

Applying IFRS

Impairment considerations
for the new leasing
standard

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The EY logo consists of the letters 'EY' in a bold, white, sans-serif font. A yellow diagonal bar is positioned above the 'Y'.

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What you need to know

- ▶ IFRS 16 *Leases* requires lessees to put most leases on their balance sheets under a 'right-of-use asset' model. IFRS 16 is effective for annual periods beginning on or after 1 January 2019, with limited early application permitted.
- ▶ Right-of-use assets may need to be tested for impairment under IAS 36 *Impairment of Assets*. Even if no indicators of impairment exist for the right-of-use assets themselves, right-of-use assets may influence impairment tests of other assets, such as goodwill.
- ▶ This publication explores practical considerations of the interaction between IFRS 16 and IAS 36, including potential impact on the discount rate used for determining value in use (VIU).

Right-of-use assets are tested for impairment under IAS 36 *Impairment of Assets*.

Overview

IFRS 16 *Leases*, as issued by the International Accounting Standards Board (IASB), requires lessees to recognise assets and liabilities for most leases.

Under IFRS 16, leases which, to date, have been accounted for as either finance or operating leases, are accounted for based on a 'right-of-use model' in the lessee's financial statements. The model reflects that, at the commencement date, a lessee has a financial obligation to make lease payments to the lessor for its right to use the underlying asset during the lease term. The lessor conveys that right to use the underlying asset at lease commencement, which is the time when it makes the underlying asset available for use by the lessee. A lessee applies IAS 36 *Impairment of Assets* to determine whether the right-of-use asset is impaired and to account for any impairment loss identified.

For lessees, the income statement presentation and expense recognition pattern will change for leases currently classified as operating leases. Operating lease costs will be replaced with separate depreciation and interest expense, and often with higher periodic expense in the earlier periods of a lease. In the statement of cash flows, a lessee must now classify, for all leases, cash payments for the principal portion of the lease liability within financing activities and cash payments for the interest portion either as cash flows from operating or financing activities depending on its accounting policy under IAS 7 *Statement of Cash flows*.

Lessor accounting is substantially unchanged from current accounting. Lessors will classify all leases using the same classification principle as in IAS 17 *Leases* and distinguish between operating and finance leases.

IFRS 16 is effective for annual periods beginning on or after 1 January 2019. Early application is permitted, provided the new revenue standard, IFRS 15 *Revenue from Contracts with Customers*, has been applied, or is applied, at the same date as IFRS 16.

This publication discusses how right-of-use assets impact the impairment tests in lessee's financial statements and it is intended to help entities consider the effects of adopting IFRS 16. In particular, this publication focuses on the discount rate applied in a value-in-use model and analyses whether the discount rate would change after the implementation of IFRS 16.

Preparers and users of financial statements are encouraged to read this publication carefully and consider the potential effects of the new standard on their impairment testing.

Many right-of-use-assets will not generate largely independent cash inflows. Therefore, they will need to be assessed for impairment at a CGU level.

1. Impairment of right-of-use assets

Upon the adoption of IFRS 16, lessees must record a right-of-use asset and a lease liability for most lease arrangements in their statement of financial position. Under IFRS 16, these 'new' right-of-use assets will be subject to the impairment requirements of IAS 36. Today, under IAS 17, no such assets are recognised for operating leases, so there are no operating lease related assets to be tested for impairment under IAS 36. However, lease payments under the leases are included in the cash flows of the related cash generating unit (CGU) when appropriate. Further, IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* applies and operating leases are assessed to determine whether they are onerous and require a provision to be recognised. For lessees that have entered into contracts classified as operating leases under IAS 17, the adoption of IFRS 16 may have a significant impact on the amount of assets recorded in the statement of financial position and, therefore, on the carrying value of assets tested for impairment.

1.1 When to test for impairment

Similar to other assets, a right-of-use-asset will only be tested for impairment when impairment indicators exist. If impairment indicators exist, an entity must determine whether the right-of-use-asset can be tested on a stand-alone basis or whether it will have to be tested at a CGU level. This will depend on whether the right-of-use-asset generates largely independent cash inflows from other assets or groups of assets.

While there may be instances where leased assets generate largely independent cash inflows, an example would be a leased investment property, many leased assets will be used by an entity as an input in its main operating activities whether these are service-providing or production-of-goods related. It is therefore likely that many right-of-use-assets will be assessed for impairment at a CGU level rather than at an individual asset level.

Even if there are no impairment indicators at the right-of-use-asset level or the respective CGU level, right-of-use-assets will impact the annual goodwill impairment test by increasing the carrying amount of the CGU, or group of CGUs, at which goodwill is assessed for impairment.

How we see it

- ▶ There will be situations in practice where right-of-use-assets generate largely independent cash inflows and will be required to be tested on a stand-alone basis. This will depend on the actual facts and circumstances and may require significant judgement.
- ▶ In many situations, the leased assets and, therefore, the right-of-use-assets will not generate largely independent cash inflows. It will be necessary to determine the CGU to which the right-of-use assets belong and to perform the impairment test at that level.

