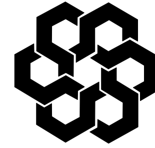

30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org Website: www.iasb.org

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:	**22 February 2007, London**
Project:	**Business Combinations II**
Subject:	**Assets acquired in a business combination that are subject to an operating lease to which the acquiree is the lessor (Agenda paper 2A)**

INTRODUCTION

1. In May 2006, the IASB and FASB discussed issues related to operating leases acquired or assumed in a business combination[1]. During the May meetings, both Boards affirmed the following provisions of the Business Combinations Exposure Draft (BC ED):

    a. The acquirer should recognise as a net amount rights and obligations related to an operating lease in which the acquiree is the lessee, rather than separately as an asset and a liability. The acquirer should recognise an intangible asset (liability) if the terms of the lease are favourable (unfavourable) relative to market terms at the acquisition date.

    b. An operating lease contract might have value for reasons other than terms that are favourable relative to market prices because of a related

[1] See IASB agenda paper 2D from the May 2006 meeting / FASB memorandum #20 from the 31 May 2006 meeting for further information.

intangible asset. If an at-market lease has an associated intangible asset, the acquirer should account for that intangible asset in the same manner as other intangible assets acquired in a business combination.

2. During the May meetings, a question was raised about the accounting for an operating lease in which the acquiree is the lessor. The question was whether the terms of an operating lease affect the fair value of the related asset. If so, any favourable or unfavourable terms of the operating lease relative to market terms at the acquisition date would be reflected in the fair value of the asset. If not, a separate asset or liability would be recognised for the fair value of the above or below market terms, respectively. The Boards requested the staff to consider this issue further.

3. This paper:

    a. discusses the guidance in the BC ED relating to the acquisition or assumption of operating leases in a business combination;

    b. discusses current US GAAP guidance and practice relating to this issue;

    c. discusses current IFRS guidance and practice relating to this issue; and

    d. explores alternatives in accounting for the above or below market terms of an operating lease of which the acquiree is the lessor.

4. The staff agrees that the above or below market terms of an operating lease should be recognised separately from goodwill. However, staff views are split on whether the above or below market value attributable to the lease should be aggregated with or recognised separately from the underlying asset.

    a. Some staff members believe accounting for the above or below market value of the operating lease separately from the related asset is appropriate because separate recognition results in accounting that better reflects the underlying economics in addition to providing better information to users (Alternative 1).

b. Other staff members believe the above or below market value of the lease should be reflected as part of the fair value of the related asset because the accounting reflects the unit of account inferred by the current leasing models under both IFRSs and US GAAP (Alternative 2). They also believe that the asset or liability recognised for the operating lease under Alternative 1 does not meet the definition of an asset or liability.

5. Given the ongoing project on leases (joint), fair value measurements (IASB), and the fair value option (FASB), the staff believe the Boards may wish to consider affirming current practice in their respective frameworks (Alternative 1 for US GAAP and Alternative 2 for IFRSs). The staff believes this difference would be convergent in principle because goodwill would not be affected regardless of which alternative is chosen because the two alternatives deal only with aggregation, and not valuation.

PROVISIONS OF THE BC ED

6. The BC ED proposes the following guidance for operating 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.

7. Paragraph A52 of the BC ED provides guidance on contract-based intangible assets, such as lease agreements:

> A52 Contract-based intangible assets represent the value of rights that arise from contractual arrangements. Customer contracts are one particular type of contract-based intangible asset. If the terms of a contract give rise to a liability (which might be the case if the terms of an operating lease or customer contract are unfavourable relative to market prices), that liability is recognised as a liability assumed. Examples of contract-based intangible assets are:
>
> […]
>
> (c) lease agreements (whether the acquiree is the lessee or lessor)

CURRENT PROVISIONS AND PRACTICE UNDER US GAAP

8. The provisions of FASB Statement No. 141, *Business Combinations*, are generally consistent with the provisions of the BC ED when the acquiree is a lessee. However, Statement 141 does not address situations in which the acquiree is a lessor under an operating lease. Statement 141 includes the following guidance on this issue:

> **Assets acquired and liabilities assumed, except goodwill**
>
> 37. The following is general guidance for assigning amounts to assets acquired and liabilities assumed, except goodwill:
>
> […]
>
> k. Other liabilities and commitments—such as unfavorable leases, contracts, and commitments and plant closing expense incident to the acquisition—at present values of amounts to be paid determined at appropriate current interest rates
>
> A10 Paragraph 39 states that an acquired intangible asset shall be recognized as an asset apart from goodwill if it arises from contractual or other legal rights (the contractual-legal criterion). Intangible assets that meet that criterion shall be recognized apart from goodwill even if the asset is not transferable or separable from the acquired entity or from other rights and obligations. For example:
>
> a. An acquired entity leases a manufacturing facility under an operating lease that has terms that are favorable relative to

