Asset to be abandoned or subleased
Supplement to KPMG’s Handbook, Leases

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Abandonments and subleases

The new leases standard (Topic 842) requires lessees to:

— recognize right-of-use assets for all leases, including operating leases, with a term greater than 12 months; and
— use the long-lived assets impairment guidance in Topic 360 (property, plant and equipment) to determine whether a right-of-use asset is impaired, and to measure any impairment loss.

Complications arise in accounting for a lease as a lessee when the lessee decides to abandon or sublease the underlying asset. These complexities increase if the lessee decides to abandon or sublease only a portion of the relevant asset – e.g. the lessee abandons or subleases a single floor of a multi-floor leased building.

This publication supplements our Handbook, Leases, by providing specific guidance on a lessee’s accounting when it abandons all or a portion of a right-of-use asset or subleases a portion of the underlying asset.

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Department of Professional Practice, KPMG LLP
About this publication

This publication addresses a lessee ceasing use of an underlying asset (or portion thereof), either through abandonment or sublease.

Supplement to KPMG’s Handbook, Leases

This publication should be read together with chapter 6 of KPMG’s Handbook, Leases, and hyperlinked cross-references are included where relevant.

Our in-depth guidance is explained through Q&As that reflect the questions we are encountering in practice, and our commentary refers to the FASB’s Accounting Standards Codification®. For example, 360-10-35-21 is paragraph 35-21 of ASC Subtopic 360-10.

Abbreviation

We use the following abbreviation in this publication:

ROU Right-of-use (asset)
1. **The concepts**

The questions and examples in this publication address a lessee ceasing use of an underlying asset (or portion thereof), either through abandonment or sublease. Although abandonment and subleasing differ in terms of the future economic benefits to be derived from the lease by the lessee (see Question 1.1), the accounting considerations are similar.

The following diagram is used throughout this publication to differentiate the timing of the accounting considerations that are discussed — in particular, at the ‘decision date’, and in the period between the decision date and the ‘cease-use date’. In sublease scenarios (see chapter 4), the date that a sublease is entered into (i.e. ‘sublease inception’) is also a key date.

**Notes:**
1. The ‘decision date’ is the date on which the lessee commits to the plan to either abandon the ROU asset or sublease the underlying asset (or portion thereof).
2. The ‘cease-use date’ is the date on which the lessee stops using the underlying asset in its operations – e.g. the date the lessee vacates a leased facility that it is either abandoning or will sublease.

**Question 1.1**

Has a lessee abandoned an ROU asset if it has ceased use of the underlying asset but intends to sublease it?

**Interpretive response:** No. We believe an ROU asset has not been abandoned if the lessee has both the intent and the practical ability to sublease the underlying asset, even if a sublessee has not been identified by the cease-use date. This is because Topic 842 considers sublease payments to be economic benefits from use of the underlying asset. Consequently, a decision by the lessee to cease use of the underlying asset, and instead to sublease it, does not constitute an abandonment. [842-10-15-17]

In contrast, ceasing use of the underlying asset does constitute an abandonment of the ROU asset if the lessee either:

— does not intend to sublease the asset; or
— does not have the practical ability to sublease the asset.
The following is a summary of the accounting issues that require consideration, highlighting at which key date accounting assessments are made and which Question addresses the issue.

The accounting steps are similar regardless of whether the whole or a portion of the underlying asset is being abandoned or subleased. However, the issues are more complex when only a portion of the underlying asset is affected and the lessee is accounting for its lease of the entire underlying asset as a single lease component – i.e. one ROU asset and one lease liability.

<table>
<thead>
<tr>
<th></th>
<th>Abandon</th>
<th>Sublease</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Whole ROU asset</td>
<td>Portion of ROU asset</td>
</tr>
<tr>
<td><strong>At the decision date</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reassess asset group?</td>
<td>Question 1.2</td>
<td></td>
</tr>
<tr>
<td>Evaluate potential impairment</td>
<td>Question 2.1</td>
<td>Note 1</td>
</tr>
<tr>
<td>Re-evaluate unit of account</td>
<td>N/A</td>
<td>Question 3.1</td>
</tr>
<tr>
<td>Determine go-forward accounting</td>
<td>Question 2.1</td>
<td>Note 1</td>
</tr>
<tr>
<td><strong>At the earlier of cease-use date and sublease inception</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reassess asset group?</td>
<td>Question 1.2</td>
<td></td>
</tr>
<tr>
<td>Re-evaluate unit of account</td>
<td>N/A</td>
<td>Question 3.1</td>
</tr>
<tr>
<td>Evaluate potential impairment</td>
<td>N/A²</td>
<td>N/A²</td>
</tr>
<tr>
<td>Determine go-forward accounting</td>
<td>Question 2.1</td>
<td>Question 3.1</td>
</tr>
</tbody>
</table>

Notes:
1. This publication does not include specific Questions or Examples related to the sublease of a whole underlying asset. Chapter 8 of KPMG’s Handbook addresses the accounting for the sublease of a whole underlying asset.
2. ROU asset carrying amount is $0 by the cease-use date (see Question 2.1).
Question 1.2

When does a lessee reassess its asset groups under Topic 360 if it plans to significantly change how it uses an ROU asset that is part of a larger asset group?

Background: Under Topic 360, to recognize and measure an impairment loss, long-lived assets are grouped with other assets and liabilities at the lowest level for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities. [360-10-35-23]

An entity should reassess its asset grouping if it experiences a significant change in facts and circumstances, including changes in operating structure or the manner in which it deploys long-lived assets (other than routine changes in management). For example, a lessee may decide to change how it uses an ROU asset by entering into a sublease rather than continuing to use the underlying asset in its ongoing operations.