An asset's CGU is the smallest group of assets that includes the asset and generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets. IAS 36 contains detailed guidance and examples on the determination of the CGUs. The example below aims to illustrate the CGU application to leasing arrangements in the lessee's financial statements.

CGU identification

Background

Retail store chain M entered into the following three leases:

- ▶ Lease for ground floor in building A: used for M's store X, leasehold improvements were made at the beginning of the lease;
- ▶ Lease for second floor in building B: originally it was planned that the space would be utilised for the payroll department, but then it was sub-let to a law firm;
- ▶ Lease for two floors in building C: used for M's HR and marketing department.

Store X makes all its retail purchases through M's purchasing centre. Pricing, marketing, advertising and human resources policies (except for hiring X's cashiers and sales staff) are decided by M. M also owns five other stores in the same city as X (although in different neighbourhoods) and 20 other stores in other cities. All stores are managed in the same way as X.

What are the cash-generating units and at which level are the leased floors and therefore the right-of-use-assets assessed for impairment?

Analysis

In identifying cash-generating units for the stores, M considers whether, for example:

- (a) Internal management reporting is organised to measure performance on a store-by-store basis;
- (b) The business is run on a store-by-store profit basis or on a region/city basis.

All M's stores are in different neighbourhoods and were determined to have different customer bases. Although X is managed at a corporate level, X generates cash inflows that are largely independent of those of M's other stores. Therefore, store X is a separate cash-generating unit. The leased ground floor of building A is used for retail store X and does not generate largely independent cash inflows. The right-of-use-asset in relation to the ground floor in building A is assessed for impairment at the store X CGU level.

The second floor of building B is sub-let to a law firm. Due to the sub-lease, the right-of-use-asset generates largely independent cash inflows and must be assessed for impairment on a stand-alone basis.

The two floors leased in building C are used for marketing and human resources corporate functions. The right-of-use-asset in relation to these floors is a corporate asset and is allocated on a reasonable and consistent basis to the CGUs to which it relates.

In addition, retail chain M assesses goodwill for impairment on a country-by-country basis. The group of CGUs underpinning the goodwill impairment test on a country basis consists of all stores in the relevant country, including any right-of-use assets in relation to these stores, together with any allocated corporate assets, including any right-of-use corporate assets.

How lease liabilities are considered in impairment tests depends on the circumstances. Regardless of the approach an entity elects, consistency between the recoverable amount and the carrying amount of the CGU is essential.

1.2 Treatment of lease liabilities

The recognition of right-of-use assets with corresponding lease liabilities raises the question of whether and how the lease liabilities associated with the right-of-use assets should be considered when performing impairment assessments. In our view, the treatment of lease liabilities may differ in practice depending on whether the recoverable amount is based on the assets' fair value less cost of disposal (FVLCD) or value in use (VIU).

In general, liabilities are ignored when performing an impairment test of a CGU, meaning that the starting point would be that both the carrying amount of the lease liabilities and the respective future lease payments would be ignored when determining the carrying amount and the recoverable amount of a CGU. However, there are exceptions to this general rule. This may occur if the disposal of a CGU would require the buyer to assume associated liabilities. In this case, the FVLCD of the CGU would be the sale price for both the CGU and the liabilities, less the cost of disposal. To perform a meaningful comparison, the carrying amount of the liabilities would then need to be deducted when determining both the carrying amount of the CGU and its VIU based on paragraph 78 of IAS 36.

When it comes to lease arrangements, in most cases, a CGU would be disposed of together with the associated lease arrangements. In such case, the FVLCD for the CGU would consider the associated lease arrangements and, therefore, the need to make the contractual lease payments. This would require the carrying amount of the lease liabilities to be deducted when determining the carrying amount of the CGU, in order to allow a meaningful comparison, and when determining the CGU's VIU.

It is important to note that if the carrying amount of the lease liabilities is deducted to arrive at the carrying amount of the CGU, the same carrying amount of the lease liabilities would need to be deducted from the VIU. Under IAS 36.78, as confirmed by the IFRS Interpretations Committee at its March 2016 meeting, it is not appropriate to calculate the VIU by reducing the CGU's future cash flows by the lease payments as distortion may arise due to the difference in the discount rate used to obtain the present value of the CGU's future cash flows and the discount rate used to calculate the carrying amount of the lease liabilities.

From a practical point of view, it may be sufficient to simply ignore lease liabilities and lease payments when determining the VIU and the carrying amount of the CGU. While this would mean that the VIU is not necessarily comparable to the FVLCD, this would not cause an issue as long as the calculated VIU is above the CGU's carrying amount, and there is therefore evidence that the CGU is not impaired, in line with paragraph 19 of IAS 36.

To illustrate this, consider a CGU consisting of goodwill of 50, fixed assets of 320 and a right-of-use asset of 133, resulting in a total carrying amount of 503. The calculated VIU, ignoring lease cash outflows reflected in the lease liability of 140, is 524.

