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On the Radar

Leases

Lease accounting is currently like a tale of two cities: companies that have adopted the new leasing standard, ASC 842, are in one place and entities that have not yet adopted the standard are in another. While companies that have already adopted ASC 842 may be focusing more on ongoing FASB activity[1] and the effects of the COVID-19 pandemic on their leasing arrangements, entities that have not yet adopted ASC 842 are still grappling with implementation challenges. Because public business entities (PBEs) were required to implement the new leasing standard for years ended December 31, 2019, most public companies have been accounting for their leases under the new rules for nearly three years. The effective date for non-PBEs, on the other hand, is still to come and is rapidly approaching. See the Implementation Considerations for Entities That Have Not Yet Adopted ASC 842 section below for more information about the effective dates for non-PBEs.

This On the Radar applies to both PBEs and non-PBEs and is divided into the following sections on the basis of whether an entity has adopted ASC 842:

- Lease Accounting Hot Topics for Entities That Have Adopted ASC 842.
- Ongoing Accounting Standards Updates.
- Implementation Considerations for Entities That Have Not Yet Adopted ASC 842.

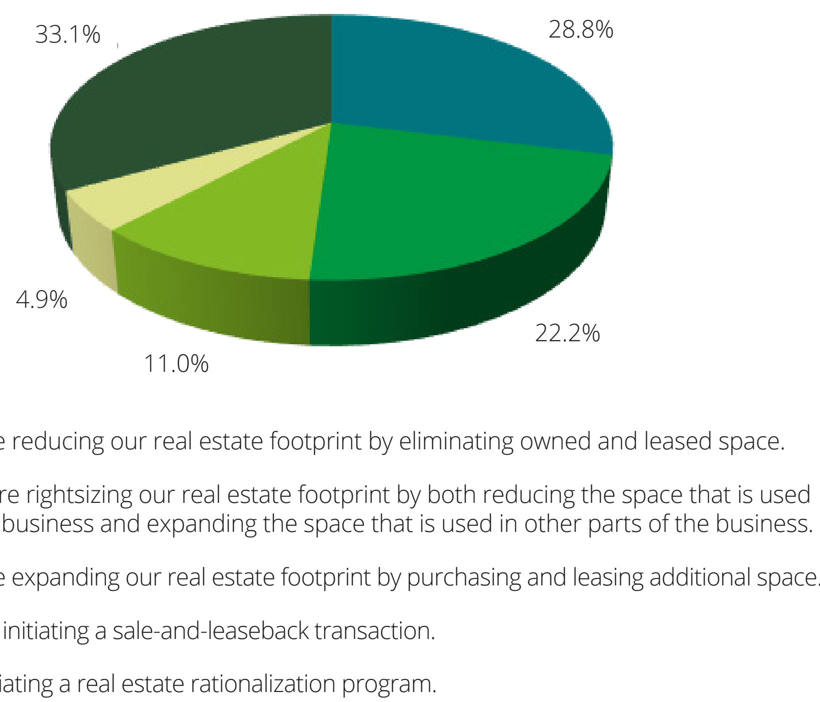
[1] This On the Radar takes into account all FASB standard-setting activity through October 31, 2021.

Lease Accounting Hot Topics for Entities That Have Adopted ASC 842

Impact of COVID-19 and Real Estate Rationalization

It has been nearly two years since the onset of the COVID-19 pandemic, which has had a pervasive impact on the global economy. COVID-19 has also changed how entities in almost every industry sector are doing business. Many entities are evaluating their current business structures and related models to adapt. As part of such an assessment, entities may reevaluate where their employees 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 goal of initiating such programs may be for entities to rightsize their real estate portfolios to manage costs while adequately supporting their evolving business needs. The graphic below illustrates the results of a Deloitte survey on the percentage of companies that plan to initiate or are initiating a real estate rationalization program.

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 have observed an increase in entities abandoning properties, subleasing space they are no longer using, or modifying existing leases to change the amount of space or the lease term. Further, as a financing method to improve their liquidity, entities are increasingly entering into sale-and-leaseback transactions involving real estate. As a result of these real estate rationalization efforts, companies are also more frequently evaluating leases for impairment. Each of these topics is addressed below (also see Deloitte's March 30, 2021, *Accounting Spotlight* for a more detailed discussion). Please note that the accounting considerations below apply to entities that have already adopted ASC 842. Entities that have not yet adopted ASC 842 should work with their accounting advisers to determine the impact of real estate rationalization under ASC 840.

