Staff Paper

Project **Leases**

Topic **Lessee accounting: subsequent measurement issues**

Introduction

1. This paper addresses various subsequent measurement issues, including:
   (a) The treatment of foreign exchange differences;
   (b) The impairment of a lessee's right-of-use asset; and
   (c) The revaluation of a lessee's right-of-use asset (IASB-only issue).
2. For each of these issues, the paper contains background information, feedback received from the *Leases* exposure draft ('the ED') and staff analyses and recommendations.
3. These issues are only discussed in the context of lessees. Nearly all of the comments received regarding foreign exchange differences discussed lessee issues. Moreover, the staff believe that existing foreign exchange guidance can be easily applied to a lessor's lease assets and liabilities. This paper does not discuss impairment or revaluation for a lessor as the boards have not yet decided on a lessor accounting model.

Summary of staff recommendations

4. In this paper, the staff recommend:
   (a) To include guidance specifying that a lessee recognise foreign exchange differences relating to the liability to make lease payments in profit or

loss based on applying existing IFRS and US GAAP guidance for foreign currency transactions.

(b) To confirm the proposal in the ED to refer to existing impairment guidance for impairment of the right-of-use asset.

(c) IASB only: to confirm the proposal in the ED to allow revaluation of the right-of-use asset.

Foreign exchange differences

5. Lessees may enter into leases with lease payments denominated in a currency different from their functional currency. For example, in the airline industry, leases of aircraft are typically denominated in USD, regardless of the functional currency of the airline leasing the aircraft.

IFRS and US GAAP Requirements

6. IAS 21 *The Effects of Changes in Foreign Exchange Rates* and Topic 830 *Foreign Currency Matters* in the *FASB Accounting Standards Codification®* address foreign currency transactions.

7. Briefly, IAS 21 requires:

   (a) non-monetary items recorded at historical cost to be translated using a historical exchange rate not taking into account subsequent changes in that rate;

   (b) non-monetary items recorded at fair value to be translated using the exchange rate at the date when fair value was determined; and

   (c) monetary items to be translated using a current exchange rate at the end of each reporting period, with differences due to subsequent changes in the exchange rate being recognised in profit or loss.

8. Although Topic 830 does not make a formal distinction between monetary and non-monetary items, it requires that foreign exchange differences be recognised in profit or loss if they affect the expected amount of functional

currency cash flows on the settlement of a foreign currency-denominated transaction. Topic 830 also provides a list of non-monetary items that should be translated using a historical exchange rate if accounting records are kept in a foreign currency. These non-monetary items include property, plant and equipment, inventory carried at cost, and intangible assets.

9. Again, although Topic 830 does not make a distinction between monetary and non-monetary assets, it contains similar guidance to IAS 21. Going forward, this paper will refer to monetary items using the definition given in IAS 21:

> units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency

10. Monetary items would have the same accounting treatment under IAS 21 and Topic 830; foreign exchange differences arising from these items would be recognised in profit or loss.

Application to lease accounting

11. In current practice, foreign currency-denominated finance/capital leases are accounted for in accordance with IAS 21 and Topic 830. Since a lessee's lease liability is a monetary item, the liability is translated using a current exchange rate at the end of each reporting period and foreign exchange differences are recognised in profit or loss. A lessee's finance/capital lease asset is a non-monetary item measured at historical cost, and is recorded at a historical exchange rate. Subsequent changes in the exchange rate are not reflected in the subsequent measurement of the asset.

12. The ED did not provide specific guidance on how a lessee should account for the effects of foreign exchange relating to the measurement of a liability to make lease payments and a right-of-use asset.

13. However, the ED did define contingent rentals as follows:

> lease payments that arise under the contractual terms of a lease because of changes in facts or circumstances occurring after the date of inception of the lease other than the passage of time.

14. The ED also required that changes in the liability to make lease payments resulting from changes in contingent rentals (variable lease payments) be recognised:

    a. in profit or loss to the extent that those changes relate to current or prior periods, [or]

    b. as an adjustment to the right-of-use asset to the extent that those changes relate to future periods.

