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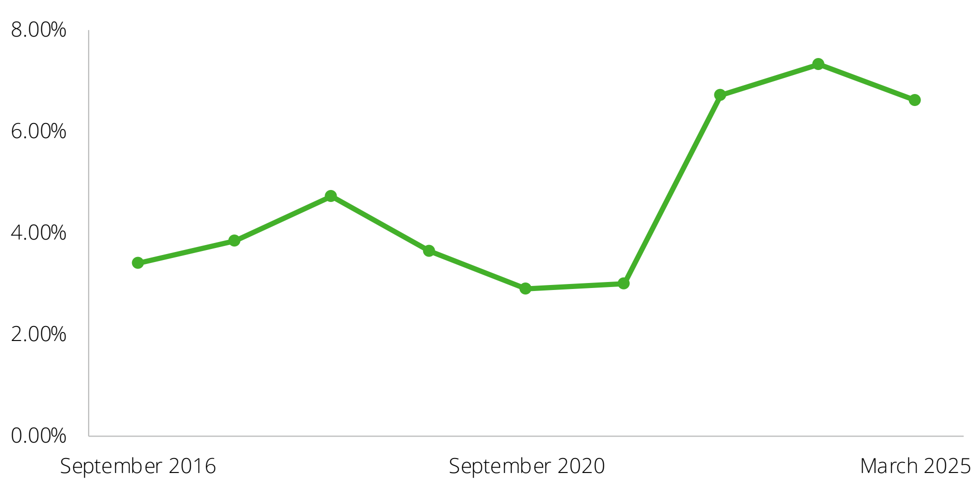
On the Radar

Leases

The Current Macroeconomic Environment

The current macroeconomic environment has created ongoing challenges and uncertainty in various areas of accounting, including the accounting for leases. For example, the U.S. 30-year fixed mortgage rate has nearly doubled since 2016, the year in which ASC 842 was issued.[1]

U.S. 30-Year Fixed Mortgage Rate



[1] Source for graphic: Mortgage Rates — Freddie Mac.

Many commercial real estate entities have encountered increased costs of capital and tightening lending standards while also dealing with higher levels of maturing debt; reductions in the volume of real estate transactions; and evolving real estate demands and preferences related to the way people work, live, and shop. The actual impact of the current macroeconomic environment on commercial real estate assets will differ on the basis of various factors, including geographic location, tenant-specific operations, and in-place lease terms. Commercial real estate entities, including real estate owners, operators, and developers, should continually monitor, evaluate, and update their lease-related accounting and reporting.

Evolution of Technology Use and the Need for More Power

More and more companies are leveraging artificial intelligence (AI) to enhance internal productivity or are incorporating generative AI into their revenue-generating products. Advancements in technology have led to rising demand for computing power.[2] To fulfill this demand, many technology companies have significantly expanded their data center footprints, leading to a rise in leasing transactions both for data center space and the hardware housed within it. Some of these transactions may also be contracted as service arrangements in which a supplier agrees to provide a specified level of computing capacity to its customer. In such cases, companies should carefully evaluate a service arrangement that involves the use of PP&E to determine whether the arrangement contains a lease.

Demand for electricity to power the surge in AI hardware investments has similarly led to a high volume of transaction activity in the power and utilities sector, including the development of new power generation facilities across the United States to meet regional demand. Given the current macroeconomic environment, many companies in the sector have entered into complex transactions to finance these projects, including sale-and-leaseback transactions, build-to-suit arrangements, and synthetic leases (e.g., a lease arrangement in which a significant portion of the lease payments is structured as a residual value guarantee, typically resulting in lower ROU asset and lease liability balances compared with leases with fixed rental payments). Because the accounting for such arrangements can be challenging, companies involved in these types of transactions should consider consulting with their accounting advisers and should continue to monitor developments related to these topics.

