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STAFF PAPER

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Project	**Leases**		
Paper topic	Consequential amendments for business combinations and borrowing costs, and transition requirements		
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Purpose

1. This paper asks the boards three questions related to :

   (a) the consequential amendments to IFRS 3 *Business Combinations*/Topic 805 *Business Combinations* in the *FASB Accounting Standards Codification* ®,

   (b) the transition requirements related to IFRS 3 and Topic 805, and

   (c) the consequential amendments to IAS 23 *Borrowing Costs*/Topic 835 *Interest*.

Business combinations—consequential amendments

Introduction and staff recommendations

2. This section of the paper discusses the measurement of lease assets and lease liabilities recognised in a business combination and the consequential amendments to the business combinations guidance in IFRS 3 and Topic 805.

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3. For situations in which an acquiree is a lessee, the staff recommend that the acquirer measure the liability to make lease payments acquired in a business combination at the present value of future lease payments in accordance with the proposed leases guidance, as if the associated lease contract is a new lease at the acquisition date. The staff also recommend that the right-of-use asset be measured at the same amount as the liability to make lease payments in accordance with the proposed leases guidance, adjusted for any off-market terms present in the lease contract.

4. For situations in which an acquiree is a lessor and applies the receivable and residual approach, the staff recommend that the acquirer measure the right to receive lease payments (hereafter referred to as the 'lease receivable') acquired in a business combination at the present value of future lease payments in accordance with the proposed leases guidance, as if the associated lease contract is a new lease at the acquisition date. The staff also recommend that the residual asset be measured as the difference between the fair value of the underlying asset at the acquisition date and the carrying amount of the lease receivable.

5. For situations in which an acquiree is a lessor of investment property, and for situations in which an acquiree has short-term leases, the staff recommend that the acquirer apply the guidance in IFRS 3 and Topic 805 relating to operating leases.

6. This analysis addresses only the initial measurement of lease assets and liabilities in business combinations. Regardless of the approach to initial measurement, the subsequent measurement of any lease assets or lease liabilities acquired in a business combination should be accounted for in accordance with the proposed leases guidance.

Proposals in 2010 ED and feedback received

7. The ED proposes that lease assets and lease liabilities would be exempt from the fair value measurement requirements in the business combinations

guidance, and, instead, would be measured in accordance with the new leases standard as follows:

> If the acquiree is a lessee, the acquirer shall recognise a liability to make lease payments and a right-of-use asset for all leases in accordance with IFRS X. The liability to make lease payments and the right-of-use asset shall be measured at the present value of remaining lease payments, discounted using the acquirer's discount rate. Where there is a difference between the rate charged in the lease and market rates, the acquirer shall adjust the right-of-use asset to reflect the off-market rate of the lease.
>
> If the acquiree is a lessor, the acquirer shall: …..recognise a right to receive lease payments and derecognise the portion of the carrying amount of the underlying asset that represents the cost of the lessee's right to use the underlying asset during the term of the lease for all leases to which the acquirer applies the derecognition approach. The acquirer measures the right to receive rentals at the present value of the remaining lease payments discounted using the acquirer's discount rate and measures the residual asset at fair value.
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> After initial measurement, the acquirer shall apply the requirements of IFRS X to the lease assets and lease liabilities.

8. The ED did not ask a specific question on consequential amendments to the business combinations guidance and few letters received commented on the general approach to accounting for leases in business combinations. The following issues were mentioned in comment letters:

   (a) There is not enough guidance on accounting for leases in business combinations. The guidance in the IASB version was considered incomplete, and the FASB ED did not provide guidance on this issue.

   (b) Some respondents from the real estate industry assumed fair value of the right-of-use asset would be required, as for other intangible assets in a business combination, and asked for confirmation.

   (c) Several respondents asked about the accounting at transition for operating lease intangible assets from previous business combinations.

9. There were only a few comments that were specific to lessors, which noted the following:

(a) The ED requires fair value only of residual assets. It is not possible to measure the fair value of residual assets without measuring the fair value of the underlying asset.

