Project **Leases**

Topic **Lessor accounting: Impairment of assets**

Introduction

1. This paper explores how to address impairment by lessors under the performance obligation model.

2. Under the performance obligation model, a lessor has two assets – the underlying asset and its receivable. The underlying asset generates economic benefits. The contractual cash flows on the receivable are created by the lease contract, but largely reflect the economic benefits expected to be generated by use of the asset. *Prima facie* it appears as if the economic benefits on the underlying asset are, in effect, being included in the measurement of two assets. Therefore, if the underlying asset was assessed in isolation, it could be argued that it is impaired because the cash flows during the lease period have been recognised by the lessor as a receivable.

3. Appendix A provides a brief discussion on the impairment of assets under the alternative approach to lessor accounting, the derecognition model.

Summary of staff recommendation

4. We recommend two options to address impairment:

   (a) Option A: Some staff members think that the lessor should:

      (i) group the underlying asset and performance obligation as a single unit of account to assess for impairment in

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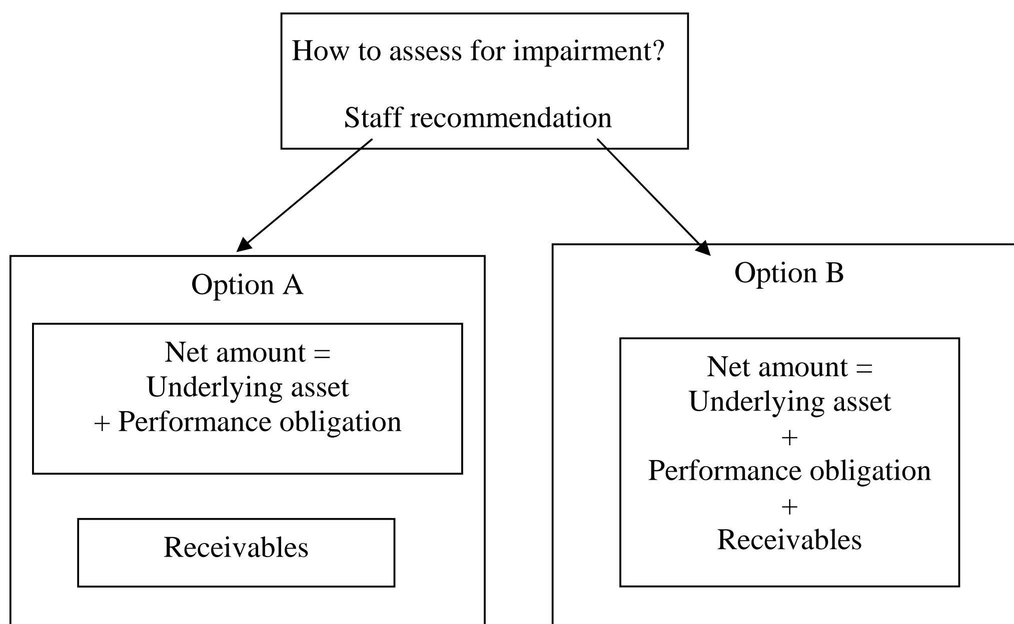
accordance with the applicable requirements on impairing non-financial assets; and

(ii) separately assess the receivables in accordance with the requirements on impairing financial assets.

(b) Option B: Other staff members think that the lessor should consider the underlying asset, receivables and the performance obligation as a single unit of account. The lessor shall assess the net amount for impairment based on the non-financial asset impairment requirements.



Which GAAP to apply?

5. We have assumed that the boards will require the lessor to apply applicable or relevant generally accepted accounting principles (GAAP) on impairment. Those applying IFRSs shall apply IAS 36 *Impairment of Assets* and IAS 39 *Financial Instruments: Recognition and Measurement*, and US GAAP preparers would apply impairment guidance for property, plant and equipment and receivables in Topic 360 and Topic 310 of the *FASB Accounting Standards Codification*™, respectively.

6. This is consistent with the boards' decisions not to develop converged requirements on impairment for lessees, but refer to applicable GAAP when assessing impairment of the right-of-use asset. The discussion on the advantages or disadvantages on whether to converge or not applies equally to lessor accounting. Appendix B provides an overview of the requirements in existing GAAP on impairment of assets.

Staff analysis

7. IAS 36 and Topic 360 require the lessor to separately assess the underlying asset and receivables because they have independent and identifiable cash flows. As mentioned earlier, if the underlying asset is assessed in isolation, it could be argued that it is impaired because the cash flows during the lease period have, in effect, been recognised by the lessor as a receivable.

8. Where there are no independent and identifiable cash flows available, existing requirements allow an entity to group assets and liabilities to form a cash-generating unit (CGU) or asset groups.

IAS 36 paragraph 78 states:

> 78 It may be necessary to consider some recognised liabilities to determine the recoverable amount of a cash-generating unit. This may occur if the disposal of a cash-generating unit would require the buyer to assume the liability. In this case, the fair value less costs to sell (or estimated cash flow from ultimate disposal) of the cash-generating unit is the estimated selling price for the assets of the cash-generating unit and the liability together, less the costs of disposal.

