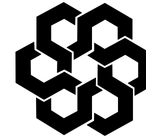

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International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **20 November 2008, London**

Project: **LEASE ACCOUNTING**

Subject: **Subleases (Agenda Paper 8D)**

Introduction

1. In July 2008 the boards tentatively decided to defer consideration of lessor accounting and concentrate on developing an improved lessee accounting model. Consequently, lessees will account for lease contracts using a new accounting model.
2. Lessors reporting under IFRS will continue to apply the accounting model in IAS 17. The FASB has not yet decided whether to require lessors to adopt IAS 17 or continue to apply the lessor accounting requirements of Statement 13. The staff will present a paper on this issue after publication of the discussion paper.
3. A reporting entity will sometimes act as both a lessor and a lessee of the same asset. For example, a reporting entity may lease a piece of equipment from one party (the head lease) and then sublet the same piece of equipment to another party (the sublease). Subleases give rise to a number of accounting problems. These problems arise because we are attempting to apply different accounting models to the head lease and the sublease.

4. At the October 2008 Leases Working Group meeting, a number of working group members stated that the leases discussion paper should include the boards' preliminary views on how to account for subleases.

5. The purpose of this paper is to explore different possible approaches to accounting for subleases.

6. The staff believe that it will be possible to develop a technically feasible solution to the problems associated with subleases. However, we are not yet in a position to recommend a particular approach to the boards. We would like to undertake more research and seek the views of constituents on the best way to address subleases. However, undertaking this additional work before publication of the discussion paper would significantly delay publication. Consequently, the staff recommend that the boards do not attempt to reach a preliminary view on the treatment of subleases at this stage. Instead, we recommend that the discussion paper include:
   (a) a description of the problems associated with subleases
   (b) a description of possible solutions to those problems
   (c) a question asking for respondents' views on which of the possible solutions they would favour and why.

7. We would also like the boards to tell us what additional analysis (if any) they would like to see in the discussion paper.

8. Throughout this paper, we have assumed that the obligation to pay rentals to the head lessor is unaffected by the sublease. Situations where the obligation to pay rentals to the head lessor are affected by the sublease (for example, lease reassignments) will be considered at a later stage of the project.

Structure of the paper

9. This paper is structured as follows:
   (a) Description of subleasing arrangements
   This section of the paper explains what is meant by a subleasing arrangement and describes the different types of arrangements.
   (b) Accounting by lessors
   In a subleasing arrangement, the reporting entity acts as a lessor (the intermediate lessor). Consequently, this section of the paper summarises lessor accounting requirements under IAS 17 and Statement 13.

(c) *Applying IAS 17 and Statement 13 to subleases*

This section of the paper describes the consequences of applying a right of use accounting model to the head lease and the lessor accounting requirements of IAS 17 or Statement 13 to the sublease. We have identified four problems with this approach, which are described in this section.

(d) *Possible approaches to accounting for subleases*

This section describes three other possible approaches to accounting for subleases that solve some of the problems identified with applying IAS 17 or Statement 13 to the sublease.

(e) *Staff recommendation*

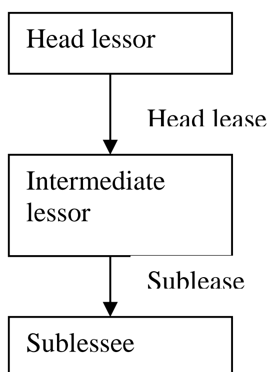
As described above, the staff recommend that the boards do not attempt to reach a preliminary view on the treatment of subleases at this stage. However, this section includes recommendations for what should be included in the discussion paper.

(f) *Questions for the boards*

This final section asks whether you agree with the staff recommendations and what additional analysis should be included in the discussion paper.

