Project **Leases**

Topic **Consequential amendments**

Purpose

1. The objective of this paper is to ask the Board's decisions on the issues identified by amending other IFRSs as a result of the proposed new leases requirements.

Accounting for operating leases under IFRS 3

2. Under IFRS 3 and Topic 805, *Business Combinations*, of the *FASB Accounting Standards Codification*™ the acquirer would not normally recognise assets or liabilities related to an operating lease in which the acquiree is the lessee. However, the acquirer will determine whether the terms of each operating lease in which the acquiree is the lessee are favourable or unfavourable. If the terms of an operating lease are favourable relative to market terms, the acquirer will recognise an intangible asset. The acquirer will recognise a liability if the terms are unfavourable relative to market terms.

3. Therefore, there are two questions to ask to the boards because under the proposed new leases requirements one leases model will be applied to all leases with no lease classification as either finance leases or operating leases:

   (a) what should IFRS 3 requires; and

   (b) whether adjustments to the carrying amount of the pre-existing intangible asset and/or the liability should be required.

New requirements in IFRS 3

4. Under the proposed new lessee accounting model, if the acquiree is the lessee, the acquiree will recognise a right-of-use asset and an obligation to pay rentals for all leases. Then, at the acquisition date, taking into account the terms of the lease, the acquirer would measure the acquisition-date fair value of that asset and liability.

5. The boards discussed whether to require the lessee to measure its right-of-use asset subsequently at fair value. However, the boards tentatively decided to subsequently measure the right-of-use asset on an amortised cost basis because they noted that determining fair value of the right-of-use asset after the inception of the lease may be difficult and costly for preparers.

6. When the boards discussed the measurement principle in the revised IFRS 3, it acknowledged that other standards required measurements that were other than fair value. However, the boards concluded that fair value is the most relevant attribute for assets acquired and liabilities assumed in a business combination. In addition, they noted that reporting the assets or liabilities of a newly acquired business using a mixture of their fair values at the date acquired and the acquirer’s historical costs or carrying amounts results in information that lacks consistency, understandability and usefulness.

7. Thus, the revised IFRS 3 set the general principle of initially measuring assets acquired and liabilities assumed at their fair values, thereby improving the relevance and comparability of the resulting information in a business combination.

8. The boards also concluded that application of that measurement principle should not impose undue incremental costs on entities. The staff note that the present value of lease payments discounted using the lessee’s incremental borrowing rate might be a reasonable approximation to fair value. This measurement is what most acquirers would use to determine the fair value of the right-of-use asset.

9. The staff think that carrying amounts that relate to transactions and events occurring before a business combination would not be relevant to users of the acquirer’s financial statements. Reporting assets and liabilities at a mixture of

some current exchange prices and some carry-forward book values can be misleading.

10. Therefore, the staff think that the measurement principle in the revised IFRS 3 should be applied to the lease assets and liabilities as well as other individual assets or liabilities of a newly acquired business. This would provide users with more useful information than using a mixture of fair values at the acquisition date and the acquirer's historical costs or carrying amounts.

Adjustments to the pre-existing intangible asset and/or the liability associated with acquired operating leases

11. The staff recommend requiring the acquirer/lessee to reverse a previously recognised intangible asset and/or liability and adjust retained earnings on the transition date related to an acquired operating lease in a business combination.

12. As from the effective date of the new leases requirements, the lease asset and liability would be presented in the acquiree/lessee's financial statements. At the acquisition date, taking into account the terms of the lease, the acquirer would measure the acquisition-date fair value of that asset and liability.

Question 1 – Amendment to IFRS 3
The staff recommend that the acquirer/lessee should eliminate a previously recognised intangible asset and/or liability, adjusting retained earnings associated with acquired operating leases on the transition date. Do the boards agree?

Accounting for investment property under IAS 40

13. The accounting for investment property under current IAS 40 is described in Appendix A. Investment properties (as currently defined in IAS 40) can be either owned by a reporting entity or held under a lease. That is, an investment property can be a leasehold interest in a property.

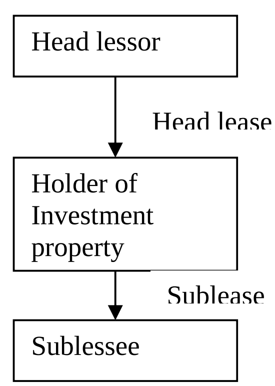
14. At the January 2010 joint meeting, the boards tentatively decided that the new lessor accounting requirements would be applied if the lessor measures its investment properties at cost. The IASB tentatively decided that if a lessor of

investment properties measures its investment properties at fair value in accordance with IAS 40 *Investment Property*, it would not apply the new lessor accounting requirements to the lease.

15. Because the FASB does not have an option to fair value investment properties, it instructed the staff to prepare an agenda request discussing whether to permit or require investment properties to be carried at fair value under US GAAP.

16. The staff has identified a number of issues to ask the boards regarding investment properties held under a lease under the proposed new leases requirements.

