Applying IFRS

Impairment for lessees that plan to reduce the use of real estate

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Building a better working world

Contents

What you need to know

- An entity that decides to change the use of an ROU asset will need to carefully consider all facts and circumstances to conclude on the accounting consequences of this decision under all applicable IFRS Standards.
- Plans to change the use of an ROU asset may lead to: a revision of the lease term and lease liability; an impairment loss; a change in the remaining useful life of the right-of-use asset; and/or application of IFRS 5 or IAS 40.
- Entities seeking to reduce their use of real estate should pay careful attention to the guidance on asset impairment.
- Plans to change the use of an ROU asset, e.g., sublease or abandon certain spaces, is, in many cases, an impairment indicator.
- Entities need to assess the potential impact of their decision to reduce their use of real estate on their cash generating units and, therefore, the level at which impairment assessments are performed.
- A decision to change the use of an ROU asset may result in the need to test the ROU asset on a stand-alone basis and, as such, may be more likely to result in impairment.

Overview

Many entities that have closed their offices or are using them temporarily in a very reduced capacity due to the ongoing COVID-19 pandemic, may consider reducing their use of real estate going forward, including after the COVID-19 pandemic.

For example, entities that have successfully implemented a virtual work environment may see an opportunity to reduce costs by reducing their use of real estate or by relocating to less expensive space. Industries with high density branch networks such as retail, restaurant, hotel or leisure businesses may also decide to close certain locations due to changing consumer behaviours and their impact on the location's ability to generate cash inflows.

Due to the complexities of implementing a plan to reduce the use of real estate, a decision may be made long before the plan is completed. Such a decision may result in an impairment loss to be recognised.

To properly assess the accounting treatment, the entity should consider the following questions at each reporting date:

- What decisions have been made by the parties authorised to make decisions (e.g., executive management, board of directors)?
- Which aspects of management's plans have been implemented?
- For aspects of the plan not implemented, what are the remaining steps required and when are they expected to be completed?

This publication addresses some common issues lessees may encounter if they plan to reduce the amount of space they use. That is, lessees should understand the interaction between the guidance in IFRS 16 *Leases*, IAS 36 *Impairment of Assets* and IAS 16 *Property, Plant and Equipment*. For owner-occupied real estate, an expected change in use will often give rise to similar issues and considerations.

1. Change in management's intended use of an ROU asset

Navigating the interaction between the guidance in IFRS 16 and IAS 36 can be challenging when an entity decides to reduce its use of leased real estate. IFRS 16 requires lessees to evaluate right-of-use (ROU) assets for impairment in accordance with IAS 36.

Lessees should apply the guidance in IAS 36 and IFRS 16 together with IAS 16 *Property, Plant and Equipment* to determine whether a change in the expected use of an ROU asset is an impairment indicator, affects the entity's determination of cash-generating unit(s) (CGUs), and impacts the estimated useful life and residual value of both the ROU asset and any related leasehold improvements. IFRS 16 may also require a reassessment of the lease term and lease liability. Judgement may be required applying IFRS 16 and IAS 36, as the timing of events resulting in a lease term and lease liability reassessment and lease modification and the existence of an impairment indicator may differ. Refer to section 3 on Lease reassessments or modifications of a lease.

Existence of an impairment indicator

A decision to change the use of the right-of-use asset would in many cases be considered an impairment indicator.

An entity is required to assess at the reporting date, for all assets in scope of IAS 36, whether there are any indicators of impairment. Considering the current adverse economic conditions, entities may have plans to abandon or sublease (a part of) certain leased spaces. In many cases, the current adverse economic conditions are considered an impairment indicator. However, IAS 36.12(f) states that significant changes in the manner in which an asset is used, or expected to be used, is an internal source of information for indication of impairment. The entity's decision to change the use of the ROU asset (or the entity's conclusion that it has no realistic alternative but to do so) would, therefore, also indicate that an asset, a group of assets or CGU(s) may be impaired. This is particularly true when a store is to be closed or where the decision impacts the level at which the ROU asset is assessed for impairment.

The existence of an impairment indicator would require an entity to perform an impairment test on the asset or CGU.

Reassessment of CGU determination

IAS 36 defines a CGU as the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.

An entity's decision to change the expected use of an ROU asset raises the question of whether the expected use has changed in such a way that it affects the composition of the CGU and, if it does, when this change in the CGU determination should be reflected.

