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Technical Line

Accounting considerations for lessees that plan to reduce physical workspace

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What you need to know

- Entities seeking to reduce their real estate footprint should pay careful attention to the guidance on long-lived asset impairment and long-lived asset abandonment if they have already adopted the new leases standard and lease the real estate.
- Lessees that decide to reduce their real estate footprint may determine that this decision is an indicator that would trigger an assessment of whether an asset group that includes right-of-use assets for leased real estate is impaired under ASC 360-10.
- Determining the appropriate grouping of long-lived assets to be evaluated for impairment requires a significant amount of judgment and consideration of the facts and circumstances as well as an understanding of an entity's business.
- A lessee that stops 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.

Overview

As entities reopen workplaces after temporary closures or reductions in capacity during the COVID-19 pandemic, they may consider reducing their real estate footprint.

For example, some entities that have successfully implemented a virtual work environment have seen an opportunity to reduce costs by reducing their real estate footprint or by relocating to a less-expensive space. Similarly, some retailers may have permanently closed certain stores because they will not generate enough cash flows to warrant the cost of maintaining the physical location.

Building a better working world

Due to the complexities of implementing a plan to reduce the real estate footprint, a decision may be made long before the plan is completed. To properly assess the accounting treatment, the entity should consider the following questions at each reporting date:

- What decisions have been made by the parties authorized to make decisions (e.g., executive management, board of directors)?
- Which aspects of management's plans have been implemented?
- For aspects of the plan not implemented, what is the timing and steps required to finalize the plans?

This publication addresses some common issues lessees that have adopted Accounting Standards Codification (ASC) 842[1] may encounter if they plan to reduce the amount of space they lease. That is, lessees should understand the interaction between the guidance in ASC 842, the long-lived asset impairment guidance in ASC 360-10,[2] and the exit or disposal cost guidance in ASC 420[3] for any non-lease components that are accounted for separately.

This publication complements our Financial reporting developments (FRD) publications, ***Lease accounting (ASC 842)***, ***Impairment or disposal of long-lived assets*** and ***Exit or disposal cost obligations***.

This publication focuses on operating leases because leases of workspace are commonly classified this way. The considerations for operating leases of other assets (e.g., equipment) and finance leases are similar but not identical to those discussed in this publication. This publication also does not address lessee considerations related to lease modifications, lease terminations or the accounting for subleases. Please refer to sections 4 and 6 of our FRD on lease accounting under ASC 842 for information on those topics.

The abandonment guidance may affect the asset groupings used to evaluate impairment.

Accounting considerations

Navigating the interaction of the guidance in ASC 842 and ASC 360-10 can be challenging when an entity decides to reduce its real estate footprint. Lessees that have adopted ASC 842 must evaluate right-of-use (ROU) assets for impairment in accordance with ASC 360-10. Lessees must also apply the guidance in ASC 360-10 to determine whether an ROU asset has been abandoned, which could affect the asset groupings used to evaluate the ROU asset for impairment and the estimated useful life of both an ROU asset and any leasehold improvements associated with the leased space.

Further, lessees that separately account for non-lease components (e.g., entities that have not made the policy election under ASC 842 to combine lease and associated non-lease components) must consider the guidance in ASC 420 to determine whether any exit or disposal costs associated with non-lease components should be accrued (e.g., when a lessee has concluded that it has permanently ceased using an asset, whether for its own use or through subleasing, and costs allocated to the non-lease component that will continue to be incurred for its remaining term will not provide economic benefit to the entity). The flowchart in Appendix A illustrates the interaction of the various pieces of guidance.

Impairment of operating ROU assets

Lessees that decide to reduce their real estate footprint may determine that their decision is an indicator that would trigger an assessment of whether the asset group that includes the ROU asset is impaired. The Financial Accounting Standards Board (FASB) indicated in the Background Information and Basis for Conclusions (BC 255) of Accounting Standards Update (ASU) 2016-02, which created ASC 842, that the impairment model in ASC 360-10 is appropriate to apply to a lessee's ROU assets because these assets are long-lived nonfinancial assets and should be accounted for in the same way as an entity's other long-lived nonfinancial assets.

The guidance in ASC 360-10 requires three steps to identify, recognize and measure the impairment of a long-lived asset (asset group) to be held and used:

- Indicators of impairment (Step 1) — Consider whether impairment indicators are present (i.e., whether there are any events or changes in circumstances that indicate that the carrying amount of the long-lived asset (group) might not be recoverable).
- Test for recoverability (Step 2) — If indicators of impairment are present, perform a recoverability test by comparing the sum of the estimated undiscounted future cash flows attributable to the long-lived asset (asset group) in question to the carrying amount of the long-lived asset (asset group).
- Measure an impairment (Step 3) — If the undiscounted cash flows used in the test for recoverability are less than the carrying amount of the long-lived asset (asset group), determine the fair value of the long-lived asset (asset group) and recognize an impairment loss if the carrying amount of the long-lived asset (asset group) exceeds its fair value.

