IFRS 3 and IFRS 16: Accounting for Acquired Leases in a Business Combination

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IFRS 3 *Business Combinations* provides guidance for leases acquired in a business combination. An acquirer is required to recognize right-of-use assets and lease liabilities in which the acquiree is the lessee.

Before IFRS 16 *Leases* was issued, paragraph 17 of IFRS 3 provided a classification exception. Under such exception, the classification of a lease as operating or finance in accordance with IAS 17 *Leases* was based on contract terms and other factors at the inception of the contract. However, there were no measurement exceptions and as such, leases were recognized at fair value.

After IFRS 16 was issued, paragraph 17 of IFRS 3 was amended to clarify that the classification exception only applies to a lease in which the acquiree is the lessor. For a lease in which the acquiree is the lessee, IFRS 3 was amended to include paragraphs 28A and 28B, which is an exception to the recognition and measurement principles in IFRS 3 for right-of-use assets and lease liabilities. The Group will discuss this recognition and measurement exception in IFRS 3.

Fact Pattern

- Entity A acquires 100 per cent of the shares in Entity S. Entity S is a lessee.
- Upon adoption of IFRS 16, Entity S elected to grandfather the assessment of whether contracts meet the definition of a lease under IAS 17 and IFRIC 4 *Determining Whether an Arrangement Contains a Lease*. Entity A had also elected to grandfather this assessment.
- Entity S has some contracts that are currently accounted for as leases because of the assessments made under IFRIC 4 that would not meet the definition of a lease under IFRS 16.
- Entity S leases a manufacturing facility in a location critical to supplying one of their customers and had concluded that it is reasonably certain of extending the renewal period for an additional five years. Entity A also has a manufacturing facility in that location with additional capacity. If Entity A were to assess Entity S's lease, it would not be reasonably certain of exercising the renewal option.
- For real estate contracts, Entity A had elected not to combine lease and non-lease components for these contracts in which it is the lessee upon adoption of IFRS 16. However, Entity S had elected to combine lease and non-lease components for leases of this class of underlying asset.

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Issue 1: At the date of acquisition, does Entity A need to assess whether the contracts acquired meet the definition of a lease under IFRS 16?

View 1A – Yes, Entity A needs to assess the contracts under IFRS 16.

Paragraph 11 of IFRS 3 indicates that, at the acquisition date, an acquirer recognizes identifiable assets acquired and liabilities assumed that meet the definitions of assets and liabilities. Furthermore, paragraph 15 of IFRS 3 indicates that the acquirer classifies and designates assets acquired and liabilities assumed based on contractual terms, economic conditions, and the acquirer's own accounting policies as they exist at the acquisition date. Therefore, under this view, if a contract does not meet the definition of a lease at the date of acquisition, the contract may be accounted for as an executory contract.

Proponents of this view also consider guidance in paragraph D9 of IFRS 1 *First-time Adoption of International Financial Reporting Standards.* This paragraph indicates that a first-time adopter assesses whether a contract contains a lease based on facts and circumstances at transition date, not at contract inception date. Proponents of this view would find it inconsistent to require different accounting between the acquisition of a non-IFRS entity that is adopting IFRS Standards and the acquisition of an entity that already reports under IFRS Standards.

View 1B – No, Entity A can retain the Entity S's assessment (i.e., rely on the assessment under IAS 17 and IFRIC 4 that has been grandfathered into Entity S's financial statements under IFRS 16)

Proponents of this view think that Entity A would not be permitted to reconsider whether the contract is a lease absent a modification to the contract on acquisition. By retaining the acquiree's assessment of whether a contract is a lease, Entity A is recognizing the existing identifiable assets and liabilities of the acquiree as required by paragraph 10 of IFRS 3.

View 1C – There is an accounting policy choice.

Proponents of this view think that IFRS Standards have no explicit guidance and therefore, Views 1A or 1B are considered appropriate and should be applied consistently.

The Group's Discussion

Group members agreed with View 1A. They thought the guidance in paragraph 28B of IFRS 3 is clear that the acquirer shall treat acquired leases as a new lease at the acquisition date in accordance with IFRS 16.

While supporting View 1A, Group members highlighted several practical challenges that the acquirer faces when assessing lease contracts in a business combination. Some Group members observed that it is often challenging for the acquirer to finish the process of reassessing the acquiree's contracts for potential leases during the reporting period in which the acquisition is completed. This is especially the case when the acquirer is unfamiliar with the acquiree's business or when the information is not immediately available to the acquirer to make proper assessments.

A representative from the Canadian Securities Administrators commented that the time constraint is even greater when the acquirer is preparing pro-forma financial statements in a prospectus. It may

be challenging for the acquirer to complete the required lease assessment for all the acquiree's contracts in such a short time frame. Considering this constraint, the acquirer should disclose in the pro-forma financial statements the key assumptions made for the lease assessments and the calculation of the right-of-use assets and lease liabilities. Such information can be valuable for financial statement users.

A few Group members acknowledged that the one-year measurement period can provide some relief for the acquirer. However, they thought that the practical challenges the Group noted may still remain when considering the additional time required to implement IFRS 16 to new leases identified.

One Group member commented on the additional rationale provided for View 1A being an analogy to IFRS 1. This Group member believed that such an analogy is not appropriate because IFRS 1 is used when an entity is first adopting the IFRS framework, which is different from paragraph 28B of IFRS 3 which provides an exception to the measurement principles of IFRS 3.

