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**International  
Accounting Standards  
Board**

*This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.*

*These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.*

## **INFORMATION FOR OBSERVERS**

**Board Meeting:** 25 May 2006, London

**Project:** Business Combinations II

**Subject:** Operating Leases (Agenda Paper 2D)

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## **INTRODUCTION**

1. The Business Combinations Exposure Draft (BC ED) proposes that assets and liabilities related to operating leases in which the acquiree is the lessee should be recognised as a net amount rather than separately recognised. The BC ED characterises the proposal as an exception to the combined recognition and measurement principle.<sup>1</sup> This paper asks the Boards to consider whether the proposed guidance is appropriate and how it should be characterised in the final business combinations standard (ie whether it is an *exception* to the recognition principle or only guidance on accounting for operating leases in a business combination).
2. This paper also asks the Boards to consider whether the final business combinations standard should provide additional guidance on:

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<sup>1</sup> The BC ED did not have separate recognition and measurement principles. The combined recognition and measurement principle was:

The identifiable assets acquired and liabilities assumed in a business combination should be recognised at their fair values on the date control is obtained.

- a. the accounting for operating leases in which the acquiree is the lessor.
- b. whether an operating lease at market terms can have a greater net value than zero.

## **BC ED PROPOSAL AND BOARDS' BASIS FOR THAT PROPOSAL**

3. The BC ED proposes the following guidance for leases of the acquiree:

### **Guidance for measuring and recognising particular assets acquired and liabilities assumed**

...

- 39 The acquirer shall account for the acquiree's operating leases in which the acquiree is the lessee in accordance with paragraph 47. For all other leases, the acquirer shall measure and recognise separately the asset and any related liability embodied in a lease at their acquisition-date fair values. After initial recognition, assets and liabilities related to leases shall be accounted for in accordance with [IAS 17/other generally accepted accounting principles].

...

### **Assets acquired and liabilities assumed that are not recognised at fair value as of the acquisition date**

...

- 47 If the acquiree is the lessee to an operating lease, the acquirer shall not recognise separately the asset and related liability embodied in the lease. If the acquiree is the lessor to an operating lease, the acquirer shall measure and recognise the asset subject to the operating lease at its acquisition-date fair value in accordance with paragraph 39. The acquirer shall also assess whether each of the acquiree's operating leases are at market terms as of the acquisition date, regardless of whether the acquiree is the lessee or lessor. If an operating lease is not at market terms as of the acquisition date, the acquirer shall recognise:
  - (a) an intangible asset if the terms of the operating lease are favourable relative to market terms.
  - (b) a liability if the terms of the operating lease are unfavourable relative to market terms.

4. The Boards discussed the accounting for an acquiree's operating leases at the following meetings:

- a. the FASB's 25 February 2004 Board meeting and

- b. the IASB's May 2004 Board meeting.
5. Paragraph 130 of the Basis for Conclusions of the IASB's BC ED describes the Boards' basis for the exception for operating leases as follows (see also paragraph B151 of the FASB's BC ED):

The [IASB] Board considered whether to require the recognition of the acquiree's rights related to its operating leases in which the acquiree is the lessee separately from its obligations. This would require, for example, recognition of an asset for an acquiree's rights to use assets according to the lease agreement, including related renewal options and other rights, and a liability for its obligations to make lease payments. Under IAS 17 *Leases*, these rights and obligations are not recognised as assets and liabilities. The [IASB] Board concluded that, because it is not prepared at this time to address how the asset and the liability for an operating lease would be accounted for after the acquisition date, consistency in lease accounting should take primacy over consistency in the application of the fair value measurement requirement in the draft revised IFRS 3. Therefore, the asset and the liability arising from an operating lease would not be recognised on a gross basis.

## **COMMENT LETTER RESPONSES**

6. Nearly all respondents who commented on the proposed guidance for operating leases agreed with the guidance. However, respondents requested that the Boards clarify:
- a. that the separate lease asset and related liability are not recognised because they are netted together.
  - b. whether the measurement attribute for the net asset or liability related to an acquiree's operating leases is fair value.
  - c. whether recognising a market-rate lease at an amount greater than zero would be permitted.
  - d. whether the guidance for operating leases also extends to other executory contracts.

