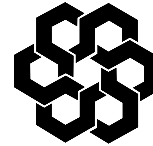

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International
Accounting Standards
Board

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:	**19 June 2007, London**
Project:	**Business Combinations II**
Subject:	**Accounting for the off-market value attributable to an operating lease in which the acquiree is a lessor (Agenda Paper 2)**

INTRODUCTION

1. In February 2007 the IASB and the FASB reached different conclusions on whether the off-market value attributable to an operating lease in which the acquiree is the lessor should be aggregated with or recognised separately from the underlying asset.

   a. The IASB tentatively decided that an acquirer should measure and recognise an asset subject to an operating lease at its acquisition date fair value considering the terms of leases in place at the acquisition date. As such, a separate asset or liability would not be recognised if the lease is favourable or unfavourable. The IASB observed that this conclusion is consistent with existing guidance in IAS 40 *Investment Property*. Given that the IASB is likely to consider this issue again in the Fair Value Measurements and Leases projects, the IASB tentatively decided not to deviate from the guidance in IAS 40.

   b. The FASB tentatively decided that the acquirer should measure and recognise an asset subject to an operating lease at its acquisition date fair value **without**

considering the terms of leases in place at the acquisition date. If the terms of the lease are favourable (unfavourable) relative to market terms at the acquisition date, the acquirer would recognise an intangible asset (liability) separately from the asset subject to the operating lease.

2. Because of this divergence, the boards discussed the issue again at the April 2007 joint meeting. At that meeting, the IASB decided to converge with the FASB on this issue.

3. While drafting the consequential amendments to IAS 40 to reflect the Board's decision, the staff identified a question regarding the application of the fair value model in periods after a business combination. Specifically, if an asset (liability) relating to the favourable (unfavourable) terms of an operating lease is recognised separately from the investment property at the acquisition date, how is the fair value of the investment property determined in periods after the combination?

STAFF ANALYSIS

4. IAS 40 includes the following relevant fair value measurement guidance:

> **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. […]
>
> 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.
>
> 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) […]
>
> (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.

50 In determining the fair value of investment property, an entity does not double-count assets or liabilities that are recognised as separate assets or liabilities. […]

5. The staff identified three possible options for measuring the fair value of an investment property in periods after a business combination if a separate asset (liability) was recognised at the acquisition date for the favourable (unfavourable) terms of an operating lease on that investment property:

   a. **Option 1:** Consistent with the provisions of IAS 40, measure the fair value of the investment property considering the cash flows from operating leases in place. However, in order to avoid double counting, this amount is adjusted by the current balance of the asset (liability) relating to the favourable (unfavourable) terms of an operating lease that was recognised separately at the acquisition date.

   b. **Option 2:** Measure the fair value of the investment property without considering the terms of any operating leases in place, even leases entered into after the acquisition.

   c. **Option 3:** Measure the fair value of the investment property without considering the terms of leases in place at the acquisition date. However, the entity does consider the terms of operating leases entered into or modified after the acquisition date.

6. Appendix A illustrates the differences between the three options and the current requirements of IAS 40.

7. The staff believes that only Option 1 is in compliance with the fair value measurement guidance currently in IAS 40. As such, the staff has drafted the consequential amendments to IAS 40 in a manner consistent with Option 1.

8. However, the staff observes that all three options result in different 'fair values' for investment property acquired in a business combination compared to property acquired outside of a business combination. This results in a situation where identical assets appear dissimilar depending on how the assets were acquired. In addition to adding complexity to financial reporting, the staff believes the lack of comparability is undesirable.

9. The staff reasons that this inconsistency could be addressed by amending IAS 40 so that the fair value of an investment property <u>never</u> reflects the terms of operating leases in

place. This would result in consistent fair value measurements regardless of how the investment property was acquired. However, the staff notes such an amendment would need to be exposed.

10. Alternatively, the Board could reconsider its April decision and affirm its tentative decision from February:

> An acquirer should measure and recognise an asset that is subject to an operating lease in which the acquiree is the lessor at its acquisition date fair value considering the terms of leases in place at the acquisition date. As such, a separate asset or liability would not be recognised if the lease is favourable or unfavourable.

11. With respect to the February decision, some Board members raised concerns about how an entity might recognise depreciation if they do not apply the fair value model or if the property is not an investment property. These Board members observed that if the asset is depreciated on a straight line basis, the favourable or unfavourable terms of the operating leases in place at the acquisition date would be recognised over the remaining life of the property, which would likely differ from the remaining term of the operating lease.

