



Project **Leases**

Topic **Business Combinations–Topic 805 and IFRS 3**

Purpose

1. The purpose of this paper is to discuss the tentative decisions made by the FASB and the IASB regarding the recognition and measurement of the lease assets and liabilities in a business combination as it relates to the guidance on business combinations in Topic 805 of the *FASB Accounting Standards Codification*TM and IFRS 3, *Business Combinations*.
2. This paper is structured as follows:
 - (a) Background
 - (b) Question for the Boards.

Background

3. Consequential amendments to IFRS 3 were discussed at the April 2010 IASB Board meeting. The IASB tentatively decided that at the acquisition date, the acquirer would measure the acquired lease asset and liability in accordance with the proposed leases requirements. Fair value measurement at the acquisition date in accordance with IFRS 3 would not be required. That was because the Board had already tentatively decided that fair valuing the right-of-use asset would be difficult.

4. Consequential amendments to Topic 805 were discussed at the June 23, 2010 FASB meeting. The FASB also tentatively decided that at the acquisition date, all lease assets and liabilities in business combinations should be measured in accordance with the proposed leases requirements. The FASB further tentatively decided that an acquirer would measure those assets and liabilities as if the lease arrangement was a new lease arrangement.
5. Although the staff thinks that the Boards tentatively decided on similar requirements, it is unclear as to whether the IASB's decision would require a separate intangible to be recorded for off-market leases.

Summary of FASB Decisions

Lessee

6. Under the approach that the FASB tentatively decided on, if the acquired entity is a lessee, the acquirer would initially measure the right-of-use asset and the obligation to pay rentals as follows:
 - (a) The right-of-use asset would initially be measured at the present value of remaining lease payments reflecting the acquirer's discount rate. That would include the acquirer's estimate of any renewal options and contingencies.
 - (b) The measurement of the obligation to pay rentals would be at the present value of remaining lease payments reflecting the acquirer's discount rate.
 - (c) An intangible asset would be recorded if the acquirer's rate in the lease is less than the market rate (an intangible liability would be recorded if the rate in the lease is greater than the market rate). An illustration of how this intangible would be measured is included in paragraphs 8-10.
7. If the acquired entity is a lessee, the acquirer would subsequently measure the right-of-use asset and the obligation to pay rentals as follow:

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- (a) The right-of-use asset would be amortized over the remaining life of the lease term. Any renewal options and contingencies would be subsequently reassessed.
 - (b) The obligation to pay rentals would be amortized over the remaining life of the lease term as the obligation is relieved, including recognition of interest expense.
 - (c) The intangible asset (or liability), if recorded, also would be amortized over the remaining life of the lease term.
8. The staff considered the following example to illustrate the approach tentatively decided on by the FASB:

Lease Term	10 years
Acquired at	End of Year 6
IBR of acquirer	9%
Rent	\$50,000
Market Rent at acquisition	\$60,000
Options	None

9. The journal entries for the example in paragraph 8 on Day 1 would be as follows:

Day 1		
ROU Asset	161,986	
Lease Obligation		161,986
Intangible Lease Asset	32,397	
Goodwill		32,397

10. The journal entries for the example in paragraph 8, assuming straight-line amortization, on Day 2 would be as follows:

Day 2		
ROU Amortization	40,496	
ROU Asset		40,496
Lease Interest Expense	14,579	
Lease Obligation	35,421	
Cash		50,000
Intangible Amortization	8,099	
Intangible Lease Asset		8,099

Lessor – Performance Obligation Approach

11. If the acquired entity is a lessor under the performance obligation approach to lessor accounting, the acquirer would initially measure the right to receive rentals and the performance obligation as follows:
- (a) The right to receive rentals would initially be measured at the present value of the remaining rental payments reflecting the acquirer's discount rate.
 - (b) The performance obligation would be measured based on the present value of the right to receive rentals reflecting the acquirer's discount rate.
 - (c) An intangible asset would be recorded if the rate in the lease is greater than the market rate (an intangible liability would be recorded if the rate in the lease is less than the market rate). An illustration of how this intangible would be measured is included in paragraphs 13-15.
12. If the acquired entity is a lessor under the performance obligation approach to lessor accounting, the acquirer would subsequently measure the right to receive rentals and the performance obligation as follows:
- (a) The right to receive rentals would be amortized, and revenue recognized, over the remaining life of the lease term as payments are received, including recognition of interest income.

