MFRS Hot Topics

Lease prepayments and impairment

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Welcome to MFRS Hot Topics - a publication from SJ Grant Thornton. This issue will provide guidance on impairment issues of lease prepayments.

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If an entity has entered into an operating lease and has prepaid some of the rentals (a lease prepayment), how should the lease prepayment be assessed for impairment?

Guidance

The operating lease prepayment asset should be considered for impairment in accordance with MFRS 136 Impairment of Assets. Accordingly:

- the entity should assess at each reporting date whether there is any indication that the lease prepayment is impaired (MFRS 136.8)
- if there is an indication of impairment, the entity determines the recoverable amount of the asset and records an impairment loss if the recoverable amount is less than carrying value (MFRS 136.59).

A lease prepayment does not usually generate cash flows independently of other assets. Accordingly, its recoverable amount will generally need to be assigned to a cash-generating unit (CGU) for the purpose of applying MFRS 136. If there is an indication of impairment, the recoverable amount is determined for the respective CGU (MFRS 136.66 and 67(b)). The impairment loss is applied first to any goodwill allocated to the CGU and then pro rata to the carrying amount of each asset in the group (including the lease prepayment) (MFRS 136.104).

Lease prepayments and the application of impairment model under MFRS 136

A lessee often makes an upfront payment to the lessor on entering into a lease. The upfront payment is sometimes referred to as a lease premium (particularly for leases of land and buildings). If the lease is classified as an operating lease in accordance with MFRS 117 Leases, the lease payments are recognised as an expense on a straight-line basis over the lease term (or another systematic basis if more representative of the time pattern of the user's benefit) (MFRS 117.33). Consequently the upfront lease payment is recorded on the statement of financial position as a prepayment asset. It should be noted that the land and buildings elements of a property lease are considered separately for lease classification purposes (MFRS 117.15A). This sometimes results in a property lease being classified as an operating lease of land and a finance lease of a building.

An upfront payment relating to a finance lease would reduce or eliminate the finance lease liability. There is therefore no need to consider whether the prepayment is impaired. Under finance lease accounting, the leased asset is recorded on the statement of financial position of the lessee. The leased asset is then within the scope of MFRS 136 for impairment purposes (MFRS 117.30).

In accordance with the normal straight-line expense pattern of MFRS 117, an operating lease prepayment is generally amortised to the income statement evenly over the term of the lease. Operating lease prepayments are within the scope of MFRS 136, which applies to all assets except those scoped out by MFRS 136.2-5. The prepayment is therefore written down to its recoverable amount if it becomes impaired.

A consequence of recording an impairment loss is that this deviates from the 'straight-lining' requirement of MFRS 117. Although this might seem to create a conflict, we consider that it is appropriate to deviate from straight-lining if the lessee does not expect to be able to recover the carrying amount of the prepayment. This is because:

- when MFRS 136 applies, its requirements must be applied in addition to the basic measurement principles of other standards that apply to the asset in question
- the straight-lining approach is also overridden when an operating lease becomes onerous (paragraph 5(c) of MFRS 137 Provisions, Contingent Liabilities and Contingent Assets).

Determining the recoverable amount of a lease prepayment

The recoverable amount is defined as the higher of fair value less costs of disposal and value in use (MFRS 136.6). When applying these concepts to a lease prepayment, it is important to note that the asset being assessed is the prepayment, not the underlying leased asset. Accordingly:

- the fair value of the prepayment reflects the amount the lessee could obtain by selling or transferring its leasehold interest. In situations when the lease is part-prepaid but also requires future lease payments, fair value would be reduced by this requirement
- the value in use reflects the present value of the future cash flows the lessee could obtain from its right to use the underlying asset over the remaining term of the lease. The future cash flows included in this estimate are reduced by any future lease payments to be made to the lessor.

In some circumstances, it might be possible to determine recoverable amount for the lease prepayment separately. In determining recoverable amount, a separate estimate must be made when it is possible to do so (MFRS 136.66). This would be the case when (for example):

- the lessee intends to transfer its rights under the lease to a third party in the near future (such that value in use is insignificant) or
- when the lessee has sub-let the asset to another party (such that the leasehold interest generates cash flows largely independently of other assets, and those cash flows are determinable).

More commonly, the lessee will generate cash flows from its rights under the lease in combination with other assets. Accordingly, the lease prepayment is assessed for impairment as part of the CGU to which it belongs (MFRS 136.66). When a lease of land and buildings is classified as a finance lease of a building and an operating lease of land, any prepayment relating to the land element is likely to be included in the same CGU as the building.

Example

An entity (the lessee) enters into a 20 year lease of land on 1 January X1. The lessee pays an upfront amount of CU40,000 to the lessor. No further lease payments are due. The lease is classified as an operating lease and the CU40,000 is therefore recorded as a prepayment. It is amortised to the income statement on a straight-line basis (resulting in an expense of CU2,000 each year). The lessee constructs a factory building and purchases plant and equipment at a total cost of CU60,000. Construction is completed on 31 December X5. The factory assets' estimated useful life is 15 years. Estimated residual value is zero. Depreciation is therefore charged on a straight-line basis at CU4,000 each year.

The leasehold interest in the land and the factory building and other assets are considered to be a single CGU for the purposes of MFRS 136. No goodwill is allocated to this CGU.

During 20X10 changes are made to applicable environmental regulations that are expected to significantly increase the ongoing operating costs of the factory. The entity considers this to be an indication of possible impairment.

Analysis

The entity has determined that the CGU might be impaired. It therefore determines the recoverable amount of the CGU. The total carrying value of the assets in the CGU at 31 December X10 is CU60,000 as follows:
- leasehold prepayment: CU20,000 (after deducting 10 years of amortisation of CU2,000 each year);
- factory assets: CU40,000 (after deducting 5 years of depreciation of CU4,000 each year).

If we assume that the recoverable amount is CU48,000, an impairment loss of CU12,000 is recorded in the income statement. This would be allocated pro-rata to the pre-impairment carrying amounts (CU4,000 to the leasehold prepayment and CU8,000 to the factory assets). Assuming there are no further impairments, the reduced carrying amounts (CU16,000 and 32,000 respectively) would form the basis for the future amortisation and depreciation charges.

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