Accounting for shrinking real estate footprints: Applying lease termination, abandonment and impairment accounting rules in the real world

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Abstract

This paper discusses the common accounting treatment most often observed in practice when real estate footprints need to be reduced. The goal is to explain and illustrate through examples the most frequently used accounting terms and show the financial statement outcome in a format designed for real estate professionals. This paper is not an all-inclusive accounting guide. It does provide information that real estate professionals can use to perform initial assessments of real estate's impact on financial statements and prepare for conversations with their accounting counterparts. Real estate professionals may also use the information presented here to craft suggestions to improve financial statement presentation.

Keywords: lease, accounting, termination, abandonment, impairment

INTRODUCTION

In today's rapidly changing business environment, companies are making decisions to adjust real estate footprints. For example, consumer behaviour and preferences drive the mix of retail and distribution centre square footage for retail companies, and almost every organisation is evaluating brick-and-mortar office utilisation and layout.

When real estate strategy indicates that a company's existing portfolio of space needs to be reduced or relocated, some leases may be terminated or abandoned, and sometimes assets associated with those leases need to be impaired. Accounting treatment will differ depending on the facts and circumstances of each case, and the terminology used by real estate departments and other departments may differ from the terminology used by the accounting department.

For example, if a company decides that a leased office space is no longer needed for business operations, management of that division or the real estate department may communicate that the space will be abandoned. Depending on the decisions that are made from that point, however, some possible different accounting outcomes are termination, abandonment or impairment. Each of these outcomes produces a different result on the company's balance sheet and profit and loss (P&L) statement.

This paper discusses the common accounting treatment most often observed in practice when real estate footprints need to be reduced. The goal is to explain and illustrate through examples the most frequently used accounting terms and show the financial statement outcome in a format designed for real estate professionals.

The information presented here is not intended to be an accounting practice guide or a substitute for qualified accounting advice. Companies considering any of the transactions discussed here should evaluate each agreement with their own internal or external accounting team.

LEASE ACCOUNTING TERMINOLOGY FOR REAL ESTATE PROFESSIONALS

Accounting rules for lease accounting in the US are set by the Financial Accounting Standards Board (FASB) in the lease accounting standard, ASC 842. Accounting methods and terminology stem from that 200-page document.[1] FASB also provides the Supplemental Conforming Amendments Related to Leases and the Background Information and Basis for Conclusions documents, which are about 150 pages each.[2]

Accounting practice follows FASB's guidance, but many times additional interpretation is required. Thus, many accountants rely on the Big 4 accounting firms' practice guides for lease accounting. Deloitte,[3] PwC,[4] KPMG[5] and Ernst & Young (EY)[6] offer lease accounting practice guides that range from 700 to 1,250 pages each. For a complete understanding of ASC 842 lease accounting rules and interpretations, someone with an accounting degree and experience would need to review approximately 4,000 pages of information, and even that would not cover all of the real-world scenarios that companies face.

Real estate professionals constantly make decisions that trigger lease accounting treatment, but many of those individuals did not start out with accounting degrees, nor do they have the time to review FASB standards and accounting practice guides in detail. Real estate professionals who develop a working understanding of the terms and scenarios presented in this paper will at least enhance their communication with accounting teams, however, and may also become better equipped to offer suggestions that improve financial statement presentation.

TERMINATION

When a space is no longer needed, a company's real estate team will likely first evaluate if an option to terminate the lease exists in the lease agreement. If that option is not present, they may try to negotiate an early termination with the landlord. Either way, a termination penalty will often be required.

In these scenarios, the wording of the option clause or the lease amendment generally states that the lease is being terminated. From an accounting standpoint, however, the lessee must evaluate if the contract is being terminated or modified. To make that determination, accountants will need to know if the termination is effective immediately or after a set time period.

Most of the time, there is a notice period required for a termination option. Similarly, a negotiated termination usually takes effect in the weeks or months after the agreement is reached. These cases are treated as lease

modifications for accounting purposes. The modification usually involves a reduction in the lease term and an increase in payments to the lessor in the form of a termination fee.

A true termination from an accounting perspective takes place immediately. In other words, the execution of the revised contract happens on the same day that the leased premises are vacated.

