Project **Leases**

Topic **Impairment of right-of-use asset**

Purpose of paper

1. The boards have tentatively decided to require initial and subsequent measurement of a right-of-use asset on an amortised cost basis. Consistent with other assets measured on an amortised cost basis it needs to be determined how a right-of-use asset will be reviewed for impairment.

2. The purpose of this paper is to discuss which accounting model will be used for impairment of a right-of-use asset.

3. The paper has the following sections:

   (a) Background explaining differences in accounting for impairment under IFRS and US GAAP

   (b) Discussion of four options for impairment accounting for right-of-use assets:

      (i) Require all entities to use IFRS approach

      (ii) Require all entities to use US GAAP approach

      (iii) Develop specific approach for right-of-use assets

      (iv) Require entities to refer to existing applicable standards (IAS 36 for IFRS preparers, SFAS 144 for US GAAP preparers)

4. The staff recommends the last alternative, ie referring to existing accounting standards. This alternative provides consistency of accounting (that is,

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impairment under IFRS would be consistent and impairment under US GAAP would be consistent) and therefore improves comparability. It also avoids complications of impairment testing for cash generating units (CGU) (referred to as asset groups in US GAAP) comprised of both leased and owned assets. It does have the downside of continued divergence in impairment accounting and a diverged lease accounting standard.

Background

5. Right-of-use assets are non-financial assets and are subject to amortisation. IAS 36 *Impairment of Assets* provides guidance on how to assess impairment of those assets.

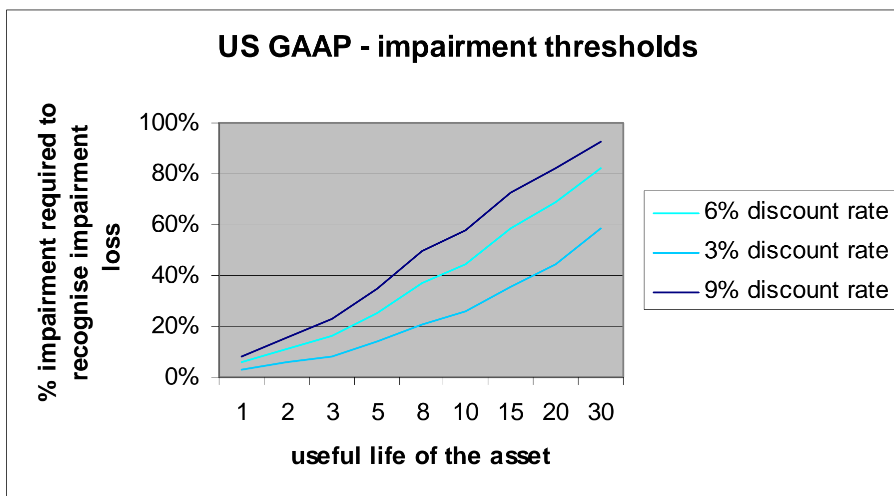
6. US GAAP prescribes different impairment accounting models for different assets in a number of standards. FASB Statement No. 144 *Accounting for the Impairment or Disposal of Long-Lived Assets* addresses long-term assets subject to amortisation, such as right-of-use assets.

7. Whilst there are a lot of similarities between the two standards, there are some key differences, presented below:

Topic	IFRS	US GAAP
Recognition of impairment for long-term assets (other than goodwill) that are subject to amortisation	Impairment is recorded when an asset's carrying amount exceeds the higher of the asset's value-in-use (discounted present value of the asset's expected future cash flows) and fair value less costs to sell.	Impairment is recorded when an asset's carrying amount exceeds the expected future cash flows to be derived from the asset on an undiscounted basis (referred to as recoverable amount).
Measurement of impairment loss for long-term assets (other than goodwill) that are subject to amortisation	Based on the recoverable amount (the higher of the asset's value-in-use and fair value less costs to sell).	Based on fair value, often based on discounted cash flows.
Subsequent reversal of an impairment loss	Required for all assets, other than goodwill, if certain criteria are met.	Prohibited.

