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Technical Line

Lessee accounting considerations for retailers in the current environment

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What you need to know

- Retailers that have adopted ASC 842 need to continue to consider the lease accounting implications of current economic conditions as they plan for the future.
- Retailers that receive rent concessions but don't make the FASB staff election to not evaluate whether a concession is a modification (or don't qualify for the election) need to evaluate the rights and obligations of any modified contracts and apply the lease modification guidance if the changes were not contemplated in the lease.
- Retailers that repurpose existing leased space or build out newly leased space need to consider the accounting for any new leasehold improvements.
- Store closures and other business disruptions may indicate a change in circumstances that could result in right-of-use (ROU) asset impairments.
- The pandemic has accelerated the shift to online shopping that has affected brick-and-mortar stores.

Overview

Retailers that have or will soon adopt Accounting Standards Codification (ASC) 842, *Leases*, need to continue to consider the lease accounting implications of changes to their business that relate to the COVID-19 pandemic, broader economic conditions and the ongoing transformation of the industry.

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Building a better working world

While many retailers significantly curtailed or suspended operations early in the pandemic, many of them are now focusing on planning for the future. That is because the pandemic has accelerated the shift to online shopping and made online operations the primary channel for some retailers, and many of them are considering how to maximize the value of brick-and-mortar stores as customers return to in-store shopping. They're also navigating supply chain disruptions and labor shortages that could affect sales.

Retailers may be considering whether:

- A store will be needed or used for any purpose
- A store can be subleased
- A lease can be renegotiated to do the following:
  - Reduce the square footage of the store
  - Lower the cost per square foot of the store
  - Provide additional lease incentives
  - Allow them to move to a more desirable space with the same landlord

Retailers can elect not to evaluate whether a concession provided by a lessor to a lessee in response to the COVID-19 pandemic is a lease modification.

This publication summarizes lessee accounting and reporting considerations for retailers in the current environment. It focuses on accounting under ASC 842 and ASC 360-10, *Property, Plant, and Equipment — Overall*. It also addresses internal control over financial reporting (ICFR) considerations relating to leases.

This publication complements our Financial reporting developments (FRD) publications, ***Lease accounting: Accounting Standards Codification 842,* Leases** and ***Impairment or disposal of long-lived assets***, which provide in-depth discussions of ASC 842 and ASC 360-10, respectively. We refer to those publications as our ASC 842 FRD and ASC 360-10 FRD.

Lease reassessments, remeasurements and modifications

While a majority of stores have reopened and economic conditions have improved, some retailers are still struggling to generate the in-store cash flows that they were able to generate before the pandemic.

Retailers with leases that don't include enforceable rights to rent concessions in certain situations continue to negotiate with landlords to forgive or defer the due dates of their rent. As a result, some retailers are reaching agreements with their landlords to modify existing leases. Retailers may also consider exercising options to terminate leases early, even though they may have previously determined that they were reasonably certain to not exercise those options.

Rent concessions relating to the COVID-19 pandemic

In response to the challenges caused by the pandemic and its continued economic impact, many landlords already provided rent concessions to retailers for a significant number of lease contracts, although some landlords have been willing to wait for further clarity on the tenant's economic conditions.

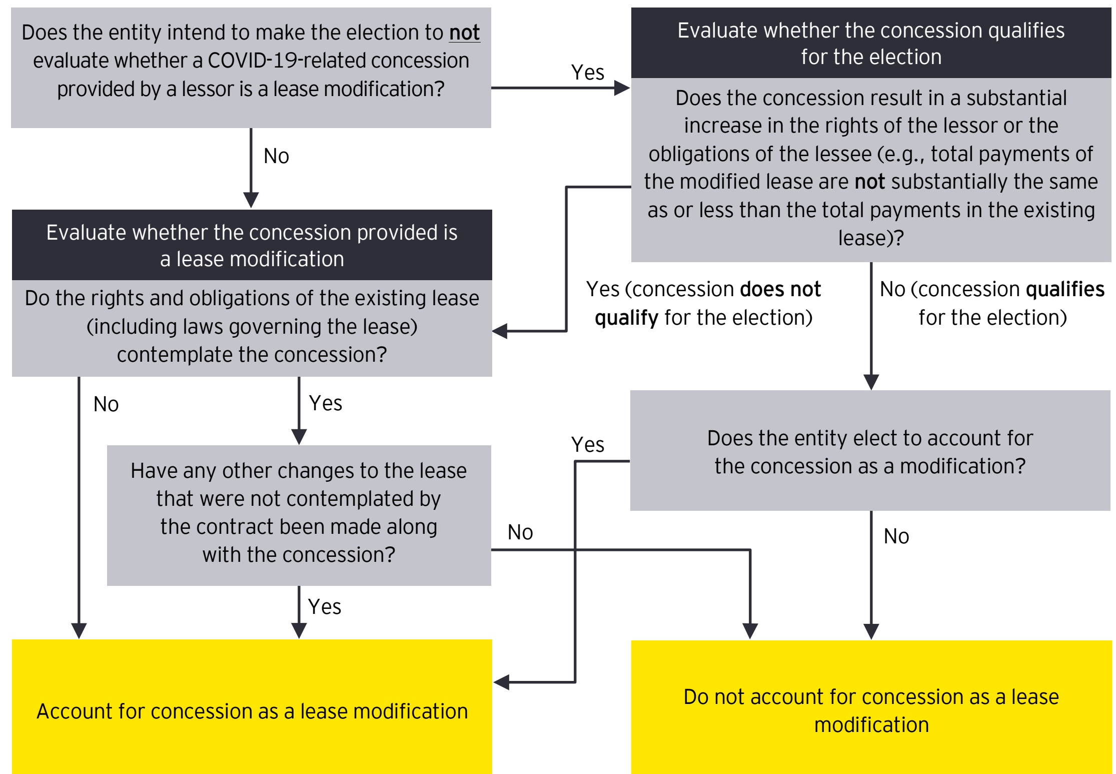
The staff of the Financial Accounting Standards Board (FASB) issued a **question-and-answer document** in 2020 that says entities can elect not to evaluate whether a concession provided by a lessor to a lessee in response to the effects of the COVID-19 pandemic is a lease modification.

Retailers that elect not to evaluate whether a concession is a modification can then elect whether to apply the lease modification guidance in ASC 842 to that concession (i.e., assume the COVID-19 related concession was always contemplated by the contract or assume the concession was not contemplated by the contract). The FASB staff said both lessees and lessors could make these elections, and these elections should be applied consistently to leases with similar characteristics and in similar circumstances, consistent with the overall objective described in ASC 842-10-10-1.

Retailers may make the elections for any lessor-provided concessions related to the effects of the COVID-19 pandemic (e.g., deferrals of lease payments, cash payments made to the lessee, reduced future lease payments) as long as the concession does not result in a substantial increase in the rights of the lessor or the obligations of the lessee. For example, retailers can make the election for concessions that result in the total payments required by the modified contract being substantially the same as or less than the total payments in the existing lease.

Retailers that don't make the elections need to apply the guidance in ASC 842 to determine whether a concession provided by a landlord should be accounted for as a lease modification. These retailers may find it operationally challenging to evaluate the rights and obligations of each contract and apply the lease modification guidance for concessions that were not contemplated in the existing lease.

The following flowchart depicts the decision-making process for determining how to account for a COVID-19-related concession provided by a lessor.



Retailers should also consider the disclosure objectives[1] in ASC 842 and provide disclosures that enable users to understand the nature and financial effect of material concessions provided that relate to the effects of the pandemic. Retailers that are Securities and Exchange Commission (SEC) registrants should also consider the SEC staff's guidance[2] on disclosing the effects of the COVID-19 pandemic and related risks. For example, we believe retailers should disclose both their accounting policies for elections that have a material effect on the financial statements and the effects of those elections.

How we see it

Retailers should make sure they have appropriate internal controls to account for rent concessions related to the effects of the COVID-19 pandemic, including controls over whether the concession qualifies for the election to not evaluate whether a rent concession is a modification, if they make the election. Further, companies should document their policy for accounting for the concessions and have controls over applying that policy consistently.

Refer to our ASC 842 FRD, for additional considerations and illustrations of the accounting for rent concessions relating to the pandemic.

Co-tenancy considerations

If a retailer does not elect to not evaluate whether rent concessions are lease modifications, it would need to consider any co-tenancy clauses in its leases. A co-tenancy clause in a lease can temporarily reduce a retailer's lease payments or change the lease payments from fixed payments to variable payments (e.g., payments based on a percentage of sales). These changes are triggered by certain events involving other tenants in the same shopping center. For example, a co-tenancy clause may be triggered if key tenants or a certain number of other tenants or those who occupy a certain amount of square footage vacate or close their stores. The effect of a co-tenancy clause when reassessing lease payments will depend on facts and circumstances.

We believe that any changes in lease payments resulting from a co-tenancy clause are temporary changes in lease payments that should be recognized as period lease costs, similar to variable lease payments, unless it is likely that the violation of the co-tenancy clause will not be resolved. That's because when the violation of the co-tenancy clause is resolved (e.g., the anchor tenant's store reopens, occupancy levels return to a stated percentage), the lease payments will revert to the previous amounts. For co-tenancy clauses triggered in the current environment, the rent reduction would likely be considered temporary unless the other economic factors result in significant permanent store closures.

However, in certain circumstances, when it is likely the co-tenancy clause will not be resolved (e.g., the lease space is an aging strip mall with a low likelihood of locating replacement tenants that comply with the clause), we believe a lessee may reasonably conclude it should remeasure the lease payments. In this example, the lease payments would be remeasured, resulting in a reduction to the existing lease liability.

Lease modifications under ASC 842

A retailer needs to evaluate whether changes to leases are modifications under ASC 842 if (1) the changes to a lease do not qualify for the election to not evaluate whether rent concessions are lease modifications, (2) the lessee does not elect to not evaluate whether rent concessions are lease modifications or (3) the changes made to the lease are not related to the effects of the COVID-19 pandemic.

ASC 842 defines a lease modification as a change to the terms and conditions of a contract that results in a change in the scope of a lease or the consideration.

Retailers that modify a lease first need to evaluate the modified contract to determine whether it still is or still contains a lease. If a lease continues to exist, a lease modification can result in either a separate contract or a change in the accounting for the existing lease.

In the current environment, most modifications will change the accounting for the existing lease and not result in a separate contract. That's because ASC 842 requires a modification to be accounted for as a separate contract only when the retailer receives an additional right of use and agrees to provide additional lease payments commensurate with the standalone price of that additional right of use.