(b) The ED mentions derecognition of the underlying asset but that is not a necessary step, as a portion of the asset would already be derecognised by the acquiree. The lessor has only to recognise a receivable and a residual asset.

10. Users of financial statements and private companies did not specifically comment on this issue.

Staff analysis

11. The staff think that it would be useful for the boards to reconsider the reasons for making an exception to the business combination measurement requirements for lease assets and lease liabilities, considering the feedback received and the revisions to the lease accounting model made during redeliberations.

Lessees

12. The staff think the boards have two alternatives to consider with regards to how to measure a lessee's lease assets and liabilities (ie the right-of-use asset and liability to make lease payments) in a business combination:

(a) Approach A: Measure the right-of-use asset and liability to make lease payments at the present value of the remaining lease payments, with an adjustment made to the right-of-use asset for any off-market terms (the approach proposed in the ED)

(b) Approach B: Measure both the right-of-use asset and the liability to make lease payments at fair value (the approach consistent with the measurement principle for business combinations).

Approach A: Measure the right-of-use asset and liability to make lease payments at the present value of the remaining lease payments, with an adjustment made to the right-of-use asset for any off-market terms

13. Under Approach A, an acquirer would measure any acquired right-of-use assets or liabilities to make lease payments in accordance with the proposed leases guidance; that is, these items would be measured at the present value of remaining lease payments, discounted using the acquirer's discount rate at the date of acquisition. Additionally, when there is a difference between the amount charged in the lease and market rates, the right-of-use asset would be adjusted for any off-market terms in the lease contract. This is the approach proposed in the ED.

14. Under this approach, the acquirer would measure a liability to make lease payments and a right-of-use asset acquired as a part of a business combination as if that asset and liability related to a new lease. That is, in order to calculate the liability to make lease payments to be recognised, the acquirer would need to determine the remaining lease term, the remaining lease payments and the discount rate at the acquisition date.

15. This approach has some advantages:

    (a) One could argue that it would achieve the benefits of fair value measurement without the related costs of fair value measurement by arriving at a net carrying amount for acquired lease contracts that closely approximates the fair value of that contract without undergoing the costs of obtaining a fair value for the individual right-of-use asset and liability to make lease payments.

    (b) It is consistent with the lessee model in the leases standard. The boards have, during redeliberations of the ED, tentatively decided against requiring measurement of lease assets or lease liabilities at fair value because it would be too onerous for lessees to measure variable lease payments and options in lease contracts.

(c) It is relatively simple to apply, and the off-market adjustment is consistent with current practice for operating leases.

(d) Even without requiring fair value, measuring a liability to make lease payments assumed in a business combination as if it were a new lease would result in a current value measurement because the discount rate would need to be updated to reflect conditions that exist at the acquisition date. This would provide more useful information than using the discount rate at lease commencement.

16. However, this approach also has disadvantages. The business combination literature in IFRSs and US GAAP is based on the premise that fair value provides the most relevant information in the case of business combinations. Given the boards' decisions to exclude particular variable lease payments and lease payments relating to options to renew from the lessee's liability to make lease payments, if a lease contract contained variable lease payments or options, it is unlikely that the carrying values of the right-of-use asset and the liability to make lease payments under this approach would be close to fair value. This approach would arguably be a step backwards for capital/finance leases today, which are required to be measured at fair value when acquired in a business combination. This decision would create an exception to the measurement principle in IFRS 3 and Topic 805 for all leases.

17. Moreover, respondents requested guidance regarding how to determine 'off-market rates'. The staff notes that this is not a defined term and there could be confusion and inconsistency in practice in determining how to identify and measure off-market rates. However, the staff also note that a similar concept exists in both IFRSs and US GAAP today within the business combinations guidance, which requires the calculation of an asset or liability relating to favourable or unfavourable terms in an acquired operating lease contract.