Description of subleasing arrangements

10. Under a subleasing arrangement, an intermediate lessor will enter into both (a) as lessee, a lease of an asset from a head lessor, and (b) as lessor, a sublease of the same physical asset to a sublessee for the same or a shorter term. This is illustrated in the following diagram:



11. Different types of arrangements include:

    (a) the head lease and sublease commence on the same date, for the same term and for the same rental amounts (possibly with a small amount being retained by the intermediate lessor)—sometimes referred to as a 'through lease'

    (b) the head lease and sublease commence on the same date, but the sublease is for a shorter term so that the intermediate lessor has the use of the asset from the end of the sublease term to the end of the head lease term (often the intermediary lessor will intend to enter into further subleases once the initial sublease has expired)

    (c) the sublease commences some time after the head lease—for example, where the intermediary lessor leases a property on a long lease, occupies it for some while, and then decides it no longer needs the property and instead of cancelling the head lease, subleases the property to a new tenant.

Accounting by lessors

Requirements of IAS 17

12. Under IAS 17 lessors are required to classify leases as finance leases or operating leases. Finance leases are defined as leases that transfer substantially all the risks and rewards incidental to ownership.

13. If the lease is classified as a finance lease, the lessor derecognises the leased asset and recognises a receivable for an amount equal to the net investment in the lease. The net investment in the lease is equal to the present value of the minimum lease payments and the present value of any unguaranteed residual value. Finance income is recognised based on a pattern reflecting a constant periodic rate of return on the net investment in the finance lease.

14. If the lease is classified as an operating lease, the lessor continues to recognise the leased asset and presents it in the statement of financial position according to the nature of the asset. The leased asset is depreciated on a basis that is consistent with the lessor's normal depreciation policy for owned assets. Lease income is normally recognised on a straight-line basis over the lease term.

Requirements of Statement 13

15. Under Statement 13, lessors are required to classify leases as:

(a) sales-type leases

(b) direct financing leases

(c) leveraged leases

(d) operating leases.

16. Sales-type leases, direct financing leases and leveraged leases are all leases that transfer substantially all the benefits and risks incident to ownership of the property. Whether a lease transfers substantially all the benefits and risks incident to ownership of the property is determined by reference to a number of detailed criteria (paragraphs 7 and 8 of Statement 13).

17. Sales-types leases give rise to manufacturer's or dealer's profit or loss because the fair value of the leased property at the inception of the lease is greater or less than its carrying amount. Direct financing leases are leases other than leveraged leases that do not give rise to manufacturer's or dealer's profit or loss. Leveraged leases are a special type of structured lease involving non-recourse financing.

18. Leveraged leases (and the associated accounting) are unusual. Consequently, this paper does not consider them further. We will consider the interaction of subleasing and leveraged leases if the FASB decide to retain Statement 13 for lessors.

19. If the lease is classified as a sales-type lease, the lessor records the sum of (i) the minimum lease payments and (ii) the unguaranteed residual value as the gross investment in the lease. The difference between the gross investment in the lease and the present value of the minimum lease payments and the unguaranteed residual value (discounted using the interest rate implicit in the lease) is recorded an unearned income. The unearned income is amortised to income over the lease term so as to produce a constant periodic rate of return on the net investment in the lease. The net investment in the lease equals the gross investment less unearned income. The present value of the minimum lease payments is treated as the sales price in a sales-type lease. The carrying amount of the leased property less the present value of the unguaranteed residual is treated as the cost of sales.

20. If the lease is classified as a direct financing lease, the lessor records the sum of (i) the minimum lease payments and (ii) the unguaranteed residual value as the gross investment in the lease. The difference between the gross investment

in the lease and the carrying amount of the leased item is recorded as unearned income. The unearned income is amortised to income over the lease term so as to produce a constant periodic rate of return on the net investment in the lease. The net investment in the lease equals the gross investment less unearned income.

21. If a lease is classified as an operating lease, the leased item is included in the statement of financial position with or near property, plant and equipment and is depreciated following the lessor's normal depreciation policy. Lease income is normally recognised on a straight-line basis over the lease term.

22. Statement 13 includes detailed guidance on how to classify subleases (paragraphs 38 and 39). If the head lease transfers ownership of the leased item to the intermediate lessor or the head lease includes a bargain purchase option, the sublease is classified as an operating lease, sales-type lease or direct financing lease in the normal way. If, however, the head lease does not transfer ownership or contain a bargain purchase option, the sublease is classified as an operating lease or direct financing lease.