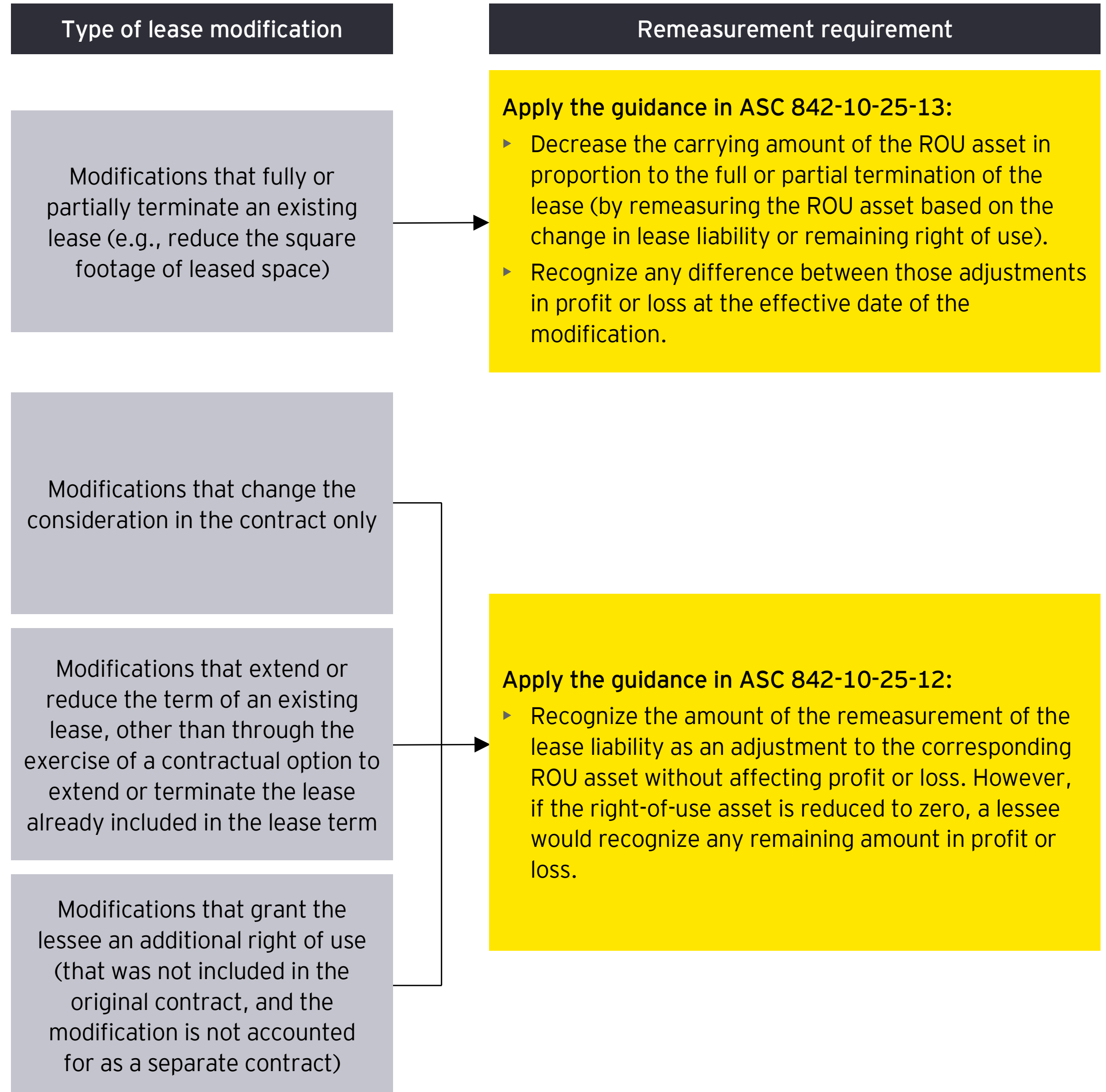
If the modification does not result in a separate contract, the retailer does the following as of the effective date of the modification:

Modifications require a retailer to remeasure and reallocate lease payments.

- Remeasures and reallocates the remaining consideration in the contract (reallocation is performed when there are multiple lease and non-lease components)
- Reassesses the lease term
- Reassesses the classification of the lease at the effective date of the modification, using the modified rights and obligations and the facts and circumstances as of that date, including:
  - The remaining economic life of the underlying asset on that date
  - The fair value of the underlying asset on that date
  - The discount rate for the lease on that date
  - The remeasured and reallocated remaining consideration in the contract on that date
  - The remeasured lease term and assessment of any lessee options to purchase the underlying asset as of that date
- Accounts for any initial direct costs, lease incentives and other payments made to or by the landlord

While calculating some of these amounts required judgment before the pandemic, these calculations will likely be more complex in the current environment, due to the uncertainties in the market. For example, to determine an appropriate discount rate (i.e., typically the retailer's incremental borrowing rate), a retailer would need to consider current interest rates and the entity's credit risk due to the continued economic impact of the pandemic.

The accounting for various types of modifications is described below:



Modification partially terminates an existing lease

A retailer may renegotiate a lease with the landlord to partially terminate an existing lease. For example, the two parties may agree to reduce the square footage of the leased space to 4,000 square feet from 5,000 square feet.

If a lease is fully or partially terminated, the retailer would remeasure and reallocate lease payments based on the guidance in ASC 842-10-25-13, which requires a lessee to decrease the carrying amount of the ROU asset by an amount that is proportionate to the partial termination of the existing lease (i.e., by remeasuring the ROU asset based on either the remaining right of use or the change in lease liability). Any difference between the adjustment to the ROU asset and the adjustment to the lease liability would be recognized in profit or loss at the effective date of the modification.

Illustration 1 — Retailer partially terminates an existing lease

On 1 January 2018, Retailer entered into a 10-year lease with Landlord for retail space in an enclosed shopping mall. The retail store is 5,000 square feet.

On 1 April 2020, Retailer and Landlord renegotiated the contract to reduce the square footage of the leased space to 4,000 square feet from 5,000 square feet and to reduce the lease payments. No other terms of the lease were modified.

On 1 April 2020, immediately before the parties signed the modified lease agreement, Retailer had a remaining ROU asset of $100,000 for the lease and a lease liability of $120,000. Based on the terms of the modified lease agreement, the lease liability is $90,000, which reflects the early termination of the right to use 1,000 square feet of space, the remaining consideration in the contract (based on the decreased lease payments) and a discount rate for the lease determined at the effective date of the modification. The classification of the lease did not change as a result of the modification.

Retailer may decide to remeasure the ROU asset based on the change in lease liability or remaining right of use.

Scenario A — remeasuring the ROU asset based on change in lease liability

Retailer accounted for the lease modification as a modification that is not accounted for as a separate contract.

The pre-modification ROU asset was $100,000. Retailer decreased the carrying amount of the ROU asset to reflect the partial termination of the lease based on the adjustment to the carrying amount of the lease liability, with any difference recognized in profit or loss.

The difference between the pre-modification liability and the modified lease liability was $30,000 ($120,000 − $90,000). That difference is 25% ($30,000 ÷ $120,000) of the pre-modification lease liability.

Therefore, at the effective date of the modification, Retailer reduced the carrying amount of the ROU asset by $25,000 (25% × $100,000). Retailer recognized the difference between the adjustment to the lease liability and the adjustment to the ROU asset ($30,000 − $25,000 = $5,000) as a gain.

Lease liability	$ 30,000 (a)	
ROU asset		$ 25,000 (b)
Gain from modification		$ 5,000 (c)

(a) Difference between the pre-modification liability ($120,000) and the modified lease liability ($90,000).

(b) Reduction of ROU asset based on the percentage change in lease liability (remaining ROU asset of $100,000 x 25% change in lease liability).

(c) Difference between the reduction in the lease liability ($30,000) and the proportionate reduction in the ROU asset ($25,000).

The following table illustrates the adjusted carrying values for the ROU asset and lease liability:

	ROU asset	Lease liability	Gain
Remaining carrying value prior to lease modification	$ 100,000	$ 120,000	
Reduction in carrying value based on change in lease liability	(25,000)	(30,000)	$ 5,000
Adjusted carrying value	$ 75,000	$ 90,000	

Scenario B — remeasuring the ROU asset based on the remaining right of use

Retailer accounted for the lease modification as a modification that is not accounted for as a separate contract.

The pre-modification ROU asset and lease liability were $100,000 and $120,000, respectively. Retailer decreased the carrying amount of the ROU asset by the same proportion as the decrease in square footage.

The difference in square feet leased between the pre-modification lease and the modified lease was 1,000 square feet (5,000 square feet — 4,000 square feet). That difference is 20% (1,000 square feet ÷ 5,000 square feet) of the pre-modification lease.

Therefore, at the effective date of the modification, Retailer reduced the carrying amount of the ROU asset by $20,000 (20% × $100,000) and reduced the carrying amount of the lease liability by $24,000 (20% × $120,000). Retailer recognized the difference between the reduction in the lease liability and the reduction in the ROU asset ($24,000 - $20,000 = $4,000) as a gain.

Lease liability	$ 24,000 (a)	
ROU asset		$ 20,000 (b)
Gain from modification		$ 4,000 (c)

(a) Reduction of lease liability in proportion to the reduction of leased space (remaining lease liability of $120,000 x 20% reduction in space).

(b) Reduction of ROU asset in proportion to the reduction of leased space (remaining ROU asset of $100,000 x 20% reduction in space).

(c) Difference between the reduction in the lease liability ($24,000) and the reduction in the ROU asset ($20,000).

Retailer then recognized the $6,000 difference between the remaining lease liability of $96,000 ($120,000 lease liability immediately before the modification less the reduction of $24,000) and the modified lease liability of $90,000 as an adjustment to the ROU asset reflecting the change in the consideration paid for the lease and the revised discount rate. Retailer records the following entry:

Lease liability	$ 6,000	
ROU asset		$ 6,000

The following table illustrates the adjusted carrying values for the ROU asset and lease liability:

	ROU asset	Lease liability	Gain
Remaining carrying value prior to lease modification	$ 100,000	$ 120,000	
Reduction in carrying value in proportion to reduction in space	(20,000)	(24,000)	$ 4,000
Adjusted carrying value (prior to remeasurement of lease liability)	$ 80,000	$ 96,000	
Change in consideration paid for the lease (and revised discount rate)	(6,000)	(6,000)	
Adjusted carrying value	$ 74,000	$ 90,000	

Modification changes the consideration in the contract only

A retailer may renegotiate a lease with a landlord that only changes the consideration in the contract (e.g., the landlord agrees to provide rent concessions to the retailer to help mitigate the effects of the COVID-19 pandemic).