Since there is headroom of 21 in this case (recoverable amount of 524 less carrying amount of the CGU of 503), a comparison by the entity of the VIU and the carrying amount of the CGU, ignoring the lease liability, would be sufficient. The lease liability in such case would not need to be deducted from the VIU nor the carrying amount of the CGU (gross basis). If the entity needs to compare the VIU with the FVLCD, based on a situation where the associated lease liability would be transferred to the buyer, the entity must determine the carrying amount of the CGU deducting the lease liability and must deduct the lease liability from the VIU as well (net basis). Under either basis, the headroom will be the same, in this example amounting to 21.

	Carrying value		VIU
Goodwill	50	VIU ignoring lease payments	524
Fixed assets	320		
Right-of-use asset	133		
<u>Gross basis</u>	503		524
Lease liability	(140)	Lease liability	(140)
<u>Net basis</u>	363		384

Consistency is an important principle in IAS 36. In testing for impairment, entities must ensure that the carrying amount of the CGU is consistent with the basis used for the recoverable amount.

How we see it

- ▶ In most cases, a CGU would be disposed of together with the associated lease arrangements. FVLCD for the CGU would therefore consider the associated lease arrangements and the need to make contractual lease payments. This would require the carrying amount of the lease liabilities to be deducted when determining the carrying amount of the CGU and, for consistency purposes, from the VIU.
- ▶ It may be sufficient to simply ignore lease liabilities and lease payments when determining both the carrying amount and VIU of the CGU. While this would mean that the VIU is not comparable to the FVLCD, it would be a reasonable shortcut as long as the calculated VIU is above the CGU's carrying amount, providing evidence that the CGU is not impaired.

2. Testing (groups of) CGUs including right-of-use assets for impairment

As discussed in the previous section, a right-of-use asset will frequently be included in a CGU to be tested for impairment. At initial recognition, the right-of-use-asset equals the recognised lease liability, plus any lease payments made at or before the commencement date, less any lease incentives received, plus any initial direct costs incurred by the lessee and an estimate of costs to be incurred by the lessee in dismantling and removing the underlying asset and restoring the site on which the leased asset is located. The most significant part of the right-of-use asset will often be the lease liability, which is the present value of the lease payments discounted at the interest rate implicit in the lease if this rate is readily determinable, or otherwise at the lessee's incremental borrowing rate. Therefore, the discount rate applied to determine the lease liability can have a significant effect on the amount of the right-of-use asset.

If, after adoption of IFRS 16, the VIU is determined in an impairment test mechanically, ignoring the lease liability and related lease payments from both the carrying amount and the VIU of the CGU, the following effects will occur when compared with the VIU with operating leases under IAS 17:

- ▶ The carrying amount of the CGU will increase by the net present value of the future lease payments discounted at the IFRS 16 rate.
- ▶ The VIU of the CGU will increase by the net present value of the future lease payments discounted at the discount rate used under IAS 36.

These two effects will usually have an offsetting effect. As a result, generally, there will be a limited effect on the impairment test, i.e., the amount of headroom or impairment calculated will not be substantially different. However, if the IAS 36 discount rate (for example, a discount rate based on the weighted average cost of capital (WACC)) exceeds the IFRS 16 discount rate (for example, the lessees' incremental borrowing rate), this will have a net negative impact on the results of the impairment test as the carrying amount of the CGU will increase more than the VIU of the CGU. In practice, this may be seen as less of an issue as long it results only in a decrease in an existing headroom. However, this effect might as well result in an increase in the impairment charge calculated. From an economic perspective, the underlying business and cash flows have not changed, thus, it is difficult to justify why there would be an effect on the impairment test as a result of the discounting effect. In the following paragraphs, we explore some arguments, which, when taken into account, would not, in our view, result in a change in headroom. Then we will share some insights on the practical challenges of applying these arguments in practice.

How we see it

- ▶ The discount rate in determining the lease liability will frequently be lower than the discount rate used in the impairment test. If applied mechanically, this may result in what appears to be an immediate impairment or reduction in headroom.
- ▶ We believe such a 'mechanical' immediate impairment or reduction in headroom should generally not occur.

2.1 Discount rate in theory

The discount rate for a VIU model must be the pre-tax rate that reflects current market assessments of:

- ▶ The time value of money;
- ▶ The risks specific to the asset for which the future cash flow estimates have not been adjusted.

Because right-of-use assets will be included in the carrying amount of CGUs, we believe it may be appropriate to adjust the discount rate for the impairment assessment to consider the changed nature of the assets under IFRS 16 compared to IAS 17. Some of the arguments for this are set out below, which address the analysis from different angles, but all based on the same underlying principle.

2.1.1 Return on equity remains stable

Generally, we believe that the return on equity, as demanded by equity investors, would remain unchanged. Assuming that investors were already aware of the operating leases and based their risk assessment thereon, such effects are already included in the required equity return. However, since the lease liability is now regarded as debt, the debt/equity ratio increases and - given that debt returns are generally lower than equity returns - the discount rate based on WACC would decrease if market participants are all impacted to the same extent.