The following are descriptions of the accounting treatment in both of these scenarios.

Scheduled termination: Technically a lease modification

Generally, there is a period of time between the date of the decision to terminate[7] and the actual lease exit date. In that case the present value of the cancelled stream of lease payments is removed from the lease liability with an equivalent decrease to the right of use asset. The termination fee is added to the stream of lease payments and the present value of that adds to the lease liability and right of use asset. The remeasured balances of asset and liability are then amortised[8] over the shortened lease term. This usually results in much higher expense on the P&L statement between the decision date and the exit date, because the entire amount of the termination fee must be amortised by the revised end of the lease. This means that the termination fee expense is recognised prospectively like the treatment of increased rent in other forms of lease modifications, such as renewals.

Prospective recognition of the termination fee for scheduled lease termination can feel counter-intuitive to some who are used to accounting for leases under the old accounting guidelines in ASC 840. Under the old guidelines, the termination fee for an operating lease was generally recorded as a loss when the termination agreement was finalised, even if there was time between that date and the exit date; however, that guidance changed with the new accounting guidelines in ASC 842.

Immediate termination

When a lease is terminated immediately, meaning the execution of the termination happens on the same day that the leased premises are vacated, the accounting rules for termination are applied. In that case, there is no more time for the asset, liability and termination penalty to be amortised. The right of use (ROU) asset and lease liability are written down to zero, and the difference in the ending asset and liability plus the termination penalty generally result in an immediate loss recognised on the P&L.

Abandonment

Abandonment typically occurs when the ROU asset is no longer needed, but the liability to make lease payments still exists, and there is not a viable option to terminate, sublease or gain any other economic benefit from the property. A termination may be a better option if the termination penalty is less than the present value of future lease obligations, in which case the company would apply the accounting treatment discussed above in the termination section. If the company has the intent and ability to sublease the space, or if it intends to use the space for an alternative purpose such as storage, impairment accounting treatment may apply. Impairment is described in the next section.

If there is no viable option to terminate or sublease and there is no alternative use, abandonment may be the only course. In that case, from the decision date, ROU asset amortisation is accelerated so that the asset is fully amortised by the cease use date. Expense on the P&L is higher during that period of accelerated amortisation. After the cease use date, only the liability remains on the balance sheet and expense going forward is only based on the amortisation of the liability using the effective interest method.

Abandonment is generally the worst-case scenario on the P&L because abandonment indicates there were no other options.

Finding a subtenant, using the space for something else or even paying a termination penalty all usually result in a lower charge to the P&L in the form of lease expense or loss when compared to abandonment.

Impairment

Companies are required to test asset groups for impairment. Basically, impairment occurs when an asset group is not delivering the value that the business expected; in other words, the asset group fails a recoverability test.[9] Impairment is not a lease accounting-specific topic, but ROU assets are included in asset group impairment testing. Some real estate assets may not pass a recoverability test on their own, but because they are part of a larger asset group, they might not need to be impaired. Making the commitment to abandon a leased asset, however, will generally result in the asset's removal from the larger asset group and the need to assess the impairment of the ROU asset prior to applying the abandonment requirements.

If a company decides that a leased property is no longer needed for its original purpose, it may still have value to the company in another form. Perhaps the space can be used for storage or there may be a reasonable expectation that a sublease will be executed to offset some of the remaining rent obligation. In these cases, an impairment will probably result and the accounting treatment will generally be more favourable than abandonment. An impairment reduces the ROU asset on the balance sheet with a corresponding loss on the P&L; however, that loss will be less than the total accelerated expense that results from an abandonment, because the new value of the ROU asset will reflect the value of the alternative use or the sublease income.

Going forward, the expense recorded on the P&L will be lower than before the impairment, and for an operating lease the pattern of expense recognition will change. Straightline rent is no longer recorded for an impaired operating lease. Rent is still recognised, but the expense recognition pattern becomes frontloaded like the expense pattern of a finance lease.

Example

The following example illustrates the differences in accounting treatment between scheduled termination, immediate termination, abandonment and impairment by applying these concepts to a simple lease scenario.

