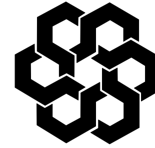

30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
E-mail: iasb@iasb.org Website: www.iasb.org

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:	**19 January 2009, London**
Project:	**LEASE ACCOUNTING**
Subject:	**Scope, an Overview of Lessor Accounting and Consideration of Sublessor Accounting (Agenda Paper 13A)**

Introduction

1. At the November 2008 FASB meeting, questions were raised about whether in-substance purchases should be in the scope of the leases project. In addition, the FASB asked the staff to further analyze the accounting for subleases for the FASB's consideration before publication of the Leases Discussion Paper (DP). The FASB also asked the staff to analyze how a model for sublessors might apply broadly to all lessors.

2. Therefore, the purpose of this paper is to:

   - Reconsider the scope of the leases project
   - Provide an overview of lessor accounting under the right-of-use model
   - Consider sublessor accounting.

3. To do so, this paper provides a discussion on the following topics:

   - Reconsideration of scope
   - Lessor application of the right-of-use model

    - Promises exchanged and rights and obligations arising in a simple lease
    - Lessor assets and liabilities
    - Derecognizing the leased asset
    - Revenue recognition
    - Summary of lessor right-of-use model
- Consideration of sublessor accounting
    - Description of subleasing arrangements
    - Application of the right-of-use model to sublessors
    - Potential difficulties if accounting for sublessors is completed prior to lessor accounting.

Reconsideration of Scope

4. At the April 2007 joint meeting, the Boards tentatively decided that the leases project will initially focus on the accounting for lease arrangements within the scope of existing lease accounting literature. Recently, the FASB has been discussing whether there should be a distinction between leases that are in-substance purchases and leases that only convey a right of use.

5. Many FASB Board members believe this distinction should be considered from the lessee's perspective because it is something they believe will need to be considered from the lessor's perspective, particularly when considering how the lessor would recognize revenue. The Revenue Recognition Discussion Paper indicates there is a difference between an entity's promise to transfer a good and/or a service. Paragraph 4.38 of the Revenue Recognition Discussion Paper states that a good is an asset that is transferred to a customer at a point in time, whereas a service typically is a continuous transfer of assets to a customer over a period of time. Some Board members believe lessees and lessors should determine whether a lease arrangement involves the transfer of a good (possibly in leases where ownership of the asset transfers) or services (all other leases).

6. Some Board members believe that the scope of the leases project should be modified to state that arrangements in which title transfers to the lessee are not leases. Those arrangements are purchases by the lessee and should be accounted for as such following applicable existing guidance for asset purchases.

7. It also has been argued that criteria other than transfer of title should be considered to determine which arrangements are outside the scope of the leases guidance (and accounted for as purchases) (for example, when the lease term is for the entire useful life of the leased item or there is a bargain purchase option).

8. It should be noted that leases for which title transfers, leases for which the lease term is for the entire useful life of the leased item, or leases for which there are bargain purchase options are currently within the existing scope of Statement 13 and IAS 17. Some believe that to try and separate these leases from other leases would result in criteria (for example, classification criteria distinguishing between purchases and leases) that would lead to similar problems that exist currently with the classification criteria in Statement 13 and IAS 17. Therefore, some recommend that all leases be accounted for under the proposed leasing guidance; that is, there is one accounting model for all leases.

Staff Recommendation

9. The staff recommends that the scope of the project should not be modified. The staff believes that if a lease is truly "the same as a purchase" then it will be *priced* the same as a purchase. If that is the case (and the staff cannot understand why it wouldn't be), the accounting model in the Leases DP should result in accounting that is the same as the accounting for a purchased asset, based on the following preliminary views that are currently included in the Staff Draft Leases Discussion Paper (the comments in parentheses are not currently in the DP):

    - The obligation to pay rentals and the right-of-use asset will be initially measured at the present value of the lease payments, discounted at the lessee's incremental borrowing rate (that is, the rate that the lessee would incur to borrow over a similar term, and with a similar security, the funds necessary to purchase the asset.)