Applying IAS 17 and Statement 13 to subleases

23. If the proposed accounting model for lessees is applied to a head lease, the intermediate lessor will recognise both:
    (a) an asset representing its right to use the leased item for the term of the head lease (the right-of-use asset)
    (b) a liability representing its obligation to pay rentals.

24. As discussed above, the boards have tentatively decided to defer consideration of lessor accounting. Consequently, the intermediate lessor will be required to apply existing lessor accounting guidance to the sublease. The implications of this are described in the following sections.

Applying IAS 17 to the sublease

25. Applying IAS 17 to the sublease would require the lessor to classify the sublease as a finance lease or an operating lease. In addition, the lessor would have to consider whether the leased property meets the definition of an investment property in IAS 40. The following tables summarise the possible outcomes:

Right-of-use asset is not an investment property:

	Sublease is:	
	Operating lease	**Finance lease**
Asset	Right-of-use asset (lessee accounting)	Receivable—net investment in the sublease (lessor accounting)
Liability	Obligation to pay rentals under the head lease (lessee accounting)	Obligation to pay rentals under the head lease (lessee accounting)
Income	Rental income from the sublease (lessor accounting)	Interest income on receivable (lessor accounting)
Expense	Interest on obligation to pay rentals (lessee accounting) Amortisation/depreciation of the right-of-use asset (lessee accounting)	Interest on obligation to pay rentals (lessee accounting)

Right- of-use asset is an investment property (sublease must by definition be an operating lease):

	Measurement option	
	Fair value	**Cost**
Asset	Right-of-use asset at fair value (investment property accounting)	Right-of-use asset at cost (investment property accounting)
Liability	Obligation to pay rentals under the head lease (lessee accounting)	Obligation to pay rentals under the head lease (lessee accounting)
Income	Rental income from the sublease (investment property accounting) Fair value gains (investment property accounting)	Rental income from the sublease (investment property accounting)
Expense	Interest on obligation to pay rentals Fair value losses (investment property accounting)	Interest on obligation to pay rentals (lessee accounting) Amortisation/depreciation of the right of use asset (investment property accounting)

26. The staff have identified four problems with applying IAS 17 to the sublease, which are discussed in the following sections:

- determining which asset to apply the classification test to
- classification inconsistencies
- inconsistencies in measurement when the sublease is classified as a finance lease
- income statement 'mismatches' when the sublease is classified as an operating lease.

Determining which asset to apply the classification test to

27. Under IAS 17, a finance lease is one that transfers substantially all of the risks and rewards incidental to ownership of an asset. The question is 'which asset should we consider?' Two approaches are possible:

(a) the test is met if the sublease transfers substantially all of the risks and rewards of the right-of-use asset recognised by the intermediate lessor

(b) the test is met only if the lease transfers substantially all the risks and rewards of the asset that is the subject of the head lease.

28. For example, suppose the head lease is for a term of five years, and the underlying asset has an expected life of ten years. The intermediate lessor recognises a right-of-use asset for the five-year term. Under approach (a) the intermediate lessor would classify the sublease as a finance lease if substantially all of the risks and rewards of this right of use were transferred to the sublessee. Consequently, if the sublease terms were the same as the head lease terms, the sublease would be a finance lease. Under approach (b), any sublease would be an operating lease because the intermediate lessor is unable to transfer substantially all of the risks and rewards of the underlying asset, since it only has the right to use the underlying asset for five years of its ten-year expected life.

29. If the intermediate lessor accounts for the sublease as a finance lease, it is derecognising its right-of-use asset and replacing this with the net interest in the lease, which represents the future rentals receivable under the sublease. Whether derecognition is appropriate should be judged on the extent to which the intermediate lessor retains an interest in the risks and rewards of the asset. If the intermediate lessor retains no significant risks and rewards in the leased

item, but instead is primarily interested in the rental stream, the right of use acquired under the head lease should be derecognised. This applies even if the head lease transfers only a portion of the expected useful life of the underlying leased item.