15. In their redeliberations, the boards have changed their decisions relating to variable lease payments. In the February 2011 and April 2011 Joint Board Meetings, the boards decided that only variable lease payments based on an index or variable lease payments that are in-substance fixed payments should be included in the initial and subsequent measurement of the liability to make lease payments and the right-of-use asset. Other variable lease payments should be recognised in profit or loss as they are incurred.

Issue

16. Respondents to the ED noted that it is clear that, at the date of initial measurement, the lessee would translate the right-of-use asset and the liability to make lease payments from the foreign currency to the functional currency using the exchange rate in effect at the date of the initial measurement. This is consistent with the requirements for initial measurement in IAS 21 and Topic 830.

17. However, respondents questioned how to record the effects of subsequent changes in the exchange rate. The liability to make lease payments would be adjusted to reflect the change in the exchange rate, but should that adjustment be recognised:

    (a) In profit or loss, consistent with the guidance in IAS 21 and Topic 830 (‘Approach A’ in this paper); or

    (b) As a change to the carrying amount of the right-of-use asset, recognising that the right-of-use asset in a lease contract is linked to the liability to make lease payments (‘Approach B’ in this paper)?

Feedback received from outreach activities and comment letters

18. Requests for additional feedback on the accounting for foreign currency-denominated leases were received from the Asia-Oceania, Europe and Africa regions, especially for lessees who enter into leases for large items of property, plant and equipment, such as aircraft, that are exclusively denominated in USD. Many of these respondents proposed that foreign exchange differences should be recognised as a change to the carrying amount of a lessee's right-of-use asset, rather than recognised in profit or loss. This is because:

    (a) the right-of-use asset and liability to make lease payments are linked in measurement at the inception of the lease contract and this linkage should be reflected in the subsequent accounting for foreign exchange differences;

    (b) changes in exchange rates represent both a change in the amount a lessee would have to make in lease payments and a change in the amount it costs a lessee to obtain the right to use the underlying asset in a lease; and

    (c) the leased asset's output may also be priced in a foreign currency, or could be viewed as a natural hedge of the foreign currency risk relating to the liability to make lease payments.

19. Respondents were also concerned about whether useful information is provided as a result of the profit or loss volatility created by recognising the foreign exchange differences in the liability to make lease payments in profit or loss rather than through remeasurement of the right-of-use asset. These respondents commented that:

    (a) there would be a material effect on the statement of comprehensive income because the only leases available for many large items of property, plant and equipment are negotiated and transacted in USD;

    (b) the exchange rate for some currencies varies widely;

    (c) it would be very expensive to hedge long-term foreign exchange exposure to avoid this volatility in profit or loss; and

(d) an entity reporting in accordance with IFRSs would have to revalue the whole class of related assets if it wanted to revalue the right-of-use asset to reflect changes in value caused by changes in exchange rates.

20. Some of the respondents proposing the remeasurement of a lessee's right-of-use asset to reflect foreign exchange differences argued that the foreign exchange portions of a lessee's lease payments could be characterised as variable lease payments.

21. They argued that foreign exchange differences are just another uncertainty relating to the measurement of lease contracts and are similar to lease payments based on indices. Based on the ED's guidance for contingent rentals, they argued that the portion of foreign exchange difference that related to past or current periods should be recognised immediately through profit or loss and the portion relating to future periods should be recognised as an adjustment to the right-of-use asset. These respondents thought this treatment would be appropriate because foreign exchange differences indicate a change in the estimated cost to acquire the right-of-use asset that was made when initially measuring the lease contract.

22. A representative comment is as follows:

> [We] recommend that the IASB provide some guidance around whether the gain or loss arising from a change in a foreign exchange rate should be recognised immediately or whether the change in the exchange rate is considered to give rise to contingent rental. We consider that there is an argument to consider the gain or loss contingent rental…The change in the exchange rate could be considered a change in circumstance which changes future lease payments. Given that the asset and liability are inextricably linked it would make sense to adjust the asset for the gains and losses which relate to the future lease payments, the same as for other contingent rentals. The right-of-use asset is measured at its estimated cost, and hence changes in the estimated future lease payments--whether because of movements in foreign exchange rates or other external factors (eg a change in an index to which the lease payments are linked)--result in a change to the asset's estimated cost. (CL no. 220)

23. Other respondents requested consistency with existing foreign exchange guidance in IFRSs and US GAAP. These respondents thought that the liability to make lease payments is a monetary item, and the right-of-use asset is a non-

monetary item and should be accounted for in accordance with guidance for such items. That is, these respondents thought that the lease liability should be updated for changes in exchange rates, with these changes being recognised through profit or loss. The right-of-use asset, as a non-monetary item measured at historical cost, should be measured using a historical exchange rate and would not be updated for future changes in the exchange rate.