A change in an asset group that results from changes in facts and circumstances is a change in estimate under Topic 250 (accounting changes and error corrections). An entity should comply with the disclosure requirements of Topic 250, including disclosing a change in asset grouping and the circumstances of the change. [250 Glossary, 250-10-50-4]

Interpretive response: The triggering event for reassessing asset grouping is generally the change in facts or circumstances, not the commitment to a plan to make the change. This is because, absent a binding commitment (e.g. an executed sublease) or substantial costs incurred (e.g. to exit a leased building), the plan would generally be reversible. This means that committing to a plan to abandon an ROU asset or to sublease an underlying asset generally will not, in isolation, trigger a reassessment of asset grouping if the lessee is continuing to use the underlying asset in substantially the same manner as before committing to the plan.

The following are examples of changes that would typically trigger a reassessment of an ROU asset’s Topic 360 asset grouping (not exhaustive):

— the lessee enters into a sublease of the underlying asset;
— the lessee ceases use of the underlying asset; or
— the lessee significantly changes how the underlying asset is used in its operations – e.g. leased equipment is redeployed from one business unit to another, and the two business units’ long-lived assets are not part of the same asset group.

If multiple changes in facts and circumstances occur, the lessee may need to undertake multiple asset grouping reassessments as those changes occur.
2. Abandonment of the entire ROU asset

Question 2.1
How should a lessee account for the abandonment of an ROU asset that is part of a larger asset group?

Interpretive response: We believe the lessee should undertake the following steps to account for the abandonment of an ROU asset (see Question 1.1) that is part of a larger Topic 360 asset group.

1. Evaluate whether the asset group is impaired

The lessee continues to evaluate impairment under Topic 360 at the same asset group level after committing to the plan to abandon the ROU asset as before committing to the plan (see Question 1.2).

However, committing to the plan of abandonment may constitute a triggering event, requiring an assessment of possible impairment for the larger asset group at the decision date. That assessment, as well as the recognition of any impairment loss, follows the guidance in Topic 360. An impairment indicator associated with a single ROU asset within a larger asset group may not signify a need to test the entire asset group for impairment. A lessee should consider the significance of the to-be-abandoned ROU asset to the asset group as a whole before concluding the asset group needs to be tested for impairment. [360-10-35-21]

If the asset group is not impaired, there is no basis in Topic 360 or Topic 842 to immediately write down the carrying amount of the ROU asset that will be abandoned.

2. Determine go-forward accounting

It is necessary to consider the go-forward accounting at the decision date if the ROU asset is either not impaired or is only partially impaired in Step 1.

The lessee should update its estimate of the useful life of the ROU asset (i.e. shorten it) to ensure that the to-be-abandoned ROU asset is amortized to its salvage value over the period of its remaining expected use. The salvage value of an ROU asset is likely to be zero, and the useful life will end at the expected cease-use date. [360-10-35-47, ASU 2016-02.BC255]

We believe there are two acceptable approaches to amortize the ROU asset over the remainder of its shortened useful life if no impairment of the ROU asset has been recognized – i.e. either as a result of Step 1 in this response or at any time before the decision date. In contrast, if the ROU asset is partially impaired (even if only by an insignificant amount), only Approach 1 is acceptable (see paragraphs 6.5.40 – 6.5.50 in KPMG’s Handbook).
Under both approaches:

— the ROU asset is amortized to $0 by the cease-use date;
— the amount of ROU amortization between the decision date and the cease-use date is greater than the amortization that would have been recognized if there were no plan to abandon the ROU asset; and
— there is no change in how the lessee accounts for the lease liability throughout the remainder of the lease term – i.e. accretion of the lease liability remains the same as if there were no plan to abandon the ROU asset, and the lease liability balance will be the same amount it would have been had there been no abandonment.

**Approach 1: Loss of straight-line lease cost**

The lessee amortizes the ROU asset over the revised remaining useful life (i.e. from the decision date to the cease-use date) on a straight-line basis.

Because the lease liability continues to be accreted in the same manner as before the decision date, the single lease cost is front-loaded over the remaining lease term similar to what occurs after impairment of an operating lease ROU asset (see Example 6.5.20 in KPMG’s Handbook).

**Approach 2: Adjusted straight-line lease cost**

Rather than amortizing the ROU asset on a straight-line basis from the decision date to the cease-use date, the lessee amortizes the ROU asset to result in both:

— a $0 ROU asset carrying amount at the cease-use date; and
— a straight-line total lease cost from the decision date to the cease-use date when combined with the accretion of the lease liability.

If the ROU asset becomes impaired at any point between the decision date and the cease-use date (e.g. because there is an intervening impairment of the asset group), the lessee is required to revert to Approach 1 from the impairment date (see paragraphs 6.5.40 – 6.5.50 and Example 6.5.20 in KPMG’s Handbook).

**Accounting after the cease-use date**

There is no specific new accounting after the cease-use date. The single lease cost between the cease-use date and the end of the lease term is equal to the lease liability accretion because the ROU asset is fully amortized by the cease-use date.
Example 2.1
Abandonment of an ROU asset that is part of a larger asset group

Lessee LE enters into a contract with Lessor LR for the right to use a machine for seven years with no renewal options. The right to use the machine is a lease and there are no other components of the contract.

The following facts are relevant at the lease commencement date.

<table>
<thead>
<tr>
<th>Lease payments:</th>
<th>Fixed payments of $1,000 per year in arrears</th>
</tr>
</thead>
<tbody>
<tr>
<td>LE’s incremental borrowing rate:</td>
<td>6% (the rate implicit in the lease cannot be readily determined)</td>
</tr>
<tr>
<td>Lease liability recognized:1</td>
<td>$5,582</td>
</tr>
<tr>
<td>ROU asset recognized:2</td>
<td>$5,582</td>
</tr>
</tbody>
</table>

Notes:
1. Calculated as the present value of the seven lease payments of $1,000, discounted at the incremental borrowing rate of 6%.
2. Calculated as the initial measurement of the lease liability because there are no initial direct costs, prepaid lease payments or lease incentives received.