Company A leases a divisional office building in January of year 1. Key facts are presented as follows:

- *Lease term*: 5 years.
- *Rent*: US$10,000 for the first year escalating at US$1,000 each year, due at the end of each month (see Figures 1 and 2).
- *Incremental borrowing rate*: 5 per cent.
- *ASC 842 lease classification*: Operating.
- *Net present value of rent payments at the beginning of year 1*: US$630,606.11.
- *Straightline rent expense*: US$12,000 per month (average of all five years scheduled rent).

The main impacts to the balance sheet and P&L at the beginning of year 1 are:

Year	Monthly Rent
YR1	10,000.00
YR2	11,000.00
YR3	12,000.00
YR4	13,000.00
YR5	14,000.00

Figure 1 Rent schedule

Period	Asset Balance	Asset Amortization	Gain (Loss)	Rent Expense	Asset Adjustment	Liability Balance	Liability Adjustment	Liability Reduction	Scheduled Payments
Beginning	630,606.11		–			630,606.11	–	–	–
Jan – YR1	621,233.64	9,372.47	–	12,000.00		623,233.64		7,372.47	10,000.00
Feb – YR1	611,830.45	9,403.19	–	12,000.00		615,830.45		7,403.19	10,000.00
Mar – YR1	602,396.41	9,434.04	–	12,000.00		608,396.41		7,434.04	10,000.00
Apr – YR1	592,931.40	9,465.01	–	12,000.00		600,931.40		7,465.01	10,000.00
May – YR1	583,435.28	9,496.12	–	12,000.00		593,435.28		7,496.12	10,000.00
Jun – YR1	573,907.93	9,527.35	–	12,000.00		585,907.93		7,527.35	10,000.00
Jul – YR1	564,349.21	9,558.72	–	12,000.00		578,349.21		7,558.72	10,000.00
Aug – YR1	554,759.00	9,590.21	–	12,000.00		570,759.00		7,590.21	10,000.00
Sep – YR1	545,137.16	9,621.84	–	12,000.00		563,137.16		7,621.84	10,000.00
Oct – YR1	535,483.56	9,653.60	–	12,000.00		555,483.56		7,653.60	10,000.00
Nov – YR1	525,798.07	9,685.49	–	12,000.00		547,798.07		7,685.49	10,000.00
Dec – YR1	516,080.56	9,717.51	–	12,000.00		540,080.56		7,717.51	10,000.00
Jan – YR2	506,330.90	9,749.66	–	12,000.00		531,330.90		8,749.66	11,000.00
Feb – YR2	496,544.78	9,786.12	–	12,000.00		522,544.78		8,786.12	11,000.00
Mar – YR2	486,722.05	9,822.73	–	12,000.00		513,722.05		8,822.73	11,000.00
Apr – YR2	476,862.56	9,859.49	–	12,000.00		504,862.56		8,859.49	11,000.00
May – YR2	466,966.15	9,896.41	–	12,000.00		495,966.15		8,896.41	11,000.00

Figure 2 Partial view of the ASC 842 lease accounting amortisation schedule at beginning of year 1

Balance sheet

- US$630,606.11 increase to ROU asset that will be amortised over time per the schedule shown in Figure 2.
- US$630,606.11 increase to lease liability that will be amortised over time per the schedule shown in Figure 2.

P&L

- US$12,000 straightline rent expense scheduled to be recognised each period until the end of the lease.

By September of year 1, a major shift in the business has occurred, the division has experienced challenges, and the company has decided that the office will be closed.

The real estate team is informed that the space will be abandoned, but they want to understand what the accounting results will be under the following unique scenarios:

- Scheduled termination;
- Immediate termination;
- Abandonment;
- Impairment.

Scheduled termination

Assume Company A is able to negotiate a termination with the landlord. The decision is made in September to terminate the lease at year end with a US$200,000 termination penalty payable in December.

This is the usual scenario with a period of time between the date of the decision to terminate and the actual lease exit date. From an accounting standpoint, this is technically not a lease termination but is a lease modification which shortens the lease term. The present value of the cancelled stream of lease payments is removed from the lease liability with an equivalent decrease to the right of use asset. The US$200,000 termination fee is added to the stream of lease payments and the present value of that adds to the lease liability and right of use asset. The remeasured balances of asset and liability are then amortised over the shortened lease term. This results in much higher expense on the P&L between the decision date and the exit date because the entire amount of the termination fee must be amortised by the revised end of the lease (see Figure 3).

