



Testing leased office space for impairment

Applying IFRS® Accounting Standards

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What's the issue?

The COVID-19 pandemic has changed working practices, driving an increase in home- and hybrid-working models.

This has already caused demand for office space to fall, particularly in city centres, and some tenants are looking to either exit or renegotiate their real estate leases.



What's the impact?

Changes in the expected use of office space could have significant accounting consequences.

For example, the right-of-use (ROU) asset in a lease arrangement could be impaired or there could be a change in its estimated useful life.



What's next?

Companies need to assess the potential impacts for their financial reporting now, because a decision to vacate or sub-let property is a potential indicator of impairment.

To help with this assessment, we share our insight and practical guidance using 10 key questions that companies might ask.

Testing leased office space for impairment

Our 10 key questions will help you assess and address the potential impacts.

- 01 Are there indicators that the ROU asset is impaired?
- 02 Is the ROU asset tested on a stand-alone basis?
- 03 How is value in use determined?
- 04 What is the impact on useful life?
- 05 What if only a portion is or will be sub-let or vacated?
- 06 What if a property is or will be vacated but not sub-let?
- 07 How is fair value determined?
- 08 How do restrictions on sub-letting affect fair value?
- 09 How is a lease liability reflected in the impairment calculation?
- 10 What else do I need to consider?

01 Are there indicators that the ROU asset is impaired?

ROU assets are tested for impairment under IAS 36 *Impairment of Assets* when indicators of impairment exist.

At each reporting date, a company is required to assess whether there is an indicator of impairment based on either internal or external sources of information.

IAS 36 provides examples of indicators of impairment. One example is actual or expected significant changes in the extent or manner in which an asset is used.

Typically, a company's decision to sub-let or vacate leased property indicates that the ROU asset may be impaired.

If an indicator of impairment exists, then a company determines the level at which it carries out impairment testing – i.e. at the asset or cash-generating unit (CGU) level (see [page 5](#)).

