IAS 36: Impairment Test on Right-of-Use Assets

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Under IFRS 16 *Leases*, lessees record right-of-use (ROU) assets and lease liabilities for most lease arrangements in their statement of financial position. The ROU assets are subject to the impairment requirements of IAS 36 *Impairment of Assets* and like other depreciable assets, a ROU asset is only tested for impairment when impairment indicators exist. If impairment indicators exist, an entity must determine whether the ROU asset can be tested on a stand-alone basis or whether it should be tested as part of a cash generating unit (CGU).

Per paragraph 22 of IAS 36, the first step in identifying the level at which the ROU asset should be tested for impairment is to look at whether it generates cash inflows that are largely independent of those generated from other assets or groups of assets in the entity. If this first condition is not met, an asset would still be tested at the individual asset level if either:

(a) the asset's individual fair value less costs of disposal (FVLCD) exceeds its carrying amount; or

(b) the asset's value in use can be estimated to be close to its FVLCD and the FVLCD can be measured.

In addition, if there is no reason to believe that an asset's value in use materially exceeds its FVLCD, the asset's FVLCD may be used as its recoverable amount. This will often be the case for an asset that is held for disposal. This is because the value in use of an asset held for disposal will consist mainly of the net disposal proceeds, as the future cash flows from continuing use of the asset until its disposal are likely to be negligible

The Group considered the following fact pattern when an entity has decided to vacate a leased property and is vacating the property shortly after the decision date. The Group discussed impairment considerations for the ROU asset.

Fact Pattern for Issue 1

- Entity X recognizes a ROU asset for a building that it currently occupies as office space. The entity has occupied the building for seven years and has three years remaining on its original 10-year lease.
- Historically, this ROU asset has been tested for impairment as part of CGU 1 within Entity X since it was used by CGU 1 and did not generate largely independent cash inflows.
- During the COVID-19 pandemic, the office space is largely vacant as many employees are working from home. As a result, immediately prior to Entity X's year end of December 31, 2020, the entity's board, in conjunction with its management, made a final decision to permanently cease using this office space and has informed the affected staff. Entity X does

not expect to be able to sublease the space given the location, relatively short remaining lease term and market conditions for office space.

- To facilitate the transition to other existing office spaces, Entity X will vacate the property two months after the final decision date. In accordance with paragraph 51 of IAS 16 *Property, Plant and Equipment*, Entity X reconsiders the ROU asset's useful life and residual value and changes its deprecation period prospectively to depreciate the remaining ROU asset's carrying value to nil over the remaining two-month period for which the space will continue to be used by CGU 1.
- Entity X considers its decision to cease use is an impairment indicator for the ROU asset on December 31, 2020, as it is considered an internal indicator of impairment under paragraph 12(f) of IAS 36.
- Assume that the recoverable amount of CGU 1 significantly exceeds its carrying amount and as such, no impairment is identified at the level of CGU 1.

Issue 1: Should the ROU asset, despite continuing to be used by CGU 1 for a two-month period before being vacated, be tested for impairment individually rather than as part of CGU 1?

View 1A – The ROU asset should be tested separately from CGU 1 when the decision to vacate is made since CGU 1 generates largely independent cash inflows from the ROU asset given the short period of use until the property is vacated

- Proponents of this view note that given the office space is used by CGU 1 for only a short period, the cash inflows generated by the other assets making up CGU 1 are largely independent from the ROU asset. As such, the ROU asset should no longer be included in CGU 1 and should be tested for impairment separately. In addition, it would be inappropriate to shelter the impairment that exists in the ROU asset simply because the ROU asset is being used by CGU 1 for two months before the office is vacated.