2.1.2 Composition of assets has changed

Effectively, the composition of the asset base has changed. In addition to the assets included in the impairment test under IAS 17, now right-of-use assets are also included. One of the concepts is that the WACC (return requirement assessed from a financing perspective) is equal to the weighted average return on assets (WARA) (return requirement assessed from an asset perspective). The asset base would increase with the right-of-use assets under IFRS 16. Since it would be generally expected that, due to the lower risk inherent in the right-of-use assets, the return on right-of-use assets is lower than the WARA of the CGU pre-IFRS 16, the expectation is that the WARA would decrease after the adoption of IFRS 16 accordingly.

2.1.3 Cash flows variability has decreased

The discount rate for VIU should reflect the risks of the cash flows. Since the lease payments relating to operating leases under IAS 17 are no longer part of the free cash flow used in the VIU calculation, the gross free cash flows will increase. Subsequently, this would mean that the relative volatility of the cash flows would decrease. For example, assume a free cash flow pre-IFRS 16 of 100. If revenue increased by 10, this has an impact on the free cash flow of 10%. When the operating lease payment amounted to 40, the free cash flow post-IFRS 16 would be 140, which means that an increase of revenue of 10 would now only have an impact of 7.1% on free cash flow. If the (relative) volatility of the cash flows decreases, this implies a lower risk and, hence, the corresponding discount rate should decrease.

2.1.4 Summary

In summary, we conclude that, upon adoption of IFRS 16, the composition of the asset base being tested for impairment, and the associated cash flows included in the VIU calculation, have changed and the discount rate used in determining VIU should be recalculated to ensure consistency. As a result, in theory, we would expect that such discount rate would generally be somewhat lower than the IAS 36 discount rate used when operating leases were off-balance sheet under IAS 17. Such decrease does not result from any future anticipated change in behaviour or risk perception of market participants, but, instead, remains based on market conditions at the measurement date and results from the change in composition of the assets (recognition of right-of-use assets) and change in cash flows (lease payments as financing cash flows instead of operating cash flows).

2.2 Illustrative example

Below is a simplified example of an impairment test that shows the situation pre-IFRS 16 and post-IFRS 16 and the effects of adjusting the (pre-tax) discount rate. The CGU has a finite life of five years, with no residual value. The lease term and useful life of the right-of-use asset are also five years.

2.2.1 Pre-IFRS 16

CUR '000		Year 1	Year 2	Year 3	Year 4	Year 5
Revenue		1,000	1,100	1,200	1,300	1,000
EBITDA before operating lease costs		120	140	150	150	100
Operating lease costs		-30	-30	-30	-30	-30
EBITDA		90	110	120	120	70
Depreciation		-64	-64	-64	-64	-64
EBIT		26	46	56	56	6
Free cash flows	Pre-tax return	90	110	120	120	70
Discount period	12.0%	0.5	1.5	2.5	3.5	4.5
Discount factor		0.9	0.8	0.8	0.7	0.6
Discounted cash flows		85	93	90	81	42
NPV/ VIU		391				
Carrying value		370				
Headroom		21				

Carrying value				Return	Weighting	Discount rate
Goodwill	50	Equity	370	12.0%	100.0%	12.0%
Fixed assets	320					
Right-of-use asset	0	Lease Liab.	0	5.0%	0.0%	0.0%
TOTAL	370		370			12.0%

Assumptions underlying the example:

- ▶ Five-year operating lease of 30 per year commencing at the start of year 1; cost of operating lease is relatively significant compared to the overall free cash flow (FCF).
- ▶ The carrying amount of the CGU includes goodwill; for a finite life time period, which is rare, although it may occur in practice that a CGU has goodwill while at the testing date the CGU has a limited life. The principles of the example would be the same if this were not goodwill, but a finite life intangible or PP&E, for example.
- ▶ Calculations are made on a pre-tax basis.
- ▶ This base case assumes, for the purposes of illustration, a business which is fully equity financed. The principle of the example would be the same if this were not the case. Under IAS 36, the discount rate must not be determined

based on the capital structure of the entity, but on the capital structure typical in the industry. In this scenario, it is assumed that both the entity's and industry's capital structures do not differ and the extent to which the entity makes use of operating leases is in line with the industry.

- ▶ For illustrative purposes, working capital movements and capital expenditures are assumed to be nil.