Period	Asset Balance	Asset Amortization	Gain (Loss)	Rent Expense	Asset Adjustment	Liability Balance	Liability Adjustment	Liability Reduction	Scheduled Payments
Beginning	630,606.11		–			630,606.11	–	–	–
Jan	621,233.64	9,372.47	–	12,000.00		623,233.64		7,372.47	10,000.00
Feb	611,830.45	9,403.19	–	12,000.00		615,830.45		7,403.19	10,000.00
Mar	602,396.41	9,434.04	–	12,000.00		608,396.41		7,434.04	10,000.00
Apr	592,931.40	9,465.01	–	12,000.00		600,931.40		7,465.01	10,000.00
May	583,435.28	9,496.12	–	12,000.00		593,435.28		7,496.12	10,000.00
Jun	573,907.93	9,527.35	–	12,000.00		585,907.93		7,527.35	10,000.00
Jul	564,349.21	9,558.72	–	12,000.00		578,349.21		7,558.72	10,000.00
Aug	554,759.00	9,590.21	–	12,000.00		570,759.00		7,590.21	10,000.00
Sep	165,272.41	55,015.47	–	56,000.00	(334,471.12)	227,272.41	(334,471.12)	9,015.47	10,000.00
Oct	110,219.38	55,053.03	–	56,000.00		218,219.38		9,053.03	10,000.00
Nov	55,128.63	55,090.75	–	56,000.00		209,128.63		9,090.75	10,000.00
Dec	–	55,128.63	–	56,000.00		–		209,128.63	210,000.00

Figure 3 Scheduled termination

The main impacts to the balance sheet and P&L are:

Balance sheet

- US$334,000 reduction of ROU asset in September.
- US$334,000 reduction of lease liability in September.

P&L

- Straightline rent expense jumps from US$12,000 per month to US$56,000 per month for the final four months of the modified lease, resulting in US$224,000 total lease expense recorded from September to December.

Immediate termination

Assume Company A is able to negotiate an immediate termination in September where the agreement to terminate the lease is executed on the same day that the office is vacated and turned back over to the lessor. In this case there is no more time for the asset, liability and termination penalty to be amortised, so the difference in the ending asset and liability plus the termination penalty results in an immediate loss recognised on the P&L (see Figure 4).

The main impacts to the balance sheet and P&L are:

Balance sheet

- Total remaining asset and liability written off in September.

P&L

- US$182,000 loss recorded in September (US$200,000 termination fee less the difference in closing liability and asset balances).

Abandonment

Assume Company A indeed has to abandon the property because there is not a viable option to terminate, sublease or gain any other economic benefit from the property. In this case, from the decision date in September, ROU asset amortisation is accelerated so the asset is fully amortised by the cease use date in December. Expense on the P&L is increased from US$12,000 per month before the decision date to US$141,000 per month during the four months of accelerated amortisation. After the cease use date in December, only the liability remains on the balance sheet and expense going forward is only based on the amortisation of the liability using the effective interest method (see Figure 5).

The main impacts to the balance sheet and P&L are:

Period	Asset Balance	Asset Amortization	Gain (Loss)	Rent Expense	Asset Adjustment	Liability Balance	Liability Adjustment	Liability Reduction	Scheduled Payments
Beginning	630,606.11		–			630,606.11	–	–	–
Jan	621,233.64	9,372.47	–	12,000.00		623,233.64		7,372.47	10,000.00
Feb	611,830.45	9,403.19	–	12,000.00		615,830.45		7,403.19	10,000.00
Mar	602,396.41	9,434.04	–	12,000.00		608,396.41		7,434.04	10,000.00
Apr	592,931.40	9,465.01	–	12,000.00		600,931.40		7,465.01	10,000.00
May	583,435.28	9,496.12	–	12,000.00		593,435.28		7,496.12	10,000.00
Jun	573,907.93	9,527.35	–	12,000.00		585,907.93		7,527.35	10,000.00
Jul	564,349.21	9,558.72	–	12,000.00		578,349.21		7,558.72	10,000.00
Aug	554,759.00	9,590.21	–	12,000.00		570,759.00		7,590.21	10,000.00
Sep	–	9.621.84	(182,000.00)	12,000.00	(545,137.16)	–	(563,137.16)	7,621.84	10,000.00