Impairment and Abandonment

The ROU assets recorded on a lessee's balance sheet under ASC 842 are subject to the ASC 360-10 impairment guidance applicable to long-lived assets. 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 an impairment exists. The decision to change the use of a property subject to a lease could be an impairment indicator.

Although the existence of an impairment indicator would not itself be a reason for a lessee to reevaluate the lease term for accounting purposes, an entity should consider whether any of the reassessment events in ASC 842-10-35-1 have occurred simultaneously with the impairment indicator.

The guidance in ASC 360-10 on accounting for abandoned long-lived assets also applies to ROU assets. 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 but still has a contractual obligation under the underlying lease, the lessee needs to evaluate whether the ROU asset has been or will be abandoned. Abandonment accounting only applies when the underlying property subject to a lease is no longer used for **any** business purposes, including storage. If the lessee intends to use the space at a future time or retains the **intent** and **ability** to sublease the property, abandonment accounting would be inappropriate.

Common Pitfall

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 it. Under these circumstances, abandonment accounting would not be appropriate. An entity may need to use significant judgment in evaluating whether abandonment has occurred.

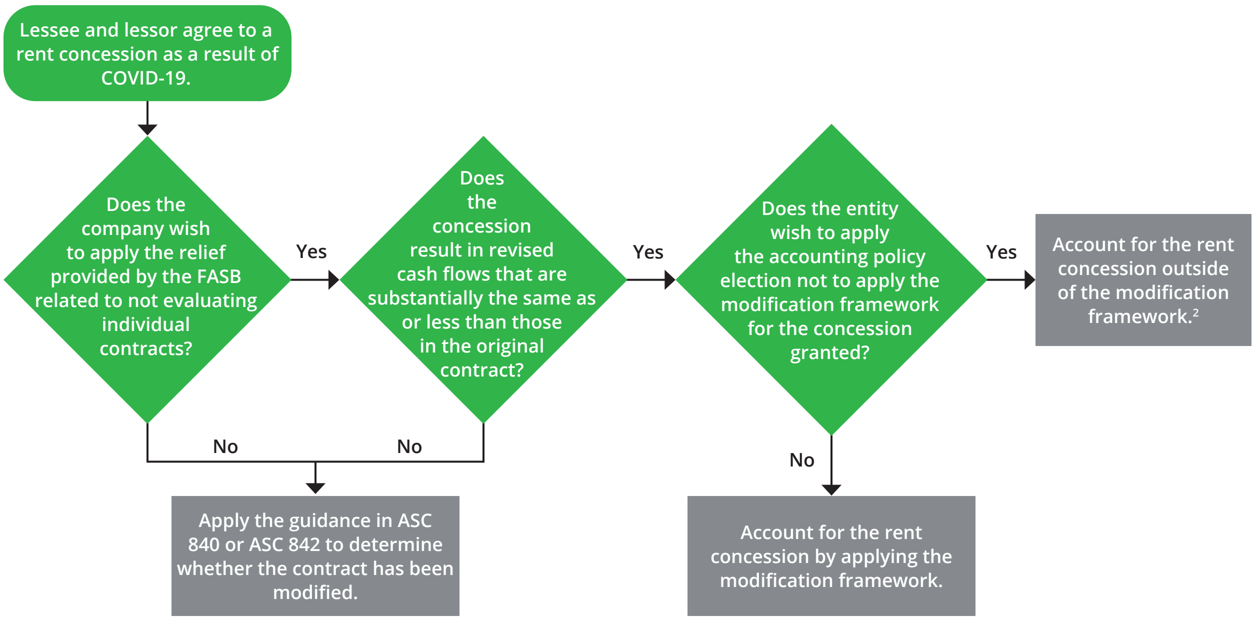
In our experience, establishing management's intent regarding subleasing involves judgment and depends on various facts and circumstances, such as the remaining lease term, the nature of the property, and the level of demand in the rental market. For example, it may be reasonable to conclude that an 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 the property 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. It may be particularly difficult to reach such a conclusion in the current environment given the uncertainties related to the duration of the COVID-19 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 from one rental market to the next. 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.

