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Project	<b>Leases</b>
Topic	<b>Revaluation of right-of-use assets</b>

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## Purpose of paper

1. The boards tentatively decided to require initial measurement of the right-of-use asset at cost. Subsequent measurement is on an amortised cost basis. IFRS allows non-financial assets subject to depreciation/amortisation initially measured at cost to be subsequently carried at fair value. US GAAP does not.
2. The boards tentatively decided not to require initial or subsequent measurement at fair value. Consequently, this paper discusses providing an option and not a requirement to revalue. If the boards agree to permit this option, the paper continues with a more detailed discussion of revaluation.
3. The paper has the following sections:
  - (a) Background describing revaluation options for similar assets under IFRS
  - (b) Discussion on whether or not to permit revaluation of right-of-use asset
  - (c) Discussion of options for revaluation of right-of-use assets:
    - (i) Reliability thresholds revaluation
    - (ii) No threshold revaluation
  - (d) Discussion of accounting for revaluation
4. The IASB staff recommends the following:
  - (a) permit revaluation of right-of-use assets,

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This paper has been prepared by the technical staff of the FAF and the IASCF for discussion at a public meeting of the FASB or the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

Comments made in relation to the application of IFRSs or U.S. GAAP do not purport to be acceptable or unacceptable application of IFRSs or U.S. GAAP.

The tentative decisions made by the FASB or the IASB at public meetings are reported in FASB *Action Alert* or in IASB *Update*. Official pronouncements of the FASB or the IASB are published only after each board has completed its full due process, including appropriate public consultation and formal voting procedures.

- (b) include reliability criteria for any right-of-use asset to be carried at a revalued amount
- (c) account for revaluation surplus/losses in other comprehensive income.

This proposal would achieve consistency of accounting for the same underlying assets, whether owned or leased.

5. The FASB staff recommends that revaluation not be permitted for right-of-use assets.

## **Background**

6. Right-of-use assets are non-financial assets subject to amortisation. Below we discuss revaluation of other non-financial assets under IFRS. Revaluation under US GAAP is not discussed as it is not permitted.
7. IAS 16 allows tangible fixed assets, following initial recognition at cost, to be carried at a revalued amount, being the asset's fair value. This option is available if the fair value of the asset in question can be measured reliably. Once the option is selected, entities have to regularly revalue the asset, which can be every year or every few years, depending on when material changes in fair value occur.
8. IAS 38 Intangible Assets allows intangible fixed assets, following initial recognition at cost, to be carried at a revalued amount, being the asset's fair value. This option is available if the fair value of the asset in question can be determined by reference to an active market. If there is no active market for the asset, it has to be measured at amortised cost. Once the option is selected, entities have to regularly revalue the asset, which can be every year or every few years, depending on when material changes in fair value occur.
9. Revaluation of assets held under finance leases is not explicitly permitted under IAS 17 but does occur in practice.

10. Entities with finance leases classified as investment property are also permitted to use a fair value option under IAS 40 Investment Property, which allows them to carry leased assets at fair value with annual reviews and adjustments going to profit or loss (same applies to operating leases, under some conditions).
11. Entities using IFRS want to have a revaluation option for right-of-use assets to achieve consistency with their owned assets. They might view these assets in the same way and want to have the same accounting for them. This is especially the case for leasehold land and buildings and may be important in jurisdictions where property leaseholds are common and are viewed as very similar to property ownership (eg in the UK and other European countries). Sometimes an entity has no choice whether to buy or lease, with lease the only available option (eg in some sectors, like retail outlets in malls or in some jurisdictions like PRC). Prohibiting revaluation may hinder comparisons between entities in different sectors and with operations in different jurisdictions.

### **Should revaluation of right-of-use assets be permitted**

12. Without getting into details of how to revalue right-of-use assets, there are two general approaches<sup>1</sup>:
  - (a) Permit entities to opt to carry their right-of-use asset at a revalued amount
  - (b) Require subsequent measurement on an amortised cost basis only.
13. Each of these approaches is discussed in the following subsections.

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<sup>1</sup> The boards tentatively decided not to require fair value measurement which is why this option is not included in the paper.

***Permit revaluation of right-of-use assets***

14. Permitting revaluation may provide users of financial statements with more relevant information about the revalued assets than amortised cost based measurement.
15. Permitting revaluation would not impose undue cost and effort on preparers who have right-of-use assets for which fair value is difficult to determine as they could carry those assets on an amortised cost basis.
16. This option would be consistent with current IFRS accounting for non-financial assets subjects to depreciation/amortisation. This is particularly relevant as the boards tentatively decided to present right-of-use assets according to their nature adjacent similar assets that are owned.
17. However, there would be inconsistency in measurement with other non-financial assets which may be (must be in US GAAP) carried at amortised cost. In addition, by providing measurement choice, there may be inconsistencies in accounting for right-of-use assets within an entity.
18. IAS 16 manages this inconsistency by requiring the same accounting policy for assets in the same class, ie if one asset in the class is revalued, all assets in that class should be revalued. To alleviate this concern, we propose to adopt a similar approach in the leases standard.
19. We would also propose to extend this approach to apply to all assets, regardless of whether owned or leased. It could however only apply in IFRS as US GAAP currently does not allow owned assets to be carried at revalued amounts.

