



Implications of ROU assets on impairment assessments

The introduction of AASB 16 Leases means the majority of leases are capitalised as both a right-of-use (ROU) asset and lease liability (LL) onto the Balance Sheet. Our article provides practical solutions to the problems this causes when performing an impairment test of a cash generating unit (CGU).

AASB 16 requires the application of AASB 136 Impairment of Assets when testing ROU assets for impairment. Under AASB 136 an impairment test is only required to be performed if:

- there are indicators of impairment; or
- the CGU includes assets that are not yet available for use; or
- the CGU contains intangible assets that have an indefinite life (for instance where goodwill is part of a CGU an impairment test is required annually).

Let's assume those indicators are present and we need to test the CGU.

Pre AASB 16 an entity which entered into an operating lease would not have recognised a ROU asset and LL. Instead, the lease payments were expensed and included in the value in use (VIU) discounted cash flow calculation when performing an impairment test (see example 1 below).

Example 1

Factor	Actual FY19	Budget FY20	Forecast FY21	Forecast FY22	Forecast FY23	Forecast FY24	
Profit & Loss							
Revenue	\$ 1,000	\$ 1,030	\$ 1,082	\$ 1,146	\$ 1,192	\$ 1,228	
Revenue growth	100%	3%	5%	6%	4%	3%	
Cost of sales	-500	-515	-541	-573	-596	-614	
Gross margin	500	515	541	573	596	614	
Lease Expense	3%	-50	-52	-53	-55	-58	
Other Expenses	3%	-300	-309	-318	-328	-338	
EBITDA	150	155	169	191	202	208	
ROU amortisation							
Depreciation	-50	-50	-50	-50	-50	-49	
EBIT	100	105	119	141	152	159	
Lease interest							
Interest	-10	-9	-8	-7	-6	-5	
Tax	30%	-27	-29	-33	-40	-46	
NPAT	63	67	78	94	102	108	
Cashflow to NPV of CGU							
		FY20	FY21	FY22	FY23	FY24	Terminal value
Normalised EBITDA		155	169	191	202	208	
Working capital movements	10%	-3	-5	-6	-5	-4	
less CAPEX		-25				-25	5%
Net PRETAX cashflows to value (FCFF)		127	164	184	198	180	2,388
Discount period		0.5	1.5	2.5	3.5	4.5	5
PRE tax WACC Discount rate	12.9%	94%	83%	74%	65%	58%	55%
NPV VIU per DCF	\$	1,927	\$ 137	\$ 136	\$ 129	\$ 104	\$ 1,302
Less PV lease liability	\$	-					TV to TEV
NPV VIU per DCF with lease liab	\$	1,927					68%
CGU asset values							
	Carrying value			Weight	Return	WARA	
Operating NWC	\$ 700	From balance sheet		50.0%	7.0%	3.5%	
Operating PP&E	\$ 200	From balance sheet		14.3%	5.0%	0.7%	
ROU asset	\$ -	From lease calc / balance sheet		0.0%	5.0%	0.0%	
Goodwill	\$ 500	From balance sheet		35.7%		8.7%	
PV of lease liability	\$ -	From lease calc / balance sheet		n/a			
Book value of operating assets	\$ 1,400			100.0%		12.9%	
Head room (NPV less Book)	\$ 527						

Post AASB 16 then the lease will result in a ROU asset and LL and the lease payments should be excluded from the VIU calculation. Lease payments are excluded as they reflect a financing arrangement. The idea is that that the decision to lease, vs. buy, using capital or long term debt is a financing choice of the entity. The return on operating assets is viewed separately from how those assets are funded.

However, the ROU and LL pose a number of practical implications when doing a VIU discounted cash flow:

1. The ROU asset reflects a short-term lease of an item rather than indefinite ownership of the asset. What assumption is made about reinvestment in a replacement asset at expiry? In most cases the entity can't continue to operate into the future without the ROU asset (e.g. retail shop or restaurant). How is the VIU terminal value adjusted to reflect a re-investment in that lease?
2. Since the LL is classified as debt should the WACC/ discount rate be adjusted to reflect the change in debt/value ratio of the entity?
3. Should the lease liability be deducted from the analysis?

We set our thinking on how to solve each of these problems below.

1. Reinvestment in Leases

AASB136 requires that VIU discounted cash flows calculations are based on cash flow projections using the most recent financial budgets/forecasts approved by management. Projections based on these budgets/forecasts shall cover a maximum period of five years, unless a longer period can be justified. Cash flow projections beyond the period covered by the most recent budgets/forecasts are based on extrapolating the budgets/forecasts using a steady or declining growth rate for subsequent years, unless an increasing rate can be justified. For most going concern entities, applying the above principle will require a 'terminal value' year after year five to capture the remaining entity value. By definition, the terminal value assumes a 'steady state' of the entity and that the cash flows will be continued to be generated in perpetuity. Usually, the terminal value is derived from the year five (adjusted) cash flow, divided by the discount rate less a steady / economic growth rate.