If this is the case, the retailer would remeasure and reallocate lease payments based on the guidance in ASC 842-10-25-12, which requires the retailer to recognize the amount of the remeasurement of the lease liability as an adjustment to the corresponding ROU asset. Refer to Example 19 in ASC 842, which appears in section 4.6.5.5, *Modification only changes lease payments*, in our ASC 842 FRD, for an illustration of the accounting for this situation.

Modification extends or reduces the term of an existing lease

A retailer may renegotiate an extension or reduction of the term of an existing lease with a landlord that doesn't involve exercising a contractual option to extend or terminate the lease. For example, a retailer and a landlord may agree to increase the lease term to six years from five years in exchange for a reduction in monthly lease payments.

If this is the case, the retailer would remeasure and reallocate lease payments based on the guidance in ASC 842-10-25-12, which requires the retailer to recognize the amount of the remeasurement of the lease liability as an adjustment to the corresponding ROU asset. Refer to Example 16 in ASC 842, which appears in section 4.6.5.2, *Modification increases the lease term*, in our ASC 842 FRD, for an illustration of the accounting in this situation.

Relocating from one leased space to another leased space with the same landlord (added October 2020)

A retailer that terminates an existing contract and enters into a new lease arrangement for a different underlying asset with a different unrelated landlord generally should account for the change as a termination of the existing lease in accordance with ASC 842-20-40-1 (i.e., by removing the ROU asset and the lease liability from the balance sheet and recognizing the difference between the ROU asset and the lease liability in profit or loss) and the execution of a new lease. Refer to section 4.8.1, Lease termination, in our ASC 842 FRD for further discussion of lease terminations.

A retailer that terminates an existing lease and contemporaneously enters into a new lease arrangement (i.e., the new lease would not be executed and the existing lease would not be terminated without the other) for a substantively different underlying asset with the same landlord (or a related party of the landlord) generally should account for the change as a termination of the existing lease by removing the ROU asset and the lease liability from the balance sheet. Any difference between the ROU asset and the lease liability is included as part of the ROU asset of the new lease upon initial recognition, similar to a lease incentive or initial direct cost of the new lease. That is because ASC 842-10-25-19 states that an entity should combine two or more contracts, at least one of which is or contains a lease, entered into at or near the same time with the same counterparty (or related parties) and consider the contracts as a single transaction if the contracts are negotiated as a package with the same commercial objective(s).

A retailer that relocates from one leased space to another leased space should also consider the accounting effects of that change on any long-lived assets (e.g., leasehold improvements) at the old space. That is, a retailer that intends to abandon long-lived assets when it relocates to another space should determine whether its depreciation estimates must be revised (in accordance with the change in estimate guidance in ASC 250, *Accounting Changes and Error Corrections*) and whether the corresponding asset group is impaired (in accordance with ASC 360-10). A decision to abandon long-lived assets is generally an indicator of impairment.

The following example illustrates the retailer's accounting for relocating from one leased space to a smaller leased space with the same landlord, and the new lease would not be executed and the existing lease would not be terminated without the other (i.e., the two contracts with the same counterparty are combined in accordance with ASC 842). The

accounting treatment would be similar if the retailer relocated from one leased space to a larger leased space with the same landlord, and the new lease would not be executed and the existing lease would not be terminated without the other.

Illustration 2 — Relocating from one leased space to another leased space with the same landlord

On 1 January 20X0, Retailer (lessee) entered into a 10-year operating lease with Landlord for retail store A in an enclosed shopping mall. Retail store A is 10,000 square feet. The lease requires Retailer to make fixed monthly payments at the beginning of each month, but the amount increases each year. There are no initial direct costs or incentives associated with the lease, and there are no non-lease components in the contract.

On 1 January 20X2, Retailer and Landlord negotiate a new contract to terminate the lease for retail store A and contemporaneously sign a new lease for retail store B (i.e., the termination of the retail store A lease is dependent on the execution of the new retail store B lease). Retail store B is 5,000 square feet and is located in a more desirable location in the same shopping mall that Retailer believes will help increase foot traffic. The term of the new lease is eight years, consistent with the remaining term of the retail store A lease. There are no lease prepayments, initial direct costs or lease incentives associated with the retail store B lease, and there are no non-lease components in the contract.

On 1 January 20X2, immediately before the parties signed the new lease agreement, Retailer has a remaining ROU asset of $115,000 and a lease liability of $120,000. For simplicity, also assume that Retailer performs an impairment test and determines that the asset group that includes the ROU asset and leasehold improvements for retail store A is not impaired.

Based on the terms of the retail store B lease agreement, the initial measurement of the lease liability is $70,000, which represents the lease payments in the new lease, discounted using Retailer's incremental borrowing rate at the commencement date of the new lease.

Analysis

Upon execution of the new lease agreement, Retailer first needs to consider whether any leasehold improvements at retail store A will be abandoned and, if so, revise its depreciation estimates. Retailer should also reassess whether its grouping of long-lived assets continues to be appropriate.

Retailer then accounts for the change as a termination of the existing lease of retail store A by removing the ROU asset and the lease liability from the balance sheet and including any difference between the ROU asset and the lease liability as part of the ROU asset it recognizes related to the new lease of retail store B. Retailer records the following entry:

Lease liability (existing lease)	$ 120,000 (a)	
ROU asset (existing lease)		$ 115,000 (a)
ROU asset (new lease)	$ 65,000 (b)	
Lease liability (new lease)		$ 70,000 (c)

(a) Removal of remaining lease liability ($120,000) and ROU asset ($115,000) associated with existing lease of retail store A.

(b) Recognition of ROU asset associated with the new lease of retail store B ($70,000) less the difference between the lease liability and ROU asset from retail store A lease ($5,000).

(c) Recognition of lease liability associated with the new lease for retail store B.

Reassessment of the lease term (updated October 2020)

ASC 842 also requires lessees to monitor leases for significant changes that could trigger a change in the lease term. That is, lessees are required to reassess the likelihood that they will exercise a renewal or termination option at the point in time when any of the following events occurs:

- **Significant event or change in circumstance**: There is a significant event or significant change in circumstances within the lessee's control that directly affects whether the lessee is reasonably certain to (1) extend the lease, (2) not terminate the lease or (3) purchase the underlying asset.
- **Contractual event**: There is an event that is written into the contract that obliges the lessee to exercise or not to exercise an option to extend or terminate the lease.
- **Option exercised**: The lessee elects to exercise an option, even though it had previously determined that it was not reasonably certain to do so.
- **Option not exercised**: The lessee elects not to exercise an option, even though it had previously determined that it was reasonably certain to do so.

A drop in demand due to the economic impact of the COVID-19 pandemic would not, by itself, trigger a reassessment of the lease term.

It is important to note that a retailer affected by the economic impact of the COVID-19 pandemic cannot change its assessment of the lease term based on changes in market-based factors (e.g., a change in market rates to lease comparable assets, changes in expected market demand for an entity's products). Further, events or changes in circumstances that indicate that the carrying amount of an ROU asset may not be recoverable in accordance with ASC 360-10 that do not occur or arise as a result of an action that is within the control of the lessee do not, by themselves, trigger a reassessment of the lease term or a lessee option to purchase the underlying asset.

In other words, a sales decline resulting from temporary store closures or a drop in demand due to the economic impact of the pandemic would not, by itself, trigger a reassessment of the lease term because those are market-based factors that are beyond the retailer's control.

The following examples illustrate changes in market-based factors that are not in the retailer's control and, therefore, would not, by themselves, trigger a reassessment.

Illustration 3 — Changes in market-based factors that are indicators of impairment in accordance with ASC 360-10

Retailer experiences a decline in sales and negative cash flows at many of its stores due to the effects of the COVID-19 pandemic. Retailer identified these factors as indicators of impairment under ASC 360-10 and tested each of the related asset groups for recoverability under ASC 360-10.

Analysis

The decline in sales and negative cash flows are market-based factors that are not within the entity's control. While these indicators might trigger Retailer to perform the recoverability test in accordance with ASC 360-10, they would not, by themselves, trigger a reassessment of the lease term in accordance with ASC 842.

Illustration 4 — Changes in market-based factors that change a retailer's assessment of whether it is reasonably certain to terminate a lease early

Retailer enters into a 10-year lease of a retail store with a contractual option to terminate the lease after seven years. At lease commencement, Retailer is reasonably certain that it will not terminate the lease after seven years and concludes that the lease term is 10 years.

After experiencing declining market conditions during the first five years of the lease, Retailer believes that it is no longer reasonably certain it will not terminate the lease after seven years. However, Retailer decides to wait until it is contractually required to notify the landlord about whether it is electing to terminate the lease.

Analysis

Although Retailer now believes it is no longer reasonably certain to not terminate the lease after seven years, Retailer would not reassess the lease term. That is, if there are no significant events or significant changes in circumstances within Retailer's control that directly affect whether it is reasonably certain to terminate the lease early (e.g., communicating its irrevocable decision to the landlord about whether it will exercise the option, announcing that the store will permanently close), then there is no reassessment event in accordance with ASC 842.

Examples of significant events or significant changes in circumstances that are within the lessee's control include:

- Making a business decision that is directly relevant to the lessee's ability to exercise or not exercise an option (e.g., Retailer decides to permanently close a group of stores due to the economic impact of the pandemic)
- Constructing significant leasehold improvements that are expected to have significant economic value for the lessee when the option becomes exercisable
- Making significant modifications or customizations to the underlying asset
- Subleasing the underlying asset for a period beyond the exercise date of the option

Lease incentives (added October 2020)

A lease agreement might include incentives for a retailer to sign a lease, such as an up-front cash payment to the retailer, payment of costs for the retailer (such as moving expenses) or the assumption by the landlord of the retailer's preexisting lease with a third party. Lease incentives may be more common in the current environment as retailers attempt to renegotiate lease arrangements with their landlords.

Lease incentives that are paid or payable at lease commencement

Lease incentives that are paid or payable to a retailer at lease commencement (or on the effective date of a modification) are deducted from lease payments, which affects the lease classification test and reduces the initial measurement of the retailer's ROU asset. Lease incentives that are payable to the retailer at lease commencement (or on the date of a modification) also reduce a retailer's lease liability.

The following example illustrates a retailer's accounting for lease incentives that are paid to the retailer at lease commencement.