Apply IAS 36 to ROU assets

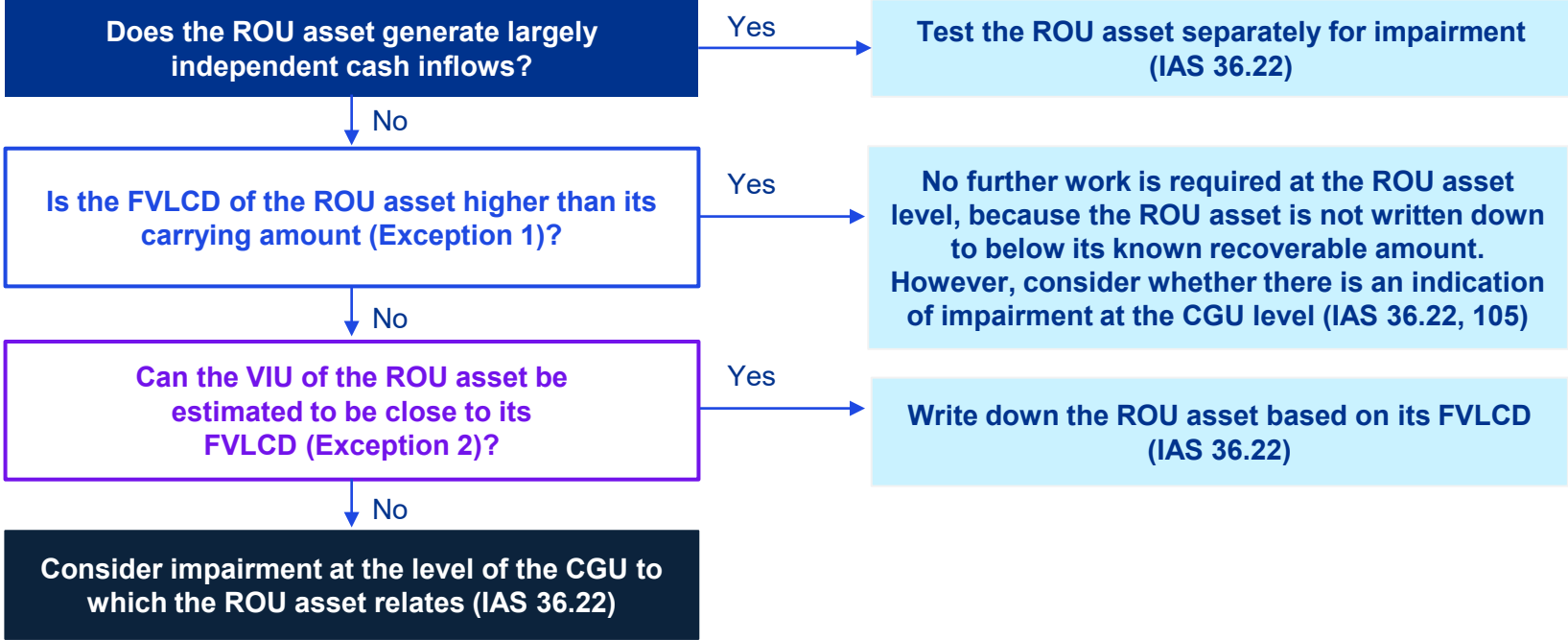


Consider whether indicators of impairment exist

02 Is the ROU asset tested on a stand-alone basis?

It depends. Under IAS 36, an ROU asset that generates largely independent cash inflows is tested for impairment on a stand-alone basis – e.g. sub-let office space.

However, an ROU asset relating to office space that a company leases for its own-use does not generate independent cash inflows so other considerations apply (see the flowchart).



Exception 1: If the fair value less costs of disposal (FVLCD) of the right to use office space is higher than its carrying amount, then the ROU asset is not impaired. In many jurisdictions, it is typically possible to measure the FVLCD of a right to use office space. The FVLCD of an ROU asset would typically be higher than its carrying amount if market rent for similar properties has increased since entering into the lease contract.

Exception 2: If the value in use (VIU) of an ROU asset is *close* to its FVLCD, then the ROU asset is tested for impairment on a stand-alone basis and its recoverable amount is based on FVLCD. A company needs to apply judgement to determine whether the VIU is close to its FVLCD because the term ‘close’ is not defined in IAS 36.

03 How is value in use determined?

VIU represents the present value of future cash flows expected to be derived from an asset (or CGU), both from its continuing use and from its ultimate disposal.

When a company decides to sub-let office space in the future, the VIU of the related ROU asset can be viewed as comprising separate **own-use** and **sub-lease** periods.

Own-use period

VIU cannot be determined at an asset level for the period in which the office space is expected to be used by the company together with other assets as part of a CGU. This is because it does not generate cash inflows that are largely independent from other assets in that CGU.

However, if the period of own use is very short, then the VIU of an ROU asset can usually be assumed to be close to its FVLCD. Office space is an administrative asset and, therefore, it would not be expected to add significant incremental value under VIU above its fair value.

Sub-lease period

The VIU of an ROU asset relating to office space can be determined for the period in which the office space is expected to be sub-let, and it is equal to FVLCD.

The shorter the own-use period relative to the sub-lease period, the closer VIU is to FVLCD.

03 How is value in use determined? (cont.)

Worked example VIU close to FVLCD

Fact pattern

- Company Z recognises an ROU asset for an office building that it rents for its own use until June 2031.
- In September 2022, Z makes a decision, approved by its board of directors, to relocate to smaller premises and sub-let the office building for the remainder of the lease term.
- In December 2022, Z has a contract in place to lease smaller premises. Z expects to vacate the current office building in March 2023 and to find a replacement tenant by June 2023.
- Market rent for similar properties has significantly decreased since Z entered into the lease. Z estimates that the FVLCD of the ROU asset is lower than its carrying amount.

Analysis

- In performing the impairment test at the reporting date (31 December 2022), management considers whether the VIU of the ROU asset is close to its FVLCD. For the own-use period (from January to March 2023) the VIU cannot be determined (because the office is used together with other assets as part of a CGU), but for the sub-lease period (from June 2023 to June 2031) the VIU can be determined and is equal to its FVLCD.
- Although the VIU for the own-use period cannot be determined, given that this period of three months is short both in absolute terms and relative to the expected sub-lease period of eight years, management concludes that the VIU of the ROU asset can be estimated to be close to its FVLCD. Therefore, management performs the impairment test on a stand-alone basis and determines the recoverable amount of the ROU asset using its FVLCD.
- In contrast, if Z concluded that the VIU is not close to its FVLCD, then it would test the ROU asset for impairment at the level of the CGU to which it relates.

04 What is the impact on useful life?

An ROU asset relating to office space is depreciated from lease commencement to the earlier of the end of its useful life or the end of the lease term. Management reviews the useful life of an ROU asset if it expects the period over which economic benefits will be obtained from that asset to change.

If an indicator of impairment exists, then this may suggest that the asset's remaining useful life needs to be reviewed and adjusted, even if no impairment loss is recognised.



In our view, after a company has tested an asset for impairment, it should consider whether changes are required to its useful life. It accounts for such changes prospectively as a change in an accounting estimate.

05 What if only a portion is or will be sub-let or vacated?

A company may lease several floors of a building under a single lease contract and recognise a single ROU asset for all of the floors. If the company decides to vacate or sub-let one of the floors, then it needs to assess whether that floor is tested separately for impairment.

