ACCOUNTING BRIEF
Impairments of right-of-use assets

August 2024

SUMMARY

For most entities, the implementation of Accounting Standards Codification (ASC) 842, *Leases*, has now been completed. As entities have moved on to post-implementation accounting, the topic of impairments has proven to be somewhat problematic for a number of lessees. This paper addresses the accounting for impairments of Right-of-Use (ROU) assets.

1. Background

Paragraph 842-20-35-9 of ASC 842 states:

> A lessee shall determine whether a right-of-use asset is impaired and shall recognize any impairment loss in accordance with Section 360-10-35 on impairment or disposal of long-lived assets.

In other words, the impairment models applicable to right-of-use (ROU) assets are the same impairment models applicable to property, plant and equipment.

1.1 Application of the ASC 360 impairment guidance

The impairment guidance for long-lived assets in ASC 360, *Property, Plant and Equipment*, requires that entities:

- Identify asset groups
- Perform a recoverability test (if a triggering event has occurred)
- Recognize an impairment loss, if appropriate

The unit of account for the held-and-used impairment model is an asset group. An asset group is defined in the Master Glossary of the ASC as "…the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities." As noted in the definition, an asset group may include both assets and liabilities. While an asset group may include ROU assets and the related lease liabilities, how those lease liabilities affect the application of the held-and-used impairment model depends on the facts and circumstances.

In most instances, an asset group does not consist solely of a single long-lived asset because such an asset is typically not going to have "identifiable cash flows that are largely independent of the cash flows of other groups of assets and liabilities." Likewise, an ROU asset typically does not have "identifiable cash flows in and of itself that are largely independent of the cash flows of other groups of assets and liabilities." As a result, an ROU asset to be held and used is generally not evaluated for impairment on a standalone basis. That said, there may be limited situations in which the nature of the underlying asset could result in the ROU asset having largely independent identifiable cash flows, such as when the underlying asset is a power plant.

Under the held-and-used impairment model, an impairment test is only performed if certain triggers are present. Examples of these triggers include:

- The market price of a long-lived asset or asset group has significantly decreased.
- There are current and historical negative cash flows associated with a long-lived asset or asset group.
- The way in which the entity will use a long-lived asset or asset group has been affected by a significant adverse change.

For the decrease in the value of an ROU asset to trigger an impairment test under the held-and-used impairment model, we believe the asset would likely have to represent a significant part of the related asset group's overall value.

Under the held-and-used impairment model, when a triggering event has occurred for an asset group, there are two steps employed to determine if an impairment charge is required. Step 1 is referred to as the recoverability test, which involves comparing the carrying amount of the asset group to the undiscounted future expected cash flows. If the carrying amount is less than the undiscounted cash flows for the asset group, the lessee has passed the recoverability test and no impairment charge should be recognized. Conversely, if the carrying amount is more than the undiscounted cash flows for the asset group, the lessee has failed the recoverability test and must move on to Step 2.

Under Step 2 of the held-and-used impairment model, the lessee compares the carrying amount of the asset group to its fair value. For this purpose, fair value is determined in accordance with ASC 820, *Fair Value Measurement*. An asset group's undiscounted cash flows used in the recoverability test (i.e., Step 1) and the fair value used in Step 2 will be different amounts. Undiscounted cash flows do not take the time value of money into consideration, whereas fair value does. In addition, undiscounted cash flows are estimated using an entity-specific perspective, while fair value is estimated using a market-participant perspective. When the carrying amount of the asset group is higher than its fair value, an impairment loss exists. When the carrying amount of the asset group is lower than its fair value, an impairment loss does not exist.

Common questions that arise in applying the held-and-used impairment model to an asset group that includes ROU assets deal with how the related lease liabilities and cash flows should be treated in the model. We believe the answers to certain questions may depend on the classification of the lease and, if the lease is classified as an operating lease, which of two analogies the lessee elects as its accounting policy.

