IFRS 16 and IAS 36
how changes in lease accounting will impact your impairment testing processes

Right-Of-Use (ROU) assets are non-financial assets in the scope of IAS 36. Unless it is tested on a standalone basis, an ROU asset is tested in combination with other assets in a Cash Generating Unit (CGU). IFRS 16 may impact both the CGU’s carrying amount and the way the recoverable amount of the CGU is measured. Elements to consider are: the cash flow forecasts, the discounted cash flow models, the discount rate and the treatment of lease liabilities.

ROU assets are non-financial assets in the scope of IAS 36 and generally need to be included in the carrying amount of Cash Generating Units (CGUs).

IFRS 16 may impact both a CGU’s carrying amount and the way the recoverable amount of the CGU is measured.

Elements to consider include:
- the cash flow forecast and discounted cash flow models;
- the discount rate; and
- the treatment of lease liabilities.

We discuss each of these areas below.

### Cash flow forecast and discounted cash flow models

Companies should ensure consistency between the Carrying Amount (CA) and the Recoverable Amount (RA) of a CGU in an IAS 36 impairment calculation. The CA will generally include the ROU asset value and the lease liability (refer to the section on *lease liabilities* below for more details). If an entity uses a “free cash flow to the firm” valuation approach to determine the RA, both the cash flows and discount rate used are likely to differ under IFRS 16.

IFRS 16 replaces operating lease expenses in the income statement with depreciation of the ROU asset and interest

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1. IFRS 16.33
2. While adding both the ROU asset and lease liability will have an offsetting effect, there would be a net impact to the CA as ROU asset and lease liability are generally not of equal and opposite amount other than at commencement of the lease (and at IFRS 16 transition date under the modified retrospective approach for those ROU assets measured at the amount equal to the lease liability [IFRS 16.C8(b)i])
3. Free Cash Flow to the Firm (FCFF) is an economic measure of a business’ cash flows before any payments to/from providers of finance. The FCFF of a business with leases will change as a result of the adoption of IFRS 16 which effectively changes the treatment of operating leases into financing arrangements. Operating lease payments will no longer be recorded as part of operating costs (and therefore deducted in arriving at FCFF) but as financing items which are not deducted in arriving at FCFF.
on the lease liability. In the statement of cash flows, the lease payments split into principal repayments of the lease liability which are included in the cash outflows related to financing activities and an interest element whose classification as operating or financing cash flows depends on a company’s accounting policy. The question arises how lease payments should be treated when determining the recoverable amount of a CGU post IFRS 16.

In practice two main approaches could be applied in the discounted cash flow analysis, which, if applied correctly, should lead to the same estimate of the RA. These approaches are:

1. follow IFRS 16 classification and treat lease payments as cash flows to debt providers in the discounted cash flow model, and subtract the fair value the lease liability from the outcome as applicable; or

2. follow IAS 17 cash flow classification and continue modelling the cash flows as before, treating the lease payments (including interest) as a cash outflow in the determination of the free cash flow to the firm. The question arises how lease payments should be treated when determining the recoverable amount of a CGU post IFRS 16.

In approach 2 the lease expenses would be classified (back) as operating expenses. This would essentially reflect the way how impairment analyses prior to the introduction of IFRS 16 would have been performed. The ‘old’ approach also assumed, often in a non-conscious way, that new leases would be entered into by growing operating expenses (that included lease payments) at a set rate. Going forward this approach would result in a mismatch between management accounts and model forecast. This mismatch should be carefully analysed and reconciled to ensure consistency between management’s expectations versus impairment model assumptions.

While either of approaches 1 or 2, should result in the same Fair Value Less Cost of Disposal (FVLCD) if applied correctly, IAS 36.78, provides that the carrying amounts of certain recognized liabilities should be deducted in a calculation of the RA under Value in Use (VIU), implying that approach 1 should be applied for VIU, but deducting the carrying amount of lease liabilities rather than their fair value. The change in cash flow classification of leases triggers a significant increase in operating cash flow.

The ROU asset balance and depreciation charge only reflects the lease payments over the IFRS 16 lease term – 3 years in the graph. Many DCF models will require an update to include replacement cash flows for ROU assets in the forecast period and terminal value (TV). Another difference may arise from ROU assets being measured excluding the interest implicit in the payments.