18. If the boards choose Approach A (measuring the liability to make lease payments and the right-of-use asset as the present value of the remaining lease payments, with the right-of-use asset being adjusted for any off-market rates),

the staff would recommend that the draft leases standard give additional guidance regarding the term 'off-market rate'. The staff is proposing two changes from the way this approach was presented in the ED:

(a) Refer to 'off-market terms' instead of 'off-market rates' to clarify that the difference could be in the actual amounts that are being paid and not only in rates (which could imply discount rate only)

(b) Further clarify the meaning by explaining that off-market terms would be measured as the difference between:

  (i) the present value of the remaining lease payments; and

  (ii) the present value of the lease payments that the acquirer would expect to pay if, at the acquisition date, it entered into an identical lease for the remaining period.

Approach B: Measure both the right-of-use asset and the liability to make lease payments at fair value

19. Under this approach, both the right-of-use asset and the liability to make lease payments would be measured at fair value.

20. The most significant advantage of this approach is that it would be consistent with the measurement principle in IFRS 3 and Topic 805 that assets acquired and liabilities assumed in a business combination be measured at their acquisition-date fair values. This approach would also be consistent with the current requirements for finance/capital leases. Therefore, one could argue that fair value would be more relevant and provide better information than the information produced by Approach A.

21. One could also argue that fair value information is even more relevant given the tentative decisions made by the boards regarding the measurement of variable lease payments and options; that is, following the leases model would result in carrying values for the right-of-use asset and liability to make lease payments that could be very different from their respective fair values, so it is

important to require measurement of those assets and liabilities at fair value in a business combination.

22. However, as discussed, the boards have tentatively decided to measure the right-of-use asset and liability to make lease payments at an amount different from fair value in the general leases guidance. Requiring fair value measurement in the case of business combinations would involve the significant cost associated with determining fair value in cases where lease contracts contain options and variable lease payments. Some however think that comparability with other assets and liabilities acquired in a business combination is more important.

Lessors—receivable and residual approach

23. Current guidance requires a lessor's assets acquired in a business combination to be measured at fair value regardless of whether the lessor has entered into a finance/capital or operating lease.

24. The ED proposed that, under the derecognition approach, lessors' residual assets acquired in a business combination should be measured at fair value, but that lease receivables should be measured at the present value of remaining lease payments, discounted using the acquirer's discount rate.

25. Some respondents mentioned the difficulty of determining fair value of the residual asset and suggested referring to the fair value of the underlying asset which is easier to obtain. They suggested that the residual asset is measured as the difference between the fair value of the underlying asset and the lease receivable recognised. Arguably, this would provide the most relevant information about the value of assets that are acquired in a business combination. Under this approach, the sum of the receivable and the residual asset will equal the fair value of the underlying asset, which is consistent with the fair value measurement principle for business combinations.

26. In addition, the measurement of the residual asset would include variable payments relating to the lease contract (eg performance-based payments not

recognised as part of the lease receivable). There is a risk that, without reference to the fair value of the underlying asset, some may only consider the fair value of the rights to the residual asset at the end of the lease term, excluding the rights to variable lease payments during the lease term otherwise not recognised.

27. Consequently, the staff think that it would be clearer if the business combinations guidance required the residual asset to be measured as the difference between the fair value of the underlying asset at the acquisition date and the lease receivable, measured at the present value of future lease payments.

28. The fair value of the underlying asset would take into account the lease contract, including any off-market terms present at the acquisition date. If it did not, the measurement of the residual asset would need to take into account any separate intangible assets representing the off-market terms.

Short-term leases and investment property lessors

29. The boards have decided that a lessee or lessor of short-term leases can choose to apply current operating lease accounting to such short-term leases. In addition, the boards decided that leases of investment property would be outside the scope of the receivable and residual approach and, thus, such lessors would continue to recognise the underlying investment property as they would under current operating lease accounting. Consequently, the staff recommend retaining the guidance currently included in IFRS 3 and Topic 805 about the acquisition of operating leases because it continues to be relevant for acquired investment property held under lease and short-term leases. That guidance addresses how to account for any favourable or unfavourable terms present in the lease contract.