- For finance leases (and operating leases for which the lessee chooses to analogize to debt), we believe the carrying amount of an asset group should not include the lease liabilities related to the ROU assets in that group and that the undiscounted cash flows used in the recoverability test for the asset group should not include the lease payments related to the ROU assets in that asset group. In addition, for fair value purposes, if the fair value of the asset group is determined using discounted cash flows, we believe the cash flows should not include the lease payments related to the ROU assets in that group. Additionally, if the fair value of the asset group is determined using a market approach, we believe the fair value of the asset group should be determined without giving effect to the fair value of the lease liabilities.

- For operating leases for which the lessee chooses to analogize to an operating liability, we believe the carrying amount of an asset group should include the lease liabilities related to the ROU assets in that group and that the undiscounted cash flows used in the recoverability test for the asset group should include the lease payments related to the ROU assets in that group (but reduced for the accretion of the lease liability). In addition, for fair value purposes, if the fair value of the asset group is determined using discounted cash flows, we believe the cash flows should include the total lease payments (both principal and interest) related to the ROU assets in that asset group, and if the fair value of the asset group is determined using a market approach, we believe the fair value of the asset group should give effect to the fair value of the lease liabilities.

To understand why the classification of a lease affects the answers to the questions posed, it is important to remember that debt is not included in the carrying amount of an asset group, and debt-related payments (principal and interest) are not included in the undiscounted cash flows for the asset group used in the recoverability test. As a result, when answering the questions posed, we are essentially indicating whether a lease liability should or should not be treated in the same way as debt for purposes of applying the held-and-used impairment model. With that as a backdrop, the bases for the previous discussion are as follows:

- *Finance leases.* With respect to finance leases, the answers to the questions are consistent with the treatment of debt and with the treatment of capital lease obligations under ASC 840. We believe this is appropriate, given the debt-like nature of a finance lease liability.
- *Operating leases: Debt analogy accounting policy.* This accounting policy is based on how an asset retirement obligation (ARO) is treated for purposes of the held-and-used impairment model (see ASC 360-10-35-18 and 35-19). An ARO is considered an operating liability instead of debt. However, unlike most other types of operating liabilities, an ARO is long-term and discounted, which is similar to debt. As a result, for purposes of applying the held-and-used impairment model, an ARO is not included in the carrying amount of an asset group, the payments to settle the ARO are not included in the undiscounted cash flows of the asset group used in the recoverability test and the fair value of the asset group should be unaffected by the existence of the ARO liabilities. Given that an operating lease liability is also a long-term discounted operating liability, we believe it would be appropriate for a lessee to elect an accounting policy under which an operating lease liability is treated the same way as an ARO for purposes of applying the held-and-used impairment model.
- *Operating leases: Operating liability analogy accounting policy.* Paragraph BC14 of ASU 2016-02 indicates that “Topic 842 characterizes operating lease liabilities as operating liabilities, rather than debt.” Because of this, we believe it would be appropriate for a lessee to elect an accounting policy under which the operating lease liability is treated similarly to other operating liabilities, such as accounts payable. Under this accounting policy, the operating lease liability is included in the carrying amount of an asset group, the portion of the payments that settle the operating lease liability (i.e., the lease payments reduced by the accretion of the lease liability) are included in the undiscounted cash flows of the asset group and the fair value of the asset group should be affected by the existence of the lease liabilities.

While we believe a lessee has an accounting policy choice with respect to its treatment of operating lease liabilities and the related cash outflows in the held-and-used impairment model, we generally do not believe different answers will result depending on the accounting policy elected. In other words, if a lessee passes (or fails) the recoverability test under one accounting policy, we generally believe it will pass (or fail) the test under the other accounting policy. Similarly, we generally would not expect the amount of an impairment loss resulting from application of Step 2 in the held-and-used impairment model to be significantly different under one accounting policy compared to the other.

The accounting policy elected by the lessee with respect to its treatment of operating lease liabilities and the related cash outflows in the held-and-used impairment model should be consistently applied and appropriately disclosed.

