Project **Leases**

Topic **Accounting for Subleases—Performance Obligation Model**

Please note this paper has been reposted on 14 April. The only difference between this version and the version previously posted is the appendix. None of the main body of this memo has been changed.

Objective

1. The objective of this paper is to address the accounting for subleases under the proposed new leases requirements under the performance obligation approach to lessor accounting.

2. The staff will include an analysis of subleases under a derecognition approach to lessor accounting in a future memo.

3. In particular, this paper addresses the following topics on the accounting for subleases under the proposed new leases requirements:

   (a) Measurement

   (b) Presentation

   (c) Disclosures

4. In this paper, the staff recommends the following:

   (a) the intermediate lessor, as a lessee in the sublease arrangement, account for its lease with the head lessor (the head lease) in accordance with the decisions-to-date for all lessees.

   (b) the intermediate lessor, as a lessor in the sublease arrangement, account for its lease with the sublessee (the sublease) in accordance with the decisions-to-date for all lessors.

(c) the intermediate lessor present all assets and liabilities arising from a sublease, excluding the intermediate lessor's obligation to pay rentals to the head lessor, together, gross on the statement of financial position (SFP), with a net subtotal.

(d) the intermediate lessor disclose in its notes, for any material subleases, the nature and amount of any sublease arrangements.

5. This paper is structured as follows:

(a) Background

(b) Comment Letter Feedback Received

(c) Leases Proposed Requirements (Summary of Decisions Made)

(d) Staff Analysis and Recommendations

6. The appendix to this paper provides illustrations of the presentation alternatives described in this paper.

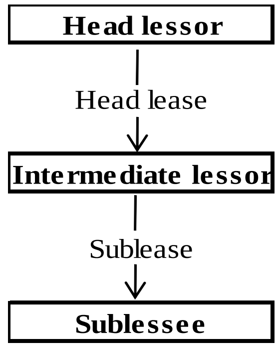
Background

7. The Master Glossary of the Accounting Standards Codification (ASC) defines a sublease as:

> A transaction in which a leased property is re-leased by the original lessee to a third party, and the lease agreement between the two original parties remains in effect.

8. An entity will sometimes act as both a lessor and a lessee of the same asset. For example, an 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).

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



10. Different types of arrangements may 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 underlying 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 long-term, occupies it for some time, and then decides it no longer needs the property and instead of cancelling the head lease, subleases the property to a new tenant.

11. The guidance on subleases in Topic 840 of the *FASB Accounting Standards Codification*™ focuses on lease classification and was considered in the staff analysis but not included for background information.

12. The Boards held preliminary discussions on sublease accounting at their November 2008 and January 2009 meetings. These discussions were held based on the decision that lessor accounting would not be addressed in the

leases project. However, the Boards have made significant progress on lessor accounting since these meetings were held.

Comment Letter Feedback Received

13. The Boards included discussions on accounting for subleases in the Discussion Paper, *Leases: Preliminary Views* (DP), published in March 2009 to receive feedback from constituents, but did not include any preliminary views.

14. The purpose of the discussion in the DP was to decide how an intermediate lessor should account for the sublease if the Boards decide to issue a new standard on lessee accounting before they issue a new standard on lessor accounting.

15. In the DP, the Boards discussed three possible ways of addressing how an intermediate lessor should account for a sublease:

    (a) Provide additional guidance on how to apply the existing lessor accounting requirements to subleases

    (b) Exclude the head lease from the scope of the new standard

    (c) Develop a lessor right-of-use model for subleases only.

16. Several respondents noted the importance of addressing subleases in this project. They noted issues with accounting mismatch and presentation as reasons that the accounting for subleases needed to be addressed.

17. The Boards have since concluded that it would not be possible to deal with subleases without developing a full lessor accounting model. Therefore, because the Boards have been developing a full lessor accounting model, the staff analysis in this paper is based on the performance obligation decisions-to-date.