30. In other words, in applying IAS 17, the intermediate lessor should consider what asset it has—the right of use—and ask whether substantially all the risks and rewards of that asset are transferred by the sublease. It should not look at the underlying physical asset, since this is not an asset of the intermediate lessor.

31. In practical terms, staff believe that where the head lease and sublease are essentially the same, the intermediate lessor's accounting for the sublease should closely match the accounting for the head lease. This is achieved only if the sublease is classified as a finance lease where it is on substantially the same terms as the head lease.

32. Consequently, the staff believe that the correct approach is approach (a). That is, the test is met if the sublease transfers substantially all the risks and rewards of the right-of-use asset.

Classification inconsistencies

33. Although IAS 17 defines a finance lease as a lease that transfers substantially all the risks and rewards incidental to ownership, this general principle is supplemented by several examples of situations that would normally lead to finance lease classification. These include:
    - The lease term is for a major part of the economic life of the leased asset.
    - The present value of the minimum lease payments amounts to substantially all the fair value of the leased asset.

34. Because of differences in the way that lease term and lease payments are determined under IAS 17 and the right-of-use approach, applying these examples may not result in an appropriate classification of the sublease.

35. For example, the intermediate lessor may sign a five-year head lease with an option to extend for an additional five years and an identical sublease. The intermediate lessor may believe that exercise of the option to extend both the head lease and the sublease is likely but not reasonably certain. Consequently, the economic life of the right-of-use asset will be ten years and the term of the

sublease will be five years. Accordingly, the intermediate lessor would conclude that the lease term is not a major part of the economic life of the leased asset. Similar problems arise because of the definition of minimum lease payments.

36. It may be possible to avoid these problems if guidance was produced that required the lessee to consider the general principle of lease classification (rather than the examples in IAS 17). For example, if the terms of the head lease and the sublease match or nearly match, the intermediate lessor has transferred substantially all the risks and rewards of ownership to the sublessee. Consequently, the lease should be classified as a finance lease.

Inconsistencies in measurement when the sublease is classified as a finance lease

37. As discussed above, if the sublease is classified as a finance lease, the intermediate lessor derecognises the leased asset and recognises a receivable for an amount equal to the net investment in the lease. The net investment in the lease is equal to the present value of the minimum lease payments plus the present value of any unguaranteed residual value.

38. If the terms of the head lease and the sublease match and they are entered into on the same date (a through lease), gains or losses could nevertheless arise because of differences in the way the right-of-use asset and the lessee's net investment in the lease are measured.

39. For example, both the head lease and the sublease could contain identical obligations to pay contingent rentals. Measurement of the right-of-use asset recognised by the intermediate lessor would be based upon the measurement of the obligation to pay rentals under the head lease. It would include an estimate of contingent rentals payable under the head lease. However, the net investment in the sublease recognised by the intermediate lessor would exclude contingent rentals. Consequently, the intermediate lessor would recognise a loss on derecognising the right-of-use asset and recognising the net investment in the sublease.

40. Similar measurement inconsistencies arise with options to extend or terminate the lease, purchase options, residual value guarantees and the discount rate. These mismatches are summarised in the following table:

Item	Measurement as part of:	
	Right-of-use asset	**Net investment in the lease**
Contingent rentals	Include based upon 'best estimate' or expected value (see agenda paper 8A/Memo No. 22)	Excluded
Options to extend or terminate the lease	Include rentals payable in optional periods based upon 'best estimate' or expected value (see agenda paper 8A/Memo No. 22)	Include rentals payable in optional periods if it is reasonably certain (assured) the option will be exercised
Purchase options	To be determined—however, unlikely to be based upon whether exercise is reasonably assured (see agenda paper 8A/Memo No. 22)	Include exercise price of purchase option if exercise is reasonably certain (assured)
Residual value guarantees	To be determined—however, unlikely to include the full amount of the guarantee (see agenda paper 8A/Memo No. 22)	Include full amount of any residual value guarantee
Discount rate	Lessee's incremental borrowing rate	Interest rate implicit in the lease or the lessee's incremental borrowing rate

41. These inconsistencies could be resolved if the measurement requirements of IAS 17 were amended for subleases only. Alternatively, the boards could decide not to resolve these inconsistencies.