Regardless of the classification of the lease, when applying the held-and-used impairment model, cash flows related to variable lease payments that were not included in the measurement of the lease liability should be:

- Included in the undiscounted cash flows of the asset group used in the recoverability test
- Included in the discounted cash flows of the asset group when the fair value of the asset group used in Step 2 of the held-and-used impairment model is determined using a discounted cash flows method

If an entity has elected the short-term lease accounting policy, it would have no ROU asset or lease liability to be included in the carrying amount of the asset group. However, payments under those leases should be included in the undiscounted cash flows used in the recoverability test. In addition, those payments should affect the fair value of the asset group used in Step 2 of the held-and-used impairment model.

1.2 Allocation and recognition of the impairment loss

The starting point for allocating and recognizing an impairment loss is the excess of an asset group's carrying amount over its fair value. This impairment loss is allocated to only the long-lived assets in the asset group (which includes the ROU assets in the asset group) on a pro rata basis using the relative carrying amounts of the assets. However, as required by ASC 360-10-35-28, if the fair value of a long-lived asset is determinable without undue cost and effort, the carrying amount of that asset should not be reduced below its fair value. As further discussed in ASC 360-10-55-22, any unallocated loss as a result of this limitation should be allocated to the other long-lived assets in the asset group on a pro rata basis using the relative adjusted carrying amounts of those assets. Given this limitation, it is possible that an amount less than the calculated impairment loss is actually recognized.

Unless doing so involves undue cost and effort, a lessee should determine the fair value of its ROU assets for purposes of determining whether there is a limit on the amount of the impairment loss that should be allocated to those assets. For this purpose, the fair value of the ROU assets should be unaffected by the related lease liabilities, regardless of the lease's classification. No part of an impairment loss is allocated to lease liabilities.

1.3 Allocation of an impairment loss

Assume that a lessee applied the held-and-used impairment model to an asset group for which impairment triggers were present. The asset group failed the recoverability test, and application of Step 2 to the asset group identified an impairment loss of $2 million. There are four long-lived assets in the asset group (one of which is an ROU asset) to which this $2 million impairment loss should be allocated. The information needed to allocate the $2 million impairment loss and the allocation of that loss are as follows:

Long-lived assets to be held-and-used	Net carrying amount	Fair value	Pro rata allocation before limitation	Allocated impairment loss
A	$1,000,000	$750,000	10%	$200,000
B	2,000,000	1,500,000	20%	400,000
C	4,000,000	3,100,000	40%	800,000
ROU asset	3,000,000	2,500,000	30%	500,000
Total	$10,000,000			$1,900,000

When initially allocating the impairment loss across all four long-lived assets in the asset group, the amount allocated to the ROU asset based on its relative carrying amount would have been $600,000 ($2,000,000 × 30%). However, allocating more than $500,000 of the impairment loss to the ROU asset would result in the carrying amount of the ROU asset being below its fair value, which the held-and-used impairment model prohibits when the fair value of an individual long-lived asset is known. As a result, only $500,000 of the impairment loss is allocated to the ROU asset, and the $100,000 of the impairment loss not allocated to the ROU asset due to the fair value limitation is reallocated to the other long-lived assets in the asset group based on their adjusted carrying amounts, provided doing so does not result in any of those assets having a carrying amount below their known fair value.

Long-lived assets to be held-and-used	Net carrying amount	Allocated impairment loss	Adjusted carrying amount	Pro rata allocation after limitation	Additional allocated impairment loss	Final allocated impairment loss
A	$1,000,000	$200,000	$800,000	14%	$14,000	$214,000
B	2,000,000	400,000	1,600,000	29%	29,000	429,000
C	4,000,000	800,000	3,200,000	57%	57,000	857,000
			$5,600,000	100%	$100,000	
ROU asset	3,000,000	500,000	$2,500,000			500,000
Total	$10,000,000	$1,900,000				$2,000,000

1.4 Subsequent accounting for an ROU asset that has been impaired

Once an ROU asset has been impaired, the remaining balance in the ROU asset should be amortized over the shorter of the remaining lease term and the underlying asset's remaining useful life on a straight-line basis or another systematic basis that better represents the pattern of benefit to be derived from the remaining ROU asset, as stated in ASC 842-20-35-10.

With respect to finance leases, if the ROU asset is adjusted as a result of an impairment, the amortization period for the post-impairment ROU asset starts with the impairment date and spans the shorter of the remaining lease term or the remaining useful life of the ROU asset.