> market prices.[2] The lease terms explicitly prohibit transfer of the lease (through either sale or sublease). The value arising from that operating lease contract is an intangible asset that meets the contractual-legal criterion for recognition apart from goodwill, even though the lease contract cannot be sold or otherwise transferred.
>
> […]
>
> A24 If the terms of a contract give rise to a liability or commitment (which might be the case if the terms of an operating lease or customer contract are unfavorable relative to market prices), that liability or commitment shall be recognized as required by paragraph 37(k) of this Statement.
>
> B173 The Board recognizes that the requirements in this Statement might change current practice with respect to the amounts assigned to some intangible assets, in particular those that arise from contractual or other legal rights. For example, the 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.

9. EITF Issue No. 01-3, 'Accounting in a Business Combination for Deferred Revenue of an Acquiree', discusses situations in which the balance sheet of an acquired entity immediately before the acquisition date includes deferred revenue. Although the topic of deferred revenue is not directly related to the issue discussed in this paper, Example 5 of Issue 01-3 illustrates the valuation of an asset acquired in a business combination that is subject to an operating lease in which the acquiree is the lessor.

[2] Footnote 28 of Statement 141 states that 'In some cases, the terms of an operating lease might be unfavorable relative to market prices. Paragraph 37(k) of this Statement states that a portion of the purchase price should be assigned to liabilities such as unfavorable leases.'

EXAMPLE OF BALANCE SHEET PRESENTATION

Example 5

> Company A owns a building having a 30-year remaining life. The building is fully leased to a single tenant under an operating lease with a three-year remaining life. That lease was fully prepaid at inception. Company B purchases Company A in a business combination. At the acquisition date, the fair value of the assumed lease obligation is estimated to be $1.5 million. *Absent that lease commitment, the building has a fair value of $30 million.* This example assumes that no other tangible or intangible assets were acquired in this transaction. [Emphasis added.]
>
> **Analysis:** Company B would separately recognize the acquired building as a balance sheet asset in the amount of $30 million and a liability in the amount of $1.5 million representing the fair value of the assumed lease obligation.

10. FASB Statement No. 157, *Fair Value Measurements,* provides guidance on measuring fair value. However, Statement 157 generally does not provide guidance on the unit of account:

> 6. A fair value measurement is for a particular asset or liability. Therefore, the measurement should consider attributes specific to the asset or liability, for example, the condition and/or location of the asset or liability and restrictions, if any, on the sale or use of the asset at the measurement date. The asset or liability might be a standalone asset or liability (for example, a financial instrument or an operating asset) or a group of assets and/or liabilities (for example, an asset group, a reporting unit, or a business). Whether the asset or liability is a standalone asset or liability or a group of assets and/or liabilities depends on its unit of account. The unit of account determines what is being measured by reference to the level at which the asset or liability is aggregated (or disaggregated) for purposes of applying other accounting pronouncements. *The unit of account for the asset or liability should be determined in accordance with the provisions of other accounting pronouncements*, except as provided in paragraph 27. [Emphasis added.]

11. The staff discussed the above guidance and current practice with a selection of audit firms and valuation consultants. Consistent with the guidance in Statement 141 and Issue 01-3, the staff understands that current practice under US GAAP values an asset that is subject to an operating lease based on market information. Favourable or unfavourable operating leases (in relation to current market terms) are separately valued and amortised over the remaining lease term.

12. It appears that the adoption of Statement 157 will not affect current practice on this issue. The issue discussed in this paper deals with unit of account and

Statement 157 only provides guidance on measuring fair value once the level of aggregation or disaggregation has been established.

CURRENT PROVISIONS AND PRACTICE UNDER IFRSs

13. IFRS 3 *Business Combinations* does not address directly whether the fair value of an asset acquired in a business combination is affected by the above or below market terms of an operating lease related to that asset. However, IFRS 3 does require intangible assets be recognised separately from goodwill if they arise from contractual or other legal rights or if they are separable. Section D of the illustrative examples to IFRS 3 indicates that lease agreements are contract-based intangible assets that are valued separately from goodwill.

14. IFRS 3 also requires an onerous contract be recognised as a liability separately from goodwill. B16 of IFRS 3 states:

> This IFRS requires an acquirer to recognise the acquiree's identifiable assets, liabilities and contingent liabilities that satisfy the relevant recognition criteria at their fair values at the acquisition date. For the purpose of allocating the cost of a business combination, the acquirer shall treat the following measures as fair values:
>
> […]
>
> (k) for onerous contracts and other identifiable liabilities of the acquiree the acquirer shall use the present values of amounts to be disbursed in settling the obligations determined at appropriate current interest rates.