Staff recommendations

Lessee

30. For situations in which the acquiree is a lessee, the staff recommend Approach A, ie that the boards reaffirm the approach in the ED to measure liabilities to make lease payments acquired in business combinations at the present value of the remaining lease payments, as if the acquired lease were a new lease at the date of acquisition. The staff further recommend measuring right-of-use assets equal to liabilities to make lease payments, with an adjustment for any off-market terms present in the lease contract. The off-market terms would be measured as the difference between the present value of the remaining lease payments, and the present value of the lease payments that the acquirer would expect to pay if, at the acquisition date, it entered into a lease of an identical lease for the remaining period.
31. Even though this would create an exception to the fair value measurement requirement, the staff think it is needed to avoid excessive costs related to the measurement of variable lease payments and options. The staff note that this approach should typically result in a net carrying amount for the lease contract that closely approximates the fair value of that net lease contract at acquisition.

Lessor

32. For situations in which the acquiree is a lessor and applies the receivable and residual approach, the staff recommend that the lease receivable should be measured at the present value of remaining lease payments, as if the acquired lease was a new lease at the acquisition date. The staff recommend that the residual asset should be measured as the difference between the fair value of the underlying asset at the acquisition date and the carrying amount of the lease receivable at that date. Again, although this approach would represent an exception to the measurement principle in the business combinations guidance, the staff note that this approach will result in the sum of the receivable and the

residual asset equalling the fair value of the underlying asset, which is consistent with the fair value measurement principle for business combinations.

Short-term leases and investment property lessors

33. For situations in which the acquiree is a lessor of an investment property or has short-term leases, the staff recommend that the acquirer apply the guidance in IFRS 3 and Topic 805 relating to acquired operating leases.

Question 1—Business Combinations—consequential amendments

The staff recommend that:

a) If the acquiree is a lessee, the acquirer should recognise a liability to make lease payments and a right-of-use asset. The acquirer should measure:
   (i) the liability to make lease payments at the present value of future lease payments in accordance with the proposed leases guidance, as if the associated lease contract is a new lease at the acquisition date, and
   (ii) the right-of-use asset equal to the liability to make lease payments, adjusted for any off-market terms in the lease contract.

b) If the acquiree is a lessor applying the receivable and residual approach, the acquirer should recognise a lease receivable and a residual asset. The acquirer should measure:
   (i) the lease receivable at the present value of the future lease payments in accordance with the proposed lease guidance, as if the lease was a new lease at the acquisition date; and
   (ii) the residual asset as the difference between the fair value of the underlying asset at the acquisition date and the carrying amount of the lease receivable.

c) If the acquiree is a lessor of investment property or if the acquiree has short-term leases, the acquirer should apply the guidance in IFRS 3 and Topic 805 relating to acquired operating leases.

Do the boards agree with the staff recommendations?

Business combinations—transition

34. This section of the paper discusses the transition issues related to business combinations.

Lessee

35. As discussed above, respondents to the ED requested that the leases standard contain transition guidance for previously recognised intangible assets or liabilities relating to favourable or unfavourable terms in an operating lease. Under current business combinations guidance, a lessee is required to recognise an intangible asset or liability relating to the favourable or unfavourable terms of any operating leases acquired. There is no such requirement for finance leases, as favourable or unfavourable terms would be reflected in the fair value measurement of the finance lease asset and liability.

36. Regarding this issue, the staff would recommend that, upon transition, a lessee with any previously recognised assets or liabilities related to favourable or unfavourable terms in acquired operating leases derecognise those assets or liabilities and adjust the carrying amount of the right-of-use asset by the amount of any asset or liability derecognised.

37. The staff recommend this approach because they do not think it is appropriate for a lessee to continue to recognise an intangible asset or liability relating to a favourable or unfavourable contract when there is an asset (the right-of-use asset) whose value is directly affected by that asset or liability. The only reason these assets and liabilities were recognised previously in a business combination was because, under previous operating lease accounting, the lessee did not recognise a lease asset (right-of-use asset) in which to reflect the value of a favourable or unfavourable contract. Moreover, if a lessee continued to recognise the intangible asset or liability, and accounted for the right-of-use asset and liability to make lease payments in accordance with the proposed leases guidance, this could result in double counting the effect of those

favourable or unfavourable terms if the right-of-use asset was impaired or revalued.