8. The differences can be summarised as follows:

   (a) **Threshold for recognition of impairment loss is much higher under US GAAP than under IFRS**. In IFRS an impairment loss is recognised whenever the asset's carrying amount exceeds the higher of fair value less costs to sell and the asset's value in use (discounted present value of the asset's expected future cash flows). In US GAAP the loss is recognised only if the sum of undiscounted future cash flows is less than the asset's carrying amount. The differences are more pronounced the longer-term the assets are and the higher the discount rate is, which can be seen in below diagram[1].



   (b) **There can be differences in the measurement of the impairment loss.** Even if an impairment loss of an asset is recognised under both IFRS and US GAAP, the amount of loss recognised can be different. Both standards refer to fair value but if a selling price is available and used as an indicator of fair value in IFRS it will be net of costs to sell whereas in US GAAP it would not (unless the asset is classified as held for sale, which would in most cases not apply to right-of-use assets). If

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[1] The fair value in this example is assumed to be equal to discounted expected future cash flows. This will not be correct in all scenarios, for example if market cash flow assumptions are different or if other fair value measures are available (such as market price).

these costs to sell are material, IFRS preparers will recognise higher impairment losses. Also, IFRS requires measuring value in use which, if higher than carrying amount of the asset, means there will be no impairment loss recognised, even if asset's fair value is less than its carrying amount. Similar to value in use, fair value can also be arrived at by discounting expected future cash flows, which can be derived from internally generated forecasts but, unlike value in use, these have to be adjusted for any marketplace assumptions.

(c) **Reversal of impairment loss.** US GAAP considers impairment, in the way it is recognised in SFAS 144, to be permanent and, once recognised, reversal is not permitted. This is coupled with higher recognition thresholds in US GAAP resulting in less frequent but irreversible losses. IFRS permits reversal of impairment losses to the extent it does not exceed original cost of the asset.

Options for impairment of right-of-use assets

9. Testing and measuring impairment of right-of-use assets can be addressed in several different ways, eg:

   (a) Require all entities to use IFRS approach

   (b) Require all entities to use US GAAP approach

   (c) Develop specific approach for right-of-use assets

   (d) Require entities to refer to existing applicable standards (IAS 36 for IFRS preparers, SFAS 144 for US GAAP preparers)

10. Each of these approaches is discussed in the following subsections.

IFRS approach

11. Requiring all entities to apply the IAS 36 impairment model for leases would result in a converged leases standard. It would be simple for IFRS preparers to

apply as they are already familiar with the standard. This approach would also increase comparability for IFRS users.

12. In preparing IAS 36 IASB (and IASC) has discussed various alternatives for accounting for impairment losses. These include:

    (a) **Criteria for recognition of impairment loss**. 'Economic' criterion (ie loss is recognised whenever the asset's carrying value exceeds recoverable amount) was chosen and undiscounted cash flows (used in US GAAP) were rejected for the reasons that include the following:

        (i) when a rational entity identifies that an asset may be impaired, it will make an investment decision. Therefore, it is relevant to consider the time value of money and the risks specific to an asset in determining whether an asset is impaired. This is particularly true if an asset has a long useful life.

        (ii) In estimating the time value of money and the risks specific to an asset in determining whether the asset is impaired, factors, such as the probability or permanence of the impairment loss, are subsumed in the measurement.

        (iii) if there is an unfavourable change in the assumptions used to determine the recoverable amount, users of financial statements are better served if they are informed about any change in assumptions on a timely basis.

    (b) **Measurement of impairment loss**. The IASB considered four options for measurement of impairment loss: sum of undiscounted future cash flows, fair value, value in use, and higher of fair value and value in use. The last option was selected for the following reasons:

        (i) no preference should be given to the market's expectation of the recoverable amount of an asset over a reasonable estimate performed by the individual enterprise that owns the asset (which is basis for fair value when market values are not available as well as for value in use). It is uncertain whether the assumptions of the market or the

assumptions of the enterprise are more likely to prevail. Currently, perfect markets do not exist for many of the assets within the scope of IAS 36 and it is unlikely that predictions of the future will be entirely accurate, regardless of who makes them.

(ii) market values are a way to estimate fair value but only if they reflect the fact that both parties, the acquirer and the seller, are willing to enter into a transaction. If an enterprise can generate greater cash flows by using an asset than by selling it, it would be misleading to base the recoverable amount on the market price of the asset because a rational enterprise would not be willing to sell the asset.