15. Although IFRS 3 does not address directly the issue discussed in this paper, IAS 40 *Investment Property* does. Under IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, a reporting entity would establish a policy for addressing these circumstances in a business combination. This policy should consider relevant guidance in other IFRSs, which includes the following guidance from IAS 40:

> 38 The fair value of investment property shall reflect market conditions at the balance sheet date.
>
> […]
>
> 40 The fair value of investment property reflects, among other things, *rental income from current leases* and reasonable and supportable assumptions that represent what knowledgeable, willing parties would assume about rental income from future leases in the light of current conditions. […] [Emphasis added.]

[…]

45 The best evidence of fair value is given by current prices in an active market for similar property in the same location and condition and subject to similar lease and other contracts. An entity takes care to identify any differences in the nature, location or condition of the property, *or in the contractual terms of the leases* and other contracts relating to the property. [Emphasis added.]

46 In the absence of current prices in an active market of the kind described in paragraph 45, an entity considers information from a variety of sources, including:

(a) current prices in an active market for properties of different nature, condition or location (or subject to different lease or other contracts), adjusted to reflect those differences;

(b) recent prices of similar properties on less active markets, with adjustments to reflect any changes in economic conditions since the date of the transactions that occurred at those prices; and

(c) discounted cash flow projections based on reliable estimates of future cash flows, *supported by the terms of any existing lease* and other contracts and (when possible) by external evidence such as current market rents for similar properties in the same location and condition, and using discount rates that reflect current market assessments of the uncertainty in the amount and timing of the cash flows. [Emphasis added.]

16. The staff discussed current practice and the above guidance with a selection of audit firms and valuation consultants. Based on those conversations, the staff understands that current practice under IFRSs values an asset acquired in a business combination that is subject to an operating lease to which the acquiree is the lessor by considering the cash flows that market participants would generate given the nature, location, or condition of the asset and the contractual terms of the leases and other contracts relating to the asset. As such, practice under US GAAP and IFRSs is consistent in that it recognises the value of the operating lease separate from goodwill. However, US GAAP and IFRS are inconsistent in the manner they account for this value.

STAFF ANALYSIS AND RECOMMENDATION

17. The staff has considered the following alternatives regarding the valuation of an asset acquired in a business combination in which the acquiree is a lessor under an operating lease:

   a. *Alternative 1:* Reaffirm the provisions of the BC ED, thereby requiring the acquirer to measure and recognise an asset subject to an

operating lease at its acquisition date fair value without considering the terms of the operating lease (ie the acquirer accounts for the above or below market value of the lease separately). The acquirer would separately 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 would recognise an intangible asset (liability) separate from the asset subject to the operating lease if the terms of the operating lease are favourable (unfavourable) relative to market terms.

b. *Alternative 2:* Require the acquirer to measure and recognise the asset subject to an operating lease at its acquisition date fair value considering the nature, location, or condition of the asset and the contractual terms of the leases and other contracts relating to the asset. Under Alternative 2, the fair value of an acquired asset that is subject to an operating lease reflects the favourable or unfavourable terms of the operating lease and a separate asset or liability is not recognised.

Analysis of Alternative 1

18. Alternative 1 is consistent with current practice under US GAAP and is consistent with the provisions of the BC ED. Alternative 1 accounts for favourable or unfavourable operating leases acquired or assumed in a business combination consistently, regardless of whether the acquiree is a lessor or a lessee. Under Alternative 1, the intangible asset (liability) for the favourable (unfavourable) terms of the operating lease would presumably be released into profit or loss over the remaining lease term. Supporters of Alternative 1 argue that if the favourable or unfavourable terms were reflected in the fair value of the asset (as they would be under Alternative 2), they would be released into profit or loss as the asset was depreciated over its remaining useful life. That period might differ significantly from the remaining lease term. As such, supporters of Alternative 1 argue that it better reflects economic reality. Supporters of Alternative 1 also believe that separate recognition of the favourable or unfavourable portion of the operating lease provides better information to users of the financial reports.

19. Some would argue that the need to recognise debits or credits related to favourable or unfavourable leases results from deficiencies in IAS 17 *Leases* or FASB Statement No. 13, *Accounting for Leases.* Alternative 1 is consistent with the FASB's previous decision in this project to allow for the recognition of an intangible asset because of deficiencies in the underlying standards when an entity acquires insurance contracts. In that circumstance, the difference between the amount recognized under FASB Statement No. 60, *Accounting and Reporting by Insurance Entities,* and fair value is recognised as an intangible asset.