24. There was no specific private company feedback on this issue.

Staff analysis

25. The staff have analysed the following approaches to accounting for foreign exchange differences:

(a) Approach A –recognise foreign exchange differences in profit or loss based on applying existing IFRS and US GAAP guidance for foreign currency transactions; or

(b) Approach B –recognise foreign exchange differences as adjustments to the right-of-use asset.

Approach A: recognise foreign exchange differences through profit or loss based on applying existing IFRS and US GAAP guidance for foreign currency transactions

26. Approach A results in foreign exchange differences being recognised in profit or loss. A lessee would remeasure a liability to make lease payments denominated in a foreign currency at the exchange rate at the end of each reporting period. Any changes in the measurement of the liability to make lease payments would be recognised in profit or loss. The right-of-use asset, as a non-monetary item measured at historical cost, would not be remeasured to reflect changes in foreign exchange rates.

27. Approach A is consistent with:

(a) existing US GAAP and IFRS guidance regarding foreign exchange differences;

(b) the accounting for a purchase of an underlying asset financed with foreign currency debt;

(c) the premise in the ED that the right-of-use asset and liability to make lease payments are linked at initial measurement, but not in subsequent measurement;

(d) the boards' tentative decisions regarding most variable lease payments; and

(e) measuring the right-of-use asset at cost.

28. Under Approach A, subsequent changes in a foreign exchange rate would not have any effect on the historical cost, and thus it would be inappropriate to include such changes in the remeasurement of the right-of-use asset.

29. Approach A would result in volatility in profit or loss from recognising the foreign exchange differences on the lessee's liability in the period in which they arise. However, those changes would be clearly presented as foreign exchange gains and losses, whilst the amortisation of the right-of-use asset would follow the pattern of its usage and not be affected by changes in foreign exchange rates. Therefore Approach A could be more useful to present the changes in foreign exchange separately, rather than within the amortisation expense recognised for the right-of-use asset. Another advantage of this approach is that it would be simple for preparers to immediately recognise foreign exchange differences through profit or loss.

30. If the boards support Approach A, the staff think the simplest and most operational way to communicate this approach in the final standard would be to include language stating that the liability to make lease payments is a monetary liability and should be accounted for in accordance with IAS 21 and Topic 830, with foreign exchange differences being recognised in profit or loss. Please refer to Appendix A for the staff's suggested drafting.

Approach B: recognise foreign exchange differences as adjustments to the right-of-use asset

31. Approach B results in foreign exchange differences being recognised as an adjustment to the right-of-use asset. A lessee would remeasure a liability to make lease payments denominated in a foreign currency at the exchange rate

existing at the end of each reporting period. Changes in the measurement of the liability to make lease payments would be recognised as an adjustment to the right-of-use asset.

32. Approach B has the following advantages:

(a) It would link the accounting of the right-of-use asset to the liability to make lease payments. One could argue that this is appropriate because in the ED the cost of the right-of-use asset is established as the present value of the lease payments. Furthermore, subsequent changes in those payments are accounted for as adjustments to the cost of the right-of-use asset. Hence, one could argue that changes in the liability arising from changes in foreign exchange rates over the lease term are another adjustment to the total cost of the right-of-use asset.

(b) It more closely reflects how some entities manage foreign exchange risk relating to lease contracts by adjusting the pricing of the outflows from the leased asset to absorb the foreign exchange differences. For example, an airline that pays for a lease of its planes in a foreign currency often adjusts its fare-pricing for exchange-rate changes.

(c) It would reduce volatility in profit or loss by avoiding large foreign exchange gains/losses at each reporting period when the foreign exchange gains or losses are viewed as relating to future periods.