To make this assessment, the company needs to consider if the right to use this floor is a separate lease component and then determine the level at which to test the ROU asset for impairment (see [page 5](#)).

The right to use an underlying asset is a separate lease component if both of the following criteria are met:

- the tenant can benefit from using the underlying asset either on its own or together with other resources that are readily available; and
- the asset is neither highly dependent on, nor highly inter-related with, the other assets in the contract.



Worked example – Part 1

Lease of several floors – Multiple lease components

Fact pattern

- Tenant X enters into a 15-year lease for five floors in a building.
- The floors are accessed via common lifts and stairs, but each floor has separate access controls.
- Each floor is equipped with the necessary facilities (e.g. toilets) to allow it to be used separately.
- X can sub-let each floor without performing significant work.

Analysis

- X concludes that it can control access to each individual floor and each floor can be sub-let separately. Therefore, X concludes that the right to use each individual floor is a separate lease component because:
 - it can benefit from the use of an individual floor on its own; and
 - the use of an individual floor is neither highly dependent on nor highly inter-related with the use of other floors in the building.

05 What if only a portion is or will be sub-let or vacated? (cont.)



Worked example – Part 2

VIU not close to FVLCD

Additional facts

- In December 2022, X makes a final decision, authorised by its board of directors, to vacate and sub-let only the third floor in the office building following the introduction of a ‘work from home’ plan.
- X expects that it will take a year to find a replacement tenant and, according to its plans, will vacate the third floor at the end of October 2023.
- The lease contract expires in December 2025.
- Market rent for similar properties has significantly decreased since X entered into the lease. X estimates that the FVLCD of the ROU asset is lower than its carrying amount.

Analysis

- X tests the ROU asset relating to the third floor for impairment at the reporting date (31 December 2022).
- Considering the length of the own-use period relative to the length of the sub-lease period, X concludes that the own-use period is not very short in absolute terms and relative to the expected sub-lease period. Therefore, the VIU of the ROU asset cannot be estimated to be close to its FVLCD.
- Consequently, X performs the impairment test at the CGU level to which the ROU asset relates.

06 What if a property is or will be vacated but not sub-let?

A company can decide to permanently cease using office space but may not be able to sub-let it. This may happen, for example, due to sub-lease restrictions included in the lease contract or because the remaining lease term is short. Such a decision is an indicator of impairment and the company will need to test the ROU asset for impairment and review its useful life.

If, during the reporting period, a company permanently vacates office space that it leases, then the company tests the ROU asset for impairment on a stand-alone basis. This is because this asset is no longer part of the CGU to which it belonged.

However, if the decision (in the current reporting period) is to permanently vacate the office space after the reporting date, then a company applies the guidance in paragraph 22 of IAS 36 to determine the level at which the ROU asset is tested for impairment (see [page 5](#)).

Test ROU asset for impairment



If office space is permanently vacated during the reporting period, then test the ROU asset for impairment on a stand-alone basis

06 What if a property is or will be vacated but not sub-let? (cont.)



Worked example

Office space to be vacated but not sub-let after the reporting date

Fact pattern

- Company G has an ROU asset for a floor in an office building that it rents for its own use until March 2023.
- G decides to cease using the floor permanently from September 2022 and vacates it, as planned.
- Because the lease ends in March 2023, G believes that it will be unable to sub-let the floor because of the short remaining lease period.

Analysis

- Vacating the floor is an indicator of impairment.
- At the reporting date (31 December 2022), G tests the ROU asset for impairment on a stand-alone basis because it is no longer part of the CGU to which it belonged. Once the office space is vacated in September 2022, it no longer contributes to any of G's CGUs (see [page 11](#)).
- Considering that no market participant would be willing to lease the floor, G concludes that both the VIU and the FVLCD of the ROU asset are equal to zero.
- Consequently, G writes down the ROU asset to zero.

07 How is fair value determined?

When testing for impairment and determining the fair value of an ROU asset, a tenant considers the amount that a market participant would pay in an up-front, one-off payment for the right to use the underlying asset for the remaining lease term, with no obligation to make lease payments (i.e. on a gross basis).

The tenant considers the ROU asset's characteristics that market participants would take into account in a transaction at the measurement date.

For an ROU asset relating to office space, key characteristics include:

- **its condition and location;**
- **the remaining lease term; and**
- **any restrictions on using or sub-letting the underlying asset.**

The fair value of an ROU asset is typically measured under the income approach using the discounted cash flow (DCF) technique based on market rents projected over the remaining lease term.

