to modify the lease to (1) immediately terminate the lease of 1,000 square feet of the office space and (2) extend the lease term for the remaining 4,000 square feet to five years. On the basis of the relative stand-alone prices, Lessee bifurcates the ROU asset and lease liability into the portion subject to the immediate termination (1,000 square feet) and the portion subject to the lease term extension (4,000 square feet). Lessee then (1) applies the guidance in ASC 842-10-25-13 to the portion of the ROU asset and lease liability associated with the immediate termination (i.e., derecognizes those balances and records a gain or loss for the difference) and (2) applies the guidance in ASC 842-10-25-12 to the portion of the ROU asset and lease liability associated with the lease term extension (i.e., remeasures the lease liability and makes a corresponding adjustment to the ROU asset).

Reduction in Lease Term Versus a Lease Termination

In the current environment, there has been a significant uptick in tenants negotiating the early exit of a lease with their landlords. Many of the amended contracts are written in a manner that indicates that the lease amendment is for the early termination of the lease. In evaluating these types of amendments, a lessee must determine whether the amendment is a reduction in the lease term or is truly a lease termination. If a termination only takes effect after a specified period (even a relatively short period), the lessee still has the right to use the leased asset for that period. Therefore, in such cases, the modification consists of a reduction in the lease term rather than a full or partial termination. The guidance on full or partial terminations only applies when all or part of the lessee's right of use ceases contemporaneously with the execution of the modification (e.g., the space is immediately vacated).

See Q&A 8-15A of Deloitte's Roadmap *Leases* for additional considerations.

Example

Lessee has an existing lease for 5,000 square feet of office space with a remaining lease term of three years. Lessee and Lessor agree to modify the lease to (1) terminate the lease of 1,000 square feet of the office space, with Lessee vacating the property within a 90-day period, and (2) extend the lease term for the remaining 4,000 square feet to five years. On the basis of the relative stand-alone prices, Lessee bifurcates the ROU asset and lease liability into the portion subject to the lease term reduction (1,000 square feet) and the portion subject to the lease term extension (4,000 square feet). Lessee then allocates the remaining consideration in the contract between the 1,000-square-foot and the 4,000-square-foot components, remeasuring the lease liability for each and making a corresponding adjustment to each respective ROU asset. As a result, Lessee will have two separate lease components: (1) a component representing 1,000 square feet of space for 90 days and (2) a component representing 4,000 square feet of space for five years.

Accounting for a Penalty for a Partial Termination

The parties in an existing lease may agree to terminate the lessee's right to use a portion of an asset (e.g., one of several leased floors in an office building). In some cases, the lessee might agree to increase the lease payments for the remaining portion of the lease or the lessor may require a one-time payment for allowing the lessee to exit part of the lease early. The guidance in ASC 842-10-35-4 and ASC 842-10-25-11 states that upon a modification that is not accounted for as a separate contract, including a partial termination, a lessee must "remeasure the lease payments" and "reallocate the remaining consideration in the contract and remeasure the lease liability." Importantly, ASC 842-10-25-11 neither requires nor permits entities to allocate a portion of the remaining consideration to the terminated component(s) of the contract. Instead, the remaining consideration is entirely **allocated to the remaining components** in the contract. This outcome illustrates the alignment of the modification frameworks in ASC 842 and ASC 606.

A termination penalty, by definition, is deemed a form of lease payment and is included in the consideration allocated to the remaining components in the contract. As described above, the revised consideration in the contract should be allocated only to the remaining components, rather than in part to the terminated component(s). As a result, regardless of the form or timing of the payments, the full amount of the termination penalty is recognized prospectively as a component of the lease cost associated with the remaining lease components, as illustrated in the example below. This outcome is counterintuitive to some, and we understand that the FASB may revisit the treatment of partial termination penalties in connection with a broader reconsideration of the lease modification framework in the future.

See Q&A 8-15AD of Deloitte's Roadmap *Leases* for additional considerations.

Example

On September 15, 2019, Lessee enters into a 15-year lease for six floors of an office building for a total of $6 million per year, with no termination or renewal options. On September 15, 2024, Lessee and Lessor agree to immediately terminate the lease of two of those six floors, while retaining the lease of the other four floors for the remaining 10-year lease term. Lessee also agrees to pay Lessor a $4 million termination penalty, which is determined by comparing the remaining lease payments related to the two floors being terminated with current market rates. That is, the $4 million represents the "in-the-money" portion of the terminated lease components.