Illustration 5 — Lease incentives paid to a retailer at lease commencement

Retailer (lessee) leases retail space in a shopping center for 10 years. Retailer agrees to pay a fixed payment per year of $100,000, due in arrears. Retailer calculates the present value of the lease payments to be $772,000 at lease commencement, using a discount rate of 5%. Retailer incurs no initial direct costs. The lease is classified as an operating lease.

To incentivize Retailer to enter into the lease, the lessor pays Retailer $100,000 on the commencement date of the lease.

Analysis

Retailer records the ROU asset, lease liability and lease incentive on the commencement date as follows:

ROU asset	$ 672,000	
Cash	$ 100,000	
Lease liability		$ 772,000

The following journal entries would be recorded in Year 1:

Lease expense	$ 100,000	
Cash		$ 100,000

To record lease expense and cash paid.

ROU asset (amortization of lease incentive)	$ 10,000	
Lease expense (amortization of lease incentive)		$ 10,000

To record amortization of the lease incentive ($100,000 ÷ 10 years = $10,000).

Lease liability	$ 61,000	
ROU asset		$ 61,000

To adjust the lease liability to the present value of the remaining lease payments with an offset to the ROU asset. The adjustment of $61,000 is calculated as the initially recognized lease liability ($772,000) less the present value of the remaining lease payments ($711,000) at the end of Year 1.

The following example illustrates a retailer's accounting for lease incentives that are payable to the retailer at lease commencement.

Illustration 6 — Lease incentives payable to retailer at lease commencement

Assume the same facts as in Illustration 5. However, to incentivize Retailer to enter into the lease, the lessor agrees to pay Retailer $100,000 at the end of the first year of the lease. There is no contingency associated with Retailer's right to receive the payment.

Analysis

In this illustration, the lease incentive receivable reduces Retailer's lease payments by the $100,000 when initially measuring the ROU asset and lease liability at lease commencement:

ROU asset	$ 677,000	
Lease liability		$ 677,000

To record the ROU asset and lease liability at commencement. The lease liability of $677,000 is calculated as the 10 $100,000 payments less the $100,000 receivable from the lessor due in one year, discounted at 5%.

The following journal entries would be recorded in Year 1:

Lease expense	$ 100,000	
Cash		$ 100,000

To record lease expense and cash paid.

Cash	$ 100,000	
Lease liability		$ 100,000

To record the cash incentive received.

ROU asset (amortization of lease incentive)	$ 10,000	
Lease expense (amortization of lease incentive)		$ 10,000

To record amortization of the lease incentive ($100,000 ÷ 10 years = $10,000).

Lease liability	$ 66,000	
ROU asset		$ 66,000

To adjust the lease liability to the present value of the remaining lease payments with an offset to the ROU asset. The adjustment of $66,000 is calculated as the initially recognized lease liability ($677,000) plus the adjustment to the lease liability resulting from the cash receipt of the lease incentive ($100,000) less the present value of the remaining lease payments ($711,000) at the end of Year 1.

Lease incentives that are neither paid nor payable at lease commencement

A lease incentive is neither paid nor payable at lease commencement or on the effective date of a modification if the timing and amount of payment from the landlord depend on future events (e.g., the timing and amount of the qualified costs a retailer incurs to construct leasehold improvements). ASC 842 does not provide guidance on how to recognize these types of lease incentives. We believe the following approaches would be acceptable:

- Approach 1: If a lease specifies a maximum level of reimbursement (e.g., for constructing leasehold improvements) and the retailer is reasonably certain to incur reimbursable costs equal to or exceeding this level, the amount would be deemed payable by the lessor at the commencement date and it would be included in the measurement of the consideration in the contract at commencement. Therefore, the amount would be recognized as a reduction in the ROU asset and lease liability.
- Approach 2: Once a retailer has incurred costs and the amounts qualify for reimbursement by the lessor, the retailer would reduce the ROU asset and lease liability by the costs incurred. The reduction to the ROU asset would be recognized prospectively over the remainder of the lease term.
- Approach 3: Once a retailer has incurred costs and the amounts qualify for reimbursement by the lessor, the retailer would reduce the ROU asset and lease liability by the costs incurred, as in Approach 2. But in this approach, the reduction to the ROU asset would be recognized as a cumulative catch-up adjustment to expense, as if the incentive were paid or payable at the lease commencement date.

Refer to Illustrations 2-8, 2-9 and 2-10 in our ASC 842 FRD for examples of the accounting for lease incentives that are neither paid nor payable at lease commencement.

Improvements to leased property (added October 2020)

Retailers that are building out newly leased space or repurposing existing leased space (e.g., converting a traditional retail location into a "dark store" used only for distribution or fulfillment activities) need to consider the accounting for any new leasehold improvements.

Whether improvements are lessee or lessor assets

Retailers should evaluate whether improvements made to the leased property are lessee or lessor assets because the determination affects whether a lessor payment to the lessee for the improvements is a lease incentive or a reimbursement of the costs incurred by the lessee to build out the space on the lessor's behalf.

For example, if a retailer leases general purpose retail space and has its own contractor build specific improvements to make the store look like the others it operates around the Country (i.e., the improvements are lessee assets), any amounts the lessor provides to pay a portion of the cost will generally be viewed as an incentive.

If a retailer leases fully built-out space and incurs costs to construct the space on the lessors' behalf (e.g., a floor in an office building with interior walls and lighting), a lessor's payment to the retailer for lessor improvements may be a reimbursement of the costs incurred by the retailer. If a retailer is not reimbursed for payments it makes or costs it incurs on a lessor's behalf, those amounts are considered noncash lease payments.

In many instances, judgment will be required to determine whether a retailer is constructing lessee improvements (i.e., leasehold improvements) or lessor improvements (i.e., leasing built-out space). Examples of factors that would be considered in making the determination of whether improvements are lessee or lessor assets include:

- What happens to the improvements at the end of the lease term (i.e., whether they are removed or preserved for the landlord)
- Whether the improvements are unique (e.g., they include the decor and logo of a national retail chain rather than general purpose improvements)
- Which party is supervising construction (i.e., whether the lessee is acting as an agent during the construction period or is actively involved in the design of the improvements)
- Which party bears all costs of the improvements (including the risk of cost overruns)
- Which party owns the improvements

Amortization of leasehold improvements

ASC 842 requires lessees to amortize leasehold improvements over the shorter of the useful life of those leasehold improvements or the remaining lease term. However, if the lease transfers ownership of the underlying asset to the lessee or the lessee is reasonably certain to exercise an option to purchase the underlying asset, leasehold improvements are amortized over their useful life. The accounting for the amortization of leasehold improvements should be consistent with the lease term.

Leasehold improvements placed in service after lease commencement

As discussed in the *Reassessment of the lease term* section, a lessee is required to monitor events that could trigger a change in the lease term. One example would be a retailer's construction of significant leasehold improvements (e.g., in the eighth year of a 10-year lease) that are expected to have significant economic value for the retailer when a renewal

option becomes exercisable. Regardless of when they are constructed, leasehold improvements (associated with an operating lease) should be amortized over the lesser of the remaining useful life of the asset(s) or the remaining lease term (after reassessment).

For example, Retailer A enters into a 10-year lease (determined to be an operating lease) with a five-year renewal option. At the commencement date of the lease, Retailer A determined that the lease term was 10 years (i.e., it determined that it was not reasonably certain to exercise the five-year renewal option). Leasehold improvements placed in service at or near the commencement date of the lease are amortized over the shorter of their useful life or 10 years. In year eight, the retailer remodels the store and adds extensive leasehold improvements. Retailer A reassesses the lease term and determines that it is now reasonably certain that it will exercise the five-year renewal option, and the remaining lease term is now seven years. Retailer A would amortize the leasehold improvements added in year eight over the shorter of their useful life or seven years (i.e., the revised remaining lease term consists of two remaining years of the original lease term plus five additional years related to the renewal option). The lessee would also reassess the amortization period for those leasehold improvements placed into service at or near commencement of the lease, which in the example above was the original 10-year term.

Judgment is required to analyze the facts, including the nature of the expenditures, to determine whether reassessment of the lease term is required and what the appropriate amortization period is.

Impairment of ROU assets or other long-lived assets

A retailer that has significantly modified its operations, experienced significant supply chain disruptions or has not been able to realize forecasted sales in the current environment may consider those factors indicators that would trigger an assessment of whether the related asset group is impaired.

Under ASC 360-10, the impairment evaluation of long-lived assets to be held and used involves three steps.

Step 1: indicators of impairment

A long-lived asset or asset group must be tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. ASC 360-10-35-21 provides examples of these events or changes in circumstances. Additional indicators for retailers may include the following:

- Negative cash flows or declines in other financial metrics, such as earnings before interest, taxes, depreciation and amortization (EBITDA)
- Declines in same-store sales or revenue projections
- Retail store sales or gross profit that falls short of target
- Planned permanent store closures
- Significant negative industry trends or an economic downturn
- Macroeconomic matters negatively affecting a specific market (e.g., negative conditions in a geographic area, unfavorable currency fluctuations)

While determining whether an asset group needs to be tested for recoverability has always required judgment, this evaluation will likely be more difficult in the current environment, considering supply chain issues and the accelerated shift to online shopping have resulted in negative store cash flows or declines in other financial metrics.

Step 2: test for recoverability

If impairment indicators are present, or if other circumstances indicate that an impairment might exist, retailers must perform a recoverability test to determine whether an impairment loss should be measured.

Grouping long-lived assets (and applicable liabilities)

To perform the recoverability test, a retailer must determine the asset group. ASC 360-10 defines an asset group as "the 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."

Grouping assets requires a significant amount of judgment. Retailers typically determine that an individual retail store is the appropriate level at which to group assets to test for and measure impairment because it represents the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities. However, a retailer may determine that it is appropriate to include more than one store in an asset group in the following situations:

- Flagship stores may be included in an asset group with multiple stores because they provide benefits to support the retailer's other stores in that area (e.g., advertising, marketing) and they typically are expected to generate losses due to factors such as significant development costs or high rents to secure prime site locations.
- Stores in close proximity may be evaluated as a group if, for example, one of them is used to test new merchandise or services for a particular market by selling it at or below cost and the cost of operating that store is being funded by revenue-producing activities at other stores in the market.
- Distribution and fulfillment centers may be included in an asset group with stores that they support.
- Off-price liquidation channel stores may be included in an asset group with full-price stores because the off-price stores liquidate inventory that cannot be sold at the full-price stores.
- A retailer's corporate office that doesn't have identifiable cash flows that are largely independent of the cash flows of other assets and liabilities or other asset groups may be grouped with assets and associated liabilities at an entity-wide level (i.e., the asset group for that long-lived asset should include all assets and liabilities of the entity).