33. Approach B would also be consistent with treatment in the ED of variable lease payments that depend on an index or a rate such as CPI. It can be argued that lease payments that depend on changes in foreign exchange rates are similar in nature to variable lease payments based on changes in an external rate or index, such as LIBOR or the CPI, and should therefore be accounted for consistently.

34. Some may be concerned that Approach B is inconsistent with measuring the right-of-use asset on a historical cost basis. However, under Approach B, one could argue that it would still be appropriate to adjust the right-of-use asset for subsequent changes in exchange rates because these changes do represent changes in the cost of the right-of-use asset that was determined at the initial measurement of the lease. Changes in the exchange rate should be reflected as changes in the lessee's ultimate cost of the right to use the leased asset. These changes should be recognised in profit or loss in the future periods in which the future economic benefits represented by the right-of-use asset are recognised.

35. A counterargument to Approach B, however, is that the boards decided in the ED against linking the liability to make lease payments and right-of-use asset in subsequent measurement. This view has also been carried forward by the boards during their redeliberations on the ED (eg when determining the profit and loss recognition pattern for lessees) at the May 2011 joint board meeting.

Staff recommendation

36. After analysing respondents’ feedback, the staff recommend that the board provide guidance in this area. Responses indicate that there will be a significant risk of inconsistency in application if the final standard continues to remain silent in the area of foreign exchange differences.

37. The staff recommend Approach A, that is, immediately recognising these differences through profit or loss. The staff think that the boards should remain consistent with the existing guidance regarding foreign exchange differences arising on monetary and non-monetary items. The liability to make lease payments is a monetary liability, and the right-of-use asset is a non-monetary asset. The staff do not think that respondents' arguments merit establishing an inconsistency with IAS 21 and Topic 830 through requiring that a cost-based non-monetary item's carrying amount be updated for subsequent changes in exchange rates.

38. Following Approach A would also mean there would be no inconsistency in accounting for a lease denominated in foreign currency and the purchase of an asset financed with foreign currency debt. The staff think that there is nothing particular about leases denominated in foreign currency that would merit a different accounting treatment from assets financed with foreign currency debt.

39. The staff also think there is a significant benefit in the boards remaining consistent with measuring the right-of-use asset at historical cost. The staff do not think that subsequent changes in the exchange rate (or, more generally, the foreign exchange risk associated with the lease liability) affect this historical cost.

Question 1
The staff recommend including guidance in the final leases standard stating that the liability to make lease payments should be treated as a monetary item in accordance with IAS 21 and Topic 830; therefore, foreign exchange differences related to this liability should be recognised in profit or loss. Do the boards agree with the staff recommendation? Why or why not?

Impairment of a lessee's right-of-use asset

40. The ED proposed that a lessee follow the existing impairment models in IFRSs or US GAAP when assessing impairment of the right-of-use asset. The staff note that the impairment models in IFRSs and US GAAP are not presently converged. For example, under IFRSs, the impairment assessment is done on a one-step discounted basis (ie the carrying amount of an asset is compared to a recoverable amount based on discounted cash flows). Under US GAAP, the impairment assessment for property, plant and equipment is done on a two-step basis; the first step of the model involves comparing the carrying amount of the asset to an amount based on *un*discounted cash flows.

Feedback received from comment letters

41. Relatively few respondents addressed this issue. Many supported impairing the right-of-use asset as proposed in the ED, while a few did not support the ED's proposals for impairment or requested a converged solution.

42. Respondents also raised a number of concerns regarding impairment that the staff think represent more minor issues that have already been addressed in practice or current guidance or can be addressed through drafting. These issues are discussed in Appendix B.

Staff analysis and recommendation

43. The staff think there are two issues to address with respect to impairment of the lessees' right-of-use asset:

    (a) The confirmation of the proposals in the ED to refer to existing impairment guidance for the right-of-use asset, and

    (b) The interaction between onerous contracts and impairment of the right-of-use asset.