View 1B – The ROU asset should be tested separately when the decision to vacate is made since it meets the exception described in paragraph 22(b) of IAS 36

- Proponents of this view acknowledge that the ROU asset does not generate cash inflows that are largely independent from other assets or groups of assets in Entity X. However, they also note that paragraph 22(b) of IAS 36 requires an entity to perform the impairment test on the individual asset level rather than as part of a CGU when the asset's value in use can be estimated to be close to its FVLCD and the FVLCD can be measured.
- In this fact pattern, Entity X has decided to vacate the office space. In addition, the period between the decision to cease using the property and the date when Entity X will vacate the property is very short. Therefore, proponents of this view think that the ROU asset's value in use can be estimated to be close to its FVLCD. Furthermore, the FVLCD of the ROU asset is assumed to be measurable. Given Entity X does not expect to be able to sublease the space, the FVLCD would likely be negligible.

- As a result, given the ROU asset's value in use can be estimated to be close to its FVLCD and the FVLCD is assumed to be measurable, the ROU asset should be tested separately when the decision to vacate is made.

View 1C – The ROU asset should continue to be tested as part of CGU 1 until the property is vacated and cannot be tested for impairment separately

- Proponents of this view note the fact pattern states that the ROU asset was not generating largely independent cash inflows. Furthermore, because the vacated space will not be subleased, the ROU asset will not generate any cash inflows after the property is vacated. They also note that even though the period is only two months, the property is still being used by CGU 1. Thus, it is not possible to reasonably determine that the cash flows from continuing use are negligible and that the value in use of the ROU asset approximates the FVLCD of the ROU asset.
- As a result, in accordance with paragraph 22 of IAS 36, Entity X should continue including the ROU asset in CGU 1 for the impairment test until the property is vacated.

The Group's Discussion

Most Group members thought that the ROU asset should be tested for impairment separately from CGU 1 and, therefore, supported either View 1A or View 1B. They noted that the ROU asset should be impaired given the office space is largely vacant due to COVID-19 and that Entity X has decided to vacate.

Group members who supported View 1A noted the short period of time the ROU asset will be in use. However, these Group members thought that the longer the period the ROU asset will be in use, the more judgment will be needed to assess whether it should be tested as part of, or separately from, CGU 1.

Group members who supported View 1B considered that the ROU asset does not generate cash inflows that are largely independent from CGU 1 but that the exception in paragraph 22(b) of IAS 36 is met in the fact pattern. A few Group members did question whether the value in use of the ROU asset would approximate FVLCD. However, these Group members observed that the outcome under
View 1A and View 1B is the same, but the technical analysis in arriving at the conclusion to test the ROU asset separately from CGU 1 for impairment is different.

A few Group members thought that it would be difficult to rule out View 1C given the judgment involved in the assessment. One Group member noted that paragraph 72 of IAS 36 indicates that CGUs should be identified consistently from period to period unless a change is justified. Therefore, a detailed analysis of the facts and circumstances would be needed to determine whether a change is justified.

Fact Pattern for Issue 2

- Same fact pattern as Issue 1 except Entity X has the ability and expectation to be able to sublease the ROU asset after vacating the property for the remainder of the lease.

Group members considered this fact pattern and discussed whether their views on Issue 1 will change.

The Group's Discussion

One Group member thought that the fact Entity X has the ability and expectation to sublease the ROU asset provides a stronger basis to support View 1A because the ROU asset can generate cash inflows that are largely independent of CGU 1. However, this Group member noted that an entity would need to be able to support its expectation of a sublease in order to incorporate the sublease income into the impairment test.

Another Group member continued to support View 1B even though the entity has the ability and expectation to sublease the ROU asset in this fact pattern. This Group member commented that the difference between the value in use of the ROU asset and the FVLCD would still be negligible because the difference in the two amounts is driven only by the two months associated with Entity X's use of the ROU asset. Therefore, the exception in paragraph 22(b) of IAS 36 would apply such that Entity X would perform the impairment test on the ROU asset separately from CGU 1.

Some Group members highlighted other points to consider. For example, since Entity X can sublease the ROU asset, an assessment may be required to determine if the change in use would result in classifying the asset as an investment property under IAS 40 *Investment Property* or whether it is a finance sublease. Furthermore, if a pending finance sublease would lead to a derecognition of the ROU asset, the entity should consider whether the asset meets the criteria to be classified as held for sale under IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*.