Paragraph 360-10-35-23 states:

> For purposes of recognition and measurement of an impairment loss, a long-lived asset or assets shall be 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. However, an impairment loss, if any, that results from applying this Subtopic shall reduce only the carrying amount of a long-lived assets or assets of the group …. .

Paragraph 360-10-35-18 *Assets Subject to Asset Retirement Obligations* states:

> … the carrying amount of the asset being tested for impairment shall include amounts of capitalized asset retirement costs. Estimated future cash flows related to the liability for an asset retirement obligation that has been recognized in the financial statements shall be excluded from both of the following:
>
> a. The undiscounted cash flows used to test the asset for recoverability
>
> b. The discounted cash flows used to measure the asset's fair value.

9. To address the issue of double counting of cash flows from a single resource, we think the lessor would have to group the performance obligation with other assets that arise from the lease contract to form a separate cash-generating unit or asset group to assess for impairment. As mentioned earlier, we propose two options.

Option A

10. The first option, Option A, requires the lessor to assess two units of account. That is, the lessor would:

    (a) group the underlying asset and performance obligation as one cash-generating unit or asset group. The lessor shall assess this net amount based on impairment of non-financial asset requirements. IFRS preparers shall apply guidance in IAS 36 and US GAAP preparers shall apply guidance in Topic 360; and

    (b) separately assess the receivables as another unit of account. IFRS preparers shall apply guidance in IAS 39 and US GAAP preparers shall apply guidance in Topic 310.

11. Supporters of option A think that this option:

    (a) reflects that the receivables are to some extent separable from the underlying asset. For example, the lessor can securitise the receivables;

    (b) results in each asset (the underlying asset and the receivables) being assessed for impairment in accordance with requirements relevant to

their nature. For example, impairment requirements on financial assets have been developed to focus on the credit worthiness of financial assets as opposed to long-lived non-financial assets.

Option B

12. The second option, Option B, requires the lessor to consider the underlying asset, receivables and the performance obligation as one unit of account.

13. Supporters of option B think that:

    (a) the lessor's receivables, underlying asset and the performance obligation are so interlinked, the lessor should consider these items as a single unit of account. This view is consistent with why the boards tentatively decided that these items are linked and should be presented net; and

    (b) the performance obligation cannot be separated from the receivables. This is because there is no receivable if the lessor does not provide (perform) the underlying asset to the lessee.

14. There are two additional issues to consider for option B:

    (a) Which impairment requirement shall the lessor apply?

    (b) How to address the allocation of impairment loss? Some may wonder how to allocate any impairment loss to the underlying asset and the receivables.

Which impairment requirements to apply?

15. In regards to impairment, the lessor could apply either the impairment requirements of a financial asset or a non-financial asset to the net amount.

16. We rejected requiring the lessor to apply the impairment requirements of financial assets. Instead we recommend that the lessor apply the requirements for non-financial assets to the net amount of the performance obligation,

underlying asset and receivables. IFRS preparers would apply the guidance in IAS 36 and US GAAP preparers would apply the guidance in Topic 360.

17. Our reasons are:

    (a) the principles to assess impairment of non-financial assets in existing requirements are broad enough to be applied to financial assets. However, the guidance to assess impairment of financial assets is focused on credit worthiness. They ignore other types of impairment such as physical damage which could be important for physical assets; and

    (b) it is consistent with how some CGUs are calculated. For example, paragraph 79 in IAS 36 states:

    > For practical reasons, the recoverable amount of a cash-generating unit is sometimes determined after consideration of assets that are not part of the cash-generating unit (for example, receivables or other financial assets) or liabilities that have been recognized (for example, payables, pensions and other provisions). In such cases, the carrying amount of the cash-generating unit is increased by the carrying amount of those assets and decreased by the carrying amount of those liabilities.

How to deal with the allocation of impairment loss problem?

18. Some question how would one allocate any impairment loss to a group of assets? Let's use the example below.

> LessorCo has a car that has a useful life of ten years. In Year 1 LessorCo leased the car to LesseeCo for five years. LesseeCo is a good customer and is expected to repay LessorCo.
>
> In Year 2, the LessorCo found that the car had to be impaired because of changes in market values.

19. Existing requirements (paragraphs IAS 36.104 and 106.35 or paragraph 360-10-35-8) state that a lessor would pro-rata the impairment loss based on the carrying amount of each asset in the unit, except that the individual asset in the unit shall not be reduced below the fair value (under US GAAP) or value in use or fair value less costs to sell (under IFRSs) of that asset if they are determinable.

20. Under the example above, LessorCo would only impair the car (and not the receivables).

Question 1
In assessing impairment shall the lessor apply: a) Option A: assess two units of accounts: i) receivables and ii) the net of the underlying asset and performance obligation **or** b) Option B: assess impairment on the net of receivables, performance obligation and the underlying asset?

Question 2
If the boards choose option B, the staff recommend that the lessor applies the requirements for impairing non-financial assets to the net receivables, performance obligation and underlying asset. Do the boards agree?