Income statement 'mismatches' when the sublease is classified as an operating lease

42. If the sublease is classified as an operating lease, the intermediate lessor will recognise amortisation of the right-of use asset and interest expense on the obligation to pay rentals. In addition, the intermediate lessor will recognise rental income from the sublease evenly over the term. As a result, in many cases the intermediate lessor will have a net loss from the arrangement in the early years. This is because interest and depreciation will exceed operating lease income in the early years, offset by higher profits in later years as the interest charge reduces.

43. This is similar to the situation that arises under current standards where the head lease is a finance lease and the sublease is an operating lease, but under the proposals will also apply to arrangements where the head lease would currently be classified as an operating lease.

44. Staff would not propose making any amendment to lessor accounting to reduce this perceived mismatch. As noted above, this mismatch already arises if the head lease is a finance lease, and is essentially the same as the accounting for situations where an entity purchases assets using borrowings and then leases them out on operating leases.

45. No such mismatches arise for simple leases where the sublease is a finance lease, because the intermediate lessor will recognise both interest income on the sublease and interest expense on the head lease.

Applying Statement 13 to the sublease

46. Applying Statement 13 to the sublease would require the intermediate lessor to classify the sublease as a sales-type lease, direct financing lease, leveraged lease or operating lease. The assets and liabilities presented under sale-type leases and direct financing leases are the same (although their measurement is different). The following table summarises the possible outcomes. Leveraged leases have been excluded for simplicity:

	Sublease is:	
	Operating lease	**Sales-type lease or direct financing lease**
Asset	Right-of-use asset (lessee accounting)	Net investment in the sublease (lessor accounting)
Liability	Obligation to pay rentals under the head lease (lessee accounting)	Obligation to pay rentals under the head lease (lessee accounting)
Income	Rental income from the sublease (lessor accounting)	Amortisation of unearned income—interest income (lessor accounting)
Expense	Interest on obligation to pay rentals (lessee accounting)	Interest on obligation to pay rentals (lessee accounting)

	Amortisation or depreciation of the right-of-use asset (lessee accounting)	

47. Similar problems to those identified for lessors applying IAS 17 to subleases arise when Statement 13 is applied to subleases. However, the more rules-based approach of Statement 13 may make the problems more difficult to resolve.

Determining which asset to apply the classification test to

48. As discussed above, it may be necessary to produce guidance that clarifies which asset the classification tests in Statement 13 should be applied to (the right-of-use asset or the underlying leased item). Because Statement 13 only applies to leases of property, plant and equipment, it may also be necessary to expand the scope of Statement 13 to include leases of right-of-use assets.

Classification inconsistencies

49. The classification inconsistencies identified for lessors applying IAS 17 are more significant for lessors applying Statement 13. This is because classification is based upon a number of detailed rules rather than on the basic principle of whether substantially all the risks and rewards incident to ownership are transferred. For example, lessors are *required* to classify a lease as sale-type or direct financing lease if:
    (a) the lease term is equal to 75 percent or more of the estimated economic life of the leased property or
    (b) the present value of the minimum lease payments exceeds 90 percent of the fair value of the leased property[1].

50. Under IAS 17, the equivalent tests are merely examples of situations that would *normally* lead to finance lease classification.

51. Consequently, it may be necessary to amend these tests when applying them to subleases.

[1] Other tests also apply

Inconsistencies in measurement when the sublease is classified as a sale-type lease or a direct financing lease

52. The same measurement problems identified for lessors applying IAS 17 arise for lessors applying Statement 13 to subleases. As discussed above, it may be possible to address these inconsistencies by amending the measurement requirements for subleases.