Subleases

A lessee may enter into a sublease if the lessee no longer wants to use the underlying asset but has identified a third party to which the asset will be leased. In a sublease, the original lease between the lessor and the original lessee (i.e., the head lease) typically remains in effect and the original lessee becomes the intermediate lessor. Generally, the lessee/intermediate lessor should account for the head lease and the sublease as separate contracts while considering whether the sublease changes the lease term of the head lease or its classification. The head lessor's accounting is unaffected by the existence of the sublease.

Modification of Existing Lease Arrangements

In April 2020, the FASB staff issued a staff Q&A, "Accounting for Lease Concessions Related to the Effects of the COVID-19 Pandemic," to provide lessees and lessors with interpretive guidance on accounting for rent concessions associated with the COVID-19 pandemic. The decision tree below summarizes the application of this guidance and the determination of whether a rent concession can be accounted for outside the modification framework.



In addition to evaluating whether lease modification accounting is required for COVID-19–related rent concessions, some lessees are also modifying existing lease agreements in response to the current environment. 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. For more information on applying lease modification accounting in the current environment, see Deloitte's April 9, 2020 (updated April 30, 2020), *Heads Up*.

Common Pitfall

Many amended contracts describe a lease amendment as an early termination. In evaluating these types of amendments, a lessee must determine whether the amendment is actually a modification to reduce the lease term. If a termination 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. 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 (i.e., the space is immediately vacated).

Sale-and-Leaseback Arrangements

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. In addition to executing such transactions to improve their overall liquidity, some entities — as part of their broader real estate rationalization

[2] Entities should consult with their accounting advisers regarding the acceptability of the model applied to account for the concession when not applying the modification framework.

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.

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, the seller-lessee would not be able to derecognize the underlying asset (i.e., a failed sale) or recognize any associated gain or loss on the sale if (1) the contract includes a provision that grants the original owner (future tenant) an option to repurchase the property or (2) the leaseback would be classified as a finance lease. Rather, both parties would account for the transaction as a financing arrangement; the seller-lessee would recognize a financing obligation for amounts received from the buyer-lessor and the buyer-lessor would recognize a financial asset for the cash paid (instead of recognizing the underlying asset). In such circumstances, the balance sheet leverage ratios would be affected since the financing obligation would be viewed similarly to a debt arrangement. The income statement profile would be similarly affected, because the seller-lessee would continue to recognize depreciation for the asset subject to the sale-and-leaseback transaction and interest on the financing obligation. In addition, the statement of cash flows would be affected because a failed sale would be accounted for as a financing activity rather than as an investing activity. The below graphic outlines key considerations related to the accounting for a sale-and-leaseback arrangement.

"Successful" sale-and-leaseback gain recognition	• **Entire gain resulting from the sale recognized immediately** • **Special considerations for off-market terms**
"Successful" sale-and-leaseback accounting	• **Account for leaseback in a manner consistent with other leases** • **Seller-lessee applies lessee model; buyer-lessor applies lessor model**
"Failed" sale-and-leaseback transaction	• **A "failed sale" will be accounted for as a financing arrangement by both parties**

Ongoing Accounting Standards Updates

Since the issuance of ASU 2016-02 more than five years ago, the FASB has released various ASUs to provide additional transition relief and make certain technical corrections and improvements to the standard.

Most recently, the FASB issued ASU 2021-05, which changed the accounting for lessors of leases with variable payments that do not depend on an index or rate. This new guidance requires a lessor to classify a lease with any variable lease payments as an operating lease at lease commencement if both of the following conditions are met:

1. The lease would have been classified as a sales-type lease or direct financing lease in accordance with the classification criteria in ASC 842-10-25-2 and 25-3, respectively.
2. The lessor would have recognized a selling loss at lease commencement.

This amendment was designed to eliminate the possibility that an economically profitable arrangement would lead the lessor to recognize a loss at lease inception as a result of the ASC 842 measurement requirements for variable lease payments that are not based on an index or rate.