Confirmation of impairment guidance

44. In the ED, the boards proposed referring to existing impairment guidance for the right-of-use asset. IFRS preparers would refer to IAS 36 *Impairment of Assets*, while US GAAP preparers would refer to Topic 350 *Intangibles—Goodwill and Other*. The boards acknowledged that this would not result in a converged solution, but they noted that the consistency and comparability that would result in using the same impairment model for leased and owned assets would outweigh the disadvantage of divergence. Moreover, the ED noted that a unique impairment model would be harder to justify as the right-of-use asset is subject to existing guidance for amortisation and revaluation, and a unique impairment model may add unnecessary complexity. The staff continue to support this proposal.

45. The staff recommend that the boards confirm their proposal in the ED to apply existing impairment guidance to the right-of-use asset, subject to the staff making some clarifications during the drafting process. The staff do not think that any issues were raised in feedback to the ED to merit a change in the boards' proposal.

Onerous contract issue

46. During the course of redeliberations, the boards have discussed the issue of impairment arising between inception and commencement of a lease contract. The staff would not expect this circumstance to occur very often; it might occur in certain build-to-suit leases with long lead times between inception and commencement. However, as the boards have identified, there could be different outcomes in this circumstance between entities applying IFRSs and those applying US GAAP:

    (a) Applying IFRSs, if impairment arose between inception and commencement, a liability for an onerous contract would be recognised in accordance with IAS 37 *Provisions, Contingent Assets and Contingent Liabilities*. This liability would be derecognised at commencement and the right-of-use asset would be recognised at its impaired amount.

    (b) Under US GAAP, there is no specific guidance on whether a liability should be recognised for onerous contracts so there is uncertainty as to whether a liability would be recognised between inception and commencement. ARB 43 *Restatement and Revision of Accounting Research Bulletins* states that losses expected to arise from firm commitments for the future purchase of inventory should be recognized and disclosed in the financial statements. Concept Statement 6 *Elements of Financial Statements* states that as long as commitment transactions remain unrecorded, the only way to recognise the loss on the commitment is to do as is done in current practice – to recognise a valuation account for estimated losses on purchase commitments and include it within the assets or liabilities.

This could result in the right-of-use asset being carried at two different amounts at commencement under IFRSs and US GAAP.

47. Two alternatives to consider with respect to this issue are:

(a) Make no change to the final standard and accept that this is an example of divergence resulting from different impairment models; or

(b) Instate a 'fair value cap' that would ensure the same initial measurement under IFRSs and US GAAP. This 'fair value cap' would ensure that the right-of-use asset would be initially measured at the lower of the present value of lease payments or the fair value of the right-of-use asset.

48. The staff thinks that this difference is an example of one of the many cases where applying the two different impairment models that exist in present IFRSs and US GAAP will result in different answers. It is outside the scope of the leases project to change existing impairment models, and the staff continues to think that applying existing impairment models to right-of-use assets is appropriate.

49. On the other hand, existing capital/finance leases are already recognised at the lower of fair value of the underlying asset or the present value of lease payments under IFRSs and US GAAP. Placing such a 'fair value cap' in the standard would solve the onerous contract issue and ensure that the right-of-use asset is initially measured (at commencement) at the same amount under IFRSs and US GAAP.

50. However, the inclusion of such a 'fair value cap' has implications beyond just resolving the onerous contract issue created by different impairment models. It also would be inconsistent with the boards' previous decision not to initially measure the right-of-use asset at fair value, which was made partly for cost-benefit reasons. This could create a significant burden for preparers having to identify the fair value of the right-of-use asset for every contract they entered into. It would also be inconsistent with the initial measurement of other non-financial assets.

51. Again, the staff think the onerous contract issue represents one of the consequences of following diverged impairment models. Although the introduction of a 'fair value cap' could be a way to address this specific issue, given the disadvantages of such a cap, the staff recommend not including a 'fair value cap' in the final standard. The boards proposed referring to existing impairment models in the ED with the knowledge that, in certain cases, this could lead to diverged accounting under IFRSs and US GAAP. The staff continue to support this.

Question 2
The staff recommend that the boards confirm their proposal in the ED to refer to existing impairment guidance for the right-of-use asset. Do the boards agree with the staff recommendation? Why or why not?

Revaluation of a lessee's right-of-use asset—IASB-only issue

52. The staff think that the IASB also need to confirm the proposals in the ED regarding the revaluation of a lessee's right-of-use asset.