Lease Accounting Hot Topics

Real Estate Rationalization

Entities in almost every industry sector continue to reevaluate how they are doing business as well as the impact of their ever-evolving business strategies on their brick-and-mortar real estate needs. For instance, certain entities in the retail sector have shifted from brick-and-mortar stores to online shopping. Moreover, such entities have been considering where their employees conduct their required business activities and to what extent brick-and-mortar real estate assets will be needed for such activities on a go-forward basis. Specifically, many entities continue to undertake real estate rationalization programs to determine their appropriate organization-wide real estate footprint. The goal of initiating such programs may be for entities to right-size their real estate portfolios to manage costs while adequately supporting their business needs.

In addition to adjusting to the evolving macroeconomic environment, entities continue to refine their hybrid-work approaches. While vacancy rates for office properties in certain areas may have been higher a couple of years ago because more professionals were allowed to spend a greater percentage of their time working from home, many entities are now expecting their employees to work more days in the office, emphasizing the importance of collaboration.

Entities continue to reassess their real estate footprint and adjust their real estate portfolios. Some entities are moving to different-sized spaces in the same geographical area, while others are changing the amount of space they are leasing in their current location. As a result, such entities are often abandoning properties, subleasing space they are no longer using, or modifying existing leases to change the amount of space or the lease

[2] According to Deloitte estimates, the data center electricity demand could rise fivefold by 2035, reaching 176 GW. For more information, see Deloitte's article *Nuclear Energy's Role in Powering Data Center Growth*.

term. Further, as a financing method to improve their liquidity, entities are increasingly entering into sale-and-leaseback transactions involving real estate. As a result of these real estate rationalization efforts, companies are also more frequently evaluating leases for impairment. Each of these topics is addressed below and within this publication.

See Deloitte's March 30, 2021, *Accounting Spotlight* and May 22, 2023, *Financial Reporting Alert* for further details on the impact of real estate rationalization and commercial real estate macroeconomic trends, respectively, on an entity's lease accounting.

Impairment and Abandonment

The right-of-use (ROU) assets recorded on a lessee's balance sheet under ASC 842 are subject to the ASC 360-10 impairment guidance applicable to long-lived assets. When events or changes in circumstances indicate that the carrying amount of the asset group may not be recoverable (i.e., impairment indicators exist), the asset group should be tested to determine whether an impairment exists. The decision to change the use of a property subject to a lease could be an impairment indicator.

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

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

Common Pitfall

We have seen some companies assert that they are abandoning the property, even though it is only temporarily idled, or that they may still be using it for minor operational needs or may have the intent and ability to sublease it. Under these circumstances, abandonment accounting would not be appropriate. An entity may need to use significant judgment in evaluating whether abandonment has occurred, and a high bar has been set for concluding that a property has been abandoned.

In our experience, establishing management's intent regarding subleasing involves judgment and depends on various facts and circumstances, such as the remaining lease term, the nature of the property, and the level of demand in the rental market. For example, it may be reasonable to conclude that an ROU asset is subject to abandonment accounting when the remaining lease term is shorter and the rental market is, and is expected to remain, weak. On the other hand, it may be more challenging to conclude that management has forgone the opportunity to sublease the property if the remaining lease term is longer, given the increased uncertainty about the level of demand in the rental market over a longer time horizon. It may be particularly difficult to reach such a conclusion in an environment in which there are significant economic uncertainties that may affect the real estate strategy of other market participants going forward. There are no bright lines regarding the duration of the remaining lease term in this analysis, and the exercise could differ from one rental market to the next. We would also expect specialized properties to be more difficult to sublease than more generic properties such as retail shopping units and office space. Entities should carefully evaluate their specific facts and circumstances when determining whether the ASC 360 abandonment accounting applies to the ROU asset.

Subleases

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

Modification of Existing Lease Arrangements

In the current environment, tenants may negotiate with lessors to exit early from a leased space, decrease the amount of leased space, or terminate the lease in its entirety. Some lessees are modifying existing lease agreements by (1) eliminating or scaling back office space as a result of hybrid models, (2) reducing space because of changes in the current environment to cut or maintain costs, or (3) expanding space as warranted in response to business needs. The accounting for a lease modification under ASC 842 depends on whether the modification is accounted for as a separate contract as well as the nature of the modification.