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- (b) The performance obligation would be amortized over the remaining life of the lease term as the obligation is satisfied.
 - (c) The intangible asset (or liability), if recorded, also would be amortized over the remaining life of the lease term.
13. The staff considered the following example to illustrate the approach tentatively decided on by the FASB:

Lease Term	10 years
Acquired at	End of Year 6
IBR of acquirer	9%
Rent	\$50,000
Market Rent at acquisition	\$60,000
Options	None

14. The journal entries for the example in paragraph 13 on Day 1 would be as follows:

Day 1		
Lease Receivable	161,986	
Performance Obligation		161,986
Goodwill	32,397	
Intangible Lease Liability		32,397

15. The journal entries for the example in paragraph 13, assuming straight-line amortization, on Day 2 would be as follows:

Day 2		
Performance Obligation	40,496	
Lease Revenue		40,496
Cash	50,000	
Lease Interest Income		14,579
Receivable		35,421
Intangible Lease Liability	8,099	
Intangible Lease Liability Amortization		8,099

Question 1

Do the Boards agree with the staff analysis (based on the FASB's tentative decisions) regarding the recognition and measurement of lease assets and lease liabilities in a business combination for lessees and lessors under the performance obligation approach to lessor accounting? If not, what approach would you support and why?

Lessor —Derecognition Approach

16. Because the FASB had tentatively decided to apply the performance obligation approach to all lessors, the derecognition approach to lessor accounting was not discussed at the June 23, 2010 FASB meeting. However, because both the IASB and FASB have tentatively decided to pursue a hybrid approach to lessor accounting, the accounting for lease assets and liabilities in a business combination under the derecognition approach to lessor accounting is discussed in paragraphs 17-21.
17. If the acquired entity is a lessor under the derecognition approach to lessor accounting, under the approach tentatively decided on by the FASB, the acquirer would initially measure the right to receive rentals at the present value of the remaining lease payments reflecting the acquirer's discount rate. An intangible asset would be recorded if the rate in the lease is greater than the market rate (an intangible liability would be recorded if the rate in the lease is less than the market rate). The residual asset would be measured in accordance with Topic 805 or IFRS 3.
18. If the acquired entity is a lessor under the derecognition approach to lessor accounting, the acquirer would subsequently measure the right to receive rentals amortized over the remaining life of the lease term as payments are received, including recognition of interest income. The intangible asset (or liability), if recorded, also would be amortized over the remaining lease term.
19. The staff considered the following example to illustrate the recognition and measurement of lease assets and lease liabilities in a business combination for lessors under the derecognition approach to lessor accounting:

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Lease Term	10 years
Acquired at	End of Year 6
IBR of acquirer	9%
Rent	\$50,000
Market Rent at acquisition	\$60,000
Options	None

20. The journal entries for the example in paragraph 19 on Day 1 would be as follows:

Day 1		
Lease Receivable	161,986	
Goodwill		129,589
Intangible Lease Liability		32,397

21. The journal entries for the example in paragraph 19, assuming straight-line amortization, on Day 2 would be as follows:

Day 2		
Cash	50,000	
Lease Interest Income		14,579
Receivable		35,421
Intangible Lease Liability	8,099	
Intangible Lease Liability Amortization		8,099

Question 2

Question 2 – Do the Boards agree with the staff analysis (based on the FASB's tentative decisions) for the derecognition approach to lessor accounting? If not, why not?