In accordance with ASC 842-10-35-4 and ASC 842-10-25-11, Lessee should remeasure the lease liability for the remaining lease components (i.e., the four remaining floors) by remeasuring the lease payments and allocating those lease payments to the remaining components in the contract. Although the $4 million penalty is paid up front and is specifically related to the terminated space, the $4 million termination penalty should be included in those revised lease payments — and thus deferred as part of the ROU asset for the remaining floors — rather than being recorded as part of any gain or loss upon termination. Lessee should then apply the guidance in ASC 842-10-25-13 to determine the gain or loss to be recognized as a result of the partial termination.

Changing Lanes — Accounting for Lease Modifications Under ASC 840

The modification framework under the ASC 840 requirements differs significantly from that under ASC 842 and depends on the original lease classification (i.e., operating or capital) and the nature of the change (i.e., a renewal/extension of the lease term or changes other than extending the lease term). The ASC 840 lease modification guidance can primarily be found in ASC 840-10-35-4 and ASC 840-30-35-15 through 35-20.

Rules of the Road

Lessees negotiating changes to their lease agreements need to understand the ASC 842 guidance and should consider published interpretive views so that they can properly apply the lease modification framework. Critical considerations include, but are not limited to, the following:

- Lessees should have systems, controls, and processes in place to identify and account for any modifications to lease agreements.
- A modification would only be accounted for as a separate contract under ASC 842 when the (1) amendment grants the lessee an additional right of use not included in the original contract (e.g., more space) and (2) pricing for the additional space is commensurate with the market price. A modification would not be accounted for as a separate contract if, in addition to the additional right of use priced at market, the modification makes other changes to the original contract.
- The effective date of the lease modification — by definition under ASC 842 — is "[t]he date that a lease modification is approved by both the lessee and the lessor." On this date, the lease is remeasured to reflect the lease modification.
- Lessees, for amendments that are not accounted for as a separate contract, are required to apply the ASC 842 lease modification framework to **all of the lease components** in a contract — not just those components directly affected by a contract amendment.
- A lessee that negotiates the early termination of a property lease under ASC 842 needs to evaluate whether it is truly a lease termination for accounting purposes (i.e., property is vacated immediately) or a reduction in lease term. The accounting for a lease termination is generally the only modification scenario that affects the income statement as of the effective date of the modification.
- Any required termination penalty represents a lease payment and therefore would not be recognized in the income statement when paid to the lessor unless (1) it is the sole lease component in the contract (i.e., it is a full termination) and (2) the property is immediately vacated. Otherwise, any termination penalty will be factored into the remeasurement of the lease in a manner consistent with all other lease payments.

When appropriate, entities should discuss any potential lease modifications and the related accounting considerations with their accounting advisers.

Sale-and-Leaseback Accounting

Observations

Sale-and-leaseback transactions involving real estate are on the rise. In addition to entities executing such transactions to improve their overall liquidity, some entities — as part of their broader real estate rationalization program — are strategically deciding to sell certain of their owned real estate assets for which the space may not be needed in its entirety or for as long as originally forecasted. In these transactions, after the sale, the original owner leases part or all of the property back for a certain period. Understanding the accounting requirements that apply to such transactions is critical.

Applying the ASC 842 and ASC 606 Models

A sale-and-leaseback transaction is a common and important financing method for many entities and involves the transfer of a property by the owner ("seller-lessee") to an acquirer ("buyer-lessor") and a transfer of the right to control the use of that same asset back to the seller-lessee for a certain period.

The sale-and-leaseback accounting guidance in ASC 842-40[4] is aligned with that in ASC 606 in that both focus on the notion of control transfer. In other words, the seller-lessee must determine whether control of the underlying asset is transferred to the buyer-lessor. If the transfer of the property is deemed a sale, sale-and-leaseback accounting applies. Alternatively, if the transfer of the property is not deemed a sale, the transaction is economically a financing arrangement and must be accounted for as such.

Broadly speaking, after concluding that a contract exists in accordance with ASC 606-10-25-1 through 25-8, an entity would determine whether control of the property has been transferred from the seller-lessee to the buyer-lessor in accordance with ASC 606-10-25-30. After this assessment is performed, both parties to the transaction must assess the two additional ASC 842 criteria: (1) whether the leaseback is classified as a finance lease from the seller-lessee's perspective and (2) whether the agreement provides the seller-lessee with a call option on the property (this provision potentially encompasses in-substance call options[5]).