12. However, the staff notes this mismatch can be addressed by emphasising the requirements of paragraph 60 of IAS 16 *Property, Plant and Equipment*, that states 'the depreciation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity.'

STAFF RECOMMENDATION

13. The staff recommends that the Board reconsider its April 2007 decision and affirm its February 2007 decision. That is, the staff recommends that in a business combination an acquirer should measure and recognise an asset that is subject to an operating lease in which the acquiree is the lessor at its acquisition date fair value considering the terms of leases in place at the acquisition date. Therefore, a separate asset or liability would not be recognised if the lease is favourable or unfavourable. This conclusion is consistent with existing guidance in IAS 40. As such, this conclusion results in consistent fair value measurements for investment property acquired in and outside of a business combination.

14. Additionally, the staff recommends that the Board emphasise in the basis for conclusions that in situations where the acquired asset is not accounted for under a fair value model,

the depreciation or amortisation of that asset shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity. As such, the value attributable to the above (below) market terms of operating leases in place at the acquisition date should be amortised as a separate component over their expected period of benefit (detriment).

15. As discussed in Agenda Paper 2A from the February 2007 IASB meeting, the staff does not believe this recommendation results in divergence with the FASB because this guidance only affects the level of aggregation (ie the unit of account) and not the measurement of the assets acquired and liabilities assumed.

QUESTIONS FOR THE BOARD

16. Does the Board agree that in a business combination an acquirer should measure and recognise an asset that is subject to an operating lease in which the acquiree is the lessor at its acquisition date fair value considering the terms of leases in place at the acquisition date (ie a separate asset or liability would not be recognised if the lease is favourable or unfavourable)? That is, does the Board agree that it should reconsider its April 2007 decision and instead affirm its February 2007 decision?

17. If not, how should an entity measure the fair value of an investment property in periods after a business combination if a separate asset (liability) was recognised at the acquisition date for the favourable (unfavourable) terms of an operating lease on that investment property?

- **a. Option 1: Measure the fair value of the investment property considering the cash flows from operating leases in place. However, in order to avoid double counting, this amount is adjusted by the current balance of the asset (liability) relating to the favourable (unfavourable) terms of an operating lease that was recognised separately at the acquisition date.**
- **b. Option 2: Measure the fair value of the investment property without considering the terms of any operating leases in place, even leases entered into after the acquisition.**
- ***c.* Option 3: Measure the fair value of the investment property without considering the terms of leases in place at the acquisition date. However, the entity does consider the terms of operating leases entered into or modified after the acquisition date.**

APPENDIX A—ILLUSTRATIVE EXAMPLE OF OPTIONS 1, 2 AND 3 AND THE CURRENT REQUIREMENTS OF IAS 40

Company X acquires Company Y on 1/1/2007. Company Y has an investment building, one floor of which is subject to a favourable operating lease. The operating lease has a remaining term of five years. The acquisition date fair value of the building is CU50 without considering the terms of the operating lease. The fair value of the favourable operating lease is CU5.

After the acquisition, Company X leases another floor of the building (under an operating lease). At the date the lease is executed, it is at market terms. However, due to decreasing property values, the lease is considered above market at year end.

At 31/12/2007, the fair value of the building without considering the terms of the operating leases in place is CU46. The fair value of the building considering the terms of the operating leases in place is CU53. Management of Company X determines that the old lease still adds CU5 of additional value while the new lease adds CU2 of value.

The accounting under the three options would be as follows. For comparative purposes, the table below also shows how the investment property would be accounted for if it were acquired outside of a business combination at 1/1/2007 for a cost of CU55.

	Investment Property	Intangible asset	Combined value	Gain/loss on Invest. Prop.	Amortization expense	Net P&L impact
Acquisition date:						
If acquired in a bus com	50	5	55	0	0	0
If acquired in separately	55	0	55	0	0	0
At 31/12/2007:						
If acquired in a bus com (Option 1)	49	4	53	-1	-1	-2
If acquired in a bus com (Option 2)	46	4	50	-4	-1	-5
If acquired in a bus com (Option 3)	48	4	52	-2	-1	-3
If acquired in separately	53	0	53	-2	0	-2