



CONSUMER SPEAKS

Real estate rationalization: Accounting insights for the consumer industry

- Moderator:** • Sam Loughry
- Guest speakers:** • Tim Kolber, Matt Hurley

Sam: Welcome to Consumer Speaks, a Deloitte podcast series where you'll hear industry specialists share their perspectives and insights on emerging topics impacting the consumer industry. I'm Sam Loughry, the leader of our consumer industry Audit & Assurance practice of Deloitte & Touche LLP. And I'm joined by Tim Kolber, Audit & Assurance managing director in Deloitte's Accounting & Reporting Advisory practice, where he co-leads the Accounting Standards Implementation Services offering on a national level at Deloitte & Touche, LLP, and Matt Hurley, senior manager in

Risk & Financial Advisory at Deloitte & Touche LLP. Today, we'll be discussing lease rationalization, current market trends, and the potential implications from a lessee's perspective. Hey guys, thank you both for joining us. Tim, what strategies are you seeing consumer companies deploy from a real estate rationalization perspective?

Tim: Well, due to the changing business landscape, many companies have been taking a good hard look at their current business model to find ways to adapt to the current environment. Two of the more

relevant questions being asked in these scenarios seem to be where its employees will work and to what extent a company's future strategy will rely on the brick-and-mortar real estate.

To deal with these questions, some companies have initiated a real estate rationalization program. The ultimate end game here is to analyze the overall organization-wide real estate footprint and right-size the real estate portfolio where it makes sense.

Consumer Speaks

In this respect, we've seen a number of levers being pulled to implement the overall real estate rationalization strategy.

- Some companies are outright exiting the release space before the end of the contract term.
- Others are going through the traps of modifying existing lease arrangements, either eliminating or scaling back existing space, or even expanding space to move to an open floor plan and allow better social distancing.
- We've also seen an uptick in real estate sale-and-leaseback transactions. These are being used to both improve liquidity while reducing unneeded space. So there seems to be, and will likely continue to be, lots of activity in the real estate rationalization front.

Matt: And just to put some statistics around what Tim just described, Deloitte did a poll with about 7,700 respondents back in March as part of our quarterly accounting roundup webcast, where we allowed them to provide their thoughts on the nature of their real estate rationalization programs. The individuals responding to the poll were from across every industry, included professionals at a number of levels, including C-suite executives, managers, and analysts, but out of the 7,700 that responded, almost 67% indicated that they have initiated or plan to initiate a real estate rationalization program. So roughly 16.5% said they were planning to expand their footprint for purchasing and leasing additional space, 43.1% said they plan to reduce their footprint by eliminating owned and leased space, and 33.2% said that they would reduce the space used for certain parts of the business and expand it for others, while a little over 7% said they plan on initiating a sale-and-leaseback transaction. Companies are revisiting or they're planning to revisit their real estate portfolio. This decision will have significant impact on the accounting and on operations as well.

Sam: If a company decides that they want to exit or change their real estate footprint, what are those potential implications?

Tim: Sam, as is the case with many of these types of questions that are asked of an accounting advisor, the answer is, it depends. And "it depends" is really linked to the nature of the changes. From the accounting perspective, there are a number of implications.

For example, if a company decides that it will be exiting or changing how it will be using certain of its leased real estate assets, but it's not formally changing the lease terms with its landlord, then this may be considered a triggering event to see if the leased asset is either impaired or abandoned. Many companies are finding the accounting requirements related to these two topics challenging to understand and apply. If impaired, the right of use asset would be written down; if abandoned, the right of use asset would be derecognized on an accelerated basis.

In contrast, if a company decides to negotiate changes to their existing contracts, whether it be reducing or expanding the lease space, shortening the lease term, or even terminating part or all of the lease, that could have different accounting consequences. When you hear "negotiated changes," that generally means a lease has been modified. And since the ASC 842 modification framework is brand new to lease accounting, applying the requirements is not always that simple and straightforward.