A decision to abandon or sublease an ROU asset might impact the CGU identification differently depending on the nature of the asset and how it is used by the entity. For example, each retail store is often determined to be a separate CGU. In contrast, administrative offices are often tested together with other assets in a CGU or classified as corporate assets and allocated on a reasonable and consistent basis to the CGUs to which they belong.

Timing of the decision

If an entity concludes that it needs to update its CGU(s), the entity first has to assess when the expected change in use would impact the CGU determination.

One important consideration is whether and when the decision to change the use has been made by the level of management that is authorised to make such decisions. This will often be executive management and/or the board of directors. In addition, it would need to be assessed whether the entity has the ability to change the use in the expected manner or whether the lessor's approval is required.

2. Impact of the change in use

The impact of the change in use will be different depending on the timing of the decision. In particular, it is important to consider how long the ROU asset is expected to be used within the current CGU and, therefore, continues to support the generation of cash inflows of the CGU. In addition, entities should take into account the length of the remaining lease term and any other facts and circumstances that are relevant to the CGU assessment. Significant judgement will often be required and might, therefore, warrant additional disclosures in the financial statements.

The shorter the time between the decision and the actual change in use occurring, the more likely the decision will impact the CGU identification.

The guidance in IAS 36.22(b) requires an entity to determine the recoverable amount for an individual asset, even where an asset does not generate largely independent cash inflows, if the asset's value in use (VIU) can be estimated to be close to its fair value less costs of disposal (FVLCD) and its FVLCD can be measured. In many jurisdictions, the real estate market is well developed and, therefore, the FVLCD of an ROU asset for real estate can be measured. The condition in IAS 36.22(b) that VIU can be estimated to be close to FVLCD for an ROU asset for real estate may be judged to be fulfilled where an ROU asset is to be used within its current CGU for only a short period of time before the abandonment or sublease occurs. In such circumstances, the ROU asset will have to be tested for impairment on a stand-alone basis.

When the ROU asset is to be used within the original CGU for only a short period of time before the abandonment or sublease occurs, one might, depending on facts and circumstances, also judge that the ROU asset and the CGU generate largely independent cash inflows. This would also mean that the ROU should be tested for impairment on a stand-alone basis.

The longer the time between the decision to abandon or sublease the ROU asset and the actual change in use occurring, the less likely it is that the decision will immediately impact the level at which any impairment assessment should be performed. The shorter the time between making the decision and the expected change in use occurring, the more likely it is that the expected change in use should currently be reflected in the CGU determination and the resulting impairment test.

If, having considered all facts and circumstances, it is concluded that the decision will not immediately impact the level at which any impairment assessment is performed, then an entity would still need to reassess the useful lives and residual values of the affected assets.

Illustrative example

Entity X ("the entity") recognises an ROU asset for a building that it currently occupies as office space. The entity has occupied the building for nine years and has three years remaining on the original 12-year lease. The lease does not include an option to extend or terminate the lease. The ROU asset was always tested for impairment as part of CGU 1 as it was not generating largely independent cash inflows. There is significant headroom (i.e., the amount by which the recoverable amount exceeds the carrying amount) in CGU 1. As such, no impairment is identified at the level of CGU 1. It is assumed that the FVLCD of the ROU asset is measurable.

With many employees working from home as a result of the COVID-19 pandemic, the space is used in a substantially reduced way. Immediately prior to Entity X's year-end of 31 December 2020, its board (in conjunction with management) made a final decision to permanently cease using the space.

There will be a period of five months before Entity X vacates the property where the space will continue to be used by CGU 1 to facilitate the transition. Entity X is not able to sublease the space given the location, relatively short remaining lease term and market conditions for office space.

Analysis and conclusion

The entity concludes that the decision is an impairment trigger for the ROU asset at the balance sheet date as it is considered an internal indicator of impairment as per IAS 36.12(f).

In this fact pattern, a final decision to vacate the space has been made. The period between the decision and the date at which the entity will vacate the property is short and, therefore, its contribution to the cash inflows of the CGU are not expected to be significant. As the property cannot be subleased for the remaining lease term, the entity concludes that the ROU asset's FVLCD is also not expected to be significant and is expected to be close to the ROU asset's value in use. Therefore, the entity concludes that the ROU asset should be tested separately from CGU 1 when the decision to vacate is made.