    - For leases of items where it is expected that the lessee will obtain title at the end of the lease term, the amortization period for the right-of-use asset would be the economic life of the leased item (that is, the exact same period over which one would depreciate a purchased asset).

- The obligation to pay rentals should be subsequently measured on an amortized cost basis (that is, the same approach that would be used for debt used to purchase an asset).

10. The staff believes the attempt to distinguish between leases that are "truly purchases" and those that are a "right of use" will inevitably fail, or will result in unintended consequences. The staff notes that if the Boards agree that leases in which title to the leased property transfers are "purchases," then it is only logical to assume that leases that extend for 100% of an asset's economic life also are purchases. Similarly, a lease in which title transfers for the payment of a nominal sum also would represent a purchase. It is unclear to the staff where the line would be drawn between a purchase and a lease.

11. The staff observes that representatives from the lessor industry have been the biggest supporters of the "in-substance-purchase" concept. The correspondence these individuals have provided to the Leases Project Team consistently request that the Boards adopt a "substance over form" approach to determining the scope of the leases project. In addition, those representatives consistently cite the model in U.S. commercial law as an effective way to distinguish between "true leases" and "purchases". The staff notes that the determination of whether an arrangement is a lease for legal purposes often hinges on whether the lessor retains a "meaningful residual interest" in the leased property. The staff also notes this sounds hauntingly similar to the 90% test in Statement 13. The staff believes this is inevitably where this approach arrives at—a search for the magical dividing line between a purchase and a lease.

12. The staff believes that if Board members are concerned with this distinction because of lessor accounting issues, then the Boards should instruct the staff to perform a full, robust analysis of the lessor's accounting before issuing a Discussion Paper. The staff also does not believe that this distinction will necessarily resolve the potential concerns with the application of the right-of-use model to the lessor's accounting.

Questions for the Boards

Question 1: Do Board members agree with the staff recommendation to not modify the scope of the project?

Question 2: If Board members believe the scope of the project should be modified, on what basis should some lease contracts be excluded from the scope:

- Only those lease contracts that transfer title to the lessee?
- Some other basis (please describe)?

Lessor Application of the Right-of-Use Model

13. A right-of-use model could be applied to lessors (and sublessors). Under this approach, the lessor would not be required to classify the leases as a finance lease or an operating lease. Instead, the lessor would recognize assets and liabilities based on the analysis in paragraphs 20-29 of this memo.

14. When considering how a right-of-use model would apply to a lessor, the staff believes one must consider the Boards' preliminary views on lessee accounting. Given that the lessee and lessor are both analyzing the exact same contract, it is unclear why the conceptual consideration of rights and obligations in a lease arrangement should diverge. As such, the Boards should note that the analysis of the lessor's rights and obligations in the following paragraphs is symmetrical to the analysis in the Discussion Paper of the lessee's rights and obligations in a lease arrangement.

15. The staff believes a similar analysis needs to be performed when considering the lessor assets and liabilities that result from entering into a lease arrangement. That is, the conceptual consideration of a lessor's assets and liabilities in a lease arrangement should be symmetrical (or at least consistent with) the Boards' preliminary views regarding the lessee's assets and liabilities.

Promises exchanged and rights and obligations arising in a simple lease

16. The Boards previously examined the rights and obligations of the lessor that arise from the exchange of promises in a simplified lease contract and whether these rights and obligations meet the definitions of assets and liabilities in the IASB *Framework* and FASB CON 6.

17. The staff have analyzed the promises exchanged and the related rights and obligations arising in a simple leasing arrangement using the following example:

A piece of machinery is leased for a fixed term of 5 years; the expected life of the machinery is 10 years. The lease is non-cancellable and there are no rights to extend the lease term or to purchase the machinery at the end of the term and no guarantees of its value at that point. Lease payments are due at regular intervals over the lease term after the machinery has been delivered; these are fixed amounts that are specified in the original agreement and are payable in advance. No maintenance or other arrangements are entered into.