7. The first three issues above either are addressed in this paper or will be addressed by the staff through drafting. The staff will bring an analysis of executory contracts back to a future meeting.

## **STAFF ANALYSIS AND RECOMMENDATIONS**

8. In March 2006 the Boards agreed that the following business combinations recognition principle should be used as a framework for redeliberations:

In a business combination, the acquirer recognises all of the assets acquired and all of the liabilities assumed.

9. The staff believes that without additional guidance different interpretations of the application of the recognition principle to an acquiree's operating leases might result. For example, constituents might interpret the recognition principle as requiring recognition of an intangible asset (liability) for the acquiree's interest in a net beneficial (onerous) contract and:
  - a. separate recognition of the assets and liabilities related to an acquiree's operating leases. For example, if the acquiree is the lessee of an operating lease, the acquirer would recognise a separate asset for the acquiree's rights to use assets according to the lease agreement, including related renewal options and other rights, and a separate liability for its obligations to make required lease payments.
  - b. no recognition of assets and liabilities related to an acquiree's operating leases because IAS 17 *Leases* and FASB Statement No. 13, *Accounting for Leases*, do not require separate recognition of assets and liabilities related to operating leases.
10. Therefore, the staff believes that guidance on accounting for an acquiree's operating leases is needed in the final business combinations standard to improve consistency in the application of the recognition principle to operating leases.

11. In this section, the staff analyses whether the BC ED guidance on operating leases in which the acquiree is the lessee is appropriate and whether additional guidance should be provided on:
  - a. the accounting for operating leases in which the acquiree is the lessor.
  - b. whether an operating lease at market terms can have a greater net value than zero.

The staff then addresses how the proposed guidance on operating leases should be characterised in the final business combinations standard.

### **Operating leases in which the acquiree is the lessee**

12. The BC ED proposes that for operating leases in which the acquiree is the lessee, the acquirer only would be required to recognise an intangible asset (liability) for the acquiree's interest in a net beneficial (onerous) contract, rather than being required to recognise separately an asset and related liability.
13. Without that guidance, the recognition principle might be interpreted as requiring the acquirer to recognise a separate asset for the acquiree's rights to use assets according to the lease agreement, including related renewal options and other rights, and a separate liability for its obligations to make required lease payments.
14. However, IAS 17 and Statement 13 preclude separate recognition of assets and liabilities related to a lessee's operating leases. If the business combinations standard required or allowed separate recognition of the asset and related liability, the Boards would need to address how the asset and liability should be accounted for after the acquisition date. This could imply developing a new model for operating lease accounting in the business combinations project. The staff does not believe that is appropriate, especially since the leases project team is in the process of developing an agenda proposal and plan for a joint project.
15. In addition, as noted above, virtually all respondents who commented on the proposed guidance for operating leases in which the acquiree is the lessee agreed with the guidance.

16. Therefore, the staff recommends that the Boards affirm the guidance proposed in the BC ED for operating leases in which the acquiree is the lessee.
17. *Do the Boards affirm the proposal in the BC ED that acquirers only should be required to recognise an intangible asset (liability) for the acquiree's interest in a net beneficial (onerous) contract, rather than being required to recognise separately an asset and related liability?*

### **Operating leases in which the acquiree is the lessor**

18. Paragraph 47 of the BC ED states:

If the acquiree is the lessor to an operating lease, the acquirer shall measure and recognise the asset subject to the operating lease at its acquisition-date fair value in accordance with paragraph 39. The acquirer shall also assess whether each of the acquiree's operating leases are at market terms as of the acquisition date, regardless of whether the acquiree is the lessee or lessor. If an operating lease is not at market terms as of the acquisition date, the acquirer shall recognise:

- (a) an intangible asset if the terms of the operating lease are favourable relative to market terms.
- (b) a liability if the terms of the operating lease are unfavourable relative to market terms.