3. Other considerations

Lease reassessments or modification of a lease

IFRS 16 defines a lease modification as a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease (for example, adding or terminating the right to use of one or more underlying assets, or extending or shortening the contractual lease term).

A modification is accounted for at its effective date. A lessee needs to carefully evaluate the terms and conditions of the lease and events and circumstances that may arise related to the lease (e.g., lease term and lease liability reassessment events). If a change to the terms and conditions results in a shorter lease term or the termination of a lease, modification accounting is applicable. In contrast, if the lease includes options to terminate or extend the lease, lessees should be mindful to determine if there has been a lease term or liability reassessment event. The lessee is required to reassess the lease term and, thus, remeasure the lease liability if there is a reassessment event (which may result in a change to the lease term).

Useful lives of ROU assets

Once a plan for change in use has been concluded, the useful lives and residual values of the affected assets should be reassessed. The change(s) must be accounted for as a change in an accounting estimate in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

Effects of vacating or subleasing a portion of an ROU asset

When different areas or floors of a building are leased under a single contract but are used for different purposes, this may raise questions in relation to the unit of account for impairment purposes. Should the ROU asset(s) resulting from a lease governed by a single lease contract be assessed and treated consistently at the overall contract level, or should the different areas or floors be assessed and treated separately?

In general, IAS 36 focuses on how assets contribute to the generation of independent cash inflows (individual asset, part of a CGU, or corporate asset). However, in our view, the answer to this question depends on whether the lease contract relates to identifiable asset(s) portions that are physically distinct and would effectively be separate units of account. In making this assessment, the guidance in paragraphs B20 and B32 of IFRS 16 and paragraph 10 of IAS 40 *Investment Property* should be considered. For leased assets/buildings that are used, or expected to be used, in parts for different purposes and where these portions are physically distinct, the (expected) usage and therefore the generation of independent cash inflows will drive the considerations under IAS 36. Judgement might be needed to determine the units of account of the ROU asset(s), and their allocation to different CGUs.

A lessee may have concluded there is no accounting difference between accounting for its lease of a ten-floor building as one lease component (the building) or as ten lease components (the ten functionally independent floors). That is, even though each floor met the criteria to be considered a separate lease component, the original lessee may have historically accounted for the entire building as one lease component if it concluded there is no accounting difference between recognising ten separate ROU assets and lease liabilities and recognising one ROU asset and lease liability for the entire building. As the entire building was used as part of one CGU, it was allocated and assessed at this level for impairment. Therefore, in this example, if the original lessee now intends to sublease a single functionally independent floor, we believe it may be reasonable to conclude that the subleased floor is a separate ROU asset that would need to be assessed separately for impairment testing from the other remaining nine floors.

Fair value less costs of disposal of ROU asset

Any restrictions on the use of an asset would need to be considered under the guidance of IFRS 13 *Fair Value Measurement* when measuring fair value. Therefore, any restrictions on subleasing or assigning the lease which are part of the lease contract, would need to be considered as being part of the characteristics of the ROU asset and such restrictions should be considered in measuring the FVLCD of the ROU asset.

Where an entity has the ability to sublease an ROU asset or assign the lease contract, but actively decides not to do so, the FVLCD would still need to take a market participant's view. Consequently, an assumption of a fair value of nil might not be appropriate where there is a market for the lease.

Held-for-sale classification

IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* stipulates that a non-current asset (or disposal group) that is to be abandoned should not be classified as held for sale. This is because the carrying amount will be recovered principally through continuing use rather than through sale.

If an entity intends to sublease the lease to a third-party under a finance lease, the requirements of IFRS 5 would need to be assessed.

Subleasing

Properties leased to third parties under one or more operating leases are generally investment properties, whether they are owned freehold by the reporting entity or are right-of-use assets held by the reporting entity relating to properties. Entities should, therefore, consider whether the requirements of IAS 40 *Investment Property* should be applied. IAS 40 states that if a property has both investment property and non-investment property uses, provided that the parts of the property could be sold or leased out under a finance lease separately, they should be accounted for separately.

Paragraph 57 of IAS 40 states that the ROU asset should be transferred from owner-occupied property to investment property upon the end of the owner-occupation, i.e., when the property is no longer used internally and made available for subleasing.

How we see it

- An entity that decides to change the use of an ROU asset will need to carefully consider all facts and circumstances to conclude on the accounting consequences of this decision under all applicable IFRS standards. Key judgements made in this respect would need to be disclosed in the entity's financial statements.

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