Income statement 'mismatches' when the sublease is classified as an operating lease

53. The same income statement mismatches identified in paragraphs 42–45 will arise for lessors applying Statement 13 to subleases. However, as noted above, the staff would not recommend attempting to remove these mismatches, because they already exist to some extent today.

Possible approaches to accounting for subleases

54. The staff have identified four possible approaches to accounting for subleases:

Approach 1 Require intermediate lessors to apply IAS 17 to their subleases

Approach 2 Exclude the head lease from the scope of the new standard

Approach 3 Develop a lessor right-of-use model

Approach 4 Apply IAS 17 classification requirements to the sublease but amend the measurement requirements.

55. Approach 1 has already been described in paragraphs 25–53 of this paper. As discussed above, the staff believe it may be possible to overcome many of the problems associated with this approach by developing additional guidance. The main advantage of approach 1 is that it ensures that similar transactions are accounted for in the same way. That is, lessors will account for all their leases in the same way whether the leased asset was acquired through purchase or through a head lease.

56. The problems associated with subleases (and approach 1) arise because we are attempting to apply different accounting models to the head lease and the sublease. These problems could be avoided if the same accounting model were applied to both the head lease and the sublease. This could be achieved if the intermediate lessor were required either to:

- apply existing lessee accounting standards (IAS 17 and Statement 13) to the head lease (approach 2); or
- apply a lessor right-of-use model to the sublease (approach 3).

57. Approach 4 is a hybrid of approaches 1 and 3. It attempts to resolve the classification and measurement problems associated with approach 1 by amending its measurement requirements.

58. The following sections discuss approaches 2–4.

Approach 2—Exclude the head lease from the scope of the new standard

59. Requiring intermediate lessors to apply existing lessee accounting standards to the head lease would leave the accounting for subleases unchanged from the current position. The intermediate lessor would not recognise a right-of-use asset and an obligation to pay rentals. Instead, the intermediate lessor would be required to classify the head lease as a finance (capital) lease or operating lease. Finance leases classification would give rise to assets and liabilities in the books of the intermediate lessor; operating lease classification would not.

60. This approach would eliminate many (although not all) of the problems identified above and, as it is familiar to preparers, would be simple to implement.

61. However, this approach has the following disadvantages:

(a) This approach would reduce comparability for users because similar transactions will be accounted for differently. Leases that are subject to subleases would be accounted for differently from leases that are not.

(b) Assets and liabilities arising under head leases that are classified as operating leases would not be recognised in the statement of financial position. This would understate the assets and liabilities of the intermediate lessor.

(c) Retaining operating lease accounting for head leases may provide opportunities for structuring.

(d) It is unclear how this approach could be made operational if the sublease is entered into after the head lease because the intermediate lessor will already have recognised a right-of-use asset and an obligation to pay rentals.

Approach 3—Develop a lessor right-of-use model

62. Many of the problems associated with applying the IAS 17 model to subleases could be avoided if lessors were required to apply a right-of-use model to subleases. The right-of-use model for subleases would mirror the recognition and measurement requirements of lessees.

63. Under this approach, the intermediate lessor would not be required to classify the leases as a finance lease or operating lease. Instead, the lessor would recognise a receivable that mirrors the lessee's obligation to pay rentals.

64. This approach has the following advantages:

    (a) It is simpler to apply as intermediate lessors will not be required to classify leases as finance lease or operating leases.

    (b) The same conceptual model is applied to both the head lease and the sublease. This will be easier for users to understand.

65. However, there are a number of disadvantages to this approach:

    (a) Similar transactions will be accounted for differently. For example, a lessor of motor vehicles may choose to buy some of its motor vehicles and lease the rest. Under this approach, leases of vehicles that are owned by the lessor will be accounted for under IAS 17/Statement 13. Leases of vehicles that are themselves leased will be accounted of under the right-of-use approach. This will reduce comparability to users.

    (b) The boards would need to decide whether lessors should derecognise the right-of-use asset on entering into the sublease.