How an entity determines asset groups depends on its facts and circumstances. While the guidance is clear that assets must be grouped at the lowest level for which there are identifiable cash flows, determining that level requires considerable judgment (ASC 360-10-55-35). Retailers should consistently apply a methodology and approach for grouping long-lived assets.

When determining the asset group, retailers also need to consider whether it is appropriate to include goodwill. If long-lived assets tested for impairment under ASC 360-10 are grouped at or above the reporting unit level, any goodwill in that reporting unit is included in the asset group for the purpose of performing the recoverability test. If the asset group only includes a part of the reporting unit, goodwill would not be allocated to the asset group for the purpose

of performing the recoverability test. Estimates of future cash flows used to test that lower-level asset group for recoverability are not adjusted for the effect of excluding goodwill from the group.

Estimating the future net undiscounted cash flows for that asset group

After determining the asset group, a retailer must estimate the future net undiscounted cash flows expected to be generated from the use of the long-lived asset group and its eventual disposal.

Predicting future cash flows may be difficult for many retailers in the current environment because it isn't clear (1) at what rate customers will return to in-store shopping, (2) how long supply chain issues and the changes in the mix of products will continue to affect margins and (3) whether stores will need to be temporarily closed again.

Depending on the facts and circumstances of each of the retailer's leases (e.g., remaining lease term, store location), retailers may need to consider multiple outcomes and perform a probability-weighted analysis to estimate expected future cash flows (refer to the *Probability-weighted cash flow approach* section below).

Estimates of future cash flows used to test the recoverability of a long-lived asset group include only future cash inflows less associated cash outflows that are directly associated with and that are expected to arise as a direct result of the use and eventual disposition of the asset group. Such estimates should incorporate the entity's own assumptions about its use of the asset group and consider all available evidence. The estimates of cash flows for performing a recoverability test are undiscounted.

Determining expected future cash flows will be difficult for retailers in the current environment.

ASC 360-10 does not address what is meant by "directly associated." Therefore, we believe retailers should make well-reasoned determinations about the types of store-level cash flows used in a recoverability test. Retailers should consider whether cash flows from the following are directly associated with the use of the asset group:

- Store payroll costs
- Visual display costs
- Information technology costs
- Advertising costs
- Purchasing costs
- Warehouse costs
- E-commerce sales (which may include services where customers buy online and pick up goods at a store)
- Returns of e-commerce purchases

Probability-weighted cash flow approach (updated October 2020)

When estimating the future net undiscounted cash flows for an asset group, retailers may need to assess the likelihood of various possible outcomes in their cash flow forecasts. ASC 360-10 allows retailers to use either a single most likely estimate of expected future cash flows (often referred to as a traditional or best-estimate approach) or a range of possible outcomes (often referred to as a probability-weighted approach). However, if a probability-weighted approach is used, the retailer needs to consider the likelihood of the possible outcomes in determining the best estimate of future cash flows. While an entity is not required to use the probability-weighted approach, we expect many retailers to do so in the current environment.

Illustration 7 — Probability-weighted cash flows in the test for recoverability

Retailer (lessee) entered into a noncancelable 10-year lease of a retail store in a freestanding building. After experiencing adverse market conditions related to the pandemic, Retailer concludes that the uncertainties in the market constitute an event or change in circumstances that indicates that the carrying amount of the asset group, which includes the ROU asset and other long-lived assets, may not be recoverable at the end of the second year of the lease and, therefore, needs to be tested for recoverability.

At that date, management considers the likelihood of the following two possible outcomes in determining the best estimate of future cash flows:

- Retailer believes the adverse market conditions are temporary and expects the financial performance of the store to improve. That is, Retailer expects to continue operating the store for the remaining lease term.
- Retailer believes the adverse market conditions will persist and plans to close the store at the end of the third year of the lease. Retailer will actively market the leased asset to be subleased for the remaining seven years of the lease term.

The possible cash flows associated with each of these possibilities are $140,000 and $55,000, respectively. They are developed based on Retailer's own entity-specific assumptions about future sales and costs in various scenarios that consider changes in economic (market) conditions, the likelihood that existing customer relationships will continue and other relevant factors.

The following table shows the possible cash flows associated with each of the possibilities:

Possible outcome	Cash flows	Probability assessment	Possible cash flows (probability weighted)
(In thousands)			
Continue operating store	$ 200	20%	$ 40
	140	50	70
	100	30	30
			$ 140
Close and sublease store (a)	$ 100	20%	$ 20
	50	70	35
	0	10	0
			$ 55

(a) The cash flows that are reflected here assume that Retailer excludes the operating lease liability from its asset group and, therefore, also excludes the fixed lease payments (assuming that the lease does not have any non-lease components) from its entity-specific cash flows. Refer to the *Treatment of operating lease liabilities in the recoverability test* and *Treatment of cash outflows for operating lease payments in the recoverability test* sections below for a discussion on how operating lease liabilities and future cash outflows for lease payments should be considered in the recoverability test.

As indicated in the following table, management further considers the likelihood of each possible outcome occurring, determining that there is a 40% chance it will continue operating the store for the remainder of the lease term and a 60% chance it will permanently close and sublease the store.

Possible outcome	Possible cash flows (probability weighted)	Probability assessment (possible outcome)	Expected cash flows (undiscounted)
(In thousands)			
Continue operating store	$ 140	40%	$ 56
Close and sublease store	55	60	33
			$ 89

As a result of this probability analysis, the undiscounted expected cash flows used to test the retail store for recoverability would be $89,000.

Cash flow estimation period (updated October 2020)

The cash flow estimation period is based on the long-lived asset group's remaining useful life to the entity. Because retailers often determine that an individual retail store is an asset group, the cash flow estimation period for that asset group is generally the remaining lease term for the store (i.e., the ROU asset will generally have a remaining useful life that is the same as the remaining lease term).

However, retailers that determine a long-lived asset group comprises multiple leased stores with different lease terms will need to identify which of the long-lived assets in the group is the primary asset (i.e., the principal long-lived tangible asset being depreciated or identifiable intangible asset being amortized that is the most significant component asset from which the group derives its cash-flow-generating capacity). The remaining useful life (and, therefore, estimation period) of an asset group with multiple assets is based on the remaining useful life of the primary asset of the group.

Factors that a retailer should consider in determining whether a long-lived asset is the primary asset of an asset group include the following:

- Whether other assets of the group would have been acquired by the retailer without the asset
- The level of investment that would be required to replace the asset
- The remaining useful life of the asset relative to other assets of the group

If the primary asset is not the asset with the longest remaining useful life, estimates of future cash flows for the group should assume the sale (or sublease) of the remaining assets in the group at the end of the remaining useful life of the primary asset.

Estimates of future cash flows should include any cash inflows and outflows that are necessary to maintain the existing service potential of assets other than the primary asset of an asset group (ASC 360-10-35-33).

Illustration 8 — Asset group with multiple ROU assets

Retailer (lessee) enters into a 20-year lease for retail space in a premier location for its flagship store and a 10-year lease for additional retail space near the flagship store.

Retailer determines that the cash flows associated with the flagship store are not independent of the cash flows of the additional retail store because the costs associated with the flagship store provide benefits to the nearby retail store (e.g., advertising, marketing). Therefore, Retailer determines that the lowest level of identifiable cash flows results in a single asset group that includes the ROU asset of the leased flagship store (lease term of 20 years) and the ROU asset of the additional leased retail store (lease term of 10 years) as well as other assets and liabilities.

After experiencing adverse market conditions, Retailer concludes that the uncertainties and volatilities in the market constitute an event or change in circumstances that indicates the carrying amounts of the ROU assets and other long-lived assets in the asset group may not be recoverable at the end of the second year of the lease; therefore, the asset group is tested for recoverability.

Analysis

Retailer determines that the ROU asset for the flagship store is the primary asset because of the level of investment that would be required to replace the asset and because it has the longest remaining useful life of the long-lived assets in the asset group. Retailer will therefore estimate cash flows over the remaining lease term of the primary asset (i.e., 18 years).

Retailer also must consider any cash flows that are likely to occur beyond the lease term of the other retail store. That is, if Retailer is likely to renew the lease of the additional retail store, it should include any cash outflows it expects to incur (consistent with its policy for including or excluding operating lease liabilities, as discussed in the *Treatment of operating lease liabilities in the recoverability test* and *Treatment of cash outflows for operating lease payments in the recoverability test* sections below) and cash inflows it expects to generate during the remaining useful life of the primary asset of the group (i.e., the remaining lease term of the flagship store).

Timing of estimates

If the long-lived asset is tested for impairment as of the balance sheet date, the estimates of future cash flows used in the recoverability test would be based on the conditions that existed at the balance sheet date, including any assessment made at the balance sheet date about the likelihood and timing of a permanent store closure or sale of the property. The assessment at the balance sheet date would not be revised solely because the entity later decided to close the store permanently or other conditions (e.g., unfavorable market trends) arose after the balance sheet date.

Applying these provisions is often difficult in practice. ASC 360-10 notes that because it is difficult not to use hindsight when assessing conditions that existed at a prior date, it is important that judgments about those conditions, the need to test a long-lived asset or disposal group for recoverability, and the application of a recoverability test be made and documented together with supporting evidence on a timely basis.

Treatment of operating lease liabilities in the recoverability test

ASC 360-10 provides principles for evaluating long-lived assets for impairment, but it does not specifically address how lease liabilities should be considered in the recoverability test. Under ASC 360-10, financial liabilities (e.g., long-term debt) generally are excluded from an asset group, and operating liabilities (e.g., accounts payable) generally are included.

ASC 842 characterizes operating lease liabilities (i.e., the lessee's obligation to make lease payments, measured on a discounted basis) as operating liabilities. In the Background Information and Basis for Conclusions (BC 264) of Accounting Standards Update (ASU) 2016-02, *Leases (Topic 842)*, the FASB noted that while both operating and finance lease liabilities are financial liabilities, finance lease liabilities are the equivalent of debt, and operating lease liabilities are operating in nature and not "debt like." Because operating lease liabilities may be viewed as having attributes of finance liabilities as well as operating liabilities, we believe it is acceptable for a retailer to either include or exclude operating lease liabilities from an asset group when testing whether the carrying amount of an asset group is recoverable.