LE appropriately classified the lease as an operating lease, because none of the tests for classification as a finance lease were met (see paragraph 6.2.50 in KPMG’s Handbook).

The ROU asset for the leased machine is part of an asset group comprising other ROU assets and owned assets.

At the beginning of Year 2 (the decision date), when the carrying amounts of the lease liability and the ROU asset are both $4,917, LE decides that it will cease using the machine after Year 5 – i.e. two years before the end of the lease term. Between the decision date and the end of Year 5, LE plans to continue using the leased machine in the same manner, and as part of the same operation, as before the decision date.

LE does not intend to sublease the asset. Consequently, LE intends to abandon the ROU asset before the end of the lease term (see Question 1.1).
1. Evaluate whether the asset group is impaired when LE commits to the plan to abandon the ROU asset

Consistent with the response to Question 1.2, LE’s decision to cease use of the ROU asset does not trigger a reassessment of the asset group that contains the ROU asset; therefore, the ROU asset remains part of the larger asset group subsequent to the decision date.

LE concludes there is no impairment of the asset group that contains the ROU asset based on an appropriate analysis under Topic 360.

2. Determine go-forward accounting

Because LE plans to abandon the ROU asset at the end of Year 5, LE updates its estimate of the remaining useful life of the ROU asset to ensure it is amortized to its estimated salvage value of $0 by the end of that revised useful life.

**Approach 1: Loss of straight-line lease cost**

LE recalculates the annual amortization of the ROU asset over its remaining expected useful life of four years from the decision date. The total single lease cost each period of the remaining lease term equals the sum of the amortization of the ROU asset and the accretion of the operating lease liability.

Amortization of the ROU asset over the remaining expected useful life of four years from the decision date occurs on a straight-line basis, while the lease liability continues to be accreted over the remainder of the 7-year lease term in the same manner as before the decision date.

<table>
<thead>
<tr>
<th>Year</th>
<th>ROU asset amortization</th>
<th>ROU asset carrying amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Single lease cost</td>
<td>Lease liab. accret.</td>
</tr>
<tr>
<td>1</td>
<td>$1,000</td>
<td>$335</td>
</tr>
<tr>
<td>2</td>
<td>1,524</td>
<td>295</td>
</tr>
<tr>
<td>3</td>
<td>1,482</td>
<td>253</td>
</tr>
<tr>
<td>4</td>
<td>1,437</td>
<td>208</td>
</tr>
<tr>
<td>5</td>
<td>1,390</td>
<td>160</td>
</tr>
<tr>
<td>6</td>
<td>110</td>
<td>110</td>
</tr>
<tr>
<td>7</td>
<td>57</td>
<td>57</td>
</tr>
</tbody>
</table>

**Notes:**

1. The single lease cost for an operating lease is generally calculated so that the remaining cost of the lease is allocated over the remaining lease term on a straight-line basis. As of the decision date, amortization of the ROU asset is no longer calculated to result in a straight-line total lease cost (see paragraphs 6.5.40 – 6.5.50 and Example 6.5.20 in KPMG’s Handbook).

2. Calculated as beginning balance of lease liability multiplied by incremental borrowing rate: Year 1 = $5,582 × 6%, Year 2 = $4,917 × 6%, etc.

3. Calculated as balance of ROU asset at beginning of Year 2 divided by remaining expected useful life: $4,917 / 4 years.
**Approach 2: Adjusted straight-line lease cost**

LE amortizes the ROU asset to result in both (1) a $0 ROU asset carrying amount at the cease-use date at the end of Year 5, and (2) a straight-line total lease cost for the four years between the decision date and the cease-use date (when combined with the accretion of the lease liability).

<table>
<thead>
<tr>
<th>Year</th>
<th>ROU asset amortization</th>
<th>ROU asset carrying amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Single lease cost</td>
<td>Lease liab. accret.</td>
</tr>
<tr>
<td>1</td>
<td>$1,000</td>
<td>$335</td>
</tr>
<tr>
<td>2</td>
<td>1,458¹</td>
<td>295</td>
</tr>
<tr>
<td>3</td>
<td>1,458</td>
<td>253</td>
</tr>
<tr>
<td>4</td>
<td>1,458</td>
<td>208</td>
</tr>
<tr>
<td>5</td>
<td>1,459</td>
<td>160</td>
</tr>
<tr>
<td>6</td>
<td>110</td>
<td>110</td>
</tr>
<tr>
<td>7</td>
<td>57</td>
<td>57</td>
</tr>
</tbody>
</table>

Note:
1. Calculated as lease cost for Years 2–5 divided by remaining estimated useful life: 
   \[\frac{($4,917 + $295 + $253 + $208 + $160)}{4 \text{ years}}\]
3. Abandonment of a portion of the ROU asset

Question 3.1

How should a lessee account for the abandonment of a portion of a single ROU asset?

Background: For purposes of this question, a lessee has leased an entire office building with five floors and accounted for that lease as a single separate lease component – i.e. as a single unit of account. Partway through the lease term, the lessee commits to a plan to abandon one of the five floors (see Question 1.1). In other words, the lessee will abandon a portion of its ROU asset.

Interpretive response: We believe the lessee should undertake the following steps to account for the abandonment of a portion of an ROU asset.

1. Evaluate whether the asset group is impaired

Evaluating whether the asset group is impaired is not substantively different from the process described in Step 1 in Question 2.1. The only difference is that it is a portion of an ROU asset that will be abandoned – not an entire ROU asset.

2. Re-evaluate the unit of account

A decision about whether the right to use the portion of the underlying asset that will be abandoned should be separated from the larger, existing ROU asset covering the lessee’s right to use the entire underlying asset is important because it determines the go-forward accounting described in Step 3.