The fair value measurement of an ROU asset is based on its use either:

- **in combination with other assets as a group or in combination with other assets and liabilities (e.g. a business); or**
- **on a stand-alone basis – e.g. sub-letting the leased asset.**

The valuation premise depends on the use that is consistent with market participants' perspective of the highest and best use of the ROU asset, notwithstanding its actual use by the company.

The highest and best use will depend on the assumed market participants and the assumptions they would make in relation to the underlying asset, including restrictions in the lease contract.

Typically, when valuing ROU assets relating to office space, fair value is determined on a stand-alone basis and based on current use.

08 How do restrictions on sub-letting affect fair value?

A lease contract may prohibit the tenant from sub-letting a leased office property. However, this does not mean that the fair value of the ROU asset is zero.

This is because fair value measurement is based on a hypothetical transaction in which a new tenant takes over the lease from the current tenant with the sub-lease restriction – i.e. the lease is assumed to be assigned, not sub-let.



In measuring the ROU asset's fair value, a company needs to consider both the effect of the restriction, being a characteristic of the ROU asset, and market participants' assumptions about the ability to assign the lease to a new tenant with the consent of the landlord.

09 How is a lease liability reflected in the impairment calculation?



When an ROU asset is tested for impairment as part of the CGU to which it relates, in our view the related lease liability is included in the impairment calculation if a buyer would be required to assume the liability on disposal of the CGU.

If a buyer would assume the lease liability and the CGU's recoverable amount is:

- **determined using VIU** – then the carrying amount of the liability is deducted both from the CGU's carrying amount and from its VIU. To avoid double counting, the future lease payments are excluded from the cash flow forecasts;
- **determined using FVLCD** – then the carrying amount of the liability is deducted only from the CGU's carrying amount. The liability is reflected in the CGU's FVLCD but is not based on its carrying amount – e.g. it might be incorporated by including the lease payments in the discounted cash flows.

Under VIU, because the carrying amount of the lease liability is deducted from both the CGU's carrying amount and recoverable amount, including (or excluding) the lease liability does not affect the impairment amount.

In some cases, a lease may include variable lease payments that depend on usage or sales of the underlying asset. Such payments are not reflected in the carrying amount of the lease liability.



In our view, a lessee should include variable lease payments that depend on usage or sales of the underlying asset in the cash flow forecasts for calculating the CGU's recoverable amount, irrespective of whether the buyer would assume the lease liability on disposal of the CGU.

10 What else do I need to consider?



Do I need to consider the useful life and the residual value of leasehold improvements?

Yes. A company needs to reassess the useful life and residual value of the leasehold improvements relating to the ROU asset that it expects to vacate or sub-let.



Do I need to consider the lease modifications (head lease)?

Yes. A company may seek to renegotiate the lease – e.g. to introduce termination options or end the lease early. Changes that result from renegotiating the lease contract are lease modifications. A company accounts for a lease modification that is not a separate lease by remeasuring the lease liability.

To do so, the company discounts the revised lease payments using a revised discount rate and:

- **for lease modifications that decrease the scope of the lease:** it decreases the carrying amount of the ROU asset and recognises a gain or loss reflecting the proportionate decrease in scope; and
- **for all other lease modifications:** makes a corresponding adjustment to the ROU asset.

See our [Lease modifications](#) publication.

10 What else do I need to consider? (cont.)



Do I need to consider the lease classification (sub-lease)?

Yes. Lessors classify real estate leases as either:

- operating leases, recognising the net consideration for the lease, including lease incentives, as income over the lease term, typically on a straight-line basis; or
- finance leases, presenting the right to receive future rentals as a receivable, and recognising interest income on that receivable.

An intermediate lessor classifies the sub-lease as a finance lease or as an operating lease with reference to the ROU asset arising from the head lease. This means that the intermediate lessor treats the ROU asset as the underlying asset in the sub-lease, not the item of property, plant or equipment that it leases from the head lessor.

See our [Real estate leases – The landlord perspective](#) publication.



Do I need to consider the classification as investment property?

Yes. An intermediate lessor applies IAS 40 *Investment Property* to account for a right of use representing an underlying asset, that is sub-let under an operating lease, if that asset meets the definition of an investment property.

The reclassification of an ROU asset from owner-occupied property to investment property is based on an actual change in use rather than on changes in a company's intentions.

Under IAS 40, a company chooses as its accounting policy either the fair value model or the cost model for measuring its investment property. The company applies the policy to all of its investment property – i.e. it applies the same policy to owned and leased investment property. However, in either case the company complies with IAS 40's disclosure requirements – including disclosures of the fair value of the investment property.

If investment property is accounted for under the cost model, then it is tested for impairment under IAS 36 on a stand-alone basis.

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