Fact Pattern for Issue 3

- Same fact pattern as Issue 2, but the lease for the ROU asset contains certain restrictions and limitations on the ability to sublease the space to a third party.

Issue 3: How should the restrictions and limitations in Fact Pattern 3 be reflected in the impairment testing of the ROU asset?

Analysis

- As these restrictions and limitations are part of the lease for the ROU asset, they should be factored into determining the FVLCD in accordance with IFRS 13 *Fair Value Measurement*.

- Paragraph 27 of IFRS 13 requires that the fair value for a non-financial asset take into account a market participant's ability to generate economic benefits by using the asset in its highest and best use or by selling it to another market participant that would use the asset in its highest and best use.

- Paragraph 28 of IFRS 13 provides further guidance on determining highest and best use:

  "The highest and best use of a non-financial asset takes into account the use of the asset that is physically possible, legally permissible and financially feasible, as follows:

  (a) A use that is physically possible takes into account the physical characteristics of the asset that market participants would take into account when pricing the asset (e.g. the location or size of a property).

  (b) A use that is legally permissible takes into account any legal restrictions on the use of the asset that market participants would take into account when pricing the asset (e.g. the zoning regulations applicable to a property).

  (c) A use that is financially feasible takes into account whether a use of the asset that is physically possible and legally permissible generates adequate income or cash flows (taking into account the costs of converting the asset to that use) to produce an investment return that market participants would require from an investment in that asset put to that use."

The Group's Discussion

Group members supported the above analysis with regards to reflecting restrictions and limitations in the impairment test of the ROU asset. A Group member observed that in practice, entities may be in the process of renegotiating lease restrictions with their landlords, and this process takes time. This Group member raised a question whether an entity should consider the likelihood that some restrictions may be removed in determining the FVLCD of the ROU asset. One Group member thought that an entity would first determine the FVLCD based on the contractual terms of the lease contract. Then, the entity would assess from a market participant's view whether the restrictions may be removed and whether that would impact on how a market participant would assess fair value before such removal.

Issue 4: In the fact pattern described in Issue 1, it is assumed that the decision to vacate has been finalized and that the period of use by Entity X before the property is vacated is very short. In alternative scenarios, these factors may not be as clear. What are some factors to consider in assessing whether the ROU asset should be tested for impairment separately or as part of CGU 1?

Analysis

- Some factors to consider when determining whether the ROU asset should be tested for impairment separately from CGU 1 include, but would not be limited to whether:

  (a) plans for ceasing use of the ROU asset have been finalized and the entity is committed to vacating the property (for example, it has announced its decision to the affected parties) versus expecting to vacate, but not yet committed to vacate the property. When making this assessment, an entity might consider the guidance in paragraph 72 of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* on assessing when a constructive obligation to restructure arises.

(b) the period of use by CGU 1 is a more extended period of use versus a relatively short period of use for the ROU asset;

(c) the ROU asset is significant to the cash inflow generation of CGU 1;

(d) the ROU asset can be subleased after it is vacated and the period of sublease relative to the period of use by Entity X before the property is vacated;

(e) the space is expected to be subleased, considering the level of management and board support and the likelihood of being able to sublease the space (e.g. a signed sublease versus general expectations of market interest in the property).

The Group's Discussion

Group members generally supported the factors identified above in assessing whether the ROU asset should be tested for impairment separately or as part of CGU 1. Other factors to consider when assessing the level at which to test the ROU asset for impairment include whether the entity has engaged real estate brokers to market the ROU asset for sublease, communicated to the landlord its the decision to cease own use and to sublease, and told employees about ceasing the use of the office space. Such activities and communications help to establish that the decision to cease own use is substantive. Group members noted that it is important that an entity takes into consideration all relevant facts and circumstances and assesses holistically whether the ROU asset should be tested for impairment separately.

Overall, the Group's discussion about Issues 1 to 4 raises awareness about impairment testing considerations for an ROU asset in light of the current economic environment. No further action was recommended to the AcSB.