Leases Proposed Requirements (Summary of Decisions Made)

Lessee

18. A lessee would recognize an asset representing its right to use the leased item for the lease term (the right-of-use asset) and a liability for its obligation to pay rentals.

19. Initial measurement of the lessee's right-of-use asset would be at cost in which cost is the present value of the lease payments plus any initial direct costs incurred by the lessee. Subsequent measurement of the lessee's right-of-use asset would be at amortized cost.

20. Initial measurement of the lessee's obligation to pay rentals would be at the present value of the lease payments discounted using the lessee's incremental borrowing rate. However, the interest rate implicit in the lease can be used if it can be readily determinable. Subsequent measurement of the lessee's obligation to pay rentals would be at amortized cost using the effective interest method.

21. The Boards tentatively decided the following with regards to lessee presentation in the SFP:

    (a) A lessee would present separately its obligation to pay rentals from other financial liabilities on the face of the SFP.

    (b) A lessee would present its right-of-use asset with property, plant, and equipment, but separate from other assets that are owned but not leased, on the face of the SFP.

Lessor

22. A lessor would recognize an asset representing its right to receive rental payments (a lease receivable); and recognize a liability representing its performance obligation under the lease—that is, its obligation to permit the lessee to use ones of its assets (the leased asset).

23. Initial measurement of the lessor's right to receive rental payments would be at the present value of the lease payments discounted using the rate the lessor is charging the lessee, plus any initial direct costs incurred by the lessor. Subsequent measurement of the lessor's receivable would be at amortized cost using the effective interest method.

24. Initial measurement of the lessor's performance obligation would be at the transaction price. That is, the customer consideration, which would be measured at the present value of the lease payments and would be discounted using the rate the lessor is charging the lessee (on the same basis as the receivable). Subsequent measurement of the lessor's performance obligation would reflect decreases in the obligation to permit the lessee to use the leased item over the lease term.

25. The Boards tentatively decided the following with regards to lessor presentation in the SFP:

    (a) A lessor would present the leased asset, the lease receivable, and the performance obligation together, gross, in the SFP with a net subtotal.

Staff Analysis and Recommendations

26. In a subleasing arrangement, an intermediate lessor will enter into a leasing arrangement as both

    (a) a lessee, leasing an asset from a head lessor, and

    (b) a lessor, subleasing the same underlying asset to a sublessee for the same or a shorter term.

27. As such, under the proposed new leases requirements, an intermediate lessor will need to account for the following:

    (a) The head lease, which includes accounting for:

        (i) An asset for the right to use the head lessor's leased asset (right-of-use asset)

(ii) A liability for its obligation to pay rentals to the head lessor; and

(b) The sublease, which includes accounting for:

(i) An asset to receive rental payments from the sublessee

(ii) A liability for its obligation to permit the sublessee to use the right-of-use asset acquired under the head lease.

Measurement

28. Based on the tentative decisions made to-date, discussed in paragraphs 18-25, the staff acknowledges that there could be differences between the measurement and presentation of the lessee's and lessor's assets and liabilities arising under a lease arrangement.

29. Economically, the staff would expect that, if the terms of the head lease and the sublease match, the obligation arising on the head lease would equal the receivable recognised on the sublease. However, because of the different decisions made on measurement (in particular, the decisions on discount rate and contingent rentals), this may not be the case. Consider for example, a head lease and sublease whose rentals are linked to usage and the terms of the head lease and sublease are identical. In measuring the obligation to pay rentals one would include an estimate of the amounts payable under the contingent rental arrangement. However, one would only include amounts payable under the contingent rental arrangement in the receivable if it could be measured reliably.

30. The staff acknowledges the accounting mismatch in the measurement of the assets and liabilities arising in a sublease for an intermediate lessor. However, the staff does not think that entering into a sublease would merit a different measurement basis as the transaction between the head lessor and the intermediate lessor and the transaction between the intermediate lessor and the sublessee represent two separate transactions.

Staff Recommendation

31. The staff does not recommend providing different accounting measurement guidance for assets and liabilities arising under lease arrangements under subleases.