At the decision date, we believe the lessee should evaluate why the existing, single separate lease component is a single unit of account. The lessee should determine whether this is the case:

— because there was only a single separate lease component when it was assessed in accordance with paragraph 842-10-15-28 (see section 4.1 in KPMG’s Handbook); or instead
— because the lessee in effect applied a portfolio approach (see section 5.8 in KPMG’s Handbook) – i.e. accounted for multiple separate lease components as a single separate lease component.

As a practical matter, the lessee may not have previously evaluated this question. For example, the lessee may not have assessed, in deciding to account for the lease of the multi-floor building as a single unit of account, whether the building was a single separate lease component or multiple separate lease components. The assessment may have had no perceived accounting effect at that time. However, upon committing to a plan to abandon a portion of the ROU asset, we believe the lessee needs to evaluate this question to properly account for the planned abandonment going forward.
This assessment undertaken at the decision date is based on the facts and circumstances that existed when this evaluation would have taken place previously, and does not take into account subsequent changes in circumstances – e.g. the changed market desirability of a particular floor of an office building.

3. Determine go-forward accounting

The re-evaluation of the unit of account when only a portion of the ROU asset will be abandoned makes the analysis of the go-forward accounting more complex. The following diagram summarizes the additional step in the process, which is explained in detail in the discussion that follows.

No separation required (single separate lease component previously)

If, upon evaluation in Step 2, there was only a single separate lease component, the to-be-abandoned portion of the ROU asset remains part of a single ROU asset – i.e. the unit of account for the lessee’s lease accounting is not revised. Therefore, neither the ROU asset, nor any portion of the ROU asset, is subject to the accelerated amortization model described in Question 2.1; this is because the single ROU asset is not being abandoned.

The lessee’s accounting for the lease liability associated with the single ROU asset is also unaffected by the lessee’s decision to abandon a portion of the ROU asset.

Separation required (right to use the to-be-abandoned portion of underlying asset was a separate lease component previously)

If the right to use the to-be-abandoned asset met the criteria to be a separate lease component, a portion of the existing ROU asset reflecting that separate lease component should be separated from the existing ROU asset and the accelerated amortization model in Question 2.1 should be applied to it.
A portion of the existing lease liability should also be allocated to the newly separate lease component. The lessee’s accounting for the newly separate lease liability is unaffected by the fact that the related ROU asset will be abandoned – i.e. the lessee accounts for the lease liability in the same manner as if the ROU asset were not going to be abandoned.

We believe the lessee should allocate the carrying amount of the existing ROU asset and lease liability to (1) the new, separate lease component (i.e. the right to use the portion of the underlying asset that will be abandoned), and (2) the separate lease component that reflects the remainder of the original lease, on a relative stand-alone price basis.

Because Topic 842 does not address allocation in this situation, we believe a lessee could base the relative stand-alone price allocation on either:

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| the stand-alone prices the lessee would have determined for the two separate lease components had they previously been accounted for separately (historical stand-alone prices); or |
| the stand-alone prices of the two separate lease components at the date the lessee commits to the plan of abandonment (decision date) based on the remaining lease term and the then-current facts and circumstances – e.g. current observable stand-alone prices (current stand-alone prices). |
---

The lessee’s accounting for the separate lease component that reflects the remainder of the original lease is accounted for from the separation date in the same manner as any other separate lease component.

### Example 3.1

**Abandonment of a portion of a leased building**

Lessee LE enters into a contract with Lessor LR for the right to use a five-story office building for five years with no renewal options. The right to use the building is a lease and there are no other components of the contract. There have been no modifications to (or remeasurements of) the lease.

The following facts are relevant at the lease commencement date.

| Lease payments (gross lease): | Fixed payments of $1,000 per year in arrears |
| LE’s incremental borrowing rate: | 6% (the rate implicit in the lease cannot be readily determined) |
| Lease liability recognized:¹ | $4,212 |
| ROU asset recognized:² | $4,212 |

**Notes:**

1. Calculated as the present value of the five lease payments of $1,000, discounted at the incremental borrowing rate of 6%.
2. Calculated as the initial measurement of the lease liability because there are no initial direct costs, prepaid lease payments or lease incentives received.
LE appropriately classified the lease as an operating lease, because none of the tests for classification as a finance lease were met (see paragraph 6.2.50 in KPMG’s Handbook). LE did not separately account for the implied land element of the lease (see Question 4.1.20 in KPMG’s Handbook) because the accounting effect of doing so would have been insignificant – i.e. the coterminous land and building elements separately would have both been classified as operating leases.

At the beginning of Year 2 (the decision date), when the carrying amount of the lease liability and the ROU asset are both $3,465, LE decides that it will cease use of the top floor of the building at the end of Year 3 – i.e. two years before the end of the lease term. Between the decision date and the end of Year 3, LE plans to continue using the top floor of the building in the same manner, and as part of the same operation, as before the decision date.

LE would have the practical ability to sublease the top floor after it ceases use of it, but does not intend to do so. Consequently, LE plans to abandon the ROU asset before the end of the lease term (see Question 1.1).

1. **Evaluate whether the asset group is impaired**

Consistent with the response to Question 1.2, LE’s decision to cease use of part of the building does not trigger a reassessment of the asset group that contains the entire building ROU asset; therefore, the ROU asset remains part of the larger asset group subsequent to the decision date.

LE concludes that there is no impairment of the asset group that contains the entire building ROU asset based on an appropriate analysis under Topic 360.

2. **Re-evaluate the unit of account**

While LE has accounted for the building lease as a single unit of account (one ROU asset and one lease liability) to date, upon deciding to abandon the top floor of the building, LE concludes that the top floor of the building previously met the criteria to be accounted for as a separate lease component.