Appendix A: Lessor accounting: Impairment of assets under the derecognition model

A1. This appendix briefly discusses how a lessor would address impairment under the derecognition model.

A2. Based on the derecognition model discussed to date[1], the lessor transfers its portion of the right to use the underlying asset to the lessee for a receivable.

A3. Under this model, the lessor assesses for impairment:

a. The residual value of the underlying asset based on either IAS 36 or Subsection 360-10-35. The lessor would not have to recognise an impairment loss to reflect the part of the cash flows from the underlying asset that has been transferred.

b. The receivable based on either IAS 39 or Topic 310 (Subsection 310-10-35-20).

A4. The issue of double counting cash flows would not be an issue under the derecognition model.

[1] The staff are still working through the derecognition model (and possible variations on that model). When further exploring the derecognition model(s), the staff will provide the boards with more analysis on impairment of assets, where necessary.

Appendix B *Overview of requirements* in existing literature

IFRSs

IAS 36 Impairment of Assets

B1. Assess when there is an indicator of impairment.

B2. Test at individual asset level (if recoverable amount can be determined) or cash-generating unit (CGU) level. CGU is the smallest group of assets that generates cash inflows from continuing use that are independent of cash inflows of other assets or groups. To qualify as a CGU:

(a) the individual asset's value in use cannot be estimated to be close to its fair value less costs to sell; and

(b) the individual asset does not generate cash inflows that are largely independent of those from other assets.

B3. Impairment loss = asset's (CGU) carrying amount exceeds recoverable amount. Recoverable amount is the greater of fair value less costs to sell and value in use.

B4. Value in use is based on the net present value of future cash flows. Estimates of future cash flows used in value in use calculation are specific to the entity. Discount rate used is based on market-related rate that reflects the current market assessment of risk specific to the asset. It is a pre-tax rate.

B5. Allocate impairment loss for CGU on a pro-rata basis on the basis of the carrying amount of each asset in the unit. However, the carrying amount of each asset cannot be reduced below its fair value less costs to sell (if determinable), value in use (if determinable). The remaining impairment loss shall be allocated pro rata to other assets of the unit.

B6. Impairment loss on revalued asset is charged directly to the revaluation reserve in OCI to the extent that it reverses a previous revaluation surplus. Excess is recognised in profit or loss.

B7. Reversals of impairment are recognised.

IAS 39 Financial Instruments: Recognition and Measurement

B8. Assess for impairment at the end of each reporting period when there is any objective evidence (based on one or more events that occurred after initial recognition) that a financial asset or a group of financial assets is impaired.

B9. Impairment loss is recognised when incurred rather than as expected.

B10. Impairment loss is measured as the difference between the asset's carrying amount and the present value of the estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate (ie interest rate computed at initial recognition).

US GAAP

Topic 360 Property, Plant and Equipment (subsection 360-10-35 Impairment or Disposal of Long-Lived Assets)

B11. Tested for recoverability only when facts indicate that the carrying amount may not be recoverable.

B12. Normally property, plant and equipment is tested at an individual asset level. Otherwise, assets are tested on a group level. An asset group is the lowest level for which there are identifiable cash flows that are largely independent of the cash flows of other groups of assets.

B13. Impairment loss of an asset group shall reduce only the carrying amounts of a long-lived asset or assets of the group. The loss shall be allocated to the long-lived assets of the group on a pro-rata basis using the carrying amount basis. However, the loss allocated to an individual long-lived asst shall not reduce the carrying amount below the fair value of the individual asset. Determining fair value should be without undue cost and effort.

B14. Impairment loss = asset's (or group of asset's) carrying amount is less than undiscounted cash flows of asset. Impairment loss is calculated based on the fair value of the asset.

B15. Estimates of future cash flows to assess recoverability of assets are specific to the entity. Cash flows are gross (not undiscounted).

B16. Impairment loss for asset group is allocated pro rata to assets in the asset group (exclude goodwill, corporate assets and indefinite-loved intangible assets).

B17. Reversals of impairment are prohibited.

ASC Subsection 450-20-25-2 or Topic 310 Receivables 310-10-35

B18. Recognition of a loss occurs when both of the following conditions are met:

(a) Information is available before the financial statements are issued or are available to be issued indicates that it is probable that an asset has been impaired at the date of the financial statements.

(b) The amount of the loss can be reasonably estimated.

B19. Losses shall not be recognised before it is probable that they have been incurred, even though it may be probable based on past experience that losses will be incurred in the future. It is inappropriate to consider possible or expected future trends that may lead to additional losses. Recognition of losses shall not be deferred to periods after the period in which the losses have been incurred.

B20. Some impaired loans have risk characteristics that are unique to an individual borrower, and the creditor measure the loss on a loan-by-loan basis.

B21. When a loan is impaired, a creditor shall measure impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate, except that as a practical expedient, a creditor may measure impairment based on a loan's observable market price, or the fair value of the collateral if the loan is a collateral-dependent loan.