

Reevaluating your real estate footprint

Potential lease accounting and impairment implications of real estate rationalization

How companies manage their business has significantly changed since March 2020. Many C-suites are strategically reevaluating their current business structures and related models to adapt to the current environment. And CFOs continue to play a critical role in these activities, tasked with supporting overall business growth by managing corporate finances, as well as capital allocation.

Where employees will work and to what extent they will rely on the use of brick-and-mortar real estate assets are among the areas CFOs and their teams are often revisiting today. Many have initiated (or may soon initiate) a real estate rationalization program to reevaluate their organization's real estate footprint. In a March 2021 poll taken during a Deloitte Dbriefs webinar, 66.9% of the more than 7,700 attendees (including C-suite, executives, managers, and analysts) who responded indicated that they have or will be initiating a real estate rationalization program.

The ultimate goal of these rationalization programs is a rightsized real estate portfolio that manages costs while supporting evolving business needs. To meet that goal, we have seen CFOs and their teams pulling various levers, including:

- Exiting leased space before the end of the contract term
- Modifying existing lease agreements
- Purchasing or leasing additional space
- Reducing owned space by executing a sale-and-leaseback transaction

Each rationalization initiative has certain accounting implications that may not be fully understood and can introduce unexpected complexities and outcomes. While the accounting for the lease or purchase of additional space is fairly straightforward, accounting for other real estate rationalization strategies may be challenging. Let's explore the nuances that CFOs and their teams should understand to properly account for these more complex activities.



Accounting for changes in the use of a property

Many companies have realized they can function effectively in a virtual or semivirtual environment. That discovery has put pressure on the C-suite, including CFOs, to reassess their real estate needs in the name of managing capital allocation and enabling a modern business model. These decisions are prompting leaders to revisit their company's lease portfolios and potentially shift how they are using certain real estate assets within their organization. As a result, there may be a need to see if the ASC 360 impairment or abandonment guidance may apply. Since right-of-use (ROU) assets were first recognized with ASC 842 (i.e., operating leases), the ASC 360 guidance is relatively new in this area, and many lessees are finding the related accounting requirements challenging.

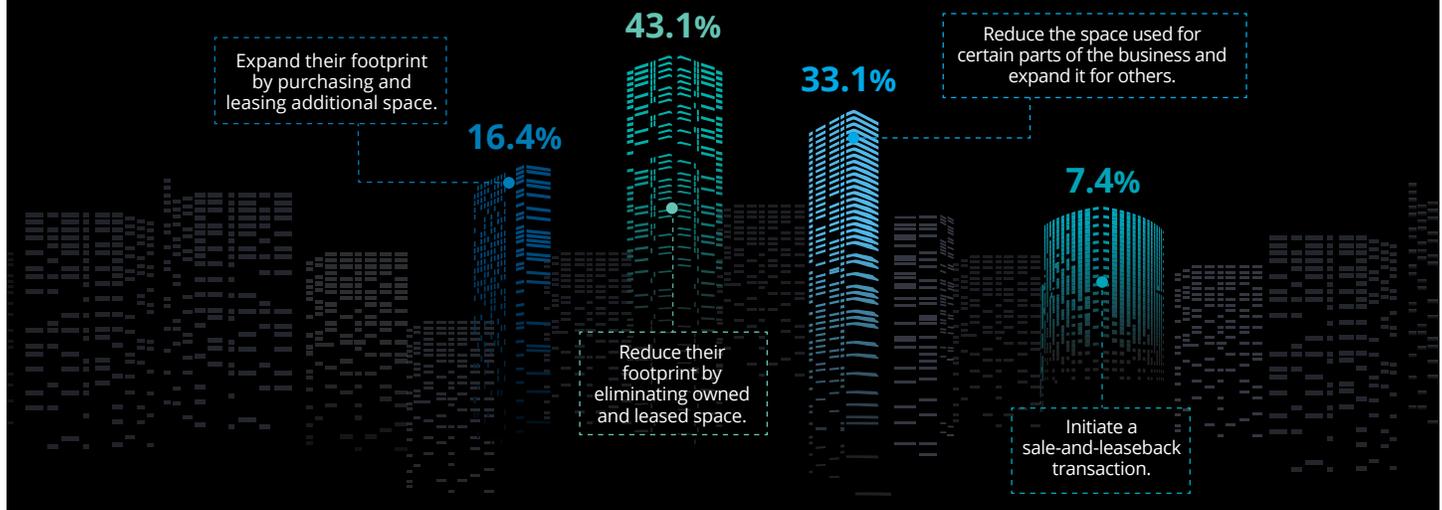
The ASC 360 impairment model requires that the evaluation of a long-lived asset or asset group for impairment should be performed "at the lowest level for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities."

66.9% have initiated or plan to initiate a real estate rationalization program



• **What does rationalization look like?**

For CFOs and their teams, rightsizing can take a range of forms. Attendees rationalizing their real estate told us how they plan to achieve a balanced portfolio.



A lessee must assess all cash flows and would therefore consider both cash outflows and inflows when identifying the asset group to be evaluated. This is often one of the trouble spots when applying the impairment guidance. An initial reaction may be that the individual ROU asset should be evaluated in a vacuum, since it's the asset affected by real estate rationalization. However, it would generally be inappropriate to apply the impairment test at that level because it's not the lowest for which identifiable cash flows exist. 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 groups or may result in a conclusion that the ASC 360 asset group would be at the consolidated level.