18. The lease described in this example is non-cancellable. That is, the lessee has no contractual right to terminate the lease agreement, return the machinery, and cease making payments to the lessor. Equally, the lessor has no contractual right to terminate the lease agreement and demand the return of the machinery prior to the end of the lease term.

19. The contractual promises exchanged and the related rights and obligations arising in this simple lease from the standpoint of the lessor are summarized as follows:

    - Obligation to permit use of the machinery during the lease term
    - Right to receive payments during the lease term
    - Right to return of machinery at end of lease term
    - Right to the economic benefits derivable from use of the machinery in the period after the lease term (this right does not arise out of the lease contract itself but is included for completeness).

Lessor assets and liabilities

20. The staff considers that the lessor's right to receive payments over the lease term is not conditional upon the lessor granting the lessee the right to use the machinery each day of the lease. Instead, the staff considers that under a non-cancellable lease, the right is unconditional once the machinery has been delivered. The lessee can normally only avoid making payments under the lease contract if the lessor, in some way, breaks the terms of the lease contract.

21. Upon signing the lease contract, the lessor obtains a conditional right to receive payments over the lease term (the right is conditional upon the lessor delivering the leased item to the lessee). Once the machinery has been

delivered to the lessee, the right to receive payment becomes unconditional and is controlled by the lessor (it is legally enforceable). The unconditional right arises out of a past event (the delivery of the machinery) and gives rise to future economic benefit. Consequently, this right meets the definition of an asset.

22. In effect, the lessor has exchanged its rights to use the machinery for a receivable from the lessee. Whether and when this exchange gives rise to revenue for the lessor also will need to be discussed.

23. If the Board does not agree with the analysis in paragraphs 20-22, then the Board may need to reconsider the basis for its conclusions regarding the lessee's right to use representing an asset of the lessee. The following are excerpts from the Staff Draft Leases Discussion Paper (paragraph 3.18), which explain the Boards' preliminary views regarding the lessee's right-of-use asset:

> Some believe that the lessee's right to use the machinery...is conditional upon the lessee making payments over the lease term…However, once the lessee has possession of the machinery, no further action is required by the lessor to enable the lessee to use it for the whole lease term.

24. The lessor's right to have the machinery returned at the end of the lease does not in itself meet the definition of an asset. The right to have the machinery returned does not result in an inflow of economic benefits. It is the lessor's right to use the machinery after the end of the lease that is an asset. The lessor has always controlled the right to use the machinery after the end of the lease (it never surrendered that right). Consequently there is no inflow of economic benefits when the machinery is returned.

25. The lessor's right to the economic benefits deliverable from the use of the machinery in the period after the lease term (the residual rights) does not arise from the lease contract, but, rather, existed before the lease contract. However, the residual rights are considered here for completeness. Control of the residual rights is established through the lessor's legal rights over the machinery. These rights may be contractual rights (if the lessor is itself a lessee of the machinery) or legal ownership (property) rights. The past event giving rise to these rights was the original acquisition of the machinery. Future economic benefits will flow to the lessor generally through sale or re-lease of

the machinery after the end of the lease term. Thus, these rights meet the definition of an asset.

26. The lessor's only obligation after delivery of the machinery is to permit the use of the machinery by the lessee over the lease term. It can be argued that the existence of this obligation means that the lessor does not have an unconditional right to receive payments over the lease term. However, this is not the case once the machinery is delivered to the lessee. The lessor has performed its obligation under the lease and generally does not have the contractual right to recall the item from the lessee unless the lessee breaches the contract. Consequently, this obligation does not meet the definition of a liability because it does not result in a future outflow of economic benefits. The outflow of economic benefits has already taken place (that is, the machinery has been delivered).

27. The lessor may have some remaining performance obligations once the machinery has been delivered. For example, they may provide a warranty that the leased item will continue to work over the period of the lease. If this is the case, then a performance obligation may need to be recognized in respect of this warranty. This is similar to the situation of a manufacturer who sells goods with a warranty attached.