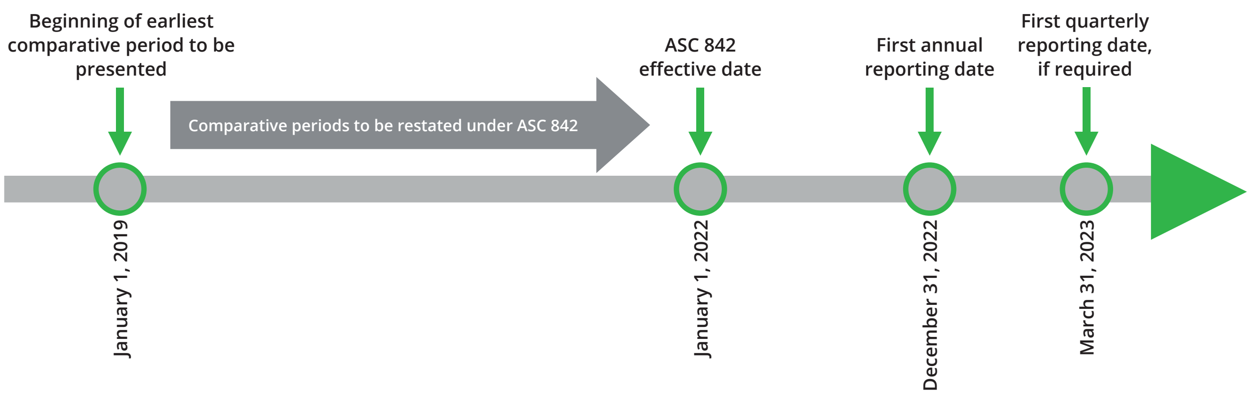
The FASB continues to evaluate stakeholder feedback on the adoption of ASC 842. These evaluation efforts included holding public roundtables in September 2020 to discuss challenges with applying the standard. The FASB also issued an invitation to comment in June 2021 to request feedback on how to refine its broader standard-setting agenda. Stay tuned for future refinements in accounting standard setting as a result of these initiatives.

Implementation Considerations for Entities That Have Not Yet Adopted ASC 842

While the accounting issues discussed above may affect both public and private companies, the accounting implications for those that have adopted ASC 842 may differ from those that are still applying ASC 840.

ASU 2020-05 (issued in June 2020) amended the effective dates of the leasing standard that were previously delayed in ASU 2019-10 (issued in November 2019) to give implementation relief to certain types of entities in response to the COVID-19 pandemic. ASU 2020-05 amends the effective dates of ASU 2016-02 as follows:

Non-PBE With a Calendar Year-End



The most significant changes in the new leasing standard are as follows:

- Lessees record most leases on the balance sheet.
- Bright-line tests are no longer used to determine lease classification, thus eliminating a potential source of structuring.
- Certain underlying principles of lessor accounting are aligned with those in ASC 606, the FASB's revenue standard.
- Expanded disclosures are required for both lessees and lessors, including the requirement for lessors to provide more transparent information about their exposure to the changes in the value of residual assets as well as how they manage that exposure.

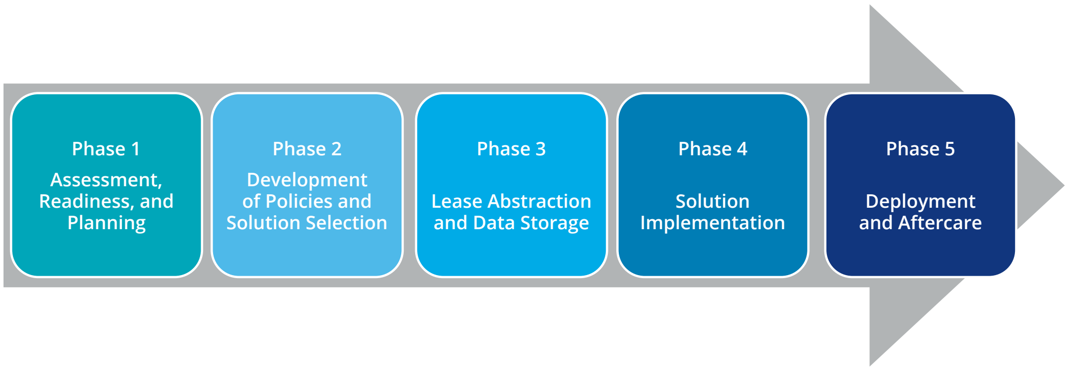
Non-PBEs that have not yet adopted ASC 842 should work with their accounting advisers when dealing with the real estate rationalization topics described in the previous section and throughout the implementation of ASC 842. Further, entities should review the best practices for adoption below.

Critical Areas of Adoption Process

In implementing ASC 842, entities will need to change not only their accounting for and financial reporting of leases but also their related systems and processes. It is important for all entities to develop an implementation plan well before ASC 842's effective date. Although some of the accounting changes may seem intuitive, the necessary data and systems changes are significant and, without preparation, may be overwhelming.

