Project **Leases**

Topic **Derecognition model - Accounting for Subleases**

Purpose

1. The purpose of this paper is to address accounting for subleases under a derecognition model for lessor accounting.

2. The staff recommend that:

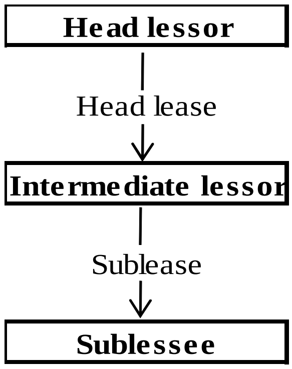
   (a) different measurement guidance should not be provided for assets and liabilities arising under a sublease; and

   (b) Intermediate lessors should present all assets and liabilities arising from a sublease gross on the statement of financial position.

Background

3. 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).

4. Under a sublease arrangement, an intermediate lessor will enter into a lease arrangement as a lessor, subleasing a right-of-use asset to a sublessee for the same or a shorter term. This is illustrated in the following diagram:



5. 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.

6. At the April 2010 joint board meeting, the boards tentatively decided that, under a performance obligation approach to lessor accounting, an intermediate lessor, as a lessee in a head lease, should account for its assets and liabilities arising from the head lease in accordance with the lessee model developed by the boards. Similarly, the intermediate lessor, as a lessor in a sublease, should account for its assets and liabilities arising from the sublease in accordance with the lessor model developed by the boards.

7. The boards also tentatively decided that intermediate lessors should present all assets and liabilities, excluding their obligation to pay rentals to the head lessor, arising from lease contracts with subleases together, in the statement of financial position, gross with a net subtotal. The obligation to pay rentals to the head lessor should be presented separately.

8. In addition, intermediate lessors are required to disclose the nature and amount of significant subleases.

Staff analysis and recommendation

Measurement

13. Economically, 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 (particularly, discount rate and contingent rentals), this may not be the case.

14. For example, consider 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, a lessee would include an estimate of the amounts payable under the contingent rental arrangement; however, a lessor would only include the contingent rentals in the receivable if it could be measured reliably.

15. The staff acknowledge the potential accounting mismatch in the measurement of the assets and liabilities arising in a sublease for an intermediate lessor. However, the staff do not think that a different measurement basis for a sublease (as the transaction between the head lessor and the intermediate lessor and the transaction between the intermediate lessor and the sublessee) should be developed as those represent two separate transactions.

16. As the boards tentatively decided at the April 2010 joint meeting not to provide different accounting guidance for assets and liabilities arising in subleases under a performance obligation approach to lessor accounting, the staff also do not recommend providing different accounting measurement guidance for assets

and liabilities arising under subleases under a derecognition approach to lessor accounting.

Journals

17. In a sublease arrangement, an intermediate lessor will enter into a lease arrangement as both a lessee and a lessor for the same or a shorter term than the head lease arrangement.

18. As such, under the proposed leases requirements and a derecognition approach to lessor accounting, an intermediate lessor would recognise the following:

    (a) For the head lease:

    (i) A right-of-use asset representing its right to use the underlying asset during the term of the head lease; and

    (ii) An obligation to pay rentals under the head lease.

    (b) For the sublease:

    (i) A receivable representing its right to receive rentals under the sublease; and

    (ii) The right-of-use asset (or part of the right-of-use asset) would be derecognised when entering into the sublease. The intermediate lessor would either recognise a residual asset, or be left with a remaining amount of its right-of-use asset – in either case, that residual asset would represent the intermediate lessor's residual interest in the right-of-use asset recognised under the head lease.

19. Under the two derecognition approaches, the staff consider two sublease examples as follows (the first one is a through lease and the other is a non-through lease):

A car's fair value (and carrying amount) is CU18,056
Estimated value at the end of lease is CU15,000
Estimated useful life is 10 years
A car is leased for a fixed term of 2 years

The car is sub-let for the same term Annual payments due in arrears (under both the head lease and the sublease) is CU5,000 Discount rate is 20% The present value of the lease payments is CU7,639 Interest component of the lease payments is CU2,361 Present value of estimated value of the car at the end of lease is CU 10,417

20. The journals at Year 0 are as follows:

DR Right-of-use asset	7,639
CR Obligation to pay rentals	7,639

To recognise the head lease as a lessee

DR Receivable	7,639
DR Residual asset	-
DR Cost of sales	7,639
CR Right-of-use asset (Underlying asset)	7,639
CR Revenue	7,639

To recognise the sublease as a lessor – Full derecognition approach

DR Receivable	7,639
DR Cost of sales	7,639
CR Right-of-use asset (Underlying asset)	7,639
CR Revenue	7,639

To recognise the sublease as a lessor – Partial derecognition approach

21. The staff note that the lessor’s obligation to pay rentals under the head lease is not affected by the sublease.

22. In this example, the lease is a through lease. Consequently, the intermediate lessor has no residual asset. Because the terms of the head lease and the

sublease are the same, the results under the both full and partial derecognition approaches are the same.

