IFRS 3 and IFRS 16: Accounting for Acquired Leases in an Asset Acquisition

Extract, IFRS® Discussion Group Report on the Meeting – May 27, 2020

IFRS 3 *Business Combinations* provides guidance for leases acquired in a business combination. An acquirer is required to recognize right-of-use (ROU) assets and lease liabilities in which the acquiree is the lessee. The acquirer is required to measure the lease liability at the present value of the remaining lease payments as if the lease were a new lease at the acquisition. The ROU asset is measured at the same amount as the lease liability, adjusted to reflect favourable or unfavourable terms of the lease when compared with market returns.

However, IFRS 3 excludes from its scope an acquisition of an asset or a group of assets that does not constitute a business. Paragraph 2(b) of IFRS 3 states, in part, that:

> the acquirer shall identify and recognise the individual identifiable assets acquired (including those assets that meet the definition of, and recognition criteria for, *intangible assets* in IAS 38 *Intangible Assets*) and liabilities assumed. The cost of the group shall be allocated to the individual identifiable assets and liabilities on the basis of their relative *fair values* at the date of purchase. Such a transaction or event does not give rise to goodwill.

The Group discussed how an acquirer should account for acquired leases in an asset acquisition.

Fact Pattern

- On January 1, 2020, Entity A acquires 100 per cent of the shares in Entity B in exchange for cash. Entity B leases a building. The transaction does not qualify as a business combination under IFRS 3 and, therefore, is an asset acquisition.
- Entity B entered into the lease agreement on January 1, 2018. Under the lease terms, Entity B agreed to lease the building for a non-cancellable five-year term in exchange for fixed monthly lease payments. The lease has a renewal option for an additional three years, at fixed prices as stipulated in the lease. At the lease commencement date, Entity B determined that it is not reasonably certain it will exercise the renewal option and concluded the lease term is five years.
- At the acquisition date, Entity A (acquirer) determines that the agreement for the rental of the building meets the definition of a lease in accordance with IFRS 16 *Leases*. Entity A also assesses that it is reasonably certain to exercise the renewal option.

Issue 1: How should the acquirer measure the ROU asset and lease liability at the acquisition date of January 1, 2020?

View 1A – Measure the ROU asset and lease liability on a relative fair value basis.

Proponents of this view consider that the ROU asset and lease liability should be measured on a relative fair value basis in accordance with paragraph 2(b) of IFRS 3.

The fair value of the lease liability would reflect market participant assumptions, which may differ from those of the acquirer. As a result, the lease liability and the corresponding ROU asset may not be the same as the amounts determined under IFRS 16 at the date of acquisition.

View 1B – Measure the ROU asset and lease liability by applying IFRS 3 and IFRS 16.

Under this view, guidance in IFRS 3 for leases acquired in a business combination and in IFRS 16 is considered more appropriate in accounting for leases acquired in an asset acquisition because the standard provides an exception to the general recognition and measurement principle in IFRS 3 for leases acquired in a business combination.

Proponents of this view look toward the IFRS Interpretations Committee's November 2017 agenda decision on "Acquisition of a Group of Assets." The agenda decision outlines two possible approaches when the purchase cost is different from the sum of the fair values of the identifiable assets and liabilities acquired. Under both approaches, when an asset or liability is measured under the relevant IFRS Standard at an amount other than cost, it is measured at such amount and not at its relative fair value. For example, a financial instrument is initially measured at fair value under IFRS 9 *Financial Instruments* and not its relative fair value in an asset acquisition.

Proponents of this view note that IFRS 16 does not use cost as a measurement basis, but rather requires the lease liability to be measured at the present value of the lease payments over the lease term. Although the ROU asset is measured at cost in accordance with paragraph 23 of IFRS 16, the starting point in measuring the asset is based on the initial measurement of the lease liability. As a result, proponents of this view think that the ROU asset and lease liability are measured at an amount other than cost and, therefore, should be measured in accordance with IFRS 3 and IFRS 16.

View 1C – Measure the lease liability by applying IFRS 3 and IFRS 16 and measure the ROU asset on a relative fair value basis.