Finally, if a company goes down the path of outright purchasing additional real estate or selling part of its existing real estate portfolio as a means of rightsizing its footprint, this too may have certain accounting consequences. An outright purchase of a new property is fairly straightforward. The asset is recognized and depreciated like any other owned property.

If an asset is sold, however, that's a totally different story, with the accounting outcome dependent on whether it is a straight sale, a sale-and-leaseback, or a sale and a partial lease back.

Matt: And, Tim, while you hit on all the debits and credit aspects of this, an important thing to keep in mind is really understanding the process and controls that are in place to make sure that your organization is capturing these changes to the lease portfolio accurately and completely. Our experience has shown that any changes to portfolios face much greater scrutiny from the auditors, given the complexity of the accounting that you just described. A robust process for tracking and communicating these changes, as well as controls being in place to identify the changes, makes sure that the data is captured completely and accurately and validate the accuracy of the accounting calculation change is critical to overall accounting success.

Sam: Tim, can you expand on what it means to abandon or impair a lease asset? And at what level is this done?

Tim: That's really a loaded question, Sam. Let's first focus on applying the impairment model, as this is one of the more prevalent areas where companies are struggling. This guidance is governed by ASC topic 360. The requirements state that the evaluation of a long-lived asset or asset group for impairment is performed "at the lowest level for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities." That was right from the standard and that was a mouthful, so let me give you some clarity here. So, the first thing a lessee must do is identify the level where there are both cash outflows and inflows when identifying the asset group to be evaluated.

Consumer Speaks

While an initial reaction is the individual right-of-use asset should be evaluated in a vacuum since that's really the asset that's being impacted by any real estate rationalization actions, it would generally be inappropriate to apply the impairment test at that level because it's really not the lowest level where there's identifiable cash flows. This would apply, for example, to a leased corporate headquarters that's considered a corporate asset. A proper evaluation may require the allocation of the corporate assets to the relevant asset group or may result in a conclusion that the ASC 360 asset group would be at a higher level, for example, at a region or even the consolidated level.

We're finding that some companies are also struggling to understand how and when to apply the abandonment guidance to the right-of-use asset. This too is governed by ASC topic 360. While impairment is assessed at the asset group level, abandonment is applied at the individual lease component level. And to be clear, this would be the case irrespective of whether the lease components were accounted for separately at the lease commencement date or not.

The abandonment framework generally results in acceleration of the right-of-use asset's amortization. But a lessee will need to use judgment in evaluating whether an abandonment has truly occurred. We've seen some companies assert that they are abandoning the property, even though it's not out of the question whether they will reoccupy this space in the future, so it's only temporarily idled. We've seen other companies take the same approach, even though they may still be using the property for minor operational needs or may have the intent and ability to sublease the asset. In each of these scenarios, this space would not be subject to abandonment accounting, because the lessee either still or plans to achieve economic benefits from the property in the future.

To clarify, right-of-use assets would only be subject to abandonment accounting when the space is no longer used for any business purposes and when there's no anticipated source of any future economic benefit. For example, there's no intent or ability to sublease the property.

In short, abandonment accounting applies when management makes a commitment not to use the lease space for any business purposes. This would include something as simple as storage.

And then abandonment accounting does not apply when management expects to obtain a future economic benefit from using the property, so this would be the case if it intends to sublease and has the ability to sublease the property.

Matt: Tim, if I can put on my "how to operationalize this" hat for just a minute, organizations should think about what their policy is or how they're establishing that they have abandoned an asset. You probably don't want to be accelerating expense due to abandonment if the asset is going to come back online later. Not only does this create unexpected expense, but likely will raise questions later on when you start using that asset that you've essentially written off.