23. However, if the leases is other than a through lease, the intermediate lessor would recognise a residual asset representing its remaining interest in the right-of-use asset at the end of the sublease. Consider the following example:

> **Head lease**
>
> A car is leased for a fixed term of 2 years
>
> Its fair value (and carrying amount) is CU18,056
>
> Annual payments due in arrears is CU5,000
>
> Discount rate is 20%
>
> The present value of the lease payments is CU7,639
>
> Estimated value of the car at the end of lease is CU15,000 (present value CU10,417)
>
> On the same day the entity enters into a sublease on the following terms:
>
> **Sublease**
>
> The car is sub-let for 1-year
>
> Annual payment due in arrears is CU5,500
>
> Discount rate is 13.6%
>
> The present value of the lease payments is CU4,842
>
> Present value of estimated value of the right-of-use asset at the end of the lease is 2,797.

24. The journals at Year 0 are as follows:

DR Right-of-use asset	7,639
CR Obligation to pay rentals	7,639
To recognise the head lease as a lessee	

DR Receivable	4,842
DR Residual asset	2,797
DR Cost of sales	7,639

CR Right-of-use asset (Underlying asset)	7,639
CR Revenue	7,639

To recognise the sublease as a lessor – Full derecognition approach

DR Receivable	4,842
DR Cost of sales	4,842
CR Right-of-use asset (Underlying asset)	4,842
CR Revenue	4,842

To recognise the sublease as a lessor – Partial derecognition approach

25. The staff note that the lessor's obligation to pay rentals under the head lease is not affected by the sublease.

Presentation

26. The staff think that the boards' tentatively decided to require a form of linked presentation under the performance obligation approach to lessor accounting to:
    (a) Better reflect the linkage between the underlying asset, the receivable and the performance obligation; and
    (b) Address the issue of grossing up of the statement of financial position under the performance obligation approach.
27. The staff note that under a derecognition approach, there is no performance obligaton. Also, the staff think that two separate transactions (the head lease and the sublease) should not be netted unless they meet the offset rules under IFRSs and US GAAP.
28. Therefore, the staff recommend that consistent with the tentative decisions on gross presentation for lessee accounting, the intermediate lessor should present its assets and liabilities arising under a sublease gross under a derecognition approach to lessor accounting.
29. If a sublease is other than a through lease, the lessor would recognise a residual asset representing its remaining interest in the right-of-use asset at the end of the sublease. Under a sublease, the right-of-use asset would become the "underlying asset" for the intermediate lessor.

30. The staff illustrate gross presentation by the intermediate lessor using the same examples above.

For the through lease:

Receivables	
Lease receivables	7,639
Total receivables	
PPE	
Right-of-use asset/Residual asset	-
Total PPE	
Liabilities	
Obligation to pay rentals	7,639
Total liabilities	

For the non-through lease (Full derecognition approach):

Receivables	
Lease receivables	4,842
Total receivables	
PPE	
Right-of-use asset	
Residual asset	2,797
Total PPE	
Liabilities	
Obligation to pay rentals	7,639
Total liabilities	

For the non-through lease (Partial derecognition approach):

Receivables	
Lease receivables	4,842
Total receivables	
PPE	
Right-of-use asset	2,797
Residual asset	
Total PPE	
Liabilities	
Obligation to pay rentals	7,639
Total liabilities	

31. As seen above, under the full derecognition approach, the intermediate lessor’s residual interest in the right-of-use asset at the end of the sublease would be

labelled as “residual asset”, whereas “right-of-use asset” would be used under the partial derecognition approach. Presentation under both approaches will be discussed in a separate paper and a sublease arrangement would follow the presentation requirements decided by the boards.

Question 1
The staff recommend that: a) Different measurement guidance should not be provided for assets and liabilities arising under a sublease. b) Intermediate lessors should present all assets and liabilities arising from a sublease gross on the statement of financial position. Do the boards agree?