Question 1
The staff recommends that different measurement guidance should not be provided for assets and liabilities arising under subleases. Do the Boards agree?

Presentation

32. The staff considered the following approaches to the presentation of the intermediate lessor's assets and liabilities arising under a sublease arrangement in the SFP:

    (a) Present the assets and liabilities under a sublease arrangement gross without a net total.

    (b) Present the assets and liabilities under a sublease arrangement gross with a net total.

    (c) Present the assets and liabilities under a sublease arrangement, excluding the intermediate lessor's obligation to pay rentals to the head lessor, gross with a net total.

    (d) Present the assets and liabilities under a sublease arrangement net.

33. Illustrations of the presentation of these approaches are included in Appendix A.

Approach A—Gross Presentation (without net total)

34. Under Approach A, an intermediate lessor would present all assets and liabilities arising from the head lease and sublease gross in their financial statements.

35. As such, under Approach A, an intermediate lessor will present the following:

    (a) The head lease, which includes presentation of:

        (i) An asset for the right to use the head lessor's leased asset (right-of-use asset) gross but separate from owned property, plant, and equipment

        (ii) A liability for its obligation to pay rentals to the head lessor gross but separate from other liabilities; and

    (b) The sublease, which includes presentation of:

        (i) An asset to receive rental payments from the sublessee gross but separate from other receivables

        (ii) A liability for its obligation to permit the sublessee to use the right-of-use asset acquired under the head lease gross but separate from other liabilities.

36. The staff have noted the following advantages of Approach A:

    (a) Approach A would be consistent with the tentative decisions made on gross presentation for lessee accounting for lease arrangements not under sublease.

    (b) Approach A would not present the assets and liabilities under separate contracts linked in the SFP because these assets and liabilities represent separate contracts.

37. The staff have noted the following disadvantage of Approach A:

    (a) Approach A would not be consistent with the tentative decisions made on lessor presentation, because the ROU asset would become the "underlying asset" for the intermediate lessor.

Approach B—Gross Presentation (net total)

38. Under Approach B, an intermediate lessor would present all assets and liabilities arising from the head lease and the sublease together in the SFP, gross, with a net subtotal.

39. As such, under Approach B, an intermediate lessor will present all of the following together in the SFP, gross, with a net asset or liability total, separate from either property, plant, and equipment or other liabilities:

    (a) The head lease, which includes presentation of:

        (i) An asset for the right to use the head lessor's leased asset (right-of-use asset)

        (ii) A liability for its obligation to pay rentals to the head lessor; and

    (b) The sublease, which includes presentation of:

        (i) An asset to receive rental payments from the sublessee

        (ii) A liability for its obligation to permit the sublessee to use the right-of-use asset acquired under the head lease.

40. Approach B would group all assets and liabilities arising under sublease arrangement together in the SFP. However, Approach B would not be consistent with the tentative decision made on lessee presentation.

Approach C—Gross Presentation (net total, obligation to pay rentals separate)

41. Approach C is similar to Approach B. Under Approach C, an intermediate lessor would present all assets and liabilities, excluding the intermediate lessor's obligation to pay rentals to the head lessor, arising from lease contracts with subleases together, in the SFP, gross, with a net subtotal. However, the intermediate lessor's obligation to pay rentals to the head lessor would be presented separately.

42. As such, under Approach C, an intermediate lessor will present all of the following gross in the SFP with a net asset or liability total, separate from either property, plant, and equipment or liabilities:

    (a) The head lease, which includes presentation of:

        (i) An asset for the right to use the head lessor's leased asset (right-of-use asset)

    (b) The sublease, which includes presentation of:

(i) An asset to receive rental payments from the sublessee

(ii) A liability for its obligation to permit the sublessee to use the right-of-use asset acquired under the head lease.

43. The liability for its obligation to pay rentals to the head lessor under the head lease would be presented separately from the net asset or liability and separate from other liabilities.