Understanding the appropriate unit of account, as you described, for applying ASC 360 impairment and abandonment requirements has also raised certain questions and has presented certain challenges. Specifically, asset groups, as well as the identified lease components, may change as a result of real estate rationalization. For example, a leased property may currently be part of a larger group. Maybe it's a satellite corporate office or may have historically been accounted for as a single lease component, but the entity may have a plan to exit part of the facility and sublease it. In these cases, lessees must use significant judgment to determine when it would be appropriate to revisit their asset

group or the identified lease components. Lessees may ultimately need to remove right-of-use assets from a previously identified asset group.

Determining when to revisit the asset group or the identified lease components and its accounting may affect the underlying lease accounting and related impairment and abandonment considerations. To summarize, it's very important to be in constant communication with your operations and real estate group and really understanding what the triggers are and what your policy and positions are in place, as this is a highly judgmental area.

Sam: Tim, earlier you talked about negotiated changes to a lease contract. What are the potential issues with that?

Tim: So what you're referring to here, Sam, is modifying existing leases. And the accounting implications of a lease modification really depends on whether the modification is accounted for as a separate contract and the nature of the modification. A company's understanding of the lease modification guidance is critical as the application of these requirements will have a direct impact on the amounts recorded in a company's financial statements. And by the way, this may not be as straightforward as expected or even desired. It's been a little more challenging than anticipated.

A range of observations have been made regarding the application of the lease modification framework. In some cases, determining whether a contract amendment represents a separate contract or a change to an existing agreement may be difficult. In other scenarios, applying the lease modification framework when the amendment results in multiple changes to an arrangement or affects different lease components can introduce unexpected complexity. For example, reducing the term of one floor and extending the term of another. Each of those have different accounting consequences, and knowing how to deal with each of those separately has introduced some challenges.

Consumer Speaks

In addition, certain nuances may exist in applying the modification guidance when a lessee early exits a property. For instance, even though the modification may be inked as an early termination, unless the space is immediately vacated, this type of change would simply be considered a reduction in lease term. For example, if a lease with the remaining lease term is modified from three years remaining to a 30-day period to allow a lessee to vacate the property, this would result in the lease term being reduced from three years to 30 days. Generally speaking, the difference between a lease termination and reduction in lease term is the immediate recognition of a gain or loss in the income statement versus changing the remaining future lease costs on a month-by-month basis.

Another complexity that has been observed is how to deal with any termination penalties that may be paid to a landlord. While the knee jerk reaction may be to recognize this payment in the income statement immediately, that may not be permitted by the guidance. The ASC 842 guidance considers a termination penalty as a lease payment and part of the consideration in the contract. Any changes in the consideration due to a lease modification will require the remeasurement of a lease, with the revised consideration allocated to all of the remaining lease components in the contract and recognized as part of the cost over the revised term. This results in the prospective recognition of the termination penalty as a component of the remaining lease costs of the remaining lease components versus the immediate recognition of the penalty up front.

Sam: Matt, Tim covered the accounting side of the house, but how are you seeing these negotiations actually happening?

Matt: Sam, that's a great question. We're seeing a lot of scenarios where negotiations take a significant amount of time. What's often challenging with this timeline is that the effective date of the modification is the date that the tenant and landlord agreed to the changes. It's at this point that the lease is required to be updated and accounted

for prospectively. Oftentimes, we see organizations wanting to push back the effective date of that change and account for it retrospectively. This may be an acceptable convention if immaterial, but it's inconsistent with requirements under GAAP. This adds to the complexity as well as it impacts the ability for systems to handle the change.

Sam: I want to circle back to something Tim mentioned early on with the trend of selling owned real estate and leasing it back. What are the pressure points there, Tim?

Tim: Great question, Sam. As a backdrop, it's clear that sale-and-leaseback transactions involving real estate are on the rise. Some companies are using these types of transactions as a means of improving overall liquidity. This allows them to release cash from existing real estate that can be used for new business acquisitions or just to provide extra working capital. Other companies are using sale-and-leaseback transactions as part of a broader real estate rationalization program. They're strategically deciding to sell owned real estate assets that are no longer needed in their entirety or for as long as originally forecasted. In these transactions, after the sale, the original owner leases back part or all of the property for a certain period of time. Applying the ASC 842 and ASC 606 accounting models to these types of arrangements isn't that straightforward at times.