19. The staff believes that final business combinations standard should clarify that the fair value of the asset subject to the operating lease is not affected by the terms of the operating lease contract associated with the asset. The fair value of the asset subject to the operating lease will reflect the effects of leasing the asset at market terms at the measurement date. The effects of the terms of the existing operating lease contract should be considered separately from the fair value measurement of the asset subject to the operating lease. If the lease is not at market terms, the lessor would recognise separately an intangible asset (beneficial contract) or liability (onerous contract). The staff is concerned that without this clarification some constituents might believe that the fair value of an asset subject to an onerous operating lease contract is lower than the fair value of the same asset leased at market terms.

20. *Do the Boards agree with the staff's proposed clarification?*

**Can an operating lease at market terms have a greater net value than zero?**

21. The BC ED guidance on operating leases describes only two types of assets and liabilities that might be recognised in relation to operating lease contracts:
- a. an intangible asset or liability if the terms of the operating lease are favourable or unfavourable relative to market terms and
  - b. the asset subject to an operating lease in which an acquirer is the lessor.
22. As noted above, respondents requested clarification on whether an operating lease at market terms may be recognised at an amount greater than zero. The question arose because of paragraph B173 of Statement 141:

...the [FASB] Board has been informed that in current practice, the amount assigned to acquired operating lease contracts (when the acquired enterprise is the lessor) and customer contracts often is based on the amount by which the contract terms are favorable relative to market prices at the date of acquisition. Thus, in some cases no amount is assigned to lease and other contracts that are “at the money”—that is, when the contract terms reflect market prices at the date of acquisition. *The Board observed, however, that such “at the money” contracts are bought and sold in exchange transactions—the purchase and sale of airport gates (an operating lease) within the airline industry and customer contracts in the home security industry are two examples of those exchange transactions. The Board believes that those transactions provide evidence that a contract may have value for reasons other than terms that are favorable relative to market prices. The Board therefore concluded that the amount by which the terms of a contract are favorable relative to market prices would not necessarily represent the fair value of that contract (emphasis added).*

23. The staff recommends that the final business combinations standard clarify, as described in the preceding paragraph, that operating lease contracts at market terms might have value for reasons other than terms that are favourable relative to market prices. For example, an operating lease contract might have value because an entity is willing to pay more than the market rate to gain entry into a market with limited access or to obtain access to existing customer relationships. In such circumstances the intangible asset to which that value is attributable should be recognised separately. That is to say, even if an acquirer’s operating

lease contract is at market terms, the acquirer still must recognise any intangible assets which create value in the at-market contract.

24. *Do the Boards agree with the staff's proposed clarification?*

**How should the guidance on operating leases be characterised in the final business combinations standard?**

25. As noted above, the BC ED characterises the proposal to recognise a net amount for assets and liabilities related to operating leases in which the acquiree is the lessee as an exception to the combined recognition and measurement principle. Some staff members believe that describing net recognition of an operating lease as an exception to the recognition principle prejudices the outcome of deliberations the Boards will have in the leasing project. That is, some Board members might be of the view that that an operating lease consists of rights and obligations and should be recognised as such. Other Board members might not agree with that view. Either way, that issue has yet to be discussed by the Boards. While the basis for conclusions might set forth Board members views on the appropriate accounting for leases, some think that the standards guidance should not be written in a way that appears to prejudge the outcome of another project.
26. As a result it is not clear to the staff whether the Boards agree with characterising the guidance for operating leases in IAS 17 and SFAS 13 as an exception to the recognition principle. If the Boards do not agree with characterising the guidance for operating leases as an exception to the recognition principle, then the staff would recommend incorporating guidance for recognising operating leases acquired in a business combination in the final standard, but characterising that guidance as additional application/implementation guidance.
27. *Do the Boards want to characterise the guidance related to operating leases as an exception to the recognition principle or as application/implementation guidance for operating leases?*