2.2.2 Post-IFRS 16, same discount rate as pre-IFRS 16

The example below is based on the same information and the same date as the example in paragraph 2.2.1, but now applying the accounting principles of IFRS 16:

CUR'000	Year 1	Year 2	Year 3	Year 4	Year 5
Revenue	1,000	1,100	1,200	1,300	1,000
EBITDA before operating lease costs	120	140	150	150	100
Operating lease costs	0	0	0	0	0
EBITDA	120	140	150	150	100
Depreciation	-64	-64	-64	-64	-64
Added depreciation right-of-use asset	-27	-27	-27	-27	-27
EBIT	29	49	59	59	9
Free cash flows	120	140	150	150	100
Discount period	12.0%				
Discount factor	0.9	0.8	0.8	0.7	0.6
Discounted cash flows	113	118	113	101	60

	Without lease liability	Lease liability	With lease liability
NPV/ VIU	505	-133	372
Carrying value	503	-133	370
Headroom	2		2

Carrying value		Return	Weighting	Discount rate		
Goodwill	50	Equity	370	14.5%	73.7%	10.7%
Fixed assets	320					
Right-of-use asset	133	Lease Liab.	133	5.0%	26.3%	1.3%
	503		503			12.0%

Analysis:

- ▶ The headroom post-IFRS 16 with an unadjusted discount rate has decreased by 19 (21 vs 2):
 - ▶ The carrying amount increased by 133 (net present value of lease payments discounted at incremental borrowing rate of 5%) from 370 to 503.
 - ▶ The VIU before deducting the carrying value of the lease liability increased by 114 (net present value of lease payments discounted at 12%) from 391 to 505.
 - ▶ Whether or not the lease liability is deducted from both the carrying amount of the CGU and the VIU will have no impact on the headroom as both would reduce by 133.
- ▶ In this scenario, the discount rate has remained at 12.0%. Implicitly, this means that the cost of equity inherent in the discount rate derived from WACC has been adjusted to 14.5%. The discount rate in this situation has been calculated based on the debt/equity-ratio using the market values of debt and equity, under the assumption that the market value of the lease liability is equal to its book value and the market value of equity is equal to the VIU less the value of the lease liability.

2.2.3 Post-IFRS 16, adjusted discount rate

CUR'000		Year 1	Year 2	Year 3	Year 4	Year 5
Revenue		1,000	1100	1200	1300	1000
EBITDA before operating lease costs		120	140	150	150	100
Operating lease costs		0	0	0	0	0
EBITDA		120	140	150	150	100
Depreciation		-64	-64	-64	-64	-64
Added depreciation right-of-use asset		-27	-27	-27	-27	-27
EBIT		29	49	59	59	9
Free cash flows	Pre-tax return	120	140	150	150	100
Discount period	10.2%	0.5	1.5	2.5	3.5	4.5
Discount factor		1.0	0.9	0.8	0.7	0.6
Discounted cash flows		114	121	118	107	64

		Without lease liability	Lease liability	With lease liability
NPV/ VIU		524	-133	391
Carrying value		503	-133	370
Headroom		21		21

Carrying value		Equity	Lease Liab.	Return	Weighting	Discount rate
Goodwill	50	370		12.0%	74.6%	8.9%
Fixed assets	320					
Right-of-use asset	133		133	5.0%	25.4%	1.3%
	503	503				10.2%

Analysis:

- ▶ The adjusted discount rate, derived from WACC, has been calculated based on the debt/equity-ratio using the market values of debt and equity, under the assumption that the market value of the lease liability is equal to its book value and the market value of equity is equal to the VIU ignoring lease payments, less the value of the lease liability.
- ▶ This calculation arrives at an adjusted discount rate of approximately 10.2%, which results in headroom in the impairment test equal to the headroom under IAS 17.
- ▶ The decrease in the discount rate is relatively high due to the significance of the operating lease payments compared to the free cash flow.
- ▶ All of the calculations above are on a pre-tax basis in line with the requirements of IAS 36 for VIU. In practice, many impairment tests are done on a post-tax basis, as market data for the equity returns and discount rate is generally available only on a post-tax basis. Using appropriate assumptions and modelling, the outcome on a post-tax basis should be similar.
- ▶ As mentioned earlier, under IAS 36, the discount rate must not be determined based on the capital structure of the entity, but on the capital structure typical in the industry. In this scenario, it is assumed that the entity's and industry's capital structures do not differ and are impacted by IFRS 16 in the same way.
- ▶ Whether or not the lease liability is deducted from both the carrying amount of the CGU and the VIU will have no impact on the headroom as both would reduce by 133.

As can be seen from the above illustrative example, there is justification for a change in the discount rate to be applied for impairment calculation purposes. The following sections describe a number of practical challenges in recalculating the discount rate.

2.3 Discount rate in practice

As mentioned in the previous section, there are some arguments in support of reducing the discount rate used for VIU purposes under IFRS 16 compared to the calculation under IAS 17. However, there are certain challenges when applying the arguments in practice.

2.3.1 Use of historical data

Normally, the inputs to calculate, for example, a discount rate based on WACC, such as cost of equity, cost of debt and debt/equity ratios are determined based on historical data (e.g., the last 5 years). The observable debt/equity ratios will differ on a pre-IFRS 16 vs post-IFRS 16 basis, which will make it difficult for valuers to determine the appropriate ratios given that historical data on a post-IFRS 16 basis are not yet available. This may mean that, for example, debt/equity-ratios will need to be estimated in a different way than is possible currently. It remains to be seen how this can be achieved in a reliable manner.