- If either of these two criteria is met, the arrangement will not qualify as a sale because control of the property will not have been transferred to the buyer-lessor for accounting purposes. In this scenario, the seller-lessee will not derecognize the underlying property and any consideration transferred in the contract will be recognized as a financing obligation that will be paid down over time as the seller-lessee makes payments to the buyer-lessor. In other words, the lease payments themselves will represent the principal and interest on the financing.
- If neither of these two criteria is met, the seller-lessee will derecognize the underlying property and any resulting gain or loss will be immediately recognized in the income statement. Special considerations would apply if the terms of the arrangement are off-market.

Connecting the Dots — Impact of "Failed Sale" Accounting

It is important for an entity to evaluate the provisions of any sale-and-leaseback arrangement since the contract terms may significantly affect the accounting. For example, if the contract includes a provision that grants the original owner (future tenant) an option to repurchase the property or if the leaseback is classified as a finance lease, the seller-lessee would not be able to derecognize the underlying asset and would be required to recognize a financing obligation for amounts received from the buyer-lessor. The seller-lessee would similarly be precluded from recognizing any gain or loss associated with the transaction. This may affect the overall leverage on the balance sheet since attributes of the financing obligation would be consistent with debt. The income statement profile would be similarly affected, because the seller-lessee would continue to recognize depreciation for the property subject to the sale-and-leaseback transaction and interest on the financing obligation.

[4] The sale-and-leaseback requirements under ASC 842-40 are generally the same for both real estate and equipment, though the considerations related to repurchase options for real estate are more restrictive than those for equipment. For a sale-and-leaseback transaction involving real estate, **any** repurchase option would result in a failed sale. In contrast, for a sale-and-leaseback transaction involving equipment, a repurchase option would not result in a failed sale if the option is priced at fair value and alternative assets that are substantially the same are readily available in the marketplace.

[5] Certain other provisions in a sale-and-leaseback agreement may be viewed in a manner similar to a call option (e.g., an option granting the seller-lessee the right to substitute a property for that which is sold). The substance of such provisions should be assessed to determine whether the seller-lessee retains control of the property that was subject to the sale agreement.

Considerations Related to Sale and Partial Leaseback

Rather than selling and subsequently leasing back an entire property, some entities may want to sell an entire property and then subsequently lease back a **portion** of the property. For example, a seller-lessee may sell its 10-story corporate headquarters, after which it will only lease back five of the floors. An entity must carefully consider the sale-and-leaseback accounting requirements in these scenarios since the legal structure of the property that is sold as well as the leaseback terms may affect the resulting accounting. For example, if the property subject to the sale is not legally subdivided and the portion of the property that is being leased back is classified as a finance lease, the arrangement will not qualify for sale treatment unless the portion being leased back is only a minor portion of the overall property. If, in contrast, the property subject to the leaseback has been legally subdivided, it may be appropriate to separately evaluate each legally subdivided portion of the larger asset when applying the sale-and-leaseback model.

We have also observed complexities in the application of the financing method when some space is leased back and other space is not. For example, questions have arisen about whether a seller-lessee in a failed sale-and-leaseback transaction should assume that space that is not leased back is being leased to the buyer-lessor (since it was previously concluded that the space was not **sold** to the buyer-lessor but nonetheless that it is the party that controls that space). If so, could that imputed lease qualify as a sales-type lease, thus leading to partial derecognition on the balance sheet and potentially a gain or loss on sale? The views of accounting professionals about such issues may differ. Therefore, we recommend that entities contemplating such a transaction consult their auditors or accounting advisers.

Impact of Off-Market Terms

ASC 842-40 requires that a sale-and-leaseback transaction be accounted for at market (i.e., at fair value). Accordingly, the seller-lessee's profit or loss on the transaction will be calculated as the difference between the carrying amount of the underlying asset and its fair value.

When a sale-and-leaseback arrangement is negotiated, it is important to determine whether the transaction is at fair value since it is not unusual for the parties to a sale-and-leaseback transaction to modify the sale price and the leaseback payments to achieve a financing for one party or the other. While the sale price of the property may be the best indicator of its fair value, there may be instances in which the contractually stated price of the property does not equal its fair value. In those instances, a valuation specialist should determine the fair value of the asset by using other standard valuation techniques (e.g., comparison to the sale price of comparable assets, discounted cash flow analysis, calculation of replacement cost).

