Project **Fair Value Measurement**

Topic **Scope considerations regarding IAS 17 *Leases***

Purpose of this paper

1. This paper discusses the scope of the final IFRS on fair value measurement with reference to IAS 17 *Leases*.

2. This paper asks the Board to:

   (a) exclude IAS 17 from the scope of an IFRS on fair value measurement; and

   (b) retain the term 'fair value' in IAS 17 for practical reasons.

Overview of comments received on the IASB's exposure draft

3. The IASB's exposure draft *Fair Value Measurement* did not exclude IAS 17 from its scope.

4. The invitation to comment asked whether the Board should consider replacing the term 'fair value' in any context *other* than the proposed approach for IFRS 2 *Share-based Payment* (see Agenda Paper 3A) and IFRS 3 *Business Combinations* (see Agenda Paper 3C).

5. Some respondents think that IAS 17 should be excluded from the scope of an IFRS on fair value measurement. This is because they are concerned that the market in which the entry transaction took place might differ form the market in which the exit transaction would take place. This could have implications for lease classification.

6. They assert that the neutral ‘exchange amount’ notion in the current definition of fair value does not create an issue. This is because the current definition of fair value does not necessarily require that entities determine the price in the exit market.

Staff analysis and recommendation

Background

7. During its deliberations for the fair value measurement exposure draft, the Board noted that the principle underlying lease accounting is that a finance lease is equivalent to a purchase. This is because the entity should recognise the price that it would have paid to acquire the asset outright, or a lower amount if it was able to negotiate a better price (or if the lease term is shorter than the economic life of the asset). This implies an entry price, because the entity effectively has acquired an asset.

8. However, during the deliberations for the fair value measurement exposure draft, the Board concluded that an entity will generate cash flows either through the use of the leased asset in its business, or by sub-leasing the asset. In either case, the asset’s value is determined by an exit price. The Board therefore decided that when IAS 17 refers to fair value, it is consistent with the proposed fair value definition and guidance.[1]

9. As noted above, the comments received on the exposure draft indicate that this conclusion might result in practical challenges. As a result, this paper sets out some practical matters the Board needs to consider before deciding whether to include or exclude IAS 17 from the scope of an IFRS on fair value measurement. The practical considerations are set out as follows:

    (a) classification;

    (b) sale and leaseback transactions; and

[1] It is worth noting that IAS 17 does not contain any fair value measurement guidance other than providing the definition of fair value.

(c) the joint IASB/FASB project on lease accounting

Practical considerations for IAS 17: Classification

10. The Board's decision on whether to include IAS 17 in the scope of an IFRS on fair value measurement could influence the classification of leases. For example, paragraph 10(b) of IAS 17 states that a lease is normally a finance lease if the lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable. Following current practice, the 'fair value' of the asset in this situation would be determined based on the entry price (ie the price for which the asset could be acquired at that date).

11. However, if fair value is determined based on the exit price (ie the price for which the asset could be sold at that date), a lessee could reach a different conclusion about lease classification if it has different exit and entry markets. This is because the determination of whether the purchase option provides a bargain purchase (making it a finance lease) could depend on whether the lessee considers the entry market or the exit market.

Practical considerations for IAS 17: Sale and leaseback transactions

12. Paragraphs 61 to 63 of IAS 17 provide guidance for the recognition of immediate profits or losses when sale and leaseback transactions occur. For example, paragraph 61 of IAS 17 states:

> If a sale and leaseback transaction results in an operating lease, and it is clear that the transaction is established at fair value, any profit or loss shall be recognised immediately. If the sale price is below fair value, any profit or loss shall be recognised immediately except that, if the loss is compensated for by future lease payments at below market price, it shall be deferred and amortised in proportion to the lease payments over the period for which the asset is expected to be used. If the sale price is above fair value, the excess over fair value shall be deferred and amortised over the period for which the asset is expected to be used.

13. Currently, entities tend to consider the market in which they normally transact and the current use of the asset in determining the fair value. The timing and amount of immediate gains and losses for sale and leaseback transactions may be different when applying:

    (a) the highest and best use concept, to the extent that an asset's current use differs from its highest and best use; and

    (b) the principal market (or most advantageous market) notion, if they are different from the market in which the entity would normally transact.

14. Furthermore, applying the exit price notion in the proposed definition of fair value might affect the profit or loss recognition to the extent there are differences between the entry market and the exit market.

Practical considerations for IAS 17: Joint IASB/FASB project on lease accounting

15. The IASB, jointly with the FASB, is currently reviewing the leasing standard. The boards have tentatively decided that the future accounting model for leases will be based on the present value of expected lease payments, not on fair value.

16. If the Board decides that IAS 17 should remain within the scope of the final IFRS on fair value measurement, it would result in entities having to make significant changes to their systems, as described in the sections above. However, entities will be required to change their systems again once the final IFRS on lease accounting becomes effective. This will result in two changes in a short space of time for entities applying lease accounting.

Staff recommendation

17. The Board can exclude IAS 17 from the scope of the final IFRS on fair value measurement *or* the Board can decide to require entities to apply the fair value measurement guidance. These approaches are discussed in more detail below.

    (a) **Approach 1**: the Board can **exclude** IAS 17 from the scope of an IFRS on fair value measurement and make no amendments to the definition of fair value in IAS 17. This approach would result in IAS 17 using the term 'fair value' and retaining the current definition of fair value.

However, even though IAS 17 refers to fair value, it will not be subject to the measurement and disclosure requirements of an IFRS on fair value measurement.

(b) **Approach 2**: the Board can **exclude** IAS 17 from the scope of the IFRS and amend the definition of fair value in IAS 17. IAS 17 could define fair value as the price that would be *paid to buy* (instead of *received to sell*) an asset in an orderly transaction between market participants at the measurement date. The change in definition would clarify that entities should look at the entry price rather than the exit price. However, this approach would result in IAS 17 using the term 'fair value', but not being subject to the measurement and disclosure requirements of the final standard on fair value. IAS 17 also does not have guidance for the terms used in the definition (for example, orderly transaction and market participants).

(c) **Approach 3**: the Board could remove the term 'fair value' from IAS 17 and develop measurement guidance specific to IAS 17 to address the concerns raised. It is outside the scope of the fair value measurement project to develop such measurement guidance. The IASB and FASB have a project currently reviewing the accounting of leases. This approach could result in significant overlap with that project. The staff do not recommend this approach.

18. The staff recommend Approach 1 because of the practical considerations set out in paragraphs 10 to 16.

Question 1
Does the Board agree with the staff recommendation in paragraph 18? If not, why not, and what would the Board propose and why?