***Prohibit revaluation of right-of-use assets***

20. The right-of-use model for lessees is not based on the same notion as finance leases under current FASB or IASB guidance. The finance lease guidance is based on the notion that substantially all the risks and rewards incidental to ownership are transferred from the lessor to the lessee (in-substance purchase).

That results in the lessee recognising the physical asset on its books. Under the right-of-use model the physical asset is not recorded on the books of the lessee.

21. The lessee is accounting on a gross basis for a lease contract and not accounting for a physical asset. The right-of-use asset could therefore be considered to be an intangible asset, resulting in the need to apply the IAS 38 Intangible Assets guidance for revaluation. As discussed in paragraph 29 below, revaluation of intangible assets is available only if the fair value of the asset in question can be determined by reference to an active market. If there is no active market for the asset, it has to be measured at amortised cost. As a result, even if revaluation were permitted it would not be available as in most cases an active market would be unlikely to exist.
22. In addition, not permitting revaluation of right-of-use assets would create full consistency in US GAAP and for all right-of-use assets in IFRS. The preparers would not have to incur costs to arrive at fair value of their right-of-use assets.
23. However, this option would lead to inconsistency for IFRS preparers. For example, consider an IFRS preparer who both owns and holds long-term leasehold office buildings. Say the preparer chooses to carry own buildings at a revalued amount. Under this option, the entity would still have to carry the long-term leasehold building on an amortised cost basis, resulting in inconsistent measurement of the same underlying assets.

**Staff recommendation**

24. The IASB staff thinks that benefits of revaluation prevail and therefore recommends that revaluation of right-of-use assets should be permitted. Revaluation provides more relevant information and allowing it will also ensure consistency with other non-financial assets in IFRS.
25. The FASB recommends that revaluation of right-of-use assets should not be permitted. Permitting revaluation of right-of-use assets would result in an inconsistency with accounting for other non-financial assets under US GAAP.

**Question 1 - Permitting revaluation**

Should revaluation of right-of-use assets should be permitted?

26. If the boards agree to permit revaluation of right-of-use assets, the following sections discuss revaluation in more detail.

***Consequence of failure to reach converged view***

27. The staff think that there is a significant risk that the boards will fail to reach a converged view on this issue. If the boards reach different conclusions, the staff will, later in the project, bring the issue back to the boards to consider whether
- (a) to attempt to reach a converged view; or
  - (b) accept a GAAP difference in this area.

**Revaluation accounting**

28. The following sections discuss revaluation accounting in more detail. In the discussion, the staff has referred to IFRS requirements only as there is no equivalent option to revalue non-financial assets in US GAAP.

**Revaluation option – reliability threshold**

***Background***

29. All IFRS standards dealing with non-current non-financial assets and permitting/requiring fair value measurement have criteria for when assets can be carried at fair value. These criteria are based on reliability of fair value measurement but with different detailed guidance in individual standards. They are summarised in the table below:

## IASB Staff paper

Standard	IAS 16	IAS 38	IAS 40	IAS 41
<b>Scope</b>	Tangible fixed assets	Intangible fixed assets	Investment property	Biological assets
<b>Revaluation option</b>	Revaluation permitted if the fair value can be measured reliably.	Revaluation permitted if there is an active market for the asset.	Fair value should be in disclosure or measurement, unless the amount is not reliably determinable on continuing basis.	Has to be measured at fair value less costs to sell, unless fair value can not be determined reliably.
<b>Threshold guidance</b>	The fair value of an asset for which comparable market transactions do not exist is reliably measurable if (a) the variability in the range of reasonable fair value estimates is not significant for that asset or (b) the probabilities of the various estimates within the range can be reasonably assessed and used in estimating fair value. (para 26)	An active market is a market in which all the following conditions exist: (a) the items traded in the market are homogeneous; (b) willing buyers and sellers can normally be found at any time; and (c) prices are available to the public.	Fair value is not reliably determinable on continuing basis when, and only when, comparable market transactions are infrequent and alternative reliable estimates of fair value (for example, based on discounted cash flow projections) are not available. (para 53)	There is a presumption that fair value can be measured reliably for a biological asset. However, that presumption can be rebutted only on initial recognition for a biological asset for which market-determined prices or values are not available and for which alternative estimates of fair value are determined to be clearly unreliable. (para 30)

### **Options for lease revaluation**

30. There are three main options in setting revaluation thresholds:

- (a) No threshold,
- (b) High threshold, such as active market in IAS 38
- (c) Middle ground, such as reliability criteria in IAS 16

Each of the options is considered below.

### **No threshold**

31. One could argue that SFAS 157 Fair Value Measurements (and Fair Value Measurement project in IFRS) provides sufficient guidance to arrive at a reliable fair value. Also, the standard requires that entities disclose the level of the fair-value hierarchy used and the impact of valuations which used significant unobservable inputs (Level 3 according to SFAS 157 and IASB's Fair Value Measurement project). This would provide users with information on how the fair value was determined.