Issue 2: When Entity A recognizes the acquired manufacturing plant lease for which it is a lessee, should the lease term established by Entity S be used, or should Entity A reassess the lease term?

View 2A – Entity A should reassess the lease term based on its own perspective.

Paragraph 28B of IFRS 3 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."

Based on this paragraph, proponents of this view think that the acquirer (i.e., Entity A) should determine what is the appropriate term of the lease to which it has become a party. Entity A acquired a new lease as a result of the acquisition. Accordingly, the lease term should be reassessed from the acquirer's perspective.

Proponents of this view also think that a market participant's view is not relevant (i.e., View 2B) because the lease term is determined using the principles in IFRS 16. This determination is based on an entity's own assessment of whether the lease is reasonably certain to renew. This is different from determining the fair value adjustment for the lease, because the fair value would be determined from a market participant's perspective.

View 2B – Entity A should reassess the lease term but using a market participant's perspective.

This view is similar to View 2A, except that the reassessment is based on a market participant's assessment of the lease term. The general principle in IFRS 3 requires the acquirer to measure identifiable assets acquired and liabilities assumed using fair value that is based on a market participant's perspective.

Furthermore, paragraph B43 of IFRS 3 provides application guidance addressing assets that the acquirer intends not to use or to use in a way that is different from the way other market participants

would use them. Therefore, proponents of this view think that the lease term should be reassessed using a market participant's perspective.

View 2C – Entity A should use the lease term established by Entity S.

Paragraph 28B of IFRS 3 deals specifically with the measurement of lease payments. However, the paragraph is silent on whether these payments are determined based on the acquiree's or acquirer's assessment.

Proponents of this view think that if the standard intended for the lease term to be reassessed, paragraphs 28A and 28B of IFRS 3 would have specified as such. Furthermore, under IFRS 16, no event has occurred that would permit the lessee in the contract to reassess the lease term. Therefore, they think that the acquiree's assessment of the lease term should be used.

View 2D – There is an accounting policy choice.

Proponents of this view think that IFRS Standards have no explicit guidance and therefore, Views 2A, 2B or 2C are considered appropriate and should be applied consistently.

The Group's Discussion

Group members agreed with View 2A for the reasons described in the analysis above.

Issue 3: For real estate leases in which Entity S is the lessee, does Entity A need to separate the lease and non-lease components upon acquisition to be consistent with its own accounting policy?

View 3A – Yes, Entity A needs to allocate the consideration between the lease and non-lease component to align with its own accounting policy.

Proponents of this view think that to apply IFRS Standards appropriately after the acquisition, Entity A must identify contracts that Entity S has elected to combine the lease and non-lease components. It will need to apply its own accounting policy and separate the lease and non-lease components from the identified contracts using stand-alone prices at the date of acquisition. As a result, Entity A accounts for similar contracts in a consistent manner within its financial statements in accordance with its own accounting policy.

View 3B – No, Entity A can retain Entity S's allocation of the consideration because there is no requirement to align the acquiree's accounting policy with the acquirer's accounting policy.

Proponents of this view think that the acquiree's accounting policy is left unchanged and the right-of-use asset is adjusted to reflect favourable or unfavourable terms of the lease from a market participant's perspective.

Under this view, IFRS 3 ensures that market values for the consideration paid are reflected in the assets acquired and liabilities assumed. This can be achieved without reallocating the consideration between the lease and non-lease components of the contract.

View 3C – There is an accounting policy choice.

Proponents of this view think that IFRS Standards have no explicit guidance and therefore, Views 3A or 3B are considered appropriate and should be applied consistently.

The Group's Discussion

Group members agreed with View 3A for the reasons described in the analysis above.

Issue 4: For lease contracts in which both Entity A and Entity S have elected to separate the lease and non-lease components, does Entity A need to revisit the allocation of consideration between the components at the date of acquisition?

View 4A – Yes, Entity A needs to assess the allocation under IFRS 16 at the date of acquisition.

Under this view, the acquirer analyzes what a market participant would pay for the contract and determines if the appropriate cash flows are allocated to the assets that the acquirer recognizes. Although market adjustments would be captured in the assets recognized, the effect on profit or loss will differ if cash flows are reallocated between lease and non-lease components. To apply other IFRS Standards appropriately after acquisition as required by paragraph 15 of IFRS 3, proponents of this view think that the remaining consideration should be appropriately allocated based on stand-alone prices at the date of acquisition.

View 4B – No, Entity A can retain the previous allocation as determined by Entity S.

Proponents of this view think that the acquiree's accounting policy is left unchanged and the right-of-use asset is adjusted to reflect favourable or unfavourable terms of the lease from a market participant's perspective. IFRS 3 has no requirement to revisit the original allocation of consideration to different components of the contract.

The Group's Discussion

Group members agreed with View 4A for the reasons described in the analysis above. One Group member highlighted the importance of revisiting the allocation between lease and non-lease components as this allocation can impact common performance measures such as earnings before interest, taxes, depreciation and amortization. One Group member observed that when the accounting of the acquiree's lease contract differs between the acquirer and the acquiree, the acquirer will need to adjust the amounts reported by the acquiree during consolidation. Depending on the terms of the lease, these consolidation adjustments could exist for many years. Several Group members thought this problem may be resolved if push-down accounting were permitted under IFRS Standards. Furthermore, the Group members observed that these types of consolidation adjustments are common for acquirers following business combinations. Several Group members therefore recommended the AcSB suggest the topic of push-down accounting be considered by the IASB as part of its 2020 Agenda Consultation.

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