Figure 4 Immediate termination

Period	Asset Balance	Asset Amortization	Gain (Loss)	Rent Expense	Asset Adjustment	Liability Balance	Liability Adjustment	Liability Reduction	Scheduled Payments
Beginning	630,606.11		–			630,606.11	–	–	–
Jan - YR1	621,233.64	9,372.47		12,000.00		623,233.64		7,372.47	10,000.00
Feb - YR1	611,830.45	9,403.19		12,000.00		615,830.45		7,403.19	10,000.00
Mar - YR1	602,396.41	9,434.04		12,000.00		608,396.41		7,434.04	10,000.00
Apr - YR1	592,931.40	9,465.01		12,000.00		600,931.40		7,465.01	10,000.00
May - YR1	583,435.28	9,496.12		12,000.00		593,435.28		7,496.12	10,000.00
Jun - YR1	573,907.93	9,527.35		12,000.00		585,907.93		7,527.35	10,000.00
Jul - YR1	564,349.21	9,558.72		12,000.00		578,349.21		7,558.72	10,000.00
Aug - YR1	554,759.00	9,590.21		12,000.00		570,759.00		7,590.21	10,000.00
Sep - YR1	416,069.25	138,689.75		141,067.91		563,137.16		7,621.84	10,000.00
Oct - YR1	277,379.50	138,689.75		141,036.15		555,483.56		7,653.60	10,000.00
Nov - YR1	138,689.75	138,689.75		141,004.26		547,798.07		7,685.49	10,000.00
Dec - YR1	138,689.75	–		140,972.24		540,080.56		7,717.51	10,000.00
Jan - YR2	–	–		2,250.34		531,330.90		8,749.66	11,000.00
Feb - YR2	–	–		2,213.88		522,544.78		8,786.12	11,000.00
Mar - YR2	–	–		2,177.27		513,722.05		8,822.73	11,000.00
Apr - YR2	–	–		2,140.51		504,862.56		8,859.49	11,000.00
May - YR2	–	–		2,103.59		495,966.15		8,896.41	11,000.00

Figure 5 Abandonment

Balance sheet

- ROU asset reduced to a balance of US$0 in December due to four months of accelerated amortisation.

P&L

- Approximately US$141,000 of rent expense recorded in each of the last four months of asset use.
- Total of US$564,000 in rent expense recognised for the months of September to December.
- Continuing rent expense (calculated as lease liability interest) for the remainder of the lease.

Impairment

Assume Company A plans to stop using the space as it was originally intended, but the real estate team knows that there is

Period	Asset Balance	Asset Amortization	Gain (Loss)	Rent Expense	Asset Adjustment	Liability Balance	Liability Adjustment	Liability Reduction	Scheduled Payments
Beginning	630,606.11		–			630,606.11	–	–	–
Jan - YR1	621,233.64	9,372.47		12,000.00		623,233.64		7,372.47	10,000.00
Feb - YR1	611,830.45	9,403.19		12,000.00		615,830.45		7,403.19	10,000.00
Mar - YR1	602,396.41	9,434.04		12,000.00		608,396.41		7,434.04	10,000.00
Apr - YR1	592,931.40	9,465.01		12,000.00		600,931.40		7,465.01	10,000.00
May - YR1	583,435.28	9,496.12		12,000.00		593,435.28		7,496.12	10,000.00
Jun - YR1	573,907.93	9,527.35		12,000.00		585,907.93		7,527.35	10,000.00
Jul - YR1	564,349.21	9,558.72		12,000.00		578,349.21		7,558.72	10,000.00
Aug - YR1	554,759.00	9,590.21		12,000.00		570,759.00		7,590.21	10,000.00
Sep - YR1	545,137.16	9,621.84		12,000.00		563,137.16		7,621.84	10,000.00
Oct - YR1	535,483.56	9,653.60		12,000.00		555,483.56		7,653.60	10,000.00
Nov - YR1	525,798.07	9,685.49		12,000.00		547,798.07		7,685.49	10,000.00
Dec - YR1	240,000.00	9,717.51	(276,080.56)	12,000.00	(276,080.56)	540,080.56		7,717.51	10,000.00
Jan - YR2	235,000.00	5,000.00		7,250.34		531,330.90		8,749.66	11,000.00
Feb - YR2	230,000.00	5,000.00		7,213.88		522,544.78		8,786.12	11,000.00
Mar - YR2	225,000.00	5,000.00		7,177.27		513,722.05		8,822.73	11,000.00
Apr - YR2	220,000.00	5,000.00		7,140.51		504,862.56		8,859.49	11,000.00
May - YR2	215,000.00	5,000.00		7,103.59		495,966.15		8,896.41	11,000.00