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4. Following IFRS 16, 50 lease payments for the principal portion are classified as financing activities and payments for the interest portion are classified in accordance with the company’s policy on classification of interest paid. In the “free cash flow to the firm” valuation approach, interest payments are cash flows to funding providers, and therefore are not part of the free cash flows to the firm.

5. As IFRS 16 eliminates the distinction between operating and finance leases this adjustment would be made for all lease payments, regardless of whether the lease was classified as operating or finance lease under IAS 17.

6. In our view, IAS 36.78 applies to a lessee’s lease liability: “…the carrying amount of the liability is deducted in determining both the cash-generating unit’s value in use and its carrying amount”, i.e. the discounted cash flows will not include the cash outflows resulting from the lease payments to avoid double counting. This is based on the guidance in IAS 36.78 and the IFRS Interpretations Committee discussion (IAS 36.29, 78. IU 05-16).
Discount rate (WACC)

The way of determining the discount rate should be consistent with what is included in the cash flows. If the lease payments are not deducted from the free cash flows to the firm (approach 1 above), then the resulting net cash flows include the cash that will be used to pay the lease obligation. In this approach the lease payments are treated as a financing item to the firm. Therefore, to ensure consistency with the cash flows, the capital cost of lease liabilities should be reflected in the weighted average cost of capital ('WACC').

Incorporating the capital cost of lease liabilities is expected to result in a reduction of the WACC, relative to a rate measurement that uses only ‘traditional’ debt and equity.

Combined impact on net present values due to changes in cash flows and discount rate

Under approach 1 above, the RA of a CGU, before consideration of lease liabilities, would increase due to both higher operating cash flows (because of the exclusion of IAS 17 operating lease payments) and from using a lower WACC. This increase in net present values may be offset by inclusion of the lease liability.

Lease liabilities

Another topic for impairment testing post IFRS 16 relates to the allocation of lease liabilities to CGUs. ROU assets are non-financial assets in the scope of IAS 36 and generally need to be included in the carrying amount of the CGU unless they generate independent cash inflows. The inclusion of the corresponding lease liabilities in the carrying amount depends on whether a buyer would assume the lease liability in a disposal of the CGU.

Under IAS 36, the CA of a CGU does not include the CA of any recognized liability, unless an entity needs to consider that liability to determine the recoverable amount of the CGU [IAS 36.78]. This may occur when a buyer would be required to assume the liability in a disposal of the CGU. In our view, this guidance applies to a lessee’s lease liability associated with ROU assets in the CGU. This is based on the guidance in IAS 36.78 and the IFRS Interpretations Committee discussion [IAS 36.29, 78. IU 05-16]. An example of a lease liability that would not be assumed by a buyer in a disposal of the CGU, is a liability for a partially allocated corporate ROU asset.

In cases where the lessee concludes that the buyer would not be required to assume the lease liability upon disposal of the CGU, then the lessee excludes the lease payments from the discounted cash flows used to measure the CGU’s VIU and, in order to ensure consistency, excludes the lease liability from the CA of the CGU. Similarly, the CGU’s FVLCD excludes the lease liability when a buyer would not be required to assume the lease liability.

Similar to what is discussed above with respect to approach 1, due consideration needs to be given to replacement cash flows for the ROU assets after the lease term and the implications of the possible change in composition of cash flows to the discount rates used.

Other considerations and further guidance

Changes to lease accounting also need to be considered when using historical information in impairment analyses, to ensure the information is like-for-like. This applies both for trend analyses of the company’s own data as well as for peer company information used (e.g. for asset beta or leverage estimates, market multiples or profitability benchmarking).

Valuators continue to discuss the appropriate and practical approach to adoption of IFRS 16 in IAS 36 impairment testing. Standard practices and further guidance on the implications of IFRS 16 are expected to become available in the course of 2019, following the adoption of IFRS 16 by all IFRS reporters.

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7 Under the assumption that the impact of IFRS 16 is similar for other market participants.
How KPMG can help

Impairment testing remains a complex accounting topic. Transitioning to IFRS 16 was (and for some still is) a time-consuming and cumbersome process. KPMG can help you to determine how IFRS 16 will change your impairment testing and how to process these changes. We can help you to determine the most practical approach on determining your CGUs’ CA and RA post IFRS 16.

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