- LE could benefit from the top floor on its own – i.e. separate from the other four floors of the building. This is evident because:
  - LE can practically sublease the top floor to a third-party sublessee; and
  - LR and other lessors regularly lease different floors in similar office buildings to unrelated lessees.

- The right to use the top floor is not highly dependent on, nor highly interrelated with, LE’s right to use the remainder of the building. At contract inception, the building was already divided into multiple floors such that LR
could have granted separate rights to multiple lessees to use different floors of the building or transferred rights to LE to use the different floors with different commencement dates.

3. Determine go-forward accounting

**Separate and allocate the existing ROU asset and lease liability to the two separate lease components created by Step 2**

Based on the conclusion reached in Step 2, LE separates its lease of the top floor from its lease of the remainder of the office building. LE allocates between the top floor lease component and the lease component for the remainder of the building on a relative stand-alone price basis as follows. In this example, LE elects to use historical stand-alone prices (see Question 3.1).

<table>
<thead>
<tr>
<th>Separate lease component</th>
<th>Stand-alone price</th>
<th>Allocated ROU asset</th>
<th>Allocated lease liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Top floor</td>
<td>$1,165</td>
<td>$807(^2)</td>
<td>$807(^2)</td>
</tr>
<tr>
<td>Remaining floors</td>
<td>3,835</td>
<td>2,658(^3)</td>
<td>2,658(^3)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$5,000(^1)</strong></td>
<td><strong>$3,465</strong></td>
<td><strong>$3,465</strong></td>
</tr>
</tbody>
</table>

Notes:
1. Because LE is using historical rather than current stand-alone prices, those prices are based on two five-year leases.
2. $807 = ($1,165 / $5,000) × $3,465 (carrying amount at beginning of Year 2).
3. $2,658 = ($3,835 / $5,000) × $3,465 (carrying amount at beginning of Year 2).

**Update useful life for new top floor ROU asset and account for new top floor separate lease component**

Because LE plans to abandon the top floor ROU asset after Year 3, LE updates its estimate of the remaining useful life of the ROU asset to ensure it is fully amortized by the end of that revised useful life.

LE elects Approach 1 in Question 2.1. Therefore, amortization of the top floor ROU asset over the remaining expected useful life of two years from the decision date occurs on a straight-line basis, while the lease liability continues to be accreted over the remainder of the five-year lease term in the same manner as before the decision date.

<table>
<thead>
<tr>
<th>Yr.</th>
<th>Lease liability carry. amt.</th>
<th>ROU asset carry. amt.</th>
<th>Single lease cost(^4)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Beg. bal.</td>
<td>Lease liab. accret.(^1)</td>
<td>Pmt.(^2)</td>
</tr>
<tr>
<td>2</td>
<td>$(807)</td>
<td>$(48)</td>
<td>$233</td>
</tr>
<tr>
<td>3</td>
<td>(622)</td>
<td>(37)</td>
<td>233</td>
</tr>
<tr>
<td>4</td>
<td>(426)</td>
<td>(26)</td>
<td>233</td>
</tr>
<tr>
<td>5</td>
<td>(219)</td>
<td>(14)</td>
<td>233</td>
</tr>
</tbody>
</table>

Notes:
1. Calculated as beginning balance of lease liability multiplied by incremental borrowing rate: Year 1 = $807 × 6%, Year 2 = $622 × 6%, etc.
Leases: Asset to be abandoned or subleased
3. Abandonment of a portion of the ROU asset

2. $233 = (\$1,165 / \$5,000) \times \$1,000.
3. Calculated as balance of ROU asset at beginning of Year 2 divided by remaining expected useful life: $807 / 2 years.
4. The single lease cost for an operating lease is generally calculated so that the remaining cost of the lease is allocated over the remaining lease term on a straight-line basis. As of the decision date, amortization of the ROU asset is no longer calculated to result in a straight-line total lease cost.

**Account for remainder of building separate lease component**

Accounting for the lease component for the remainder of the building from the decision date to the end of the lease term is as follows; this assumes there are no modifications to the lease, no reassessment events resulting in remeasurement and no impairments of the ROU asset.

<table>
<thead>
<tr>
<th>Yr.</th>
<th>Lease liability carry. amt.</th>
<th>ROU asset carry. amt.</th>
<th>Single lease cost²</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Beg. bal.</td>
<td>Lease liab. accret.¹</td>
<td>Pmt. ²</td>
</tr>
<tr>
<td>2</td>
<td>$(2,658)</td>
<td>$(159)</td>
<td>$767</td>
</tr>
<tr>
<td>3</td>
<td>(2,050)</td>
<td>(123)</td>
<td>767</td>
</tr>
<tr>
<td>4</td>
<td>(1,406)</td>
<td>(84)</td>
<td>767</td>
</tr>
<tr>
<td>5</td>
<td>(723)</td>
<td>(44)</td>
<td>767</td>
</tr>
</tbody>
</table>

Notes:
1. Calculated as beginning balance of lease liability multiplied by incremental borrowing rate: Year 2 = $2,658 \times 6\%$, Year 3 = $2,050 \times 6\%$, etc.
2. $767 = (\$3,835 / \$5,000) \times \$1,000$.
3. Calculated as the difference between the single lease cost and the lease liability accretion: Year 2 = $767 - \$159$, Year 3 = $767 - \$123$, etc.
4. Single lease cost is calculated as lease cost for Years 2–5 divided by remaining lease term: $3,068 / 4$ years. The $3,068 is calculated using the allocated portion of total lease payments: $(\$3,835 / \$5,000) \times \$1,000 \times 4$. 

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4. **Sublease of a portion of the underlying asset**

**Question 4.1**

**How should a lessee account for the sublease of a portion of a single underlying asset?**

**Background:** For purposes of this question, a lessee has leased an entire office building with five floors and accounted for that lease as a single separate lease component. Partway through the lease term, the lessee commits to a plan to sublease one of the five floors. In other words, the lessee will sublease a portion of what it has previously accounted for as a single unit of account.