17. As it is possible to use investment property accounting for properties that are held by the lessor under a lease rather than owned outright, a right-of-use asset under the proposed new leases requirements could also potentially meet the definition of an investment property. If the investment property is held under a lease, there is a head lessor, a reporting entity acting as both a lessee and a lessor of the property and a sublessee (ie there is a head lease and a sub-lease).



18. Under the new leases requirements, the head lease will give rise to a right-of-use asset and to an obligation to pay rentals. If the intermediate lessor classifies the right-of-use asset as investment property held by the lessee, it would be required to choose either the cost model or the fair value model.

19. If the entity elects to use the fair value model, its investment properties are subsequently measured at fair value in accordance with IAS 40. Therefore, the new lease accounting requirements on subsequent measurement would not be

required. Gains and losses arising from changes in fair value are recognised in profit or loss in the period that they arise.

20. Under the proposed new leases requirements, the subsequent measurement of the right-of-use asset and the obligation to pay rentals would be on an amortised cost basis. However, if the right-of-use asset classified as investment property is measured at fair value, the staff think that changes to the obligation to pay rentals arising from changes in the lease term, or to estimated contingent rentals, should be recognised in profit or loss, not as adjustments to the carrying amount of the right-of-use asset.

21. If an entity elects to use the cost model, the new lessor accounting requirements would be required. Therefore, the requirement to subsequently measure the investment property at depreciated cost using the cost models in IAS 16 *Property, Plant and Equipment* under IAS 40 would be replaced with the new leases requirements.

22. The obligation to pay rentals would continue to be accounted for under the proposed new leases requirements. If the right-of-use asset is measured at cost, changes to the obligation to pay rentals should be accounted for under the proposed new leases requirements, that is:

    (a) changes in the obligation to pay rentals arising from changes in the lease term would be added to the carrying amount of the right-of-use asset

    (b) changes in the obligation to pay rentals arising from changes in amounts payable under contingent rental arrangements would be recognised in profit or loss if the changes arise from current or prior periods. All other changes would be recognised as an adjustment to the carrying amount of the right-of-use asset.

Question 2 – Intermediate Lessor Accounting under IAS 40
The staff recommend: (a) If an entity elects to use the fair value model, its right-of-use asset classified as an investment property is subsequently measured at fair value in accordance with IAS 40. Therefore, the new lessee accounting requirements on subsequent measurement would **not** be required.

> (b) If an entity elects to use the cost model, the new lessee accounting requirements for right-of-use assets would be required. Therefore, the requirement under IAS 40 to subsequently measure investment property at depreciated cost using the cost models in IAS 16 *Property, Plant and Equipment* would be replaced with the new lessee accounting requirements.
>
> (c) If the right-of-use asset is measured at fair value, the adjustments to the obligation to pay rentals arising from changes in the lease term or changes to estimated contingent rentals would be recognised in profit or loss.
>
> Do the boards agree?

Appendix A – Requirements of IAS 40 *Investment Property*

A2. This appendix summarises the accounting requirements of IAS 40 *Investment Property*.

A3. Investment property is defined in IAS 40 as:

> …property (land or building – or part of a building – or both) held … to earn rentals or for capital appreciation or both, rather than for: (a) use in production or supply of goods or services or for administration purposes; or (b) sale in the ordinary course of business.

A4. IAS 40 applies to individual properties. Consequently, it is possible for a reporting entity that is not an investment property company to hold investment property.

A5. The classification and disclosure requirements of IAS 17 apply to investment properties. However, leases of investment properties provided by lessors under operating leases are excluded from the measurement requirements of IAS 17. Instead, they are accounted for under IAS 40.

(a) Note: the proposed new leases requirements will no longer distinguish between operating and finance leases; therefore IAS 40 will need to be revised to reflect this change.

A6. Leases of investment properties provided by lessors under finance leases are deemed to be in-substance sales of the property. Consequently, they cannot be treated as investment properties. Instead, they are accounted for under IAS 17.

(a) Note: Transactions that are considered sales of the property will be excluded from the scope of the proposed new leases requirements.

A7. It is also possible to use investment property accounting for properties that are held by the lessor under a lease rather than owned outright.

A8. IAS 40 provides entities with a choice for subsequent measurement of the investment property. The holder of the investment property must choose either the cost model or the fair value model and apply it to all its investment properties (subject to some limited exceptions). The choice between the two models is an accounting policy choice. Changing between the two models is only permitted if the change would result in more relevant or reliable information. Paragraph 31 of IAS 40 states that it is highly unlikely that a change from the fair value model to the cost model would result in more relevant information.

A9. If an entity elects to use the fair value model, its investment properties are subsequently measured at fair value. Gains and losses arising from changes in fair value are recognised in profit or loss in the period that they arise.

A10. If an entity elects to use the cost model, the investment property is subsequently measured at depreciated cost (using the cost models in IAS 16 *Property, Plant and Equipment*). The fair value of investment properties held is disclosed.