Grouping long-lived assets

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." Assets generally should be grouped when they are used together (i.e., when they are part of the same group of assets and are used together to generate joint cash flows).

Grouping assets requires judgment and will require consideration of the facts and circumstances as well as an understanding of an entity's business. Each time a lessee performs a recoverability test, it should reassess whether its grouping of long-lived assets continues to be appropriate. Changes to a lessee's real estate footprint might indicate that the related asset grouping may have changed. This might be the case even when the ROU asset is not the primary asset in the asset group.

Questions a lessee should consider when evaluating whether the inclusion of an ROU asset in the asset grouping continues to be appropriate include:

- Has the lessee ceased using (i.e., abandoned) the leased asset, or does the lessee plan to do so?
- Has the lessee already incurred, or will the lessee incur, significant costs as part of a plan to cease using the leased asset?
- Has the lessee changed the fundamental use of the leased asset, or does the lessee plan to do so?
- Has the lessee executed a sublease for the leased asset, or does the lessee plan to do so?
- Has the lessee actively marketed the leased asset for sublease (e.g., hired a broker), or does the lessee plan to do so?

Effects of subleasing a portion of an asset on asset groupings

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 ROU asset, or the portion of an ROU asset subject to a sublease, meets the criteria to be identified as a single lease component (i.e., separate from any other lease components of the contract).

For example, an original lessee may have concluded 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 met 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 if it concluded 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 conclude that the subleased floor is a separate ROU asset that would be evaluated to determine its asset grouping.

Determining whether to include lease liabilities in the Step 2 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 as operating liabilities. In the Basis for Conclusions (BC 264) of ASU 2016-02,[4] 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 lessee to either include or exclude operating lease liabilities from an asset group when testing whether the carrying amount of an asset group is recoverable.

Determining which future cash outflows for lease payments should be included in the Step 2 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.

In summary, if a lessee 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 payments should be included when determining the fair value in Step 3 if the lessee uses a discounted cash flow approach.

An entity uses different assumptions to develop estimates of future cash flows in Steps 2 and 3 of the impairment test.

As a reminder, a lessee uses its own assumptions to develop estimates of future cash flows in Step 2. This differs from the approach in Step 3, where the lessee measures the fair value of the asset group based on market participant assumptions.

Measure an impairment (Step 3)

If the undiscounted cash flows used in the recoverability test are less than the carrying amount of the long-lived asset (asset group), an entity is required to determine the fair value of the long-lived asset (asset group) and recognize an impairment loss when the carrying amount of the long-lived asset (asset group) exceeds its fair value.

When determining the fair value of an ROU asset, a lessee should consider what market participants would pay to lease the asset for its highest and best use, even if that use differs from the current or intended use by the reporting entity.

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 effectively 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 circumstances (e.g., due to decreases in the fair value of the lease liability relative to its carrying amount).

As a reminder, in accordance with ASC 360-10, an impairment loss for an asset group reduces only the carrying amounts of the long-lived assets of the group (including lease-related ROU assets). The loss must be allocated to the long-lived assets of the group on a pro rata basis using the relative carrying amounts of those assets, except that the loss allocated to an individual long-lived asset of the group must not reduce the carrying amount of that asset below its fair value whenever the fair value is determinable without undue cost and effort. ASC 360-10 prohibits the subsequent reversal of an impairment loss for an asset held and used.

Accounting for an operating lease after an impairment of an ROU asset

As discussed above, a lessee recognizes an impairment loss by adjusting the carrying value of the ROU asset by the amount of the impairment. A lessee subsequently amortizes the held-for-use ROU assets, generally on a straight-line basis, from the date of the impairment to the earlier of the end of the useful life of the ROU asset or the end of the lease term.

Events or changes in circumstances that indicate 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, in isolation, trigger a reassessment of the lease term or a lessee option to purchase the underlying asset.

If the lease is remeasured after the impairment (e.g., as a result of a modification or a subsequent reassessment event), we believe that a lessee would continue to amortize a held-for-use ROU asset, generally on a straight-line basis, from the date of remeasurement to the earlier of the end of the useful life of the ROU asset or the end of the lease term.

Abandonment of ROU assets

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

A lessee 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 lessee 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. An entity 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 lessee 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 lessee does not currently plan to sublease or otherwise use the asset but may sublease it in the future (e.g., a lessee 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 lessee has not yet decided that it will not sublease or otherwise use the leased asset.

The flowchart in Appendix B summarizes considerations for determining whether an ROU asset is abandoned.

Reassessment of lease term and classification

If a lessee determines that it has abandoned an ROU asset or will abandon it at a future date, it reassesses the lease term if any of the following conditions in ASC 842-10-35-1 exist:

- There is a significant event or a significant change in circumstances that is within the control of the lessee that directly affects whether the lessee is reasonably certain to exercise or not to exercise an option to extend or terminate the lease or to purchase the underlying asset.
- 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.
- The lessee elects to exercise an option even though the entity had previously determined that the lessee was not reasonably certain to do so.
- The lessee elects not to exercise an option even though the entity had previously determined that the lessee was reasonably certain to do so.