Under ASC 842-40, in determining whether the transaction is at fair value, the parties to the transaction must compare, on the basis of whichever is more readily determinable, either the (1) sale price and fair value or (2) present value of lease payments and present value of market rental rates. The parties are required to use whichever benchmark is more readily determinable, maximizing the use of observable prices and observable information when selecting the most appropriate benchmark. The transaction is not off-market solely because the sale price (or lease payments) includes variable amounts. To determine whether the sale-and-leaseback transaction is at fair value, the sale price (or present value of lease payments) should include an estimate of variable payments.

It is not uncommon for the terms of a sale-and-leaseback transaction to include compensation for the value of the leaseback being "in place" from the buyer-lessor's perspective. The buyer-lessor places value on this because such a provision allows the buyer-lessor to avoid the cost of attracting a tenant for the term of the leaseback. We are aware of different views regarding the treatment of such value when it is incorporated (fully or partially) into the sale price for the real estate. Accordingly, we recommend that entities contemplating such a transaction consult with their auditors or accounting advisers.

Connecting the Dots — Impact of Off-Market Terms

Since the gain or loss on a sale-and-leaseback transaction is recognized at market, it is limited to the difference between the carrying amount and the fair value of the property that is being sold. Accordingly, the sale price may need to be adjusted to reflect the appropriate profit or loss that would be recognized if the sale was measured at fair value, with any excess of the fair value over the sale price (i.e., the sale price is "below market") recognized as prepaid rent and any excess of the sale price over the fair value (i.e., the sale price is "above market") recognized as additional financing provided to the seller.

Changing Lanes — Accounting for Sale-and-Leaseback Transactions Under ASC 840

The sale-and-leaseback accounting guidance in ASC 840 differs significantly from that in ASC 842. For transactions involving real estate, the sale-and-leaseback requirements in ASC 840 only apply when (1) the transaction meets the definition of a normal leaseback, (2) the payment terms and provisions adequately demonstrate the buyer-lessor's initial and continuing investment in the property, and (3) the payment terms and provisions transfer all of the risks and rewards of ownership of the property (i.e., there is no continuing involvement from the seller-lessee perspective).

A seller-lessee of real estate must thoroughly evaluate both the sale and leaseback portions of the transaction to verify that it is subject to the ASC 840-40 requirements. Some of the more common provisions in these types of transactions that may be problematic include, but are not limited to, the following:

- The leaseback is not considered a normal leaseback because the seller-lessee either does not use the property in its normal trade or business or the property is subject to a sublease that is other than minor.
- The leaseback includes an option that grants the seller-lessee the right to repurchase the property at **any** price.
- The leaseback includes fixed-price renewal options that, if exercised, make up 90 percent or more of the remaining economic life of the underlying property.
- The seller-lessee indemnifies the buyer-lessor for loss or damage caused by environmental contamination.
- Contract terms and related payments may indicate that the seller-lessee is providing nonrecourse financing to the buyer-lessor, as may be the case if (1) other-than-customary security deposits are provided, (2) the leaseback includes a rent-free period, or (3) the leaseback is priced below market.

Careful consideration is required in the evaluation of whether a sale-leaseback under ASC 840-40 qualifies for sale treatment.

Rules of the Road

Entities that are considering the sale and subsequent leaseback of real estate should keep the following in mind as they negotiate the transaction:

- Contract terms and pricing could have a significant accounting impact on the overall transaction. This could be the difference between achieving sale treatment (i.e., property derecognition, gain/loss recognition, operating lease accounting) and not achieving sale treatment (i.e., property remaining on seller-lessee's balance sheet with continued depreciation recognition, recording of a financing obligation and interest expense recognition).

- Special considerations will apply when the leaseback is for only a part of the property sold or if the sale-and-leaseback transaction is not priced at market. This could also significantly affect whether sale treatment is achieved and the amounts that are recognized on the balance sheet and income statement. The application of the financing method to a sale with a partial leaseback can also introduce complexities.
- It is critical to know the appropriate accounting model to use since the accounting for a sale-and-leaseback transaction in accordance with ASC 842-40 (control-based model) differs significantly from that under ASC 840-40 (risks-and-rewards model).

When appropriate, entities should discuss any of the potential sale-and-leaseback transactions and the related accounting considerations with their accounting advisers.

Where to Find Additional Information

For a more in-depth discussion and analysis of the issues presented in this *Accounting Spotlight* or the application of the requirements in the new lease accounting standard as a whole, see Deloitte's Roadmap *Leases*. In addition, if you have questions about the new lease accounting standard or need assistance with interpreting its requirements, please contact any of the following Deloitte professionals:

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