28. Some working group members have questioned in the past whether it is possible for the lessor to deliver the full right to use on delivery of the machinery. Some could therefore argue that the lessor has a performance obligation to deliver the right to use the leased item over the term of the lease. That performance obligation would be recognized by the lessor as a liability upon delivery of the leased item, and that obligation would be settled over the term of the lease.

29. However, the staff believes it is difficult to reconcile a conclusion in which the lessor has an ongoing performance obligation with the Boards' preliminary view that the lessee has an unconditional obligation to pay rentals once the leased asset is delivered to the lessee. If the Boards were to conclude that the lessor has an ongoing performance obligation to allow the lessee to use the leased asset, then wouldn't the lessee's obligation to pay rentals represent a conditional obligation? If so, what would be the basis for a lessee recognizing

the liability to pay rentals prior to the lessor providing the leased item (each day of the lease)? In addition, what would be the basis for a lessor recognizing a receivable prior to providing the leased item (each day of the lease)? This conclusion also would seem to ignore the rest of the logic that supports the Boards' preliminary views for the lessee recording a liability for the obligation to pay rentals.

Derecognizing the Leased Asset

30. The issue of asset derecognition was not specifically discussed in previous staff papers on the lessor's accounting. However, the staff believe there are four possible approaches to derecognition of the leased asset:
    - View A: Lessor derecognizes the whole of the leased asset – The lessor removes the whole of the leased asset from its balance sheet and records an asset for its lease receivable and an asset for its interest in the residual value (if any) in the leased asset
    - View B: Lessor derecognizes a portion of the leased asset – The lessor removes a portion of the leased asset from its balance sheet representing the right to use the leased item over the lease term and records an asset for its lease receivable
    - View C: Lessor does not derecognize the leased asset (gross presentation of lease liability) – The lessor leaves the leased item on its balance sheet and records an asset for its lease receivable and a liability for its performance obligation to allow the lessee to use the leased asset
    - View D: Lessor does not derecognize the leased asset (linked presentation of lease liability) – The lessor leaves the leased item on its balance sheet and records an asset for its lease receivable and a contra-asset for its performance obligation to allow the lessee to use the leased asset.

31. Each of these approaches is discussed below.

View A: Lessor derecognizes the whole of the leased asset

32. The staff's analysis regarding the lessor's accounting (discussed above) implies that the leased asset, or a portion of the leased asset (see View B),

would be derecognized from the lessor's balance sheet. The lessor exchanges the physical property for the right to receive payments over the lease term and the right to receive the property back at the end of the lease term. This results in the lessor recording a receivable (a financial asset) and a residual value (a non-financial asset). This model is essentially the same model (from a balance-sheet perspective) as the direct financing and sales-type lease models under U.S. GAAP today.

33. This view is also consistent with the Boards' tentative conclusions on lessee accounting. For example, paragraph 3.18 of the Staff Draft Leases Discussion Paper indicates that the lessee's right to use the leased item is an economic resource that is controlled by the lessee during the lease term. Inherent in this conclusion (and in the conclusion that the lessor does <u>not</u> have a liability to permit the lessee to use the leased asset during the lease term) is the view that benefits from the right to use the leased asset are separable from the physical asset. That is, in a lease contract, the lessor has exchanged its rights to use the machinery during the lease term for a receivable from the lessee. Other than the lessor's retention of the right to use the asset in future years (the residual right), the lessor's remaining ownership interest does not represent an asset separate from the right to receive rentals.

View B: Lessor derecognizes a portion of the leased asset

34. This view reflects the idea that the lessor has only disposed of a portion of the leased asset, representing the right to use that item for the lease term, in return for a receivable. The portion of the leased asset retained by the lessor (the residual) would not be derecognized.