38. The staff recommend including this transition guidance in the draft leases standard, given respondents' request for guidance in this area.

Lessor

39. There is also a FASB-only issue related to transition. Under IFRS 3, an acquirer of any assets subject to operating leases in which an acquiree is the lessor is required to consider the terms of the operating leases when arriving at the fair value of that acquired asset. The staff do not think this should cause any transition problems. However, under Topic 825, an acquirer is required to measure the acquisition date fair value of such acquired assets separately from the lease contract and to record a separate asset or liability for favourable or unfavourable lease terms.

40. The staff do not think it is appropriate that such assets or liabilities related to favourable or unfavourable lease terms continue to be separately recognised. Those assets and liabilities would effectively be recognised as a part of the lease receivable under the proposed receivable and residual approach. Therefore, the staff would recommend that such assets or liabilities be treated as adjustments to retained earnings on transition.

Question 2—Business Combinations--transition
Do the boards agree that, upon transition, a lessee that previously recognised assets or liabilities related to favourable or unfavourable terms in acquired operating leases derecognise those assets or liabilities and adjust the carrying amount of the right-of-use asset by the amount of any asset or liability derecognised? Does the FASB agree that, upon transition, a lessor (applying the receivable and residual approach) that previously recognised assets or liabilities related to favourable or unfavourable terms in acquired operating leases derecognise those assets or liabilities and adjust retained earnings by the amount of any asset or liability derecognised?

Borrowing costs

42. The ED proposed removing finance charges in respect of finance leases from the scope of IAS 23 *Borrowing Costs*. Some respondents noted this and questioned if interest expense incurred under a lease could be capitalised, if appropriate, under IAS 23 and Topic 835 *Interest*.

43. The ED proposed removing finance lease charges from the scope of IAS 23 because the Board thought, at that time, that a right-of-use asset itself would never be a qualifying asset. A qualifying asset is defined in IAS 23 as 'an asset that necessarily takes a substantial period of time to get ready for its intended use or sale'. The Board concluded that a right-of-use asset would never take a substantial period of time to get ready for use since, by definition, it would be available for use at lease commencement. Consequently, the ED proposed removing finance lease charges from the scope of IAS 23 since there would be no point to include them.

44. However, the staff think that the boards should re-examine this proposal. The staff think that, in some cases, a right-of-use asset could be used to construct a qualifying asset (eg in the case of leasing a specialised piece of equipment solely to construct a building). Provided that the interest charges incurred in a

lease are 'directly attributable to the acquisition, construction or production of a qualifying asset.' (IAS 23 paragraph 10), the staff think it would be appropriate for the interest charges incurred on such a lease to be capitalised as appropriate under IAS 23 or Topic 825.

45. Constituents have provided the staff with some examples of equipment that is leased exclusively for the construction of one asset. These constituents request that the expense incurred in relation to these leases be allowed to be capitalised. The staff do not think it would be appropriate to disallow the capitalisation of the related interest charges on such leases simply because the lessee has decided to lease, rather than borrow the money to buy, that equipment. Moreover, the staff think that such capitalisation currently occurs under both finance and operating leases:

   (a) the finance charges in finance leases are explicitly allowed to be capitalised under IAS 23/Topic 825, and

   (b) the rent charges in operating leases could be capitalised following the guidance in IAS 16 *Property, Plant and Equipment*/Topic 360 *Property, Plant, and Equipment* if such charges are 'costs directly attributable to bringing [an] asset to the location and condition necessary for it to be capable of operating in the manner intended by management' (IAS 16 paragraph 16(b)).

46. The staff recommend that interest expense incurred in a lease be included in the scope of IAS 23/Topic 825.

Question 3—Borrowing costs
The staff recommend that interest expense incurred in a lease be included in the scope of IAS 23/Topic 825. Do the boards agree with the staff recommendation?