(iii) If no deep and liquid market exists for an asset, value in use would be a reasonable estimate of fair value.

(iv) IAS 36 includes sufficient requirements to prevent an enterprise from using assumptions different from the marketplace that are unjustified. For example, an enterprise is required to determine value in use using:

- (i) cash flow projections based on reasonable and supportable assumptions and giving greater weight to external evidence; and
- (ii) a discount rate that reflects current market assessments of the time value of money and the risks specific to the asset.

(c) **Reversal of impairment loss**. Loss reversal was allowed for the reasons that include the following:

(i) it is consistent with the Framework and the view that future economic benefits that were not previously expected to flow from an asset have been reassessed as probable.

(ii) impairment losses are recognised and measured based on estimates. Any change in the measurement of an impairment loss is similar to a change in estimate.

(iii) reversals of impairment losses provide users with a more useful indication of the potential for future benefits of an asset or group of assets.

(iv) results of operations will be more fairly stated in the current period and in future periods because depreciation or amortisation will not reflect a previous impairment loss that is no longer relevant. Prohibition of reversals of impairment losses may lead to abuses such as recording a significant loss one year with the resulting lower amortisation/depreciation charge and higher profits in subsequent years.

13. It can be argued that some of IASB's reasoning for measurement using value in use as well as fair value was preceded with accounting developments, in particular the fair value measurement project which says fair value reflects 'highest and best possible use'. It can be argued this eliminates the requirement to measure value in use.

14. If the leases standard were to require all entities to apply the IAS 36 approach to impairment, the result under U.S. GAAP would be different impairment accounting models for right-of-use assets and other assets. We note that US GAAP already has different impairment accounting models for different assets.

15. This approach may not work for impairments of a group of assets (cash generating units). For example, an entity could have one leased component of a production line whilst the rest is owned. If the leased component does not generate independent cash flows (and its value in use can not be estimated to be close to fair value), in order to test for impairment, the production line as a whole would need to be considered. It would be possible to test one component of the production line for impairment under IAS 36 and the rest of the production line under Statement 144 by conducting two separate impairment

exercises. This would however be highly complex exercise where costs could easily exceed benefits.

16. In addition, this approach, whilst improving comparability for IFRS users, would reduce it for US GAAP users who might see similar underlying assets tested for impairment in different ways, depending on whether they were leased or owned.

US GAAP approach

17. Similar to the IFRS approach, requiring all entities to apply the Statement 144 impairment model for leases would result in a converged leases standard. It would be simple to follow as (US GAAP) preparers and users are already familiar with the standard. This approach would also increase comparability for US GAAP users.

18. In preparing Statement 144 FASB discussed various alternatives for accounting for impairment losses. These include:

    (a) **Criteria for recognition of impairment loss**. An impairment loss is recognised only if the carrying amount of the asset is not recoverable from its undiscounted cash flows and exceeds its fair value. The undiscounted cash flows recoverability test was kept for practical reasons. In reaching that decision, FASB also considered 'economic', 'permanence' and 'probability' criteria. They were all rejected, some of the explanations provided include the following:

        (i) Economic criteria presupposes that fair value is available for every asset. Results of measurement should not be a sufficient reason to trigger recognition of an impairment loss. The write-down might result from measurements reflecting only temporary market fluctuations.

        (ii) Permanence criteria (recognising a loss when it is considered to be permanent) was too difficult to apply and required judgement beyond managements' ability.

(b) **Measurement of impairment loss**. FASB considered four options: fair value, a recoverable cost measure, a recoverable cost including interest measure, different measures for different impairment losses. The Board decided to use fair value for the following reasons:

(i) The FASB concluded that a decision to continue to operate rather than sell an impaired asset is economically similar to a decision to invest in that asset and, therefore, the impaired asset should be measured at its fair value... . . . The Board . . . concluded that the fair value of an impaired asset is the best measure of the cost of continuing to use that asset because it is consistent with management's decision process.

(ii) The FASB believes that fair value is an easily understood notion. The fair value measure is basic to economic theory and is grounded in the reality of the marketplace. Fair value estimates are readily available in published form for many assets, especially machinery and equipment. For some assets, multiple, on-line database services provide up-to-date market price information. Estimates of fair value also are subject to periodic verification whenever assets are exchanged in transactions between willing parties.

