ACCOUNTING BRIEF

Early lease terminations, reduced payments and subleases

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SUMMARY

As entities continue to struggle with the current economic conditions, they are looking to contain costs. As part of this movement, many lessees are considering making changes to their leases by various methods including, but not limited to:

- **Terminating leases early**
- **Negotiating reduced lease payments**
- **Subleasing space**

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1. Introduction and background

As entities continue to struggle with the current economic conditions, they are looking to contain costs. As part of this movement, many lessees are considering making changes to their leases by various methods including, but not limited to:

- Terminating leases early
- Negotiating reduced lease payments
- Subleasing space

In this paper, we discuss the accounting for each of these methods. It should be noted, however, that this paper does not address changes arising from the COVID-19 pandemic.

2. Terminating leases early

As part of the cost-containment methods referred to above, some lessees are terminating leases in full, while others are partially terminating leases (e.g., reducing the amount of space leased in an office building or eliminating a lease component in an arrangement containing multiple lease components).

The lessee's accounting for a lease termination is addressed in paragraph 842-10-25-13 of Accounting Standards Codification (ASC) 842, *Leases*, which states:

> … the lessee shall decrease the carrying amount of the right of-use asset on a basis proportionate to the full or partial termination of the existing lease. Any difference between the reduction in the lease liability and the proportionate reduction in the right-of-use asset shall be recognized as a gain or a loss at the effective date of the modification.

2.1 Full termination

When a lease is fully terminated before the end of the lease term, and the lessee does not purchase the underlying asset, the lessee should derecognize the ROU asset and lease liability and recognize the difference between the ROU asset and lease liability in the income statement.

When a lessee terminates a lease before the end of the lease term by purchasing the underlying asset in other than a business combination, the asset should be adjusted for the difference between the underlying asset's purchase price and the lease liability's carrying amount at the time of purchase. ASC 805, *Business Combinations*, should be used to account for the termination of a lease and the purchase of the underlying asset in connection with a business combination. Example 23 in ASC 842-10-55-211 to 55-217 and Example 24 in ASC 842-10-55-218 to 55-224 illustrate how a lessee should account for the purchase of a leased asset resulting from the lessee's exercise of a purchase option.

2.2 Partial termination

In a number of instances, lessees in operating lease arrangements are looking to partially terminate their leases by reducing space in a leased office building or by reducing the term of a lease. It is unlikely that that classification would change given the nature of the modification, as actions such as reducing a lease term would not

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result in an operating lease meeting any of the criteria needed to be classified as a finance lease.

The lessee would remeasure the lease liability as of the effective date of the partial modification using the remaining lease payments, modified lease term and discount rate as of the date of the modification.

As noted in Example 18 of ASC 842-10-55-177 to 55-185, the lessee then has to elect how to remeasure the ROU asset when there is modification that results in a reduction of the right of use. The options available are:

- Remeasure the right-of-use asset based on the change in the lease liability.
- Remeasure the right-of-use asset based on the remaining right of use.

2.2.1 Remeasure the right-of-use asset based on the change in the lease liability

When the lessee elects to remeasure the right-of-use asset based on the change in the lease liability, the lessee calculates the difference between the pre-modification lease liability balance and the post-modification balance, determines the percentage change, and reduces the pre-modification right-of-use asset balance by the same percentage. Any difference between the change to the liability balance and the change to the asset balance is recognized in income.

2.2.2 Remeasure the right-of-use asset based on the remaining right of use

When the lessee elects to remeasure the right-of-use asset based on the remaining right of use, the lessee determines the proportionate decrease in the carrying amount of the right-of-use asset based on the remaining right-of-use asset. For example, if the modification results in a 40% reduction in square footage leased, the lessee reduces the lease liability and the ROU asset by 40%. Any difference between the decrease in the lease liability and the decrease in the right-of-use asset is recognized in income.

3. Negotiating reduced lease payments

Another method employed by lessees has been the negotiation of reductions in lease payments. Example 19 of ASC 842-10-55-186 to 55-189 provides an example of the accounting for such a modification (that is, a modification that solely changes the lease payments).

In this type of modification, the lessee remeasures the lease liability for the modified lease using the reduced payments for the remaining lease term, discounted using the discount rate in effect at the date of the modification.

The lessee would recognize the difference between the premodification lease liability balance and the post-modification balance as a corresponding reduction to the right-of-use asset.

4. Subleasing

Another method of cost containment involves subleasing space. For example, Entity A has been leasing three floors in an office building. During the lease term, Entity A concludes that it no longer needs three floors, as a significant number of its employees have begun to work from home on a regular basis. In response to this

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situation, Entity A sublets one of the floors to Entity Z. Entity A is generally referred to as the sublessor for that one floor, and Entity Z is referred to as the sublessee.

The effects of a sublease on the sublessor's accounting depends on whether the nature of the sublease is such that the sublessor is relieved of its obligations under the head lease.

When the sublessor is relieved of its obligations under the head lease, it should account for the transaction as a termination of the head lease. Any amounts paid or received upon termination of the head lease should be taken into consideration when determining the income statement effects of the lease termination, provided those amounts were not included in the lease payments used to account for the head lease prior to the sublease. When the sublessor becomes secondarily liable under the sublease (i.e., the sublessor must make payments if the sublessee does not), it becomes a guarantor and accounts for the guarantee it has provided in accordance with ASC 460, *Guarantees*, regardless of whether consideration was explicitly transferred in connection with providing the guarantee.

When the sublessor is not relieved of its obligations under the head lease, it accounts for the head lease as a lessee separate from the sublease as a lessor. The specific accounting consequences to a sublessor depend on the classification of the head lease and the sublease. Classification of the sublease is based on the underlying asset and not the ROU asset related to the head lease. In addition, the discount rate used by the sublessor for purposes of classifying the sublease and, depending on its classification, measuring the net investment in the sublease should be the rate implicit in the sublease unless it cannot be readily determined, in which case the discount rate for the head lease may be used.

The following table highlights the effects of a sublease on the sublessor's accounting for the head lease, based on the classification of the head lease and sublease.

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Head lease classification	Sublease classification	Accounting effects of the sublease on the sublessor's accounting for the head lease
Finance	Sales-type or direct financing	• *ROU asset related to the head lease*: Derecognize the ROU asset, unless the sublease is a sales-type lease and collectibility of the lease payments is not probable, in which case the guidance in ASC 842-30-25-3 should be applied. • *Lease liability related to head lease*: Continue to account for the lease liability as it was accounted for before the sublease.
Operating	Sales-type or direct financing	• *ROU asset related to the head lease*: Derecognize the ROU asset, unless the sublease is a sales-type lease and collectibility of the lease payments is not probable, in which case the guidance in ASC 842-30-25-3 should be applied. • *Lease liability related to the head lease*: Account for using the finance lease accounting model in ASC 842-20-35-1 and 35-2.
Finance or operating	Operating	• *ROU asset and lease liability*: Continue to apply the same accounting model applied prior to the sublease. • *Impairment of ROU asset*: The lease costs for the sublease's term being more than the anticipated sublease income for that term is an indicator that the carrying amount of the ROU asset may not be recoverable, which may trigger the need to perform an impairment test in accordance with ASC 360-10-35.

5. Conclusion

In general, accounting for lease modifications and other revisions to leases is driven by facts and circumstances. We encourage entities to ensure that they have a detailed understanding of the changes before concluding on a position. In many circumstances, it might be beneficial to seek assistance from specialists.

For additional guidance on these issues, as well as on ASC 842 as a whole, please see our comprehensive guide, *A guide to lease accounting*.

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