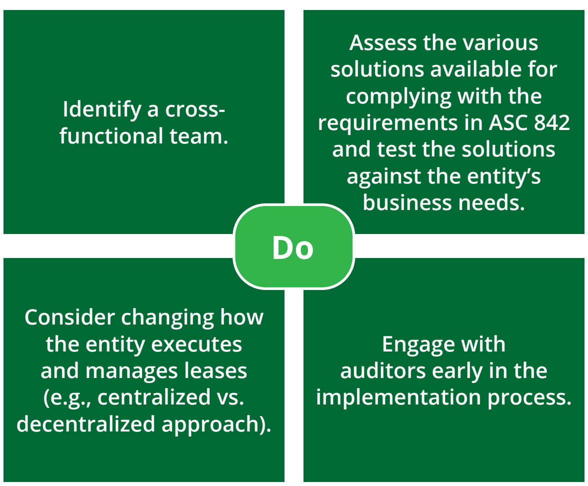
Phases of Implementation

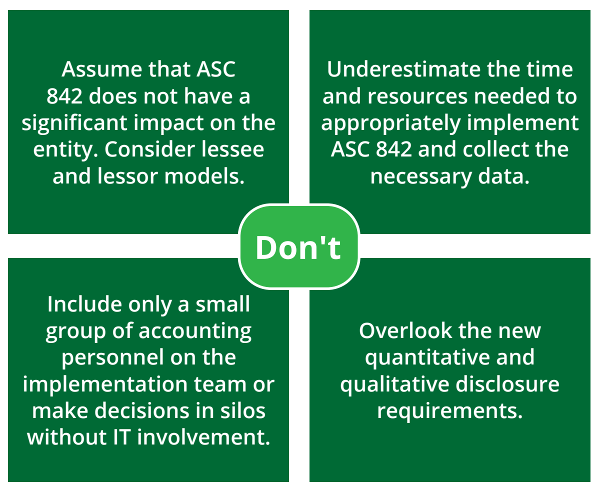
The sections below highlight five phases of adopting ASC 842, including key activities that an entity may perform and factors it may consider to gauge how much time and effort it will take to complete certain steps in the transition process. Although implementation strategies vary, we developed these recommendations on the basis of experiences with public-company implementation. While an entity works toward adoption of ASC 842, the entity's normal operations do not cease; new leases are entered into, and existing leases are modified or terminated. Accordingly, the adoption of ASC 842 should not be viewed strictly as a linear process.



Phase 1: Assessment, Readiness, and Planning

The first phase of the adoption effort should focus on understanding the accounting and disclosure requirements, understanding an entity's lease population, and performing a data gap analysis. The following graphics illustrate best practices for an entity to consider when developing an implementation plan:





Phase 2: Development of Policies and Solution Selection

This phase consists of two primary activities:

1. Developing accounting policies, which includes evaluating the lease population and performing the main technical accounting analysis, including making relevant accounting policy elections and designing internal controls.
2. Selecting the long-term lease accounting solution on the basis of the entity's business and functional requirements.

Phase 3: Lease Abstraction and Data Storage

The third phase of the adoption effort is centered on data readiness, which includes activities related to lease abstraction and data storage.

Phase 4: Solution Implementation

The solution that is selected in phase 2, if applicable, will govern the timing and activities in the solution implementation phase, which may include technical integration with an entity's existing system(s), customized configuration, and validation of functionality. These activities may be conducted (1) in house, (2) with an external vendor, or (3) both. An entity's IT department is often heavily involved in implementation of a solution; however, the core accounting function should also participate.

The solution implementation phase should also include revisions to the design and development of internal controls to address the changes to the lease accounting process for the new solution.

Phase 5: Deployment and Aftercare

Although an entity's adoption of the guidance in ASC 842 may seem like a one-time effort, the success of such adoption depends partly on the activities performed during the deployment and aftercare phase. After adoption, the entity should perform a postimplementation review. Depending on the outcome of the postimplementation review, some entities may need to continually dedicate resources to ensure compliance with ASC 842.

Transition Elections and Practical Expedients

ASC 842 offers practical expedients that can be elected by certain entities or in certain arrangements.

For a comprehensive discussion of the lease accounting guidance in ASC 842, see Deloitte's Roadmap *Leases*.

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