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International
Accounting Standards
Board

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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: **Sublessor Accounting – Alternative Staff View (Agenda Paper 13B)**

Implication of the staff recommendation on lessor accounting

1. As discussed in agenda paper 13A/FASB Memo No. 27 some staff believe that the existing accounting model for lessors cannot be applied to subleases. Consequently, they recommend that publication of the leases discussion paper be deferred until an accounting model for lessors (including sublessors) has been developed.

2. I agree that the best solution to the problem of subleases would be to develop an accounting model for lessors. However, this approach is inconsistent with the boards' decision in July 2008 to defer consideration of lessor accounting. The main reason for this decision was timing. It will not be possible to produce a revised standard that deals with both lessor and lessee accounting by mid-2011. The reasons for deferring lessor rather than lessee accounting (as summarised in the staff draft of the discussion paper) were as follows:
    - Most of the problems associated with the existing accounting model relate to the treatment of operating leases in the financial statements of lessees.

Users of financial statements have raised fewer concerns about the existing accounting for lessors.

- Consideration of lessor accounting at the same time as lessee accounting will delay publication of a new accounting standard for lessees. Lessee accounting affects a wide range of entities across all industries. Existing accounting standards significantly understate the extent of those entities' assets and liabilities. Consequently, improvements to lessee accounting would be of benefit to a large number of users.
- Lessor accounting raises issues that relate to other projects the boards are currently considering – in particular, derecognition and revenue recognition. Until conceptual models for derecognition and revenue recognition have been developed, it will be difficult and perhaps premature to build an accounting model for lessors.
- Any project dealing with lessor accounting will need to consider how to account for investment property. The existing accounting models for investment property under US GAAP and IFRS are very different. Reconciling these differences will be time consuming.

3. Developing a full accounting model for lessors would delay publication of a final standard by at least 12 months (publication in mid-2012 at the earliest). It may be possible to develop an outline of an accounting model for lessors for the discussion paper in a shorter timeframe (say 4 months). However, this would still need to be developed into a full model before publication of a final standard.
4. Consequently, if the boards agree with the staff recommendation in agenda paper 13A/FASB Memo No. 27, it will not be possible to produce a revised standard on lease accounting by mid-2011.

Alternative proposal

5. Clearly, if it is not possible to find a solution to the problem of subleases, the boards would have no alternative but to accept a delay to the publication of a final standard. However, I believe it is possible to develop a technically feasible solution and issue a revised standard on lessee accounting by mid-2011. The solution would involve providing additional guidance on how to apply the existing standards to a subleasing arrangement. The appendix summarises the problems

associated with subleases and possible additional guidance. This appendix is based on the subleasing paper presented to the boards in November.

6. Consequently, I recommend the following:

   - We publish the discussion paper as planned in February. The paper would include the following:
     1. a description of the problems associated with subleases
     2. a description of the possible additional guidance
     3. a question asking for respondents' views on the proposed approach.
   - We develop additional guidance on how to account for subleases in accordance with the existing standards as part of our work on the exposure draft.
   - We do not attempt to develop a lessor accounting model until the revised standard on lessee accounting has been completed.

7. I have recommended this approach as I believe that the proposals on lessee accounting in the discussion paper are significantly better than the requirements of the existing standards. Although the problems associated with subleases are significant, they represent a subset of all leases and not all subleases will give rise to significant accounting problems. In addition, I believe the proposals outlined in the appendix could provide a reasonable short-term approach to accounting for subleases. Consequently, I do not believe that the problems associated with subleasing justify delaying publication of these improvements.

Appendix A - Summary of problems associated with subleases

A.1 We have identified four problems with applying existing standards to a sublease:

(a) determining which asset to apply the classification tests to

(b) classification inconsistencies

(c) inconsistencies in measurement when the sublease is classified as a finance lease

(d) income statement ‘mismatches’ when the sublease is classified as an operating lease.

A.2 These problems and possible solutions are described on the following sections.

Determining which asset to apply the classification test to

A.3 Under IAS 17, a finance lease is one that transfers substantially all risks and rewards incidental to ownership of an asset. The question is ‘which asset should be considered?’ 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.

A.4 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.

A.5 Some staff believe that the correct approach is to apply the classification tests to the right-of-use asset (approach (a)) and would develop guidance to this effect.

A.6 Similar problems arise under Statement 13. However, 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

A.7 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:

(a) The lease term is for a major part of the economic life of the leased asset.

(b) The present value of the minimum lease payments amounts to substantially all the fair value of the leased asset.

A.8 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.

A.9 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.

A.10 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.

A.11 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].

A.12 Under IAS 17, the equivalent tests are merely examples of situations that would *normally* lead to finance lease classification.

A.13 Consequently, it may be necessary to amend these tests when applying them to subleases.

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

A.14 As discussed above, if the sublease is classified as a finance lease under IAS 17, 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.

A.15 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.

A.16 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. Similar measurement inconsistencies arise with

[1] Other tests also apply

options to extend or terminate the lease, purchase options, residual value guarantees and the discount rate.

A.17 Similar problems arise if a lease is classified as a sales type or direct financing lease under Statement 13.

A.18 These inconsistencies could be resolved if the measurement requirements of the existing standards were amended for subleases only. Alternatively, the boards could decide to require additional disclosures to explain these inconsistencies.

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

A.19 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.

A.20 This is similar to the situation that arises under existing 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. As this mismatch already arises under the existing standards, the boards could decide not to resolve this issue.