53. For preparers following IFRS, the ED proposed in paragraphs 21-23 that:

(a) a lessee's right-of-use asset would be initially measured at cost.

(b) revaluation of a lessee's right of use asset would be permitted if a lessee revalued all owned assets in the underlying asset's class of property, plant and equipment, but would not be required, even if the rest of the asset class was revalued.

(c) if a lessee revalues its right of use assets, it would be required to revalue the entire class of asset to which the underlying asset belongs.

(d) revaluation would be required to be performed in accordance with IAS 38 *Intangible Assets*; however, an active market would not be required to revalue right-of-use assets. Revaluation gains and losses would be recognised in other comprehensive income.

54. For preparers following US GAAP, the ED did not allow revaluation of the right-of-use asset. Revaluation is currently prohibited in US GAAP.

Feedback received from comment letters

55. Relatively few respondents addressed this issue. Many supported revaluing the right-of-use asset as proposed in the ED, while a few did not support the ED's proposals for revaluation or requested that the Board prohibit revaluation to be consistent with US GAAP.

56. Also, a few respondents requested that right-of-use assets be treated as their own class for purposes of revaluation.

Staff analysis and recommendation

57. The staff recommends the Board confirm their proposal in the ED to allow revaluation of the right-of-use asset. If an entity chooses to revalue a right-of-use asset, it would be carried at fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. There would be no requirement for an active market in order to determine the fair value of a right-of-use asset.

58. The boards have tentatively decided to confirm the lessee accounting model in the ED, and the staff have not identified any reason to change the revaluation model applied to this accounting model. Although this will not result in a converged solution, the Board had previously decided that the consistency and comparability that would result in using the same revaluation model for leased and owned assets in IFRSs would outweigh the disadvantage of divergence with US GAAP. Moreover, the prohibition of revaluation would be hard to justify as the right-of-use asset is subject to existing guidance for amortisation and impairment, and existing IFRS guidance currently allows revaluation for non-financial assets. Additionally, many respondents who commented on the issue of revaluation supported the Board's proposal.

59. Regarding classes of assets, the staff also think the Board should confirm their proposals in the ED. It is important for right-of-use assets to be treated

consistently with owned assets, and staff do not think right-of-use assets are sufficiently different from owned assets to be treated as their own class for purposes of revaluation. The staff think the ED's proposals allow sufficient flexibility for preparers in their choice of whether to revalue a right-of-use asset.

60. Again, the staff recommend that the IASB confirms its proposal in the ED to allow revaluation of the right-of-use asset if a revaluation policy is applied to owned assets of the same class. If an entity chose to revalue a right-of-use asset, it would be carried at fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. The staff do not think that any issues were raised in feedback to the ED to merit a change in the boards' previous proposal.

Question 3
The staff recommend that the IASB confirm their proposals in the ED to allow revaluation of the right-of-use asset. Do the boards agree with the staff recommendation? Why or why not?

Appendix A: suggested wording for foreign exchange guidance

The preliminary draft wording included in this appendix has been prepared by the staff to help the Boards reach decisions regarding the scope of the leases standard. The Boards have not yet made decisions about the views reflected in this appendix, and, therefore, the wording is subject to change.

A1. A lessee shall apply IAS 21 *The Effects of Changes in Foreign Exchange Rate* /Topic 830 *Foreign Currency Matters* to a lease denominated in a foreign currency. It shall account for the liability to make lease payments as a monetary item/foreign currency transaction. Exchange differences arising from translating the liability to make lease payments at an exchange rate different from the exchange rate used at initial recognition shall be recognised in profit or loss in the period in which those differences arise.

Appendix B: other impairment issues raised by respondents

B1 Respondents raised a number of other issues regarding impairment that the staff think represent issues that have already been addressed in existing guidance or those that can be addressed through the drafting process. These issues are:

(a) The inclusion of the liability to make lease payments in the assessment of the right-of-use asset.

(b) The consistency of assumptions (eg discount rates and option periods) between the initial measurement of the right-of-use asset and the measurement of that asset's recoverable amount.

(c) How to apply existing impairment models to a new 'type' of asset, the right-of-use asset.

(d) The matter of which Topic to refer to for impairment (FASB-only issue).