Common Pitfall

Many amended contracts describe a lease amendment as an early termination. In evaluating these types of amendments, a lessee must determine whether the amendment is actually a modification to reduce the lease term. If a termination takes effect after a specified period (even a relatively short period), the lessee still has the right to use the leased asset for that period. In such cases, the modification consists of a reduction in the lease term rather than a full or partial termination. The guidance on full or partial terminations only applies when all or part of the lessee's right of use ceases contemporaneously with the execution of the modification (i.e., the space is immediately vacated). As a reminder, an immediate charge to the income statement is only appropriate when the lease is fully or partially terminated.

Evaluation of Lease Options

When determining the lease term at lease commencement, an entity should determine the noncancelable period of a lease, which includes lessee renewal option periods whose exercise is believed to be reasonably certain (and includes lessee termination option periods when exercise is reasonably certain not to occur). The likelihood of whether a lessee will be economically compelled to exercise or not exercise an option to renew or terminate a lease is evaluated at lease commencement. In performing this assessment, an entity would consider contract-based, asset-based, entity-based, and market-based factors (e.g., the market rental rates for comparable assets), which may be affected by changes in the macroeconomic environment.

A lessor would not reassess the lease term unless the lease is modified and the modification is not accounted for as a separate contract.

Sale-and-Leaseback Arrangements

A sale-and-leaseback transaction is a common and important financing method for many entities and involves the transfer of a property by the owner ("seller-lessee") to an acquirer ("buyer-lessor") and a transfer of the right to control the use of that same asset back to the seller-lessee for a certain period.

It is important for an entity to evaluate the provisions of any sale-and-leaseback arrangement since the contract terms may significantly affect the accounting. For example, the seller-lessee would not be able to derecognize the underlying asset (i.e., a failed sale) or recognize any associated gain or loss on the sale if (1) the contract includes a provision that grants the original owner (future tenant) an option to repurchase the property or (2) the leaseback would be classified as a finance lease. Rather, both parties would account for the transaction as a financing arrangement. The below graphic outlines key considerations related to the accounting for a sale-and-leaseback arrangement.

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

Lease Collectibility

In addition to the impairment considerations described above, lessors should be aware that net investments in leases (arising from sales-type and direct financing leases) are subject to the CECL impairment model, which is based on expected losses rather than historical incurred losses. See Section 5.3 of Deloitte's Roadmap *Current Expected Credit Losses* for further discussion of the application of the CECL model to the net investment in the lease (i.e., lease receivables and the unguaranteed residual asset).

Lessors with outstanding operating lease receivables must apply the collectibility model under ASC 842-30. Entities should apply this collectibility model in a timely manner in the period in which amounts under the lease agreement are due. Under the ASC 842-30 collectibility model, an entity continually evaluates whether it is probable that future operating lease payments will be collected on the basis of the individual lessee's credit risk. When collectibility of the lease payments is probable, the lessor will apply an accrual method of accounting. When collectibility is not probable, the lessor will limit lease income to the cash received, as described in ASC 842-30-25-13. Entities should continue to assess the impact of the current environment when determining whether to move tenants either to or from this cash basis of accounting as opposed to the accrual method of accounting.

Ongoing Accounting Standard-Setting Activities

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

In addition, as part of its agenda consultation process, the FASB issued an invitation to comment (ITC) on January 3, 2025, to solicit feedback on the Board's future standard-setting agenda. Leasing-related items addressed in the ITC include the following:

- For "transactions that involve (1) transfers of real estate (with a repurchase option) to a legal entity and (2) a sale and leaseback of assets," the relationship between the variable interest entity (VIE) model in ASC 810-10 and the accounting for sale-and-leaseback transactions in ASC 842-40.
- Accounting for lease arrangements in which the lessee agrees to pay the lessor by transferring noncash consideration in the form of a share-based payment over the lease term.

Comments on the ITC are due by June 30, 2025.

The FASB is currently performing a postimplementation review of ASU 2016-02 and continues to evaluate stakeholder feedback on the adoption of ASC 842. Stay tuned for future refinements in accounting standard setting as a result of these initiatives.

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

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