35. As with View A, this view is consistent with the staff's tentative conclusions on lessor accounting (discussed above) and the Boards' decisions on lessee accounting

View C: Lessor does not derecognize the leased asset (gross presentation of lease liability)

36. This view treats the leased item itself as the lessor's economic resource (as opposed to the *right to use* the leased item). If this approach is taken it is possible to conclude that the lease of the item to the lessee does not result in a lessor losing control of that economic resource (and, thus, the asset would not

be derecognized from the lessor's books). In other words, the lessor does not lose control of the leased property for the lease term; instead, the lessor commits to allow the lessee to consume the benefits of that economic resource for the lease term. This obligation would meet the definition of a liability because it would result in a future outflow of economic benefits to the lessee.

37. Some believe that this would result in symmetry between the lessee and lessor within the right-of-use model. That is, if the lessee has an asset representing the rights to the economic benefits of the leased property, the lessor also would have a liability representing its obligation to provide those benefits to the lessee.

38. However, the staff notes that this symmetry is only achieved if certain fundamental premises of the right-of-use model (as it has been described in the Staff Draft Leases Discussion Paper) are reconsidered.

39. For example, this conclusion would be in direct conflict with the Boards' preliminary view in paragraph 3.26 of the Staff Draft Leases Discussion Paper that the obligation to return the leased item does not result in an outflow of economic benefits from the lessee. Paragraph 3.25 of the Staff Draft Leases Discussion Paper provides the Boards' basis for this preliminary view:

> It might seem that there is an outflow of economic benefits at the end of the lease term because the lessee must surrender the leased item (which presumably still has some economic potential). However, the boards have tentatively concluded that there is no outflow of economic benefit from the lessee when it returns the leased item…Although the lessee has physical possession of the leased item, it has no right to use the item once the lease term expires. The position of the lessee at the end of the lease term can be compared to that of an asset custodian. The lessee is holding an asset on behalf of a third party but has no right to the economic benefits embodied in that asset.

40. If the lessee's requirement to return the leased item does not result in an outflow of economic benefits, it is difficult to understand how this would reconcile to a conclusion that the lessor's retention of title to the leased property represents an economic resource to the lessor during the lease term. The lessor does <u>not</u> have the right to use the leased asset during the lease term, and the logic in paragraph 3.25 of the Staff Draft Leases Discussion Paper would indicate that the lessor also does <u>not</u> have the right to the economic

benefits embodied in that asset. The lessor has exchanged those rights for another asset—the right to receive lease payments.

View D: Lessor does not derecognize the leased asset (linked presentation of lease liability)

41. This is a variation of View C under which the leased asset and the performance obligation are linked for presentation purposes.

Revenue Recognition

42. The Revenue Recognition Discussion Paper indicates that an entity's performance obligation is a promise in a contract with a customer to transfer an asset (such as a good or service) to that customer. An entity satisfies a performance obligation and, hence, recognizes revenue when it transfers a promised asset (such as a good or a service) to the customer. The Boards propose that an entity has transferred that promised asset when the customer obtains control of it.

43. The staff believes it is difficult to argue that the asset transferred by the lessor to the lessee is anything other than the "right to use" the leased asset. The Staff Draft Leases Discussion Paper clearly indicates that this is the asset booked by the lessee and states that the right to use the leased item is an economic resource, which is controlled by the lessee during the lease term. As such, it is difficult to conclude that the lessor has an ongoing performance obligation related to the provision of the right to use the leased asset.

44. This conclusion would result in the lessor recording a receivable for the lease payments and a residual value, and then recognizing interest income[1] on the accretion of the two amounts. Absent the consideration of lessor profit, this model aligns well with the lessee right-of-use model. Specifically, the lessee right-of-use model results in accounting that indicates the lessee has borrowed money to purchase the right to use a leased asset. The lessor has provided this financing and should record income related to the financing. This model works particularly well for "third-party lessors", which are not manufacturers or

[1] Presumably, the same Board members interested in exploring a way to allow the lessee to classify some of its rental payment as "rent expense" also would be interested in a exploring a way for the lessor to classify the accretion as "rental income". This is a topic that should be discussed further with users of lessor financial statements.

dealers of the leased asset (examples include banks and independent finance companies). The fact pattern that requires further analysis is leases from manufacturers or dealers of the leased asset that provide a leasing alternative as another means to market their product.