If the lease term changes, the lessee 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 lessee decides to abandon an ROU asset, the lessee 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.

Effect of a plan to abandon on the estimated useful life of an ROU asset

Regardless of whether an ROU asset is impaired, a lessee 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 lessee has committed to a plan to abandon an ROU asset in the future is based on the facts and circumstances. If the lessee is ceasing to use an asset temporarily (e.g., a lessee plans to vacate a leased office building for one year as a result of COVID-19 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. 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 decision to abandon a long-lived asset is viewed as an indicator of impairment.

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

Internal control over financial reporting

Companies that report on internal control over financial reporting (ICFR) must also consider whether a plan to reduce their real estate footprint presents any new or heightened financial reporting risks 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 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 impairment of an ROU asset or other long-lived assets in an asset group
- Controls to review the appropriateness of management's determination of whether an ROU asset has been abandoned

Next steps

- Entities that plan to reduce their real estate footprint should make sure that appropriate personnel across the organization (e.g., operations, accounting) are involved in carrying out the plan.
- Management should discuss its approach to reduce its footprint and any implications for lease accounting with the entity's independent auditor and its audit committee (or those charged with governance).
- Management of entities that report on ICFR should make sure their control structure is designed and operating at a level that would mitigate the risks related to a plan to reduce the entity's real estate footprint.

Endnotes:

[1] ASC 842, *Leases*.
[2] ASC 360-10, *Property, Plant, and Equipment — Overall*.
[3] ASC 420, *Exit or Disposal Cost Obligations*.
[4] ASU No. 2016-02, *Leases*.

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Appendix A

The following flowchart illustrates the interaction of the guidance in ASC 842, ASC 360-10 and ASC 420.

Contract within the scope of ASC 842

Lease component (i.e., ROU asset)	Non-lease component*

ASC 360-10 (Lease component)

Step 1
Consider whether impairment indicators are present (e.g., a decision to abandon an ROU asset).**

Step 2
Compare the sum of the estimated undiscounted future cash flows to the carrying amount of the long-lived asset (asset group).

Step 3
Measure and record any impairment loss if the carrying amount of the long-lived asset group exceeds its fair value.

ASC 420 (Non-lease component)

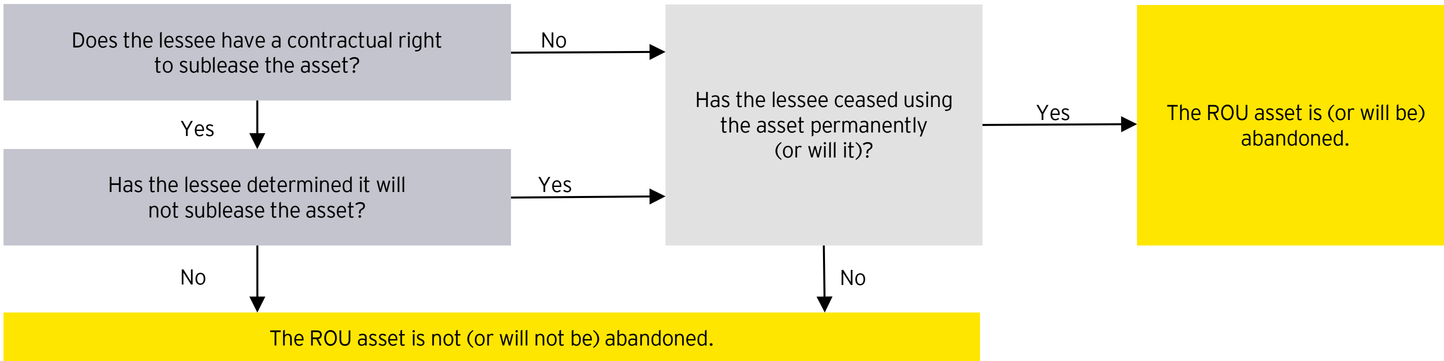
Determine whether any exit or disposal costs should be accrued.

* Generally, applies only to lessees that do not make the policy election to combine the lease and associated non-lease components of a contract.

** Refer to Appendix B for a flowchart that summarizes considerations for determining whether an ROU asset is abandoned and Appendix C for a flowchart summarizing the accounting considerations for a lessee that abandons an ROU asset or decides now to abandon it at a future date (e.g., in 12 months).

Appendix B

The following flowchart summarizes considerations for determining whether an ROU asset is (or will be) abandoned.



Note: In some circumstances, a lessee may commit to a plan to abandon an ROU asset at a future date. In those cases, an entity may need to reconsider the lease term and useful life of the ROU asset. Refer to the *Abandonment of ROU assets* section above.

Appendix C

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