44. The staff notes that Approach C would be consistent with both the tentative presentation decisions made for lessees as well as the tentative presentation decisions made for lessors.

Approach D—Net Presentation

45. Under Approach D, an intermediate lessor would present all assets and liabilities arising from the head lease and sublease net in their financial statements creating a net leased asset/liability.

46. The staff have noted the following advantages of Approach D:

(a) Approach D would clearly show the net results of an entity's sublease arrangements separate from other lease arrangements.

(b) Approach D would reflect the fact that all of the elements of the multiple lease arrangement are linked in some way (for example, to the same underlying asset).

47. The staff have noted the following disadvantages of Approach D:

(a) Information about the assets and liabilities would not be presented on the face of the SFP which may add complexity to users. Additionally, any changes in assets and liabilities of a head lease and related sublease would not be known absent additional disclosures.

(b) Approach D would not be consistent with the tentative decisions on lessee and lessor presentation for leases not under sublease.

(c) Currently, there is no guidance in U.S. generally accepted accounting principles (GAAP) or International Financial

Reporting Standards (IFRS) that nets assets with liabilities, unless the offset rules are met which are specific to contracts with different counterparties.

Staff Recommendation

48. The staff recommends Approach C. That is, lessors would present all assets and liabilities arising from a sublease, excluding the intermediate lessor's obligation to pay rentals to the head lessor, together, gross on the SFP, with a net subtotal.

Question 2
The staff recommends Approach C. That is, lessors would present all assets and liabilities arising from a sublease, excluding the intermediate lessor's obligation to pay rentals to the head lessor, together, gross on the SFP, with a net subtotal. Do the Boards agree?

Disclosures

49. Under current guidance of Topic 840 and IAS 17, *Leases*, there are no specific disclosure requirements for sublease arrangements.

50. The staff thinks that, for material sublease arrangements, the nature and amount of these arrangements should be disclosed in the lessor's financial statements.

51. This would result in disclosures necessary to provide investors a transparent picture of the potential future impact on earnings and cash flows from financial transactions. Additionally, consistent with the Investors Technical Advisory Committee (ITAC) Disclosure Framework, this would provide information of the composition of the account balance.

52. The staff do not feel that this would create any unnecessary additional costs as this information is substantially available, as most of this data is required and important for the management of entities.

Question 3

The staff recommends that, for any material subleases, the nature and amount of the subleases shall be disclosed in the lessor's financial statements.

Do the Boards agree?

Appendix A: Illustrations of Presentation Approaches

A1. The following illustrations illustrate the different presentation approaches considered by the staff. These illustrations only include assets and liabilities arising from a sublease arrangement. Assets and liabilities not in bold represent assets and liabilities a lessor would ordinarily already have presented. The purpose of this is to show where assets and liabilities arising from a sublease arrangement would be shown geographically in comparison to other assets and liabilities.

Approach A: Gross without a net total

Approach A	
Receivables	
Lease Receivables	
Total Receivables	
PPE	
ROU Asset	
Total PPE	
Liabilities	
Obligation to Pay Rentals	
Performance Obligation	
Total Liabilities	

Approach B: Gross with a net total for all assets and liabilities arising from a sublease arrangement

Approach B	
Receivables	
Total Receivables	
PPE	
Total PPE	
ROU Asset	
Lease Receivable	
Performance Obligation	
Obligation to Pay Rentals	
Net Asset/Liability	
Liabilities	
Total Liabilities	

Approach C: Gross with a net total for the ROU asset, lease receivable and performance obligation. The obligation to pay rentals to the head lessor is presented separately.

Approach C	
Receivables	
Total Receivables	
PPE	
Total PPE	
ROU Asset	
Lease Receivable	
Performance Obligation	
Net Asset/Liability	
Liabilities	
Obligation to Pay Rentals	
Total Liabilities	

Approach D: Net

Approach D	
Receivables	
Total Receivables	
PPE	
Total PPE	
Net Asset/Liability for Subleasing arrangement	
Liabilities	
Total Liabilities	