**Interpretive response:** We believe the lessee should undertake the following steps to account for the sublease of a portion of a single underlying asset.

1. **Evaluate whether the asset group is impaired**

   The lessee continues to evaluate impairment under Topic 360 at the same asset group level after committing to the plan to sublease as before committing to the plan (see **Question 1.2**).

   However, committing to the sublease plan (i.e. at the decision date) may constitute a triggering event – e.g. if the lessee believes it is likely to incur a loss on the sublease or based on other economic facts and circumstances associated with the lessee’s decision to sublease. This would require an assessment of possible impairment for the larger asset group to which the existing ROU asset belongs. That assessment, as well as the recognition of any impairment loss, follows the guidance in Topic 360. An impairment indicator associated with a portion of an ROU asset may not signify a need to test impairment for the entire asset group. A lessee should consider the significance of the portion of the ROU asset affected by the sublease plan to the asset group as a whole, and the circumstances leading to the sublease decision, before concluding the asset group needs to be tested for impairment.

   If the asset group is not impaired, there is no basis in Topic 360 or Topic 842 to immediately write down the carrying amount of the existing ROU asset.

2. **Re-evaluate the unit of account**

   A decision about whether the right to use the portion of the underlying asset that will be subleased should be separated from the larger, existing ROU asset covering the lessee’s right to use the entire underlying asset is important because it determines the go-forward accounting described in Step 3.

   At the earlier of the cease-use date and sublease inception (‘earlier of’ date), we believe the lessee should evaluate why the existing, single separate lease component is a single unit of account.
The lessee should determine whether this is the case:

— because there was only a single separate lease component when it was assessed in accordance with paragraph 842-10-15-28 (see section 4.1 in KPMG’s Handbook); or instead

— because the lessee in effect applied a portfolio approach (see section 5.8 in KPMG’s Handbook) – i.e. accounted for multiple separate lease components as a single separate lease component.

As a practical matter, the lessee may not have previously evaluated this question. For example, the lessee may not have assessed, in deciding to account for the lease of the multi-floor building as a single unit of account, whether the building was a single separate lease component or multiple separate lease components. The assessment may have had no perceived accounting effect at that time. However, at the ‘earlier of’ date, we believe the lessee needs to evaluate this question to properly account for both the head lease and the sublease going forward.

This assessment undertaken at the ‘earlier of’ date is based on the facts and circumstances that existed when this evaluation previously would have taken place, and does not take into account subsequent changes in circumstances – e.g. the changed market desirability of a particular floor of an office building.

In re-evaluating the unit of account for the head lease, we believe the lessee’s ability to enter into the sublease for a portion of the underlying asset separately suggests that the right to use that portion of the underlying asset previously would have met the criteria to be a separate lease component. An exception may arise, for example, if there have been substantial modifications to the underlying asset (e.g. converting a warehouse into a multi-story office building) after the date that evaluation would have taken place.

3A. Determine go-forward accounting: Topic 360

The re-evaluation of the unit of account when only a portion of the underlying asset will be subleased makes the analysis of the go-forward accounting more complex. The following diagram summarizes the additional step in the process, which is explained in detail in the discussion that follows.
Leases: Asset to be abandoned or subleased

4. Sublease of a portion of the underlying asset

No separation required (single separate lease component previously)

If, upon evaluation in Step 2, there was only a single separate lease component, no portion of the existing ROU asset (or lease liability) should be separated into its own unit of account for the right to use the to-be-subleased portion of the underlying asset.

As a result, unless the sublease is for a significant portion of the underlying asset, it is unlikely that entering into the sublease or ceasing use of the portion of the underlying asset that will be subleased (e.g. the floor of the building in the background example) will trigger a change in asset grouping.

Entering into the sublease or ceasing use of the portion of the asset that will be subleased may constitute a triggering event, requiring an impairment assessment of the asset group. This may be in addition to a triggering event identified in Step 1. For example, either of these events may be an additional triggering event if the terms of the executed sublease are less favorable, or expectations about the lessee’s ability to sublease the asset have deteriorated, from what was anticipated in Step 1.

Separation required (right to use the to-be-subleased portion of underlying asset was a separate lease component previously)

If the right to use the to-be-subleased asset previously met the criteria to be a separate lease component, a portion of the existing ROU asset reflecting that separate lease component should be separated from the existing ROU asset. A portion of the existing lease liability should also be allocated to the newly separate lease component.

We believe the lessee should allocate the carrying amount of the existing ROU asset and lease liability to (1) the new, separate lease component (i.e. the right to use the portion of the underlying asset that will be subleased), and (2) the separate lease component that reflects the remainder of the original lease, on a relative stand-alone price basis.

Because Topic 842 does not address allocation in this situation, we believe a lessee could base the relative stand-alone price allocation on either:

— the stand-alone prices the lessee would have determined for the two separate lease components had they been previously accounted for separately (historical stand-alone prices); or

— the stand-alone prices of the two separate lease components at the earlier of (1) the cease-use date and (2) sublease inception based on the remaining lease term and the then-current facts and circumstances – e.g. current stand-alone prices (current stand-alone prices).

Next, the lessee should reassess its Topic 360 asset grouping in accordance with Question 1.2. The lessee should assess whether the new, separate ROU asset (and related assets such as leasehold improvements) is its own asset group (as will frequently be the case for a subleased ROU asset) or part of an asset group that is different from its previous group.

Entering into the sublease or ceasing use of the to-be-subleased portion of the underlying asset may constitute a triggering event for the asset group that contains the newly separate ROU asset, requiring an impairment assessment under Topic 360. For example, if the new ROU asset is its own asset group, or
the predominant asset in the group (e.g. a retail space ROU asset when the asset group is the store), either of the following would likely constitute a triggering event:

— entering into a loss-making sublease; or
— ceasing use of the asset without a sublease in place if facts and circumstances at the cease-use date call into question the lessee’s ability to obtain a favorable sublease.