45. The staff does not believe distinguishing between a right to use a leased asset and an in-substance purchase (or in-substance sale from the lessor's point of view) would necessarily change the analysis under the Revenue Recognition Discussion Paper. The staff views the right to use a leased item as an asset. Under the model put forth in the Staff Draft Leases Discussion Paper, the lessee records the right to use the leased property as an asset when the lessor delivers the leased property. In other words, the right to use the leased asset would always be considered a "good" and the financing component of the lease would be considered a "service" for purposes of the Revenue Recognition Discussion Paper.

46. Rather than trying to create a distinction between leases that are in-substance purchases and leases that transfer a right to use, the staff believes the Board should focus on whether there are situations where a lessor should recognize a profit on day one of the lease arrangement. Consider the following leasing arrangements:

Lease Financing Provided By a Bank

> A bank will often offer a customer a lease that has as its purpose the financing of the use of an asset for a substantial portion of the asset's useful life (and perhaps all of the asset's useful life). These leases are typically provided by lessors who are not in the business of selling the assets it leases and the lessor essentially functions as a lender. In these leases, the lessee will often receive a copy of the contract by which the lessor acquires the asset before signing the lease. The bank/lessor may never take possession of the leased asset (in fact, the bank/lessor will generally have no contact with the leased asset at all), and their legal obligation to lease the asset does not occur until the lessee accepts the asset from the supplier. The lessee will generally have no rights against the bank/lessor if the equipment does not perform. These arrangements exist in the market because banks and independent leasing companies are willing

to finance a higher portion of an asset through a lease as opposed to a traditional purchase financing; in addition, a bank will often finance 100% of the acquisition cost (including delivery, installation, etc.) through a lease as opposed to a traditional purchase financing.

Lease Financing Provided By a Manufacturer/Dealer of the Leased Asset

A manufacturer or dealer of equipment will offer customers leases that finance the use of an asset for a substantial portion of the asset's useful life (and perhaps all of the asset's useful life). There are numerous business reasons why a lessor will structure this transaction as a lease as opposed to an outright sale, but one of the key differences between this type of lease and the lease provided by a bank/lessor is the fact that the manufacturer/dealer will also seek to earn a profit on the manufacture of the asset in addition to financing income.

Summary of Lessor Right-of-Use Model

47. The staff believes the lessor right-of-use model discussed in paragraphs 20-29 would faithfully represent both of these fact patterns if the Board further considers when it would be appropriate for a lessor to recognize a selling profit. The lessor right-of-use model would require (for both leases) that the lessor reflect the fact that it has exchanged the right to use the leased asset for the right to receive lease payments from the lessee and the right to the value of the asset at the end of the lease term. The lessor right-of-use model would result in the lessors in both scenarios recognizing interest income, which reflects the fact that both leases would result in the lessor financing the lessee's purchase of the right to use the leased asset. The Boards could consider further whether there are situations where the interest income could be classified as rental income (perhaps through consideration of how management views its business activities – an approach similar to the management approach concept in the Financial Statement Presentation Discussion Paper). The Board and staff also would need to consider further how this model would impact lessors who provide short-term leases and lessors of real estate. The Boards also could further consider what situations would result in the lessor recognizing profit other than financing income

(perhaps in situations where the lease payments and the estimated residual value are in excess of the purchase or manufacturing cost of the leased asset).

48. As discussed in paragraph 30, the staff thinks there are four views the Boards could consider regarding the assets and liabilities recognized by a lessor under the right-of-use model to lessors:

    - View A: Lessor derecognizes the whole of the leased asset
    - View B: Lessor derecognizes a portion of the leased asset
    - View C: Lessor does not derecognize the leased asset (gross presentation of lease liability)
    - View D: Lessor does not derecognize leased asset (linked presentation of lease liability)

49. The Boards could decide to describe these four views in the Leases Discussion Paper (perhaps with a preliminary view) or they could decide to not address lessor accounting in the Leases Discussion Paper.