Certain contract provisions could prevent the arrangement from qualifying as a sale and impact the entity's ability to derecognize the underlying property and recognize a gain on the sale. In this respect, there are nuances that could have a significant impact on accounting. There may be certain other unique accounting considerations related to the sale and partial lease-back of the property. Further, there may be certain accounting consequences if the arrangement is priced at off-market terms, so there's a lot to consider here.

Understanding the sale-and-leaseback accounting guidance is important to properly account for such transaction, as the structure of the transaction will

generally have a direct impact on the accounting outcome. For example, the structure could impact whether the transaction is accounted for as a clean sale with up-front gain recognition or a failed sale and as a financing transaction.

Matt: Those are some great points, Tim. I cannot stress enough the importance of understanding the guidance and keeping that in mind up front. In this respect, companies that plan to execute a sale-and-leaseback should direct their focus to the structure of the arrangement while it is being negotiated.

You really want to make sure you're engaging experts to help you with this type of transaction. You want experience both from a legal perspective, but also an accounting perspective, as this is an area ripe with pitfalls. The last thing that anyone wants to have happen is a surprise in what the required accounting treatment could be.

If the arrangement is not structured correctly, you could have a legal sale, receive the cash proceeds, but from an accounting perspective, it could be a failed sale and become a financial arrangement, which is a very different treatment from a successfully designed and executed sale-and-leaseback where you get to derecognize the asset, have a clean slate, and get to recognize the gain or profit on the sale.

The bottom line is that the devil is in the details and understanding the impact of certain key terms in a sale-and-leaseback agreement is critical.

Sam: Guys, do you have any other closing thoughts?

Tim: Well, let me jump in from the accounting perspective. It's quite evident that many companies will continue to make certain strategic decisions about their real estate portfolio, whether it be exiting space before the end of the lease term, modifying existing agreements, buying new property, or selling owned space and, in some cases, leasing it back. The new lease accounting standard has introduced

Consumer Speaks

some wholesale changes that impact each of these real estate rationalization activities: learning the guidance and interpretive views related to assessing a right-of-use asset for impairment, applying the abandonment requirements, and applying the ASC 842 lease modification framework. These accounting requirements can be very nuanced with what may be considered certain unexpected accounting outcomes. It's also similarly important to understand the accounting implications of selling a property and leasing it back. These accounting requirements are also more complex than expected. So know the requirements is the bottom line here.

Matt: I agree 100%. The only thing that I would add to what you just said is that this increase in lease changes we are seeing is not only complex from getting the pure debits and credits right, but it's adding significant additional complexity in

the processes and systems. The process of revisiting and re-negotiating contracts and making changes is introducing new scenarios to be handled that many organizations hadn't really thought about or considered previously and may find that the process or systems in place today are not prepared to handle these new fact patterns to get the accounting right. I think the biggest piece of advice I have for accounting functions is to stay close to the decision-making process and get engaged in the conversations early to be ready to deal with the impact, as well as to be able to share how the transaction impacts the financials. We continue to see situations where an action is taken and it doesn't have the expected end financial result because the accounting treatment is complex. And adding onto this, don't hesitate to phone a friend. There are numerous user groups and sounding boards out there for help. As we've alluded to, we are seeing a big uptick

in efforts to rationalize lease portfolios and modifications being made, which means that you likely aren't the only one dealing with this issue and it's always helpful to have that support.

Sam: Well, that's our time for today. Tim and Matt, I really appreciate you joining the discussion and highlighting the accounting considerations companies should be thinking about related to lease rationalization programs. For more information on this topic, please visit deloitte.com to download the "[Re-evaluating your real estate footprint](#)" article, or email me, sloughry@deloitte.com. While there, be sure to check out our other consumer insights. Thank you for listening to Consumer Speaks, sponsored by Deloitte's Audit & Assurance business. Until next time, take care.

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