Some companies are similarly struggling to understand how and when to apply ASC 360 abandonment guidance to an ROU asset. The abandonment framework generally results in acceleration of an ROU asset's amortization. But a lessee will need to use judgment in evaluating whether an abandonment has truly occurred. We have seen some companies assert that they're abandoning a property, even though it's only temporarily idled. They may still be using it for minor operational needs or have the intent and ability to sublease. These assets wouldn't be subject to abandonment accounting because the lessee is still achieving, or plans to achieve, economic benefits from the property. ROU assets would be subject to abandonment accounting when they're no longer used for *any* business purposes and aren't the anticipated source of any future economic benefit (e.g., there's no intent and ability to sublease the property).

Understanding the appropriate unit of account for applying the ASC 360 impairment and abandonment requirements has also raised certain issues at the CFO level. Specifically, asset groups and identified lease components may change as a result of real estate rationalization. For example, a company may plan to exit and sublease a property that's currently part of a larger group (e.g., a satellite corporate office) or may have historically been accounted for as a single lease component. In such cases, lessees must use judgment to determine when it would be appropriate to revisit their asset group or the identified lease components. Lessees may ultimately need to remove ROU assets from a previously identified group.

Determining when to revisit the asset group or the identified lease components is important, as these decisions will have a direct impact on the underlying accounting and related impairment and abandonment considerations.

 **Modifying existing lease arrangements¹**

As part of their real estate rationalization program, some lessees work with their landlords to modify existing lease agreements. This could include eliminating or scaling back office space or expanding to accommodate social distancing and open floor plans. The accounting for these kinds of modifications under ASC 842 lease accounting model depends on whether the modification is accounted for as a separate contract and the nature of the modification. The CFO's understanding of the ASC 842 lease accounting modification guidance is critical, as the application

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of these accounting requirements will have a direct impact on amounts recorded in the company's financial statements.

A range of observations have been made regarding the application of the ASC 842 lease accounting modification framework in these circumstances. In some cases, determining whether a contract amendment represents a separate contract or a change to the existing agreement may be difficult. In others, applying the ASC 842 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).

Certain other accounting nuances may exist in applying the lease accounting modification guidance when a lessee exits a property early. Consider a modification inked as a "early termination." Unless the space is vacated immediately, this type of change would simply be considered a reduction in lease term. If a lease is modified from the three-year remaining term to a 60-day period to allow a lessee to vacate the property, this would result in the lease term being reduced from three years to 60 days.

Another complicating factor is termination penalties that may be owed to a landlord. While the knee-jerk reaction may be to recognize this payment in the income statement immediately, that may not be permitted. The ASC 842 lease accounting modification guidance actually considers a termination penalty as a lease payment and part of the contract consideration. Any changes in the consideration due to a lease modification will require the remeasurement of the lease, with the revised consideration allocated to all of the remaining lease components in the contract over any revised term. This results in the prospective recognition of the termination penalty as part of lease cost for the remaining lease components.

The bottom line is that the ASC 842 lease accounting modification guidance is new to US GAAP and presents new challenges. Knowing how the ASC 842 lease modification guidance works, as well as its potential pitfalls, is critical to allow for the proper accounting of a modified lease.

Sale-and-leaseback accounting

Sale-and-leaseback transactions involving real estate are on the rise. Some CFOs are using these types of transactions to improve overall

liquidity by releasing cash from existing real estate. That cash can be used for new business acquisitions or just provide extra working capital. Other CFOs are using sale-and-leaseback transactions as part of a broader real estate rationalization program. They are 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 part or all of the property back for a certain period. Applying the ASC 842 and ASC 606 accounting models to such arrangements isn't always straightforward.

Certain contract provisions could prevent the arrangement from qualifying as a sale. This may affect the entity's ability to derecognize the underlying property and recognize a gain on the sale. In addition, there are also other nuances that could have a significant impact on accounting. For example, sale-and-leaseback transactions are always required to be accounted for at fair value, and the sale price would need to be adjusted for any off-market terms when this is not the case, requiring the recognition of additional financing or prepaid rent.

Understanding the sale-and-leaseback accounting guidance is important to properly account for such a transaction. It may also allow a CFO and their team to structure the transaction to get the desired accounting outcome that aligns with the overall business strategy (i.e., the structure could affect whether the transaction is accounted for as a "clean sale" with gain recognition or a "failed sale" and a financing arrangement).

Dig deeper into real estate rationalization

A more in-depth discussion and analysis of the observations highlighted in this publication can be found in the Deloitte Accounting Spotlight [Real Estate Rationalization 101: Current Market Trends and the Potential Accounting Implications From a Lessee's Perspective](#). If you have questions about applying the requirements of the lease accounting standard, want to know how it fits into the CFO's mission of supporting business growth, or need assistance with interpreting its requirements, please contact any of the following Deloitte professionals:

Endnotes

1. The discussion in this section is based on the lease modification guidance in ASC 842 and does 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 the Deloitte *Heads Up* report, "FASB Decides to Defer Certain Effective Dates and Provides Guidance on COVID-19," for more information.

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