2.3.2 Assumption that equity return is unchanged

As mentioned above, one of the input factors is the cost of equity. Such cost is often based on a model that considers the equity beta (i.e., capital asset pricing model). According to finance theory, the beta needs to be adjusted for the level of leverage, which is often expressed as the unlevered beta (beta when 100% equity financed) and the levered beta (beta considering the specific leverage ratio). Normally, an increase in leverage means that the levered beta also increases and, ultimately, the cost of equity.

As expressed earlier, the general assumption is that the equity return is unchanged, as market participants have already considered the effect of operating leases on their required equity return. This means that the increase in the debt-equity ratio as a result of the lease liabilities should not increase the levered beta. When, however, debt-equity ratios are adjusted for IFRS 16, this effectively means that the unlevered beta may need to be adjusted downwards. In practice, this may create a challenge in obtaining historical data that have been prepared on a sufficiently consistent basis.

Additionally, the above discussion assumes that investors had the correct insight in the use of operating leases and the effect thereof on the risks for the entity. In certain situations, investors/analysts may have overestimated the use of operating leases and, due to the additional transparency requirements of IFRS 16, this may actually decrease the required equity return. In other situations, it may turn out that investors/analysts had underestimated this effect and the additional transparency would increase the discount rate. The application of IFRS 16 is intended to result in a net decrease in the required return. This is because IFRS 16 brings more transparency and less uncertainty to operating lease activity, whereas pre-IFRS 16, investors/analysts were more likely to have priced in additional risk (i.e., the required return) for such lack of transparency and higher uncertainty.

Additionally, some effects may arise in practice when the use of operating leases by the company differs substantially from the industry average and such difference has not been taken into account in the past.

However, these effects may vary from company to company and, as such, the assessments would require the professional judgment of valuation specialists. Valuation specialists will need to be careful to ensure they are not anticipating future changes in market participant rates but, instead, are basing their analysis on market participant assumptions at the measurement date.

How we see it

- ▶ As mentioned before, we generally do not believe an immediate impairment or reduction in headroom would occur as a result of adopting IFRS 16.
- ▶ An impairment test is inherently forward-looking and may require significant estimates. Consequently, there may be some effect as a result of including right-of-use assets and also further refinements might be required to the impairment model applied, due to a better understanding of operating leases.

2.4 Practical considerations

In practice, a CGU or a group of CGUs, might have sufficient headroom that the adoption of IFRS 16 will have no material impact on the result of an impairment test. In such circumstances, entities, therefore, might choose to adopt certain shortcuts to reflect the requirements of the new lease standard in their impairment model.

For example, reflecting a reduction in the discount rate post IFRS 16 in the year of adoption of IFRS 16 would not be needed if the impairment assessment with the pre IFRS 16 discount rate shows no impairment. The challenge discussed in 2.3.1 above in respect of historical data will resolve itself over time when historical data becomes available.

An entity might alternatively adopt an approach where, instead of excluding the operating lease cash flows from the VIU calculation and adjusting the discount rate as discussed above, it continues to include the cash outflows in the VIU calculation, includes the right-of-use assets together with the lease liability in the carrying amount of the CGU and uses the unadjusted pre-IFRS 16 discount rate. This approach should generally come to the same result as the approach discussed in 2.2.3 above. As always, it will be of utmost importance to ensure that the discount rate used for the VIU calculation is reflective of the approach used, which cash flows are included in the VIU calculation and the composition of the carrying amount of the CGU. We expect that observable debt/equity ratios in the market will, over time, reflect the move from a pre-IFRS 16 to a post-IFRS 16 basis. This might make it difficult to obtain appropriate discount rates on a pre-IFRS 16 basis for later years.

3. Other factors to consider in the impairment test

3.1 Lease payments during the lease term

Under IAS 17, operating lease payments were reflected as cash outflows in determining VIU. Under IFRS 16, these lease payments, to the extent that they are reflected in the recognised lease liability, are financing cash flows in nature and are, therefore, excluded from the cash flows used to determine VIU.

It is important to note, only the lease payments specified in IFRS 16 are included in the recognised lease liability. Variable lease payments that do not depend on an index or a rate and are not in-substance fixed, such as those based on the performance or usage of the underlying asset, are not reflected in the recognised lease liability. For example, in a retail lease, variable payments based on a percentage of the sales of the retailer would not form part of the lease liability. These contractual payments still need to be reflected in the cash flow forecast used for the VIU calculation.

In addition, IFRS 16 has certain exemptions for low-value assets and short-term leases. If a lessee elects to use these exemptions and therefore not to record right-of-use assets on the balance sheet, then the cash flows in relation to those leases would still need to be included in the VIU cash flow forecast.

3.2 Effects later in the lease term - front loading effect

A lessee needs to apply the depreciation requirements in IAS 16 *Property, Plant and Equipment* when depreciating right-of-use assets. This will often result in a straight line depreciation. In the case of even lease payments during the lease term, the lease liability will decrease unevenly over time. Because interest expenses are higher in the early years of the lease term - as the liability is higher - the decrease in the lease liability will be lower in the first years and will increase during the lease term. This has the effect that the right-of-use asset has a lower carrying amount than the lease liability during the lease term. This also results in higher total expenses relating to an individual lease in the early years of the lease term compared to later years (front loading effect). The result of this effect may be an increased headroom during later years of the lease under IFRS 16 compared to IAS 17. This effect results from the fact that IFRS 16 is more conservative in this respect than IAS 17 (see also paragraph 4.1).

