Have lease assets become impaired?

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Companies may face challenges in determining the impairment charge for lease assets given the uncertainties involved and the additional considerations that apply when testing lease assets for impairment.

What's the issue?

External events – e.g. a natural disaster, geopolitical event or pandemic – may cause economic uncertainty and have an adverse impact on companies that commonly lease assets they use in their business. This includes retailers that lease stores, and transport companies that lease aircraft, ships and rolling stock.

The right-of-use assets arising under these lease contracts are now subject to impairment testing under IAS 36 *Impairment of Assets*. This is a significant change from the onerous lease test that companies applied before implementing IFRS 16 Leases.

Although impairment testing of right-of-use assets is generally similar to impairment testing of **other non-financial assets**, additional considerations apply.

Lessors generally apply IFRS 9 *Financial Instruments* to test lease receivables for impairment.

Getting into more detail

Impairment considerations for lessees

The principles and procedures of IAS 36 that apply to impairment of other non-financial assets apply equally to right-of-use assets. For example, right-of-use assets are allocated to cash-generating units (CGUs) and an impairment test is performed when, and only when, it is required by IAS 36. However, additional considerations apply.

Leases to which the lessee applies the right-of-use model

Generally, a right-of-use asset is tested for impairment as part of the larger CGU to which it relates. However, a right-of-use asset that meets the definition of investment property and is measured at cost is tested for impairment separately because it generates independent cash flows. *[Insights 3.10.670]*

Right-of-use assets that meet the definition of investment property and are measured at fair value are excluded from the scope of IAS 36.

The related lease liability is also included in the carrying amount of the CGU if, on disposal of the CGU, a potential buyer would be required to assume the lease liability. Companies need to make this assessment, which also affects the CGU's recoverable amount.

If the buyer *would be required* to assume the lease liability, then:

– if the recoverable amount of the CGU is determined using value in use (VIU), then the company deducts the carrying amount of the lease liability both from the CGU's carrying amount and from its VIU; and

– if the recoverable amount of the CGU is determined using fair value less costs of disposal (FVLCD), then the company deducts the carrying amount of the lease liability only from the CGU's carrying amount; the lease liability is inherently reflected in the CGU's FVLCD. *[Insights 3.10.670.30]*

If the buyer would not be required to assume the lease liability, then the company excludes the lease liability from the carrying amount of the CGU and, to achieve a like-for-like comparison, excludes the lease payments from the discounted cash flows used to measure the CGU's VIU. Similarly, the CGU's FVLCD excludes the lease liability.

Leases to which the lessee applies the recognition exemptions

Under IFRS 16, a lessee can choose not to apply the right-of-use model to some leases – i.e. short-term leases and leases in which the underlying asset is of low value. For these leases, the lessee includes the future lease payments in the cash flow forecasts when calculating the CGU's recoverable amount. *[IFRS 16.5]*

Impairment considerations for lessors

For operating leases, a lessor includes the underlying leased asset in the carrying amount of the CGU and applies IAS 36. The lessor includes the future cash receipts in its cash flow forecasts. In addition, the company applies IFRS 9 to test operating lease receivables for impairment.

To test finance lease receivables for impairment, a lessor generally applies IFRS 9, and also applies IFRS 16 to recognise reductions in the unguaranteed residual value of the underlying asset. *[Insights 7.8.410]*

Can a lease ever be onerous?

Generally, a lessee does not apply IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to leases.

However, in the following specific circumstances, companies may be required to recognise a provision under IAS 37 for their lease contracts:

– for leases to which the company applies one of the recognition exemptions, if those leases become onerous;

– for the non-lease components in a lease contract – e.g. maintenance obligations – if those components become onerous; and

– for a lease that becomes onerous after inception but before commencement date – i.e. after the company is contractually committed to the lease but before it recognises the assets and liabilities arising from the lease. *[IAS 37.5(c)]*

Disclosure

IAS 36 requires disclosure of the key assumptions used to determine the recoverable amount of the CGU. It also requires sensitivity disclosures if a reasonably possible change in a key assumption would cause the CGU's carrying amount to exceed its recoverable amount.

Furthermore, IAS 1 *Presentation of Financial Statements* requires disclosure of the key assumptions that a company makes about the future and other major sources of estimation uncertainty at the reporting date that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities in the next financial year. *[IAS 1.125, 129, 36.134(d)–(f)]*

Actions for management

– Assess whether there are any indicators of impairment for the CGUs to which the right-of-use asset relates.

– Assess whether IAS 36's requirements have been applied appropriately when testing if the right-of-use asset has been impaired.

– Assess whether any onerous contract provisions need to be recognised.

– Consider enhancing sensitivity disclosures and disclosures about the key assumptions and major sources of estimation uncertainty.

References to 'Insights' mean our publication **Insights into IFRS®**

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