With respect to operating leases, generally the single lease cost for a period is the sum of the periodic amortization of the remaining ROU asset over the shorter of the remaining lease term and the ROU asset's remaining useful life on a straight-line basis, or another systematic basis that better represents the pattern of benefit to be derived from the remaining ROU asset, plus the periodic accretion of the lease liability by an amount that produces a constant periodic discount rate on the liability's remaining balance. The sum of the two amounts is considered the single lease cost for the period. If none of the single lease cost should be capitalized, the single lease cost is included as one amount in the income statement and not split between amortization expense and interest expense.

If, however, the ROU asset has been impaired (including having had an impairment allocated to it), the single lease cost for a period generally would be the sum of the periodic amortization of the remaining ROU asset over the shorter of the remaining lease term and the ROU asset's remaining useful life on a straight-line basis plus the periodic accretion of the lease liability by an amount that produces a constant periodic discount rate on the liability's remaining balance. The sum of the two amounts is considered the single lease cost for the period. If none of the single lease cost should be capitalized, the single lease cost is included as one amount in the income statement and not split between amortization expense and interest expense.

1.5 Long-lived assets to be abandoned

A key date in the abandonment model is the date on which the entity decides to abandon the assets and is committed to a plan to do so (the commitment date), which is typically some time before it actually abandons the assets. Another key date in the abandonment model is the date on which the entity ceases to use the asset (cease-use date). On that date, the entity accounts for the abandonment as a disposal.

Between the commitment date and the cease-use date, the entity accounts for the assets to be abandoned as assets that are being held and used. In addition, if the cease-use date is before what would otherwise have been the end of the asset's depreciable or amortizable life, the entity reduces the depreciable or amortizable life and accounts for that change in estimate in accordance with ASC 250-10-45-17 to 45-20. Under that guidance, when the depreciable or amortizable life of a long-lived asset is shortened, the remaining carrying amount of that asset is depreciated or amortized over the shortened depreciable or amortizable life. Questions that arise in applying the abandonment model to ROU assets the lessee is committed to abandoning include:

- *Does a lessee ceasing use of an ROU asset with a plan to sublease the underlying asset constitute abandonment?* No, provided the lessee has the intent and ability to sublease the underlying asset. When there is the intent and ability to sublease the underlying asset, the ROU asset related to the lease is subject to the held-and-used impairment model even if a sublessee has not been identified. If either the intent or ability to sublease the underlying asset does not exist, the lessee should apply the abandonment model to the ROU asset.

- *Is the accounting for the asset group to which an ROU asset to be abandoned belongs affected by the expected abandonment of the ROU asset?* When an ROU asset is expected to be abandoned, the lessee should consider whether the reasons behind that expected abandonment constitute a triggering event that requires an impairment test to be performed on the asset group to which the ROU asset belongs as a whole.

- *Does the accounting for the lease liability related to an ROU asset change if the ROU asset is expected to be or is abandoned?* No. The accounting for a lease liability changes only when a remeasurement of the liability is otherwise required or the lease is terminated.

- *How is a change in the amortizable life of an ROU asset to be abandoned reflected in the amortization recognized by the lessee between the commitment date and the cease-use date?* To the extent an ROU asset has not previously been reduced by an impairment loss, we believe when there is a change in the amortizable life of an ROU asset to be abandoned, it would be acceptable for a lessee to either amortize the remaining balance in the ROU asset generally on a straight-line basis over its remaining amortizable life (which is most consistent with the subsequent accounting for a finance lease) or amortize the remaining balance in the ROU asset in a manner that results in straight-line recognition of the remaining lease costs over the ROU asset's remaining amortizable life (which is most consistent with the subsequent accounting for an operating lease). For these purposes, the remaining amortizable life is the period from the commitment date to the cease-use date. The remaining amortizable life does not take into consideration a sublease period because, as discussed earlier, the ROU asset for a lease that the lessee has the intent and ability to enter into a sublease is not subject to the abandonment model (i.e., it is subject to the held-and-used impairment model).

+1 800 274 3978
rsmus.com

RSM