Inclusion of the liability to make lease payments

B2 Some respondents expressed confusion relating to whether the liability to make lease payments should be considered when assessing the right-of-use asset for impairment. Both IAS 36 and Topic 360 include criteria for when a liability should be included in the impairment assessment of an asset.

B3 Paragraphs 29 and 78 of IAS 36 do allow liabilities to be considered when determining the recoverable amount of an asset or CGU if disposal of that asset or CGU would require the buyer to assume the related liability. Paragraph 360-10-35-23 of Topic 360 allows liabilities to be grouped with assets if the cash flows of an asset are not independent of the cash flows of that liability.

B4 The staff view that cash flows from the right-of-use asset are separate from the liability (consistent with the boards' view that the assets and liabilities from the contract should be separately measured). Consequently, applying the impairment guidance would generally result in the liability to make lease payments being excluded from the calculation of expected cash flows in the impairment assessment.

B5 The staff think that the existing guidance in IFRS and US GAAP is sufficiently clear and no further clarification would be needed in the final standard.

Consistency of assumptions

B6 There were a number of issues that respondents raised in regard to the consistency of assumptions used in the initial or subsequent measurement of the right-of-use asset (as required in the leases ED) and the measurement of its carrying amount (as required by present accounting guidance relating to impairment assessments).

B7 Respondents argued that, if these assumptions were different, impairment losses could be recognised when it would not be appropriate and questioned whether consistent assumptions should be used. For example, assumptions used for initial or subsequent measurement of the right-of-use asset and measurement of that asset's recoverable amount could be different in respect of the discount rate or assumptions in regards to the lease term.

B8 Assessing impairment ensures that the assets are carried at no more than their recoverable amount. A change in assumptions does not necessarily mean the value of the asset would have declined beyond its recoverable value. Assuming that there is an indication of impairment, the impairment guidance:

(a) informs entities which discount rate to use when assessing the fair value or the value in use of the asset. This discount rate could be different to that applied in the final leases standard; and

(b) clearly states that the entity has to base estimates of future cash flows on those that will exist over the useful life of the asset (right-of-use asset). This useful life should be consistent with the definition of lease term applied in the final leases standard.

B9 The staff note that the issues raised is applicable to any non-financial asset measured at historical cost. Therefore, the staff recommend that no change be made or additional guidance is given to the final standard because of this issue.

Application of impairment model to the right-of-use asset

B10 Some respondents questioned how the existing impairment models in IFRSs and US GAAP would apply to a new ‘type’ of asset, the right-of-use asset. Respondents also questioned how to calculate a fair value for the right-of-use asset.

B11 The staff think that it is relatively clear how the impairment models under IFRS and US GAAP should be applied to the right-of-use asset. Under both IFRS and US GAAP, impairment can be tested by comparing an asset’s carrying amount to the cash flows an entity expects to derive from the asset. Under Topic 360, you would calculate the undiscounted cash flows as the first test for impairment, and under IAS 36, these discounted cash flows would form the value in use.

B12 These same cash flows can be used to come up with a fair value for the right-of-use asset; they would simply need to be adjusted to conform to market assumptions. The staff think it would not be unduly difficult for an entity to come up with these cash flows for a right-of-use asset as the entity would likely have estimated these cash flows when entering into the lease.

B13 Moreover, the recoverable amount of a right-of-use asset does not need to be determined every period; a lessee would only need to determine a right-of-use asset’s recoverable amount if there are indications that a right-of-use asset is impaired.

B14 Regarding respondents' questions about which asset to determine a recoverable amount for, the boards have decided that a lessee has a right-of-use asset, not the underlying asset. The staff think it is clear that an entity should consider only the cash flows relating to the right-of-use asset (not the cash flows relating to the entire underlying asset) when testing for impairment.

Topic 350 vs. Topic 360

B15 Some US respondents expressed confusion over which impairment model to apply: the model in Topic 350 *Intangibles—Goodwill and Other* or Topic 360 *Property, Plant, and Equipment*. The staff note that the impairment model under the two topics is the same; for intangible assets subject to amortisation, Topic 350 simply refers to the impairment requirements of Topic 360. However, the staff propose clarifying this issue in the drafting process when the boards have made a decision on the presentation of the right-of-use asset.