How we see it

- ▶ The front loading effect of lease expenses may result in increased headroom during the later years of the lease under IFRS 16 compared to IAS 17.

3.3 Lease payments beyond current lease term

When testing (groups of) CGUs, cash flow forecasts (including any terminal value) in a VIU model are often longer than the lease term of right-of-use assets included in the carrying amount.

An assumption of new capital investments is, in practice, intrinsic to the VIU test. The future cash flows of the CGU must be assessed. The cash flows into the future will include sales of products or services, cost of sales or services and all other cash flows necessary to generate independent cash inflows. They must necessarily include capital expenditure as well, at least to the extent required to keep the CGU functioning in its current condition.

Where the cash flows of the CGU are dependent on the right-of-use underlying asset, but the lease term will end during the cash flow forecast period, replacement of the underlying right-of-use asset will have to be assumed. This can be done either by assuming a new lease will be entered into and, as such,

considering lease payments for this replacement lease in the cash flow forecast or terminal value, or by assuming a replacement asset will be purchased. This will depend on the entity's planned course of action. It would be inappropriate **not** to reflect such replacement needs in the CGU's cash flows if the CGU's future cash inflows depend thereon.

Special attention is required when a terminal value calculation is used and the terminal value is calculated before the end of the lease term. For example, the terminal value may be based on the extrapolation of the cash flow expected for year five, while the lease term ends at the end of year eight. This means that the cash flow at the end of year five does not yet represent a sustainable cash flow on which to base terminal value, since the leased asset will need to be replaced in some way after year eight. This may be addressed by including replacement leases/capital expenditures in the terminal year, and separately calculating the adjustment to reflect that some of these expenditures will only start after year eight (if material).

How we see it

- ▶ It will usually be necessary to include cash outflows for replacement leases in the VIU discounted cash flow model. Including replacement leases can be especially challenging when the VIU incorporates a terminal value.

3.4 Corporate assets

Entities frequently enter into lease arrangements at a corporate level, such as a leased corporate headquarters or leased IT equipment. Under IFRS 16, these lease arrangements will result in right-of-use assets. Similar to other corporate assets, the right-of-use assets' carrying values have to be tested for impairment along with the CGUs they serve. An entity will need to allocate the carrying amount of corporate right-of-use assets to (groups of) CGUs when performing the impairment test. If a portion of the carrying amount of a corporate asset can be allocated on a reasonable and consistent basis to the individual CGUs it serves, then the entity will test the CGUs for impairment including this portion of the corporate asset. If a portion of the carrying amount of a corporate asset cannot be allocated on a reasonable and consistent basis to the individual CGUs it serves, then an entity will test the CGUs for impairment without including a portion of the corporate asset. It would then need to identify the smallest group of CGUs, which includes the CGU assessed for impairment, to which a portion of the corporate asset can be allocated on a reasonable and consistent basis. This group of CGUs will then need to be assessed for impairment next to the CGU in question.

Where material amounts of corporate right-of-use assets are allocated to CGUs for impairment testing purposes, the assessment of the potential impact on the discount rate explored in section 2 of this publication might be complex and challenging and would need to be carefully assessed.

How we see it

- ▶ In practice, entities may include a surcharge for corporate assets when determining the recoverable amount of the CGU. This may be appropriate when the discounted value of the surcharges approximates the carrying value of the (otherwise) allocated corporate assets.

4. Transition methods

4.1 Full versus modified retrospective method

IFRS 16 has two approaches to transition from IAS 17 to IFRS 16. IFRS 16 may be adopted in a way that assumes IFRS 16 had always been applied ('full retrospective method'). Alternatively, IFRS 16 can be adopted on the date of initial application, together with a variety of practical expedients ('modified retrospective approach'). When applying the modified retrospective approach, the lessee does not restate comparative figures but, instead, recognises the cumulative effect of initially applying IFRS 16, if any, as an adjustment to the opening balance of retained earnings at the initial date of application.

Under the full retrospective method, an entity determines the lease liability for each individual lease at the original commencement date, and it determines the carrying amount of the right-of-use asset at the same date. The right-of-use asset and lease liability must then be brought forward to the transition date as if IFRS 16 had always been applied.

Alternatively, when using the modified retrospective approach, a lessee measures the lease liability at the date of initial application at the present value of the remaining lease payments, discounted using the lessee's incremental borrowing rate at that date.

As a result, depending on the adoption method chosen, different dates are used for determining the discount rate to calculate the lease liability. Therefore, the carrying amount of the right-of-use asset will also be different.