3B. Determine go-forward accounting: Topic 842

Similar to the go-forward accounting under Topic 360, the go-forward accounting under Topic 842 depends on the conclusion reached in the assessment of the unit of account.

**No separation required (single separate lease component previously)**

If the existing separate lease component was previously a single separate lease component, the lessee accounts for the head lease after the cease-use date or sublease inception in the same manner as any other lease, which includes recognizing any Topic 360 impairment loss identified in Step 3A and following the post-impairment lease accounting guidance. Accounting for the sublease would follow the guidance in chapter 8 of KPMG’s Handbook.

**Separation required (right to use the to-be-subleased portion of underlying asset was a separate lease component previously)**

If the right to use the to-be-subleased asset previously met the criteria to be a separate lease component, the newly separate ROU asset and lease liability are accounted for from the separation date (i.e. the ‘earlier of’ date) in the same manner as any other lease of a lessee, which includes recognizing any Topic 360 impairment loss identified in Step 3A and following the post-impairment lease accounting guidance. Accounting for the sublease would follow the guidance in chapter 8 of KPMG’s Handbook.

The lessee’s accounting for the separate lease component that reflects the remainder of the original lease is accounted for from the separation date in the same manner as any other separate lease component.

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### Example 4.1

**Sublease of a portion of a leased building**

Lessee LE enters into a contract with Lessor LR for the right to use a five-story office building for five years with no renewal options. The right to use the building is a lease and there are no other components of the contract. There have been no modifications to (or remeasurements of) the lease.

The following facts are relevant at the lease commencement date.

<table>
<thead>
<tr>
<th>Description</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease payments (gross lease):</td>
<td>Fixed payments of $1,000 per year in arrears</td>
</tr>
<tr>
<td>LE’s incremental borrowing rate:</td>
<td>6% (the rate implicit in the lease cannot be readily determined)</td>
</tr>
<tr>
<td>Lease liability recognized:</td>
<td>$4,212</td>
</tr>
</tbody>
</table>
Leases: Asset to be abandoned or subleased
4. Sublease of a portion of the underlying asset

ROU asset recognized: $4,212

Notes:
1. Calculated as the present value of the five lease payments of $1,000, discounted at the
   incremental borrowing rate of 6%.
2. Calculated as the initial measurement of the lease liability because there are no initial
direct costs, prepaid lease payments or lease incentives received.

LE appropriately classified the lease as an operating lease, because none of the
tests for classification as a finance lease were met (see paragraph 6.2.50 in
KPMG’s Handbook). LE did not separately account for the implied land element
of the lease (see Question 4.1.20 in KPMG’s Handbook) because the
accounting effect of doing so would have been insignificant – i.e. the
coterminus land and building elements separately would have both been
classified as operating leases.

At the beginning of Year 2 (the decision date), when the carrying amount of the
lease liability and the ROU asset are both $3,465, LE decides that it will cease
use of the top floor of the building at the end of Year 3 – i.e. two years before
the end of the lease term. Between the decision date and the end of Year 3, LE
plans to continue using the top floor of the building in the same manner, and as
part of the same operation, as before the decision date.

LE intends and has the practical ability to sublease the top floor after it ceases
use of it. Consequently, LE does not plan to abandon the ROU asset before
the end of the lease term (see Question 1.1). At the beginning of Year 3 (i.e.
12 months before LE’s planned cease-use date), LE enters into a sublease for
the top floor with Sublessee SE for the remainder of LE’s head lease term. The
sublease will commence immediately following the cease-use date.

The following are the key terms of the sublease.

<table>
<thead>
<tr>
<th>Lease payments (gross lease):</th>
<th>Fixed payments of $120 per year in arrears</th>
</tr>
</thead>
<tbody>
<tr>
<td>LE’s discount rate for the sublease:</td>
<td>6% (the rate implicit in the sublease cannot be readily determined – see section 8.2.1 in KPMG’s Handbook)</td>
</tr>
</tbody>
</table>

Note: There are no initial direct costs, prepaid lease payments or lease incentives provided.

1. Evaluate whether the asset group is impaired

LE’s decision to sublease the top floor of the building does not trigger a
reassessment of the asset group that contains the entire building ROU asset,
because LE will continue to use the building (including the top floor) until the end of Year 3 in substantially the same manner as before the decision date (see Question 1.2). Therefore, the ROU asset remains part of the larger asset group subsequent to the decision date.

LE further concludes that there is no impairment of the asset group that contains the entire building ROU asset based on an appropriate analysis under Topic 360.

However, at the decision date, LE has leasehold improvements on the top floor of the building with a carrying amount of $200, which LE concludes will no longer provide economic benefits after the cease-use date (end of Year 3); this is because they are specific to LE’s use of the top floor and will not provide a benefit associated with the sublease. Consequently, LE concludes that it needs to shorten the remaining useful life of those assets to two years as of the decision date.

2. Re-evaluate the unit of account

While LE has accounted for the building lease as a single unit of account (one ROU asset and one lease liability) to date, upon entering into the sublease with SE (which precedes the cease-use date), LE concludes that the top floor of the building previously met the criteria to be accounted for as a separate lease component.

— LE could benefit from the top floor on its own – i.e. separate from the other four floors of the building. This is evident because:
  — LE can practically sublease the top floor to a third-party sublessee; and
  — LR and other lessors regularly lease different floors in similar office buildings to unrelated lessees.

— The right to use the top floor is not highly dependent on, nor highly interrelated with, LE’s right to use the remainder of the building. At contract inception, the building was already divided into multiple floors such that LR could have granted separate rights to use different floors of the building to multiple lessees or transferred rights to use the different floors to LE with different commencement dates.