(iii) use of the recoverable cost including interest measure would result in different carrying amounts for essentially the same impaired assets because they are owned by different entities that have different debt capacities. The FASB does not believe that discounting expected future cash flows using a debt rate is an appropriate measure for determining the value of those assets.

(c) **Reversal of impairment loss**. Reversal (or restoration) of impairment loss was prohibited with the following reasoning provided:

> 'Impairment loss should result in a new cost basis for the impaired asset. The new cost basis puts the asset on an equal basis with other assets that are not impaired. The new cost basis should not be adjusted subsequently other than as provided under current

> accounting model for prospective changes in the depreciation estimates and method and for further impairment losses' (Para B52 of SFAS 144)

19. It can be argued that some of FASB's reasoning for recognition and reversal was preceded with accounting developments. For example, prohibiting reversal of impairment has attributes of conservatism, which is not the objective of financial reporting, according to the developments on the Framework. The FASB's initiation of the project to permit reversal of impairment for financial assets may suggest a change of direction. Similarly, stability (achieved by rarely recognising impairment and instead writing off assets in a linear fashion) is not an objective of financial reporting. Therefore, following some of the above principles may not result in faithful presentation of transactions and events and would mislead users of financial statements.

20. Similarly to adopting an IFRS impairment approach for all leases, adopting a US GAAP impairment approach for all leases would result in different impairment models for IFRS preparers and would be impractical to apply to asset groups comprised of both leased and owned assets.

Lease specific approach

21. Given limitations of above two approaches, one might consider developing specific approach for impairments of right-of-use assets.

22. In addition to removing inconsistency between IFRS and US GAAP, a single approach could deal with lease specific aspects of impairment, considering for example:

    (a) Timing of recoverability testing and its relationship to changes to the right-of-use asset which arise from changes in the lease liability (ie change in indices, reassessment of lease term, purchase options, contingent rentals (IASB), discount rates)

(b) Any eligible cash flows which could be different than those currently allowed under IAS 36/SFAS 144. Excluding cash outflows already included in lease obligations to avoid double-counting.

(c) Assumptions used and their relationship with those used in reassessment of lease obligation, where those are relevant (eg length of lease term, contingent rentals where they are based on usage or income). Assumptions, impairment tests and lease obligation reassessments are done at different times.

(d) Discount rates used and their relationship to incremental borrowing rate.

(e) When testing CGU (asset group) for impairment, cash flows to be included when the lease term is shorter than the useful life of CGU (asset group).

23. If the boards would like to pursue this approach, the staff will develop a detailed model and bring proposals to the boards.

24. The staff notes that these lease specific aspects could more easily be addressed as consequential amendments to the existing impairment standards. Right-of-use assets are just like any other assets and it would be difficult to justify why their impairment accounting model is not same as for other assets. It would also add to complexity of financial reporting, which the boards are working to reduce.

25. This approach would as a minimum have to address differences between IFRS and US GAAP in order to arrive at a single view. These discussions would be equally applicable to impairment of other assets and not only be relevant to right-of-use assets. As this project is leasing specific, discussion could miss some issues relevant to other assets but not to right-of-use assets and therefore be misleading in determining the way forward for impairment accounting in general.

26. In addition, a specific impairment accounting model for right-of-use assets would also result in complications in impairment testing when there is an asset group (CGU) comprised of both leased and owned assets.

Final option – refer to existing impairment standards

27. Another way forward is to refer to existing impairment requirements (IFRS and US GAAP, respectively).

28. This would be easy for preparers to understand and implement and would remove difficulties with impairment testing of CGUs. It would also increase comparability for both IFRS and US GAAP users. Any lease specific aspects could be addressed as application guidance through consequential amendments.

29. However, this option would not create convergence as IFRS and US GAAP impairment standards are different. The FASB and IASB have a plan to work on a converged impairment standard but there are no specific dates or commitments yet.

30. Given the limitations of other options available, the staff recommends this option.

Impairment
Question 1 – Do the boards agree with staff recommendation to refer to existing impairment models in the leasing standard? If not, what approach do you prefer and why?