Treatment of cash outflows for operating lease payments in the recoverability test

ASC 360-10 does not specifically address how future cash outflows for operating lease payments should be considered in the recoverability test. The FASB staff said in response to a technical inquiry that if a lessee includes an operating lease liability as part of the carrying amount of the asset group, only the principal component of future lease payments would be included as an outflow in the undiscounted future cash flows used to test recoverability of the asset group. That is, the lessee would include the future cash lease payments for the lease, excluding the component that effectively represents the accretion of the lease liability (even though interest expense is not recognized separately for an operating lease). As a result, we believe a lessee's decision to include or exclude operating lease liabilities from an asset group generally should not affect the outcome of its recoverability test. Refer to Illustration 2-13 in our ASC 360-10 FRD, ***Impairment or disposal of long-lived assets***, for more information.

In summary, if a retailer includes operating lease liabilities in its asset group, it should include only the principal component of future cash lease payments in the undiscounted future cash flows. If it excludes operating lease liabilities from its asset group, it should exclude all future cash lease payments for the lease.

ASC 842 requires lessees to exclude certain variable lease payments from lease payments and, therefore, from the measurement of a lessee's lease liabilities. Because these payments do not reduce a lessee's lease liability, we believe the variable payments a lessee expects to make should be included in a lessee's estimate of undiscounted cash flows in the recoverability test (Step 2), regardless of whether the lessee includes or excludes operating lease liabilities from the asset group. How these payments are included in the lessee's estimate of future cash flows will depend on the cash flow estimation approach (e.g., probability weighted, best estimate) it uses. We also believe these variable lease payments should be included when measuring an impairment (Step 3) if the lessee uses a discounted cash flow approach.

See section 2.3.2 of our ASC 360-10 FRD for further discussion of considerations related to estimates of future cash flows used to test a long-lived asset group for recoverability.

Performing the test for recoverability

Once undiscounted cash flows are estimated for a long-lived asset group being evaluated for recoverability, they are compared to the carrying amount of the asset group.

If the estimated undiscounted cash flows exceed the carrying amount of the asset group, the long-lived asset group is recoverable, and an impairment does not exist.

However, if the estimated undiscounted cash flows are less than the carrying amount of the long-lived asset group, the long-lived asset group is not recoverable and the fair value of the long-lived asset group must be determined.

How we see it

If the fair value of the long-lived assets in an asset group appears to be less than the assets' carrying amount, the retailer should not measure and record a long-lived asset impairment unless it first determines that the carrying amount of the asset group is not recoverable (i.e., an entity must first perform and fail the Step 2 recoverability test before measuring an impairment in Step 3).

Step 3: measurement of an impairment

If the undiscounted cash flows used in the recoverability test are less than the long-lived asset group's carrying amount, a retailer is required to determine the fair value of the long-lived asset group and recognize an impairment loss if the carrying amount of the long-lived asset group exceeds its fair value.

Cash flows used to determine fair value

While the undiscounted cash flows used in the recoverability test (Step 2) are based on an entity's own assumptions, the discounted cash flows used to determine fair value when determining the impairment loss (Step 3) must be based on assumptions that market participants would use in their estimates of fair value. As a result, retailers are not able to simply apply a discount rate to the cash flows used in Step 2 to determine fair value without first determining whether those cash flows reflect the expectations of market participants. Retailers may use their own assumptions as a starting point in developing market participant assumptions and apply reasonable judgment in analyzing whether their assumptions are representative of market participant assumptions.

Treatment of operating lease liabilities in measurement of impairment

We believe that if a lessee excludes operating lease liabilities from the asset group when performing the recoverability test, it also should exclude operating lease liabilities from the asset group when measuring the group's fair value. Alternatively, if a lessee includes operating lease liabilities in the asset group when performing the recoverability test, it also should include operating lease liabilities in the asset group when determining the group's fair value.

If the fair value of the asset group is determined based on discounted cash flows, the market participant cash flows should be adjusted to align with an entity's decision to include or exclude operating lease liabilities in the carrying amount of the asset group. If the carrying amount of the asset group includes operating lease liabilities, the market participant discounted cash flows used to estimate fair value should include both principal and interest payments, unlike the cash flows used in the recoverability test, which, as discussed above, exclude the component of the operating lease payments that represents the accretion of the lease liability.

While we may not expect including or excluding the lease liability to cause significant differences in the measurement of impairments, measurement differences could exist in some situations (e.g., due to decreases in the fair value of the lease liability relative to its carrying amount). Refer to Illustration 2-14 in our ASC 360-10 FRD for more information and examples.

Determining fair value

While determining the fair value of ROU assets or other long-lived assets required judgment before the COVID-19 pandemic, this determination will likely be more complex in the current environment because retailers will need to consider the uncertainties and volatility in the market.

For example, determining current market rents for a lease might be difficult due to the lack of comparable information (i.e., lack of recently executed leases). Calculating a market participant discount rate may also be more challenging because of current interest rates and the entity's credit risk due to the economic impact of the pandemic. Retailers will need to consider the expectations of market participants when determining the fair value of ROU assets or other long-lived assets.

ASC 820, *Fair Value Measurement*, defines the term fair value and provides a principles-based framework for measuring fair value when US GAAP requires or permits a fair value measurement. The objective of a fair value measurement is to determine the price at which an orderly transaction would take place between market participants under the market conditions that existed at the measurement date. While volatility in the financial markets may suggest that the prices are aberrations and do not reflect fair value, it would not be appropriate for a company to disregard market prices at the measurement date unless those prices are from transactions that are not orderly.

The concept of an orderly transaction is intended to distinguish a fair value measurement from the price in a distressed sale or forced liquidation. The intent is to convey the current value of the asset or liability at the measurement date, not its potential value at a future date.

For long-lived asset groups that have uncertainties both in timing and amount of cash flows, an expected present value technique (e.g., discounted cash flow analysis) will often be the appropriate technique to use to estimate fair value.

Determining the fair value of ROU assets will likely require significant judgment.

See section 2.4 of our ASC 360-10 FRD for guidance on the application of ASC 820 when determining fair value measurements related to the impairment or disposal of long-lived assets. Also refer to our FRD, ***Fair value measurement***, for detailed guidance regarding the application of ASC 820.

Retailers should consider the following matters when measuring impairment:

- They need to determine who the relevant market participants are for the fair value analysis (e.g., whether the store will continue to be operated in its current use or permanently closed and subleased).
- To perform a discounted cash flow analysis, they need to apply a discount rate that reflects the expectations of a market participant. These expectations will likely differ from the incremental borrowing rate used to calculate the lease liability and, therefore, the ROU asset in the asset group.
- They should consider using a specialist to assist with the valuation when the ROU asset is material or management lacks in-house real estate expertise.

How we see it

In response to the economic impact of the COVID-19 pandemic, retailers need to consider whether to adjust the assumptions used to determine fair value (e.g., discount rate, market rent, rent growth, downtime). For example, retailers may need to increase the discount rate to reflect the additional uncertainty inherent in the projected cash flows of the discounted cash flow analysis in the current environment.

While we believe the economic impact of the pandemic is affecting commercial real estate values, the magnitude and timing of the effect is unclear. Determining the fair value of ROU assets or other long-lived assets likely will require judgment, and a retailer may want to engage external specialists to assist with the evaluation.

Allocation of an impairment loss

An impairment loss should reduce only the carrying amount of the long-lived assets of the group that are covered by ASC 360-10. Thus, goodwill, indefinite-lived intangibles or other assets (e.g., inventory) excluded from the scope of ASC 360-10 (or liabilities, if part of an asset group) will not be affected by an impairment loss recognized under ASC 360-10, even if those assets or liabilities are included in the asset group being tested for recoverability. The carrying amounts of any assets and liabilities, except for goodwill, that are not covered by ASC 360-10 but are included in an asset group should be adjusted in accordance with other applicable US GAAP topics before testing the asset group for recoverability. ASC 350-20-35-31 requires that goodwill be tested for impairment only after the carrying amounts of the other assets of the reporting unit, including the long-lived assets covered by ASC 360-10, have been tested for impairment under other applicable accounting guidance.

The impairment loss should reduce the carrying amount of long-lived assets of a group covered by ASC 360-10 on a pro rata basis using the relative carrying amounts of those assets. However, the carrying amount of a long-lived asset of the group would not be reduced below its fair value, if it is determinable without undue cost and effort.

Illustration 9 — Allocation of impairment loss

Retailer operates a leased retail store that, together with other assets and liabilities, is tested for recoverability as a group. In addition to the ROU asset, leasehold improvements and fixtures (the long-lived assets), the asset group includes inventory, which is measured based on the guidance in ASC 330-10-35, and other current assets and liabilities. Retailer has elected to exclude operating lease liabilities from the asset group. The $2.75 million aggregate carrying amount of the asset group is not recoverable and exceeds its fair value by $600,000. The impairment loss of $600,000 would be allocated as shown below to the long-lived assets of the group.

Asset group	Carrying amount	Pro rata allocation factor	Allocation of impairment (loss)	Adjusted net carrying amount
(In thousands)				
Current assets	$ 400	–	$ –	$ 400
Liabilities	(150)	–	$ –	$ (150)
Long-lived assets:				
ROU asset	$ 1,800	72%	$ (432)	$ 1,368
Leasehold improvements	500	20	(120)	380
Fixtures	200	8	(48)	152
Subtotal — long-lived assets	2,500	100%	(600)	1,900
Total	$ 2,750		$ (600)	$ 2,150

If the fair value of an individual long-lived asset in an asset group is determinable without undue cost and effort and exceeds the adjusted carrying amount of that asset after an impairment loss is allocated initially, the excess impairment loss initially allocated to that asset (i.e., the amount by which fair value exceeds the adjusted carrying amount) would be reallocated to the other long-lived assets of the group. For example, if the fair value of the ROU asset is $1,468,000, the excess impairment loss of $100,000 initially allocated to that asset (based on its adjusted carrying amount of $1,368,000) would be reallocated as shown below to the other long-lived assets in the asset group (i.e., leasehold improvements and fixtures) on a pro rata basis using the relative adjusted carrying amounts of those assets.