3A. Determine go-forward accounting: Topic 360

*Separate and allocate the existing ROU asset and lease liability to the two separate lease components created by Step 2*

Based on the conclusion reached in Step 2, at the sublease inception date LE separates its lease of the top floor from its lease of the remainder of the office building. LE allocates between the top floor lease component and the lease component for the remainder of the building on a relative stand-alone price basis. In this example, LE elects to use historical stand-alone selling prices (see Question 4.1).

<table>
<thead>
<tr>
<th>Separate lease component</th>
<th>Stand-alone price</th>
<th>Allocated ROU asset</th>
<th>Allocated lease liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Top floor</td>
<td>$1,165</td>
<td>$623(^2)</td>
<td>$623(^2)</td>
</tr>
<tr>
<td>Remaining floors</td>
<td>3,835</td>
<td>2,050(^3)</td>
<td>2,050(^3)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$5,000(^1)</strong></td>
<td><strong>$2,673</strong></td>
<td><strong>$2,673</strong></td>
</tr>
</tbody>
</table>

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Notes:
1. Because LE is using historical rather than current stand-alone prices, those prices are based on two five-year leases.
2. $623 = ($1,165 / $5,000) × $2,673 (carrying amount at beginning of Year 3).
3. $2,050 = ($1,165 / $5,000) × $2,673 (carrying amount at beginning of Year 3).

Reassess Topic 360 asset grouping

LE concludes that the identifiable cash flows associated with the top floor ROU asset and leasehold improvements and the top floor lease liability are largely independent of the cash flows of other long-lived assets and related liabilities. LE’s cash inflows and outflows will principally consist of the sublease payments from SE and head lease payments to LR.

Assess impairment under Topic 360

LE concludes that there are no impairment indicators with respect to the asset group that contains the ROU asset for the remaining floors. Therefore, no impairment assessment is undertaken by LE for that asset group as a result of subleasing the top floor of the building.

LE concludes that entering into the loss-making sublease for the top floor of the building and planning to abandon the related leasehold improvements are indicators of impairment for the top floor asset group. LE conducts an appropriate analysis under Topic 360 and concludes that the asset group is impaired by $320. The impairment charge is allocated to the ROU asset and the leasehold improvements on a pro rata basis using the relative carrying amounts of those assets as follows. [360-10-35-28]

<table>
<thead>
<tr>
<th>Asset</th>
<th>Pre-impairment carrying amount</th>
<th>Allocated impairment loss</th>
<th>Post-impairment carrying amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>ROU asset</td>
<td>$623</td>
<td>$276¹</td>
<td>$347</td>
</tr>
<tr>
<td>Leasehold improvements</td>
<td>100</td>
<td>44²</td>
<td>56</td>
</tr>
<tr>
<td>Total</td>
<td>$723</td>
<td>$320</td>
<td>$403</td>
</tr>
</tbody>
</table>

Notes:
1. $276 = ($623 / $723) × $320.
2. $44 = ($100 / $723) × $320.

3B. Determine go-forward accounting: Topic 842

Accounting for the top floor lease component

LE’s accounting for the top floor ROU asset and lease liability after the impairment recognized in Step 3A (at sublease inception) is as follows.
Leases: Asset to be abandoned or subleased

4. Sublease of a portion of the underlying asset

<table>
<thead>
<tr>
<th>Yr.</th>
<th>Lease liability carry. amt.</th>
<th>ROU asset carry. amt.</th>
<th>Single lease cost</th>
<th>Sub-lease inc.</th>
</tr>
</thead>
<tbody>
<tr>
<td>5</td>
<td>(220)</td>
<td>(13)</td>
<td>233</td>
<td>-</td>
</tr>
</tbody>
</table>

Notes:
1. Calculated as beginning balance of lease liability multiplied by incremental borrowing rate: Year 3 = $623 × 6%, Year 4 = $427 × 6%, etc.
2. $233 = ($1,165 / $5,000) × $1,000.
3. Calculated as balance of ROU asset at beginning of Year 2 divided by remaining expected useful life: $347 / 3 years.
4. The single lease cost for an impaired operating lease is calculated as described in paragraph 6.5.50 in KPMG’s Handbook.

**Accounting for the leasehold improvements in the top floor asset group**

Subsequent to reducing the carrying amount of the leasehold improvements by $44 in Step 3, LE will continue to depreciate the remaining, post-impairment carrying amount of $56 over the remaining, shortened useful life for those assets (which is one year between sublease inception and the cease-use date).

**Accounting for the separate lease component for the remainder of the building**

Accounting for the lease component for the remainder of the building from sublease inception to the end of the lease term is as follows (assuming no lease modifications, no reassessment events resulting in remeasurement, and no impairments of the ROU asset).

<table>
<thead>
<tr>
<th>Yr.</th>
<th>Lease liability carry. amt.</th>
<th>ROU asset carry. amt.</th>
<th>Single lease cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>3</td>
<td>$2,050</td>
<td>$123</td>
<td>$767</td>
</tr>
<tr>
<td>4</td>
<td>(1,406)</td>
<td>(84)</td>
<td>767</td>
</tr>
<tr>
<td>5</td>
<td>(723)</td>
<td>(44)</td>
<td>767</td>
</tr>
</tbody>
</table>

Notes:
1. Calculated as beginning balance of lease liability multiplied by incremental borrowing rate: Year 3 = $2,050 × 6%, Year 4 = $1,406 × 6%, etc.
2. $767 = ($3,835 / $5,000) × $1,000.
3. Calculated as the difference between the single lease cost and the lease liability accretion: Year 3 = $767 - $123.
4. Single lease cost calculated as lease cost for Years 3–5 divided by remaining lease term: $2,301 / 3 years. The $2,301 is calculated using the allocated portion of total lease payments: ($3,835 / $5,000) × $1,000 × 3.
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