The transition guidance for IFRS 16.C8(b) provides two methods for lessees to determine the carrying amount of right-of-use asset under the modified retrospective approach. Lessees may choose, on a lease-by-lease basis, to measure a right-of-use asset at either:

- i. Its carrying amount, as if IFRS 16 had been applied since the commencement date of that lease, but discounted using the lessee's incremental borrowing rate at the date of initial application

Or

- ii. An amount equal to the lease liability, adjusted by the amount of any prepaid or accrued lease payments relating to that lease recognised in the statement of financial position immediately before the date of initial application

The first method will generally lead to lower right-of-use asset because of the front loading expense effect under IFRS 16. Because the amount of the right-of-use asset differs under the two approaches, this has an effect on the results of the impairment test.

The example below illustrates the effect of the possible transition choices based on the following fact pattern:

Company X enters into a 10-year lease requiring payments of 1,000 payable at the start of each year. At the date of initial application of IFRS 16, the lease contract is at the start of year five (the lease payment for year five has not yet

been made). The lease payments are discounted at the incremental borrowing rate, which, at the commencement of the lease, was 6%, and at the date of initial application of IFRS 16 was 4%. The calculation of the VIU is based on a pre-tax discount rate of 10% (no adjustment has been made as described in section 2). The table below sets out the amounts at the date of initial application of IFRS 16.

Transition method	Right-of-use asset	Lease liability	Equity impact
<i>Full retrospective</i>	4,681	5,212	-531
<i>Modified - i)</i>	5,061	5,452	-391
<i>Modified - ii)</i>	5,452	5,452	-

As can be seen from the numbers in the table above, the full retrospective approach and the modified -i) approach result in a decrease in equity. In this publication we effectively discussed the scenario modified -ii) concluding that, in general, we would not expect a decrease in the headroom. Due to the more conservative accounting in the other two transition methods, we would generally expect the headroom to increase.

4.2 Modified retrospective method - onerous lease provisions

IFRS 16 .C10(b) provides a practical expedient that lessees do not have to test right-of-use assets for impairment under IAS 36 at the date of initial application. Instead, a lessee may rely on its assessment of whether leases were onerous applying IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* immediately before the date of initial application as an alternative to perform an impairment review. If a lessee chooses this practical expedient, the lessee must adjust the right-of-use asset at the date of initial application by the amount of any provision for onerous leases recognised in the statement of financial position immediately before the date of initial application of IFRS 16.

This practical expedient only applies at the date of initial application. At the first reporting date after the date of initial application, right-of-use assets will be subject to the requirements in IAS 36.

There may be various reasons why the amount of an onerous lease provision under IAS 37 might differ from an impairment charge under IAS 36:

- ▶ Use of a different discount rate. IAS 37 uses a discount rate specific to the liability that is derived from a risk-free discount rate. IAS 36 uses an asset-based discount rate. In practice, discount rates under IAS 37 are usually lower than discount rates under IAS 36.

- ▶ The cash flows included in the IAS 37 calculation for an onerous contract provision may not be the same as the cash flows used for IAS 36. IAS 36 has detailed guidance on which cash flows to include, whereas IAS 37 is less clear and differences exist in practice.¹
- ▶ While IAS 37 generally looks on a contract-by-contract basis, IAS 36 may require entities to test right-of-use assets for impairment on a CGU basis.

How we see it

- ▶ Entities need to carefully consider the transition approaches under IFRS 16. When selecting the modified retrospective approach, further choices need to be made regarding the measurement of right-of-use assets and whether or not to use the practical expedient relating to onerous lease contracts (amongst others).
- ▶ These choices will have an effect on the amount of work to be done, the effect on equity on the date of initial application and also the reported results going forward. The depreciation of right-of-use assets is impacted as are possible future impairment charges.

5. Conclusion

Right-of-use assets will be included in the statement of financial position as a result of the introduction of IFRS 16. Right-of-use assets will have consequences on the impairment tests required under IAS 36, either because there are indicators that the right-of-use assets may be impaired or because the right-of-use assets are part of a CGU that needs to be tested for impairment.

A very important consideration for the impairment test is to ensure lease liabilities and the associated cash flows are treated consistently in both the determination of the carrying amount and the recoverable amount of the CGU.

In our view, there are strong arguments as to why the discount rate used for calculating VIU would decrease after the introduction of IFRS 16. It is generally expected that there will be no impairment as a result of the application of the new leasing standard. The need to adjust the discount rate and, therefore, its relevance, will, in general, depend on the existing headroom and the precision of the impairment methodology adopted. Determining the appropriate discount rate will require appropriate consideration and expertise, in particular, due to the potential lack of market data on the effects of applying IFRS 16. As a result, for certain individual cases, there is still a risk that impairments will arise.

This publication has discussed some of the issues relating to leases that entities need to consider when performing impairment tests. However, there are various other elements that need to be considered. Finally, entities need to be aware that the choices made on transitioning to IFRS 16 may affect the amount of future impairments.

¹ In November 2017, the IFRS Interpretations Committee decided to add a narrow-scope standard-setting project to its agenda. The objective of the project is to clarify the meaning of the term 'unavoidable costs' in the definition of an onerous contract in IAS 37.

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