As the terminal value is a perpetuity, it is illogical to think the entity can generate operating cash flows indefinitely without a reinvestment in its assets. After all, those assets are needed to generate those cash flows in the first place.

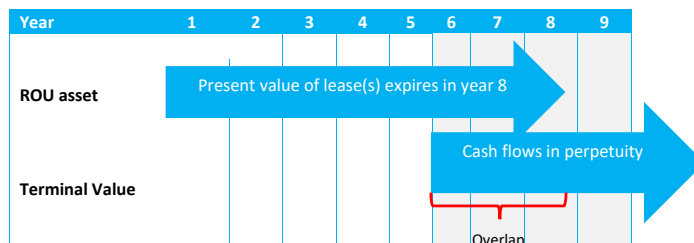
For property plant & equipment (PP&E) this problem is solved by assuming a rate of CAPEX reinvestment to be included in the terminal value calculation to renew those items.

So if the company relies on leases to operate then the terminal value must also include the cost of re-investment in expired leases. This can be achieved by including a rate of CAPEX reinvestment similar to the year five rent payment outflow in the terminal value calculation.

Whilst this sounds simple, in practical terms this is a difficult process to avoid 'double counting'. You must examine when your current lease(s) expire. For instance:

- You have long term leases that extend beyond year five well into the terminal value period. This means that your ROU asset (and LL) already captures some cash flows that are in your terminal value period. Why? Because your ROU asset is the present value of all the future lease payments.
- You then also use the lease payment in the year five as the re-investment in the lease cost in the terminal value calculation.

A timeline of the example looks like this:



See the problem? There is an overlap of the same lease cash flows. The cash flows of the lease will be overstated by double counting those payments once in the ROU asset and secondly deducting them again in the terminal value calculation. To avoid this double count, we have seen two approaches:

1. Use the lease payment in the last forecast year as the re-investment in the lease cost for the terminal value calculation, but add back the PV of lease payments associated with leases that extend into the terminal value period. For instance, if your lease extends two years into the terminal value period then add back (as a positive) the PV of these two payments. A trap here is to make sure you calculate the PV of those two years at the discount rate used in the VIU calculation (i.e. not the ROU asset calculation which generally uses the lower incremental borrowing rate); or
2. Reduce the re-investment in the lease cost included in the terminal value calculation to reflect the impact of long term leases that have not expired (significant judgement required as to how to do this).

Of the two approaches, we think the first is easier to justify. The second approach requires judgement to 'back-solve' an adjusted rent amount to get to a similar result.

The example has not shown what happens when the lease expires before year five. If that happens, then you could assume:

- Another replacement ROU asset. If that lease then extends into the terminal value period, then use approach one above; or
- Outright asset purchase as CAPEX (in say year three). The purchase price to buy outright the market value of the asset (e.g. premises) will generally be quite high compared with a replacement ROU asset; or
- You could simply include the annual rental cash flows in years three to five as well as in the terminal value. This is the simplest approach and assumes that the entity will enter into 1 year rolling leases.

This is why we call this the lease 'hokey-pokey' as you are basically taking lease payments out of the cash flows during the ROU period and then putting them back in.

2. Should the WACC/discount rate be adjusted?

The objective of AASB16 is that lease debt is like any other debt. Therefore it is likely the discount rate will decrease as a result of an increase in cheaper LL debt in the entity's overall funding mix.

AASB 136 requires the use of a discount rate that investors would require and that reflects current market assessments of the time value of money and the risks specific to the asset. When an asset-specific rate is not directly available from the market, an entity uses surrogates to estimate the discount rate.

This is usually derived from the "Weighted Average Cost of Capital" (WACC). The 'weights' are the proportional mix of equity and debt. The costs are rates of return for equity and debt. In this way, if there is more 'weight' in cheaper debt, then the overall WACC decreases.

You can build the WACC 'bottom-up' from first principles using estimates for the cost of equity and debt. You can also reconcile the WACC by allocating a weighted average return on assets (WARA).

3. Should the lease liability be deducted from the VIU analysis?

When performing an impairment test of a CGU financial liabilities are normally ignored. The only exception to this rule is where the buyer would assume the liability (AASB 136.78). In the case of testing a ROU asset this means a judgement needs to be made as to whether a theoretical buyer would assume (take on) the lease liability. We think

that for premises that are critical to generating the cash flows (e.g. a shop), this will usually be the case. Therefore:

- If they would assume the LL, then deduct the LL from both the CGU and VIU; or
- If they wouldn't assume the LL then ignore in both the CGU and VIU.