Long-lived assets of asset group	Adjusted carrying amount	Pro rata reallocation factor	Reallocation of excess impairment (loss)	Adjusted carrying amount after reallocation
(In thousands)				
Leasehold improvements	$ 380	71%	$ (71)	$ 309
Fixtures	152	29	(29)	123
Subtotal — long-lived assets	532	100%	(100)	432
ROU asset	1,368		100	1,468
Total	$ 1,900		$ –	$ 1,900

In this illustration, the excess impairment on the ROU asset of $100,000 is reallocated to the other long-lived assets in the asset group (i.e., leasehold improvements and fixtures). When reallocating the excess impairment, the carrying amounts of the other long-lived assets also cannot be reduced below their respective fair values. If the initial allocation of the impairment loss already reduced the carrying amounts of the other long-lived assets in the asset group to their respective fair values, the total impairment loss measured cannot be recognized, because the carrying amount of an individual asset cannot be reduced below its fair value. As a result, the total impairment loss recognized would only be $500,000.

If an entity believes that it cannot record the entire impairment loss measured for an asset group because doing so would result in the individual long-lived assets being recorded at amounts below their respective fair values, we believe the entity should first reevaluate the carrying amounts of other assets and liabilities outside of the scope of ASC 360-10 in accordance with ASC 360-10-35-27. If necessary, the entity should then reevaluate its determination of the fair values of the individual long-lived assets in the asset group.

Abandonment of the ROU asset (updated October 2020)

Determining whether the ROU asset is abandoned

A retailer that decides to cease using a leased asset, either immediately or at a future date (e.g., in 12 months), needs to assess whether the corresponding ROU asset is or will be abandoned. A plan to abandon an ROU asset is considered an indicator of impairment under ASC 360-10 that results in the lessee evaluating the ROU asset (asset group) for recoverability and may also result in the lessee reassessing the lease term and classification under ASC 842. Evaluating a lessee's intent and ability to sublease a leased asset is an important factor in determining whether the leased asset has been or will be abandoned.

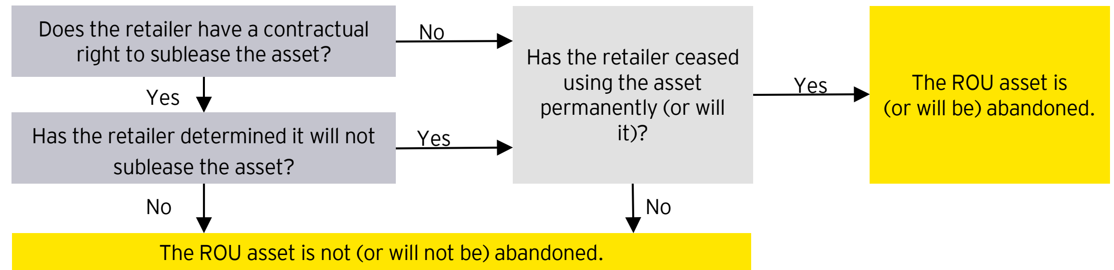
If the retailer doesn't have a contractual right to sublease the underlying asset and the retailer's cease use of the asset is not temporary, the ROU asset is abandoned at the date the retailer ceases using the underlying asset.

A retailer that has a contractual right to sublease the asset will need to consider the facts and circumstances of the lease and its planned remaining use of the underlying asset. If the retailer plans to sublease the underlying asset, it is not abandoning the ROU asset. ASC 842-10-15-17 states that economic benefits from using an asset include subleasing the asset. A retailer that decides to sublease an asset and obtains those economic benefits has not abandoned the ROU asset. However, a decision to sublease the underlying asset still may be an indicator of impairment or indicate a change in the asset grouping.

A retailer that has ceased use of the leased asset and will not sublease it or use it for other purposes (e.g., storage) generally has abandoned the asset. However, if the retailer does not currently plan to sublease or otherwise use the asset but may sublease it in the future (e.g., a retailer may wait to make final decisions until existing economic conditions change or use its

right to not sublease as a negotiating tactic when attempting to terminate a lease early), the ROU asset is not or will not be abandoned because the retailer has not yet decided that it will not sublease or otherwise use the leased asset.

The following flowchart summarizes considerations for determining whether an ROU asset is abandoned:



A retailer that plans to sublease an underlying asset is not abandoning the ROU asset.

Accounting for an abandonment

If a retailer determines that it has abandoned an ROU asset or will abandon it at a future date (e.g., in 12 months), it reassesses its lease term if any of the conditions in ASC 842-10-35-1 exist (e.g., if the lessee is no longer reasonably certain to exercise a renewal option on the asset it has decided to abandon). If the lease term changes, the retailer also reassesses the lease classification. The existence of an impairment indicator alone does not result in reassessment of the lease term and classification.

Under ASC 360-10, a long-lived asset to be disposed of in a manner other than a sale (e.g., abandonment) is considered held and used until the long-lived asset ceases to be used. Because a decision to abandon a long-lived asset before the end of the lease term is akin to a decision to dispose of a long-lived asset before the initially intended date, a decision to abandon the asset is viewed as an indicator of impairment for a held and used long-lived asset. Therefore, if a retailer decides to abandon an ROU asset, the retailer should test whether the carrying amount of the ROU asset (asset group) is recoverable before abandoning it and, if it is not recoverable, measure it for impairment consistent with the discussion above.

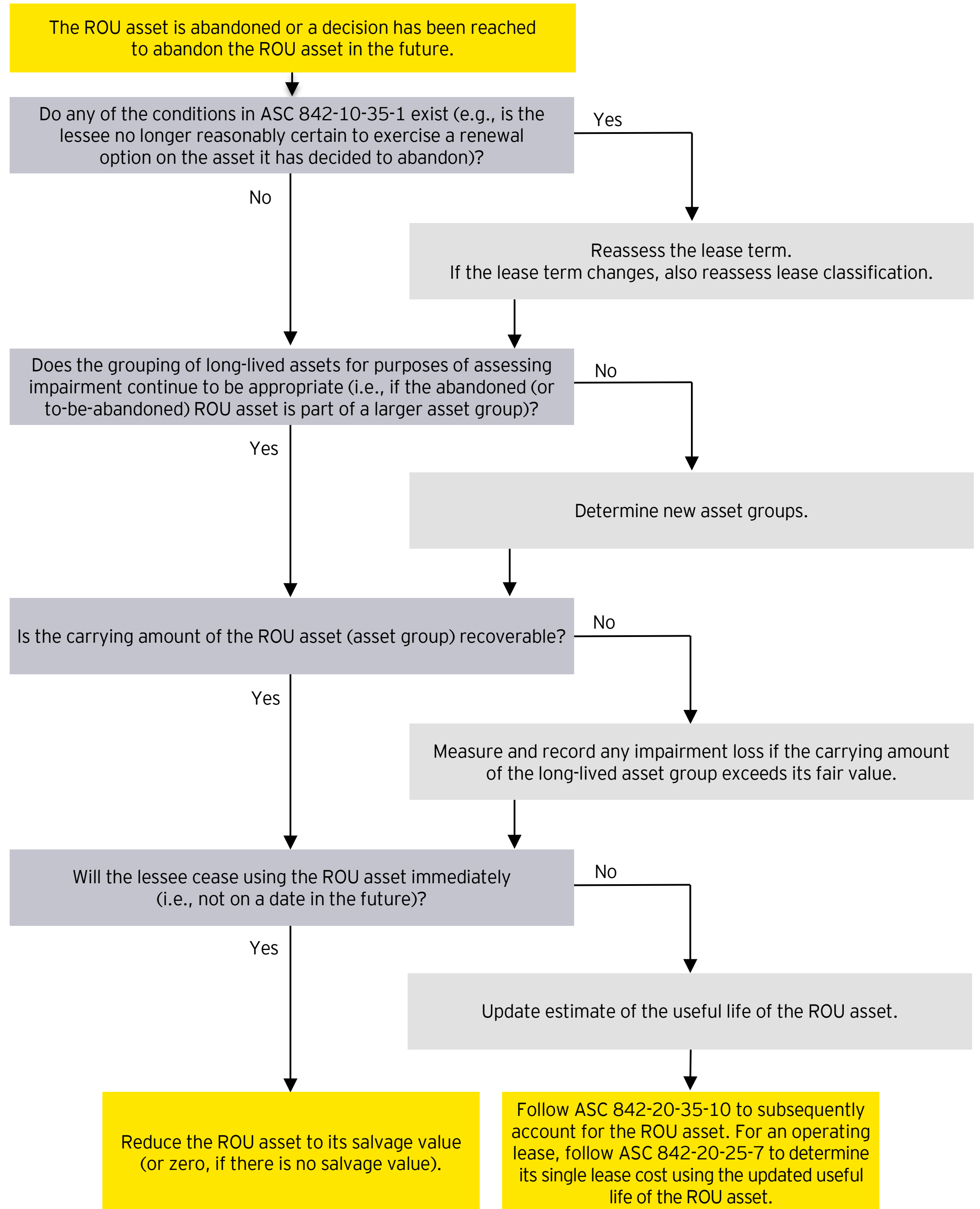
Before assessing impairment, a retailer that abandons or decides to abandon at a future date (e.g., in 12 months) an ROU asset that is part of a larger asset group should first reassess whether its grouping of long-lived assets continues to be appropriate. For example, a functionally independent asset that is abandoned (e.g., a building) may no longer be part of an existing asset group.

Regardless of whether an ROU asset is impaired, a retailer that commits to a plan to abandon an ROU asset in the future (e.g., in 12 months) but before the end of the lease term should update its estimate of the useful life of the ROU asset. The evaluation of whether a retailer has committed to a plan to abandon an ROU asset in the future is based on the facts and circumstances. If the retailer is ceasing to use an asset temporarily (e.g., a retailer plans to vacate a leased building for one year as part of a restructuring but intends to reoccupy that facility in 12 months), the temporary abandonment would not result in a reassessment of the useful life of the related ROU asset.

If no impairment is recorded but the useful life is shortened, we believe a retailer would follow the guidance in ASC 842-20-25-7 and ASC 842-20-35-10 to subsequently account for the ROU asset and lease liability and to determine its single lease cost after estimating the useful life of the ROU asset. If an impairment is recorded, the retailer measures the ROU asset at its carrying amount immediately after the impairment and follows the guidance in ASC 842-20-25-7 and ASC 842-20-35-10 to subsequently account for the ROU asset and lease liability and to determine its single lease cost.

An ROU asset that has been abandoned should be reduced to its salvage value (or zero, if there is no salvage value) as of its cease-use date. The salvage value of an ROU asset will often be de minimis.

The following flowchart summarizes the accounting considerations for a retailer that abandons an ROU asset or decides to abandon it at a future date (e.g., in 12 months). The flowchart assumes that the retailer has appropriately considered ASC 360-10 up to the date the decision is made to abandon the asset.