32. On the other hand, allowing revaluation at fair value without any limitation could lead some entities to revalue right-of-use assets using level 3 assumptions where there are large variations in a range of possible outcomes. It can be argued that any value obtained in such a way may not be more decision-useful than amortised cost.

***Active market threshold***

33. It can be argued that a right-of-use asset is an intangible asset. Consequently, to be consistent with the treatment of other intangible assets, the boards could decide only to permit revaluation when an active market exists for that right-of-use asset.
34. As an active market is unlikely to exist for majority of the right-of-use assets, setting this threshold would effectively prohibit revaluation of a right-of-use asset. There is a little point in allowing an option but setting a threshold for its execution such that it can hardly ever be reached.

***Reliability threshold***

35. Measuring the fair value of right-of-use assets may be more difficult than measuring the fair value of property plant and equipment as a lease contract gives rights to a part of the useful life of the asset, the value of which may not bear a direct relationship with the value of the underlying asset.
36. If we consider the reliability threshold together with guidance in SFAS 157 (and Fair Value Measurement project), the threshold is quite easy to cross. There are two aspects:
- (a) the variability in the range of reasonable fair value estimates is not significant for that asset – this can be an issue when there are varying uses for the asset. However, the entity should first determine the highest and best use. Once that is determined, it is very likely that the range of fair value estimates will not be so spread to be considered unreliable.



- (b) the probabilities of the various estimates within the range can be reasonably assessed and used in estimating fair value. Similarly, once the highest and best use for the asset is determined it is likely that probabilities can be reasonably assessed.
37. If the fair value of the asset does not pass these tests, it suggests that there is something seriously wrong with the measurement. Would we still want such measurement to appear in the financial statements? Probably not.
38. Also, setting criteria at the level of IAS 16 would achieve consistency of measurement for all tangible fixed assets, whether owned or leased (for IFRS preparers). Consistency of treatment is one of the reasons for considering revaluation to be a permitted option in the first place.
39. For these reasons, the staff recommends including a threshold in the leases standard with wording similar to that in IAS 16.
40. If the boards decide to include leases of intangible assets within the scope of the project they may wish to include an active market threshold for those leases in order to achieve consistency with IAS 38.
41. The staff is aware that the term reliability was replaced with faithful presentation in the boards' work on Phase A of the Framework project. As Phase A is not yet a final standard, we propose to keep the wording as in IAS 16 and review it at a later stage.

**Question 2 - Revaluation threshold**

Do the boards agree with staff recommendation to set a reliability threshold before revaluation option can be exercised, along the lines of IAS 16? If not, why not?

**Accounting for revaluation gains/losses**

42. Where IFRSs permit revaluation of non-financial assets subject to depreciation, such revaluation is reflected in other comprehensive income in equity. Only to the extent a revaluation surplus reverses previous revaluation loss recognised in

profit or loss is this surplus recognised in profit or loss. Similarly, if the carrying amount of asset is reduced as a result of revaluation, it should be recognised in profit or loss unless there was a previous revaluation surplus (recognised in equity) to offset against.

43. Following the principle for revaluation of other assets subject to depreciation, one could argue that revaluation of right-of-use assets should be treated in the same way, ie through other comprehensive income.
44. However, there are a number of arguments against this:
  - (a) Other comprehensive income is not conceptually defined in IFRSs or US GAAP
  - (b) For some assets that are not subject to depreciation, the entire fair value change is recognised through profit or loss. For assets that are measured at fair value and depreciated, this change is split into three components: depreciation, impairment and revaluation. If depreciation and impairment are reflected through profit or loss, there is no reason why revaluation component should not be.
  - (c) The direction of other projects suggests the boards' objective is to eliminate OCI items (eg Employee Benefits).
45. Some might argue that recognising fair value changes through profit or loss might hide the entity's operating performance. However, several projects have come up with the proposals to show remeasurements separately from profit or loss items not arising from remeasurements (Reconciliation schedule proposed in Financial Statement Presentation project, Remeasurement section in the Statement of Comprehensive Income discussed in Employee Benefits project, plus disclosures in SFAS 157/Fair Value Measurement project).
46. Recognising fair value changes through profit or loss would create inconsistency with other non-financial assets subject to depreciation in IFRS. There would be no such inconsistency in US GAAP (inconsistency in US GAAP would arise out of the mere fact that a revaluation option is permitted).

47. In the staff's opinion, this is a question of principle, the answer to which should not differ whether the asset is tangible, intangible or right-of-use. Whilst the staff thinks that remeasurements should not be shown as OCI items, until this issue is resolved in related standards, we recommend that remeasurements are treated in a consistent manner.
48. The staff therefore recommends recognising fair value remeasurements of right-of-use assets through other comprehensive income.

**Question 3 - Accounting for revaluation**

Do the boards agree with the staff recommendation that revaluation of right-of-use assets should be accounted through other comprehensive income until OCI is addressed in related standards? If not, why not?