Because the 'in or out' LL adjustment is made on both sides of the calculation, the impairment/headroom will be identical under either scenario. Take for instance a CGU with assets (excluding LL) of \$100 and a VIU calculation of \$90 (excluding LL). The impairment in this example is \$10 (ignoring FVLCD implications). If there is a LL of \$30 and a theoretical buyer would assume that liability, then the CGU and VIU calculation both decrease by \$30 and the impairment remains the same (CGU = \$70 and VIU = \$60). Therefore, assuming the buyer would take on the LL does not make the impairment of ROU assets go away!

Let's illustrate on these three problems above with Example 2 below:

- The terminal value of \$2,661 includes a re-investment in the lease at -\$58 per year as the asset is required to generate the cash flows. We assumed that the lease expired in year 5 so there was no 'overlap' or double count to add back.
- A reduction in the WACC/discount rate assumption from 12.9% to 12.1% as a result of the increased LL of \$241 in the funding mix. The 'bottom up' WACC calculation is not shown but reconciles to the shown WARA calculation.
- We deduct the LL of \$241 from the VIU as we assume the buyer would take on the LL.

Example 2

Factor	Actual FY19	Budget FY20	Forecast FY21	Forecast FY22	Forecast FY23	Forecast FY24	
Profit & Loss							
Revenue	\$ 1,000	\$ 1,030	\$ 1,082	\$ 1,146	\$ 1,192	\$ 1,228	
Revenue growth	100%	3%	5%	6%	4%	3%	
Cost of sales	-500	-515	-541	-573	-596	-614	
Gross margin	500	515	541	573	596	614	
Rent Expense	0	0	0	0	0	0	
Other Expenses	-300	-309	-318	-328	-338	-348	
EBITDA	200	206	222	245	258	266	
ROU amortisation	-46	-46	-46	-46	-46	-46	
Depreciation	-50	-50	-50	-50	-50	-49	
EBIT	104	110	126	149	162	171	
Lease interest	-13	-11	-9	-7	-4	-2	
Interest	-10	-9	-8	-7	-6	-5	
Tax	-27	-29	-33	-40	-44	-46	
NPAT	54	61	76	95	108	118	
Cashflow to NPV of CGU							
		FY20	FY21	FY22	FY23	FY24	Terminal value
Normalised EBITDA		206	222	245	258	266	
Working capital movements	10%	-3	-5	-6	-5	-4	
less CAPEX		-25				-25	5%
Net PRETAX cashflows to value (FCFF)		178	217	239	254	238	2,661
Discount period		0.5	1.5	2.5	3.5	4.5	5
PRE tax WACC Discount rate	12.1%	94%	84%	75%	67%	60%	57%
NPV VIU per DCF	\$ 2,347	\$ 168	\$ 183	\$ 180	\$ 170	\$ 142	\$ 1,504
Less PV lease liability	-\$ 241					TV to TEV	64%
NPV VIU per DCF with lease liab	\$ 2,107						
CGU asset values							
	Carrying value	Weight	Return	WARA			
Operating NWC	\$ 700 From balance sheet	50.3%	7.0%	3.5%			
Operating PP&E	\$ 200 From balance sheet	14.4%	5.0%	0.7%			
ROU asset	\$ 231 From lease calc / balance sheet	16.6%	5.0%	0.8%			
Goodwill	\$ 500 From balance sheet	36.0%		7.0%			
PV of lease liability	-\$ 241 From lease calc / balance sheet	n/a					
Book value of operating assets	\$ 1,391	100.0%		12.1%			
Head room (NPV less Book)	\$ 716						

Conclusion

AASB 16 Leases means careful adjustments to VIU impairment testing cash flows are required for ROU assets, LL and when to include or exclude rent payments. We hope our practical solutions above will help you in doing the lease hokey-pokey in those calculations.

The information contained in this article is for general guidance only and does not represent, nor intend to be advice. Our Audit and Corporate Finance can provide you with tailored advice if required.



Author: David Holland

National Head of Technical Accounting, Moore Stephens Australia

T +61 03 9909 7371

dholland@moorestephens.com.au

David has 20 years' experience in a variety of positions including, providing technical advice and training, corporate development and strategic planning. This experience also includes six years within BHP in strategic planning and development.



Author: Colin Prasad

Associate Director - Corporate Finance, Moore Stephens Victoria

T +61 3 9608 0213

cprasad@moorestephens.com.au

Colin is a specialist accountant in Corporate Finance at Moore Stephens with more than 25 years experience in audit, industry and commercial corporate advisory roles. He is also a CAANZ Business Valuation Specialist.

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