Accounting when there is no abandonment

If a retailer determines that it has not abandoned an ROU asset or will not abandon it at a future date, it should reassess its lease term only if any of the conditions in ASC 842-10-35-1 exist.

Retailers that determine that an ROU asset is not abandoned (e.g., because it may be subleased) should consider whether the temporary cease use (or future plan to temporarily cease use) of the asset is an indicator of impairment in accordance with ASC 360-10. Retailers that determine that an indicator of impairment is present should perform the recoverability test for the asset (or asset group) and measure and record any impairment. In doing so, the retailer should first reassess whether its grouping of long-lived assets continues to be appropriate. If an impairment is recorded, the retailer measures the ROU asset at its carrying amount immediately after the impairment and follows the guidance in ASC 842-20-35-10 to subsequently account for the ROU asset and, for an operating lease, ASC 842-20-25-7 to determine its single lease cost.

How we see it

If the ROU asset is not or will not be abandoned, a retailer should not reduce the ROU asset's remaining life, even if it has temporarily ceased using (or will temporarily cease using) the store.

Sublease arrangements (added October 2020)

A retailer may enter into an arrangement to sublease retail space to a third party. In these arrangements, the retailer acts as both the lessee and lessor of the same underlying asset. The original lease is often referred to as a head lease, the original lessee (the retailer) is often referred to as an intermediate lessor or sublessor, and the ultimate lessee is often referred to as the sublessee.

If the original lessee is relieved of the primary obligation under the original lease, the transaction is not a sublease. Such transactions are considered a termination of the original lease, and the lease-related assets and obligations are derecognized. Any consideration paid or received upon termination that was not already included in the lease payments (e.g., a termination penalty that was not included in lease payments based on the lease term) is included in the gain or loss on termination of the original lease. If the original lessee remains secondarily liable for the original lease, the guarantee obligation is recognized by the lessee in accordance with ASC 405-20-40-2 (i.e., measured at fair value and included in the determination of gain or loss on lease termination).

Sublessor accounting

A sublessor assesses sublease classification independently of the classification assessment that it made as the lessee of the same asset. A sublessor classifies a sublease with reference to the underlying asset (e.g., the retail store that is the subject of the lease) rather than the ROU asset. A sublessor uses the rate implicit in the lease (i.e., the rate implicit in the sublease) to determine the classification of the sublease and to measure its net investment in a sublease that is classified as a sales-type or a direct financing lease. If the rate implicit in the lease cannot be readily determined, the sublessor uses the discount rate for the lease established for the head lease.

The following table summarizes how the original lessee/sublessor accounts for the head lease and sublease at the commencement of the sublease.

<table>
<tr><th></th><th>Sublease — sales-type or direct financing lease</th><th>Sublease — operating lease</th></tr>
<tr><td>Head lease — finance lease</td><td>The original lessee derecognizes the original ROU asset and continues to account for the original lease liability as it did before the commencement of the sublease (i.e., in accordance with the finance lease provisions of the lessee accounting guidance). The original lessee, as the sublessor, recognizes a net investment in the sublease and evaluates it for impairment under ASC 310 (before adoption of ASU 2016-13) or ASC 326 (after adoption of ASU 2016-13).</td><td rowspan="2">The original lessee continues to account for the head lease as it did before the commencement date of the sublease (i.e., in accordance with the lessee accounting guidance).
If the lease cost for the term of the sublease exceeds the sublessor's anticipated sublease income for the same period, this indicates that the ROU asset associated with the head lease should be assessed for impairment under the long-lived asset impairment provisions of ASC 360 (i.e., an impairment indicator).</td></tr>
<tr><td>Head lease — operating lease</td><td>The original lessee derecognizes the original ROU asset at the sublease commencement date and accounts for the original lease liability in accordance with the finance lease provisions of the lessee accounting guidance. The original lessee, as the sublessor, recognizes a net investment in the sublease and evaluates it for impairment under ASC 310 (before adoption of ASU 2016-13) or ASC 326 (after adoption of ASU 2016-13).</td></tr>
</table>

Retailers are required to disclose sublease income, on a gross basis, separately from finance or operating lease expense.

Sublease may affect head lease classification

When a retailer enters into sublease arrangements as a sublessor and determines that the term of the sublease (including the noncancelable term and any lease renewal options that are reasonably certain to be exercised by the sublessee or controlled by the sublessor) is longer than the lease term of the head lease, the sublessor is required to reassess the lease term of the head lease in accordance with ASC 842-10-35-1(a). However, the existence of the renewal option on its own does not result in the head lease being extended.

For example, assume a head lease has a noncancelable term of five years and provides a lessee with an option to renew for two additional years that it determines it is not reasonably certain to exercise. If the lessee subleases the underlying asset and provides the sublessee with the same noncancelable term and renewal option and determines that the sublessee is reasonably certain to exercise that renewal option, the lessee would reassess the term of the head lease as the renewal options are now reasonably certain to be exercised. This is because the lease term under the sublease effectively establishes an obligation to renew the head lease. If the lease term of the head lease changes, the sublessor is also required to reassess the lease classification of the head lease. Alternatively, if the lessee determines that the sublessee is not reasonably certain to exercise the renewal option, the lessee would not remeasure the lease term on the head lease solely as a result of entering into the sublease.

Presentation of sublease income

ASC 842 does not address how a sublessor should present the income from a sublease in its statement of comprehensive income. However, the FASB indicated in the Basis for Conclusions (BC 115) of ASU 2016-02 that the head lease and the sublease should be accounted for as two separate contracts unless those contracts meet all of the criteria in ASC 842's contract combination guidance. Therefore, we believe that the sublessor should present the income from a sublease separately from the lease expense on the head lease (i.e., gross presentation) unless both the head lease and the sublease meet all of the criteria in the contract combinations guidance in ASC 842-10-25-19.

Further, ASC 842 requires an original lessee/sublessor to disclose sublease income, on a gross basis, separate from finance or operating lease expense.

In some instances, a sublessee may be required to make variable lease payments directly to the head lessor, rather than to the sublessor. ASC 842 requires a lessor to exclude lessor costs paid directly by a lessee to third parties on the lessor's behalf (e.g., taxes) from variable payments. However, a sublessor should not exclude a sublessee's variable lease payments that are not lessor costs (e.g., variable payments based on sales) from variable payments. Rather, a sublessor should present the sublessee's variable lease payments made directly to the head lessor as variable sublease income separately from lease expense on the head lease (i.e., gross presentation). If the sublessor does not know the amount of these payments, it should develop reasonable estimates of the amount.

ROU asset groups for purposes of impairment assessments

Lessees' ROU assets, for both operating and finance leases, are subject to existing impairment guidance in ASC 360-10 (see the Impairment of ROU assets or other long-lived assets section). Questions have arisen regarding whether the original asset group that included the ROU asset should be reassessed for purposes of the ASC 360-10 impairment assessment if all or part of the original ROU asset is subleased to a third party. We believe that in certain circumstances it is reasonable for the original lessee to conclude that a subleased portion of an ROU asset meets the criteria to be identified as a single lease component.

For example, an original lessee may conclude there is no accounting difference between accounting for its lease of a 10-floor building as one lease component (the building) or as 10 lease components (the 10 functionally independent floors). That is, even though each floor meets the criteria to be considered a separate lease component, the original lessee may have historically accounted for the entire 10-floor building as one lease component because there is no accounting difference between recognizing 10 separate ROU assets and lease liabilities and recognizing one ROU asset and lease liability for the entire building. Therefore, in this example, if the original lessee subleases a single functionally independent floor, we believe it is also reasonable to disaggregate the ROU asset for the subleased floor from the existing asset group as long as that floor meets the criteria to be identified as a separate lease component.

As mentioned above, in accordance with ASC 842-20-35-14, if the sublease is classified as a sales-type lease or a direct financing lease, the original lessee should derecognize the original ROU asset. Therefore, in the example above, the original lessee would disaggregate the asset group in order to derecognize the portion of the asset being subleased.

Sublessee disclosures

In addition to making other lessor disclosures (refer to section 5.9, *Disclosure*, in our ASC 842 FRD), ASC 842 requires an original lessee/sublessor to disclose (1) the existence, and terms and conditions, of residual value guarantees provided by the sublessee and (2) sublease income, on a gross basis, separate from finance or operating lease expense.

Internal control over financial reporting

Retailers that report on ICFR should consider whether there are any new or heightened financial reporting risks related to the effects of both the COVID-19 pandemic and planned changes to their operations and whether internal controls continue to be sufficiently precise to mitigate those risks. ICFR considerations that may require additional attention from management include:

- Controls to identify lease modifications and other lease reassessment and remeasurement events
- Controls to identify events or changes in circumstances that indicate the carrying amount of an asset group may not be recoverable

- Controls to review cash flow forecasts and other assumptions (e.g., discount rate, market rent) used to measure an impairment of an ROU asset or other long-lived asset in an asset group
- Controls to review the appropriateness of management's determination of whether an ROU asset has been abandoned
- Controls to review the appropriateness of the accounting for subleases
- Controls to review the appropriate disclosure of around judgements and estimates related to leases

Retailers also need to consider whether the design or operating effectiveness of any key controls is affected by policies that allow employees to work from home. That is, retailers may need to develop alternative methods for executing the control activities and retaining proper support that evidences that the control activities were completed as designed.

If a retailer uses a service organization to perform some or all its lease administration or accounting, management should also keep in mind that relevant controls may be located at the entity, the service organization or both. The retailer should obtain a Service Organization Controls (SOC) 1 report related to the service organization's processes and controls that affect the retailer's ICFR. Refer to our Technical Line publication, ***How SOC reporting may be affected by the COVID-19 pandemic***, for additional considerations. A retailer may also need to understand whether the service organization's processes and controls have been affected and any effect that might have on its ICFR.

Next steps

- Management should continue to discuss its approach to responding to the risks posed by the disruption in the retail environment related to the COVID-19 pandemic or the current environment and any implications to lease accounting with the entity's auditor and its audit committee (or those charged with governance).
- Management of retailers that report on ICFR should make sure their control structure is designed and operating at a level that would mitigate the risks related to the current environment.

Endnotes:

[1] ASC 842-20-50-1.

[2] The SEC's Division of Corporation Finance issued Disclosure Guidance Topic No. 9, Coronavirus (COVID-19), which provides the SEC staff's views on disclosure and other securities law obligations that registrants should consider with respect to the COVID-19 pandemic and its effects on their operations and financial condition. See our To the Point, ***SEC extends relief and issues staff guidance on COVID-19 disclosures***, for more information.

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