Figure 6 Impairment

an alternative use of the space for storage or an opportunity to obtain a subtenant for the duration of the lease term. The value to Company A of the alternative use is US$240,000 in December of year 1 when the ROU asset has a book value of US$516,080.56. The difference in these two numbers becomes a reduction in the ROU asset and an impairment loss (see Figure 6).

The main impacts to the balance sheet and P&L are:

Balance sheet

- ROU asset reduced to a balance of US$240,000 in December.

P&L

- US$276,000 recorded as a loss in December (US$516,000 balance of ROU asset from original schedule less US$240,000 impaired value of asset).
- Note that rent expense is no longer straightlined after the impairment, but asset amortisation is straightlined.

CONCLUSION

Terminology can be tricky, especially when descriptions used by business units or even the real estate and finance teams do not match up with accounting terminology. Companies considering transactions like those discussed in this paper should consult their auditors or other accounting advisers along the way to make sure proper accounting entries are recorded and avoid any surprises at audit time. This paper explains and illustrates the most frequently used accounting terminology involved when companies make decisions to reduce real estate footprints. While this paper is not an all-inclusive accounting guide, it can be useful for real estate professionals to prepare for conversations with their accounting counterparts and perform an initial assessment of the potential impact transactions will have on a company's financial statements.

References and Notes

(1) ASC 842 in this article refers to Accounting Standards Update 2016-02, Leases which

was ultimately added to US Generally Accepted Accounting Standards in the form of Accounting Standards Codification Topic 842, Leases, available at https://www.fasb.org/leases (accessed 22nd March, 2024).

(2) *Ibid*.

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(5) KPMG (June 2023), 'Handbook: Leases', available at https://frv.kpmg.us/reference-library/2023/handbook-leases.html (accessed 22nd March, 2024).

(6) Ernst & Young (EY) (August 2023), 'Financial Reporting Developments – Lease Accounting – Account Standards Codification 842, Leases', available at https://www.ey.com/en_us/assurance/accountinglink/financial-reporting-developments---lease-accounting---accounting (accessed 22nd March, 2024).

(7) The decision date refers to the date that both the lessee and lessor agree to terminate the lease.

(8) The term 'amortisation' is used throughout this paper to describe the scheduled decrease of assets or liabilities over time. That is a common term in practice, but the Securities and Exchange Commission (SEC) in the US has weighed in that operating leases do not technically result in amortisation. Therefore, from a technical accounting perspective, it is more correct to say 'asset reduction' or 'liability accretion' in reference to operating leases. Because this paper is intended for a non-accounting audience, however, the author decided to use the common term 'amortisation' on charts and in the text.

(9) Financial Accounting Standards Board (FASB) (December 2011), 'Property, Plant, and Equipment (Topic 360)', available at https://fasb.org/page/ShowPdf?path=ASU%202011-10.pdf&title=UPDATE%20NO.%202011-10%E2%80%94PROPERTY,%20PLANT,%20AND%20EQUIPMENT%20(TOPIC%20360):%20DERECOGNITION%20OF%20IN%20SUBSTANCE%20REAL%20ES (accessed 22nd March, 2024). 'The carrying amount of a long-lived asset (asset group) is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset (asset group)'. 'An asset group is 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'.