20. However, under Alternative 1 an asset is recognised if the terms of the lease are favourable, even though the favourable terms do not seem to give rise to an identifiable intangible asset. Similarly, a liability is recognised if the terms of the lease are unfavourable, even though the lease may not be onerous. Some might argue a debit for an above market lease or a credit for a below market lease that is not onerous fails to meet the definitions of an asset or a liability in either the IASB's *Framework for the Preparation and Presentation of Financial Statements* or FASB Concepts Statement No. 6, *Elements of Financial Statements.* While that might be true, supporters of Alternative 1 argue such credits or debits are attributes of the lease agreement and not attributes of the asset itself. As such, they argue they should not be recognised as part of the fair value of the asset.

21. The staff observes that Alternative 1 creates complications under IFRSs. Accounting for the favourable or unfavourable terms of the operating lease separate from the asset to which the lease relates would conflict with the guidance in IAS 40 noted above. If the IASB was to select Alternative 1 and the provisions of IAS 40 were not amended, a gain or loss might be recognised on day two when the investment property is remeasured at fair value in accordance with the provisions of that standard. If the IASB was to amend IAS 40, constituents might object given that there is an ongoing Fair Value Measurements project addressing the same guidance.

Analysis of Alternative 2

22. Alternative 2 is consistent with current practice under IFRSs, though it differs from the provisions of the BC ED. Supporters of Alternative 2 argue that because the current lease models under both IAS 17 and Statement 13 do not record

operating leases on the balance sheet, the fair value of the underlying asset is affected. In other words, they argue that the provisions of IAS 17 and Statement 13 establish the level of aggregation for accounting purposes and, because the leases are not separately recorded on the balance sheet, the favourable or unfavourable nature of the leases in force affects the value of the asset in the same way as it would affect any other restriction or enhancement.

23. Furthermore, supporters of Alternative 2 argue that the cash flows a market participant can generate from an asset are affected by the terms of the operating leases in force. They argue that market participants would consider the terms of leases when pricing the asset just as they would consider any other contractual enhancements or restrictions attached to the asset. This is analogous to contractual restrictions that relate to an asset, which, under paragraph 6 of Statement 157, would affect the fair value of the asset.

24. Some might argue that Alternative 2 results in inconsistent accounting for operating leases acquired or assumed in a business combination depending upon whether the acquiree is a lessor or a lessee. However, supporters of Alternative 2 think the apparent inconsistency reflects the different accounting by lessors and lessees for operating leases under IAS 17 and Statement 13. Those supporters think that because the lessor recognises the asset on its balance sheet, it is appropriate to reflect the operating lease's effect on the value of the asset together with the asset itself. Because the lessee does not recognise the asset, there is no alternative but to separately recognise an asset or liability for the value of the operating lease.

25. As noted above, Alternative 2 would result in an economic mismatch if the above or below market value of the operating lease was released into profit or loss over the remaining useful life of the related asset. However, in situations in which a fair value model is applied (eg as companies are permitted to do for investment property under IAS 40), changes in the fair value of the property would reflect changes in the underlying operating lease terms as they develop, thus avoiding a mismatch. Additionally, IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets* both require the depreciation or amortisation method that reflects the pattern in which the asset's future economic benefits are expected to be consumed by the entity. As such, under IFRSs it might be possible to adjust

the depreciation or amortisation method to reflect the timing of cash flows attributable to the underlying leases. US GAAP does not contain detailed guidance on depreciation methodologies. Furthermore, as current practice under both accounting frameworks is to generally apply a consistent and systematic depreciation or amortisation methodology (such as the straight-line method), Alternative 2 will likely result in a mismatch in situations in which a fair value model is not employed in periods subsequent to initial recognition.

Staff recommendation

26. Staff views are split on this issue. The staff agree with the underlying principle that the above or below market value of an operating lease should be recognised separately from goodwill. However, some staff members argue that Alternative 1 is appropriate because the value enhancement or detriment attributable to the lease is recognised separately from the related asset, which results in accounting that better reflects the underlying economics while providing better information to users of the financial reports.

27. Other staff members believe Alternative 2 is preferable because the accounting reflects the unit of account established by the current leasing models under both IFRSs and US GAAP and because the asset or liability recognised for the operating lease under Alternative 1 does not meet the definition of an asset or liability.

28. Given the differences in existing literature under US GAAP and IFRSs, the ongoing joint Leases project, the IASB's Fair Value Measurements project, and the second phase of the FASB's Fair Value Option project, the staff believes it might be appropriate to retain current practice in US GAAP (Alternative 1) and IFRSs (Alternative 2). The staff believes this difference would be convergent in principle because goodwill would not be affected regardless of which alternative is chosen because the two alternatives deal only with aggregation, and not valuation. Rather, the differences would develop only in periods subsequent to the business combination as a result of other existing literature in IFRSs and US GAAP.

Do the Boards prefer Alternative 1 or Alternative 2?

If the FASB was to select Alternative 1 and the IASB was to select Alternative 2, would the Boards accept the different positions on this issue since the measurement of goodwill would not be affected by selecting either alternative?