    (c) If the boards conclude derecognition is appropriate, guidance will need to be created for partial disposals (that is, where the terms of the sublease do not match the head lease).

    (d) If the boards conclude derecognition is inappropriate, guidance on how to account for the credit that arises on recognition of a receivable from the sublessee will need to be developed.

    (e) If the measurement of the intermediate lessor's receivable mirrors that of the sublessee's obligation to pay rentals, it may include cash flows arising from optional periods, contingent rentals, purchase options and residual value guarantees. The boards would need to conclude whether this is appropriate.

66. The staff note that attempting to resolve these issues would be time consuming because we would effectively be attempting to develop a right-of-use model for lessors. The staff note that the boards have tentatively decided to defer consideration of lessor accounting.

Approach 4—Apply existing lease accounting standards to the sublease but amend the measurement requirements

67. Under this approach, the intermediate lessor would still be required to classify the sublease as a finance lease (sales-type lease or direct financing lease under US GAAP) or an operating lease. However, the definition of minimum lease payments would be amended for subleases so that it is consistent with the measurement of the right-of-use asset. This revised definition would apply for both classification purposes and measurement of the lessor's net investment in the lease. For example, rather than exclude contingent rentals from minimum lease payments, the definition of minimum lease payments could be amended to include an estimate of contingent rentals payable under the sublease. The following table summarises other possible amendments to the definition of minimum lease payments:

Item	**Treatment under :**	
	Current definition of minimum lease payments	**Revised definition of minimum lease payments**
Contingent rentals	Excluded	Include estimate of contingent rentals payable under the sublease
Options to extend or terminate the lease	Include rentals payable in optional periods if it is reasonably certain (assured) the option will be exercised	Include estimate of rentals payable in optional periods an a basis that is consistent with the measurement of the right-of use asset
Purchase options	Include exercise price of purchase option if exercise is reasonably certain (assured)	Include exercise price of purchase option on a basis that is consistent with the measurement of the right-of-use asset
Residual value guarantees	Include full amount of any residual value guarantee	Include estimate of amount payable under the residual guarantee on a basis that is

		consistent with the measurement of the right-of-use asset

68. This approach would eliminate many of the measurement mismatches that would arise if the existing standards were applied without modification. For example, no gains or losses will arise if the sublease is entered into at the same time and on the same terms as the head lease. Subleases entered into after the signing of the head lease would, however, give rise to gains or losses.

69. Through leases would always be classified as finance leases, and the income from the receivable would match the interest expense on the obligation to pay rentals in respect of the head lease.

70. The income statement mismatch identified in paragraphs 42–45 would still exist (that is, where the sublease is classified as an operating lease). However, the mismatch will occur less often because fewer subleases will be classified as operating leases under this approach.

71. However, this approach also has a number of disadvantages:

    (a) As with approach 3 similar transactions will be accounted for differently depending upon whether the leased asset was purchased by the intermediate lessor or acquired through a lease.

    (b) As noted above, any receivable recognised by the intermediate lessor may include cash flows arising from optional periods, contingent rentals, purchase options and residual value guarantees. The boards would need to conclude whether this is appropriate.

Staff recommendation

72. Based on the above analysis, the staff believe that it will be possible to develop a technically feasible solution to the problems of subleases. However, we are not yet in a position to recommend a particular approach to the boards. We would like to undertake more research and seek the views of users on the best way to address this problem.

73. As subleases represent a relatively small proportion of all leasing transactions, we do not believe that this is necessary to develop a solution to the problem of

subleases ahead of the publication of the discussion paper. Consequently, the staff recommend that we include in the discussion paper:

(a) a description of the problems associated with subleases

(b) a description of possible solutions to those problems

(c) a question asking for respondents' views on which of the possible solutions they would favour and why.

Questions for the boards

Q1: The staff recommend deferring consideration of subleasing until after publication of the discussion paper.

Do the boards agree?

If you disagree, please describe how you would like to proceed.

Q2: What additional analysis (if any) do you believe should be included in the discussion paper on this issue?