This view is similar to View 1B, except that since the measurement basis of the ROU asset is at cost based on paragraph 23 of IFRS 16, paragraph 2(b) of IFRS 3 would apply such that the cost of the ROU asset is measured using a relative fair value basis at the date of purchase.

The Group's Discussion

Group members thought that all three views presented have some merit given the lack of specific guidance in IFRS 3 regarding the measurement of ROU assets and lease liabilities for asset acquisitions.

Some Group members preferred View 1B and the second approach outlined in the November 2017 IFRIC Agenda Decision. Under that approach, the entity would initially measure the ROU asset and the lease liability applying IFRS 3 and IFRS 16. The entity then deducts these amounts from the transaction price of the asset group and allocates the residual transaction price to the remaining identifiable assets and liabilities based on their relative fair values at the date of the acquisition. These Group members thought the measurement of the ROU asset and lease liability using this approach aligns with IFRS 16 and thus more intuitive. One Group member observed that under

View 1A, the relative fair value approach uses market participant assumptions that could differ from those of the acquirer, resulting in a lease liability and the ROU asset that do not reflect the cash payments the acquirer is obligated to make under the lease. Another Group member thought that the lease liability measured using the cash payments required under the lease provides more relevant information to financial statement users. This Group member also thought that measurement of the corresponding ROU asset should reflect the value of the asset acquired.

One Group member commented that the acquirer should disclose in the financial statements which approach they have used, given that the measurement of these assets and liabilities could differ significantly dependent on which approach is applied.

Issue 2: Assuming View 1A in Issue 1 applies, is the acquirer required to make an adjustment to the ROU asset and lease liability to comply with the measurement principles in IFRS 3 and IFRS 16 immediately after the acquisition date?

One potential view is that if an adjustment is required after the acquisition date, it seems to contradict the purpose of paragraph 2(b) of IFRS 3. This paragraph is intended to measure identifiable assets and liabilities based on their relative fair values at the date of purchase. Therefore, the relative fair value amount can be viewed as the starting point or "deemed cost" for purposes of applying IFRS 16 for the ROU asset and lease liability such that after the acquisition date, no adjustment to amount initially recognized is required.

The Group's Discussion

Several Group members commented that this issue highlights various complex challenges when applying View 1A in Issue 1, as opposed to View 1B and the second approach outlined in the November 2017 IFRIC Agenda Decision. To illustrate, one Group member contemplated a scenario where a market participant would assume the lease will be renewed, which may differ from the acquirer's assumption. Under the relative fair value approach, the entity will incorporate the market participants' assumption and include the renewal period in the lease term. As a result, the initial measurements of the lease liability and the ROU asset can be considerably larger than those under IFRS 16. This Group member observed that this difference in measurement can cause complexity in the acquirer's subsequent measurement of the ROU asset and the lease liability following IFRS 16.

Issue 3: Assuming Views 1B or 1C in Issue 1 applies, is the acquirer required to reassess the assumptions used to measure the lease liability at the acquisition date based on the requirements in IFRS 16?

One potential view is to reassess the assumptions based on considering the requirements in paragraph 28B in IFRS 3 for leases acquired in a business combination. This paragraph states, in part, that "the acquirer shall measure the lease liability at the present value of the remaining lease payments (as defined in IFRS 16) as if the acquired lease were a new lease at the acquisition date." Proponents of this view think that this paragraph suggests an acquired lease should be treated as a new lease at the acquisition date and, therefore, the acquirer would need to reassess the assumptions, as well as the lease term, to measure the lease liability and ROU asset.

The Group's Discussion

Group members agreed with the above analysis.

Overall, Group members observed that the new definition of a business in IFRS 3 may result in more acquisitions being classified as asset acquisitions. Given the lack of guidance on asset acquisitions in IFRS 3, Group members thought some standard setting on asset acquisition accounting may be necessary. Therefore, the Group recommended that the AcSB consider suggesting that this topic be considered by the IASB as part of its 2020 Agenda Consultation or referring to the IFRS Interpretations Committee as a follow up to the November 2017 Agenda Decision.

(For a full understanding of the discussions and views expressed, listen to the audio clip).