Consideration of Sublessor Accounting

Description of subleasing arrangements

50. A reporting entity will sometimes act as both a lessor and a lessee of the same asset. 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.

51. Different types of arrangements include:

    - 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’
    - 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 intermediate lessor will intend to enter into further subleases once the initial sublease has expired)

- The sublease commences some time after the head lease—for example, where the intermediate lessor leases a property on a long lease, occupies it for a while, then decides it no longer needs the property and instead of canceling the head lease, subleases the property to a new tenant.

Application of the right-of-use model to sublessors

52. The staff has already presented the Boards with the difficulties that will arise if a model for sublessors is not developed. That is, there are a number of problems that were identified in trying to apply the current lessor guidance under IAS 17 or Statement 13 to a sublease transaction that is originally accounted for under a right-of-use model. Some staff members do not believe the lessor accounting model in the current literature can be applied to a right-of-use asset in a sublease. Consequently, they believe there are two alternatives: develop a right-of-use model for sublessors only or defer publication of the Leases Discussion Paper until an accounting model for lessors (including sublessors) has been developed. An alternative staff view is described in agenda paper 13B.

53. A right-of-use model could be applied to sublessors only. Under this approach, the intermediate lessor would not be required to classify the leases as a finance lease or as an operating lease. Instead, the intermediate lessor would record assets and liabilities based on the analysis in paragraphs 20-29 of this memo.

54. This approach has the following advantages:

    - Intermediate lessors will not be required to classify leases as finance leases or operating leases.
    - The same conceptual model is applied to both the head lease and the sublease. This will be easier for users to understand.

55. However, there are a number of disadvantages to this approach if the overall lessor model is not changed as well:

    - Similar transactions will be accounted for differently. For example, a lessor of motor vehicles may choose to buy some 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 and/or Statement 13. Leases of vehicles that are themselves leased will be accounted for under the right-of-use approach. This will reduce comparability to users.

- The Boards would need to decide whether lessors should derecognize the right-of-use asset on entering into the sublease.
- 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).
- 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 would need to be developed.
- 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.
- The Boards would need to discuss when and if the lessor would recognize revenue.

Potential Difficulties If Accounting for Sublessors Is Completed Prior to Lessor Accounting

56. The decision to defer lessor accounting should be reconfirmed given the potential accounting consequences that could occur if accounting for subleases is part of a proposed new leases standard.

57. A new leases standard that applies a right-of-use model to subleases only (and not other lessor transactions) will impact preparers, users, and auditors. Each constituent will be forced to obtain knowledge of three lease models (that is, lessee, sublessor [right-of-use model], and lessor [existing standards]) and be able to interpret how each respective model impacts the financial statements. In addition, they will eventually need to adopt a new model that converges accounting for lessors and sublessors.

58. If there are two different models for sublessors and lessors, structuring opportunities will be available and economically similar transactions will be accounted for differently.

Staff Recommendation

59. Because of the difficulties outlined above, the staff does not recommend developing a right-of-use model for sublessors only.

60. Some staff members believe that accounting for sublessors and lessors is critical to the success of a new leasing standard. Accordingly, those staff members recommend that the Boards defer the issuance of the Leases Discussion Paper until accounting for lessors and sublessors is addressed. Additional time would be needed to fully develop the lessor accounting model prior to issuance of the Discussion Paper.

61. An alternative staff view is described in agenda paper 13B (Memorandum 28).

Questions for the Boards

Question 3: Do Board members agree with the staff recommendation not to develop a right-of-use model for sublessors only?

Question 4: Do Board members agree with the staff recommendation to defer publication of the Discussion Paper until after an accounting model for lessors (including sublessors) has been developed?

Question 5: If the Boards disagree with the staff recommendation to defer publication of the Discussion Paper until after an accounting model for lessors (including sublessors) has been developed, what additional analysis on the subleasing issue or on lessor accounting, if any, should be included in the Discussion Paper?