Project **Leases**

Topic **Subleases**

Purpose

1. The purpose of this paper is to address the accounting for subleases under the proposed leases requirements for lessees and lessors.
2. This paper does not discuss the presentation or the disclosures for intermediate lessors, which will be discussed at a future meeting.
3. This paper is organized as follows:
   (a) Summary of staff recommendations
   (b) Background
   (c) Summary of proposals in the *Leases* Exposure Draft
   (d) Feedback received
   (e) Staff analysis of the following:
      i. Are the head lease and the sublease separate transactions?
      ii. Should a lessee's right-of-use (ROU) asset and a lessor's right to receive lease payment (lease receivable) in a sublease be accounted for consistently with ROU assets and lease receivables recognized in accordance with all other lease arrangements?
      iii. If the Boards decide to have two approaches to lessor accounting, to which asset should the lease principles and indicators be applied?

Summary of staff recommendations

4. The staff recommends that the Boards affirm their view in the *Leases* Exposure Draft (ED) that a head lease and a sublease should be accounted for as separate transactions.

5. However, the staff recommends that the Boards clarify that an intermediate lessor do the following:

   (a) As a *lessee* in a head lease arrangement, it should account for its lease with the head lessor (head lease), including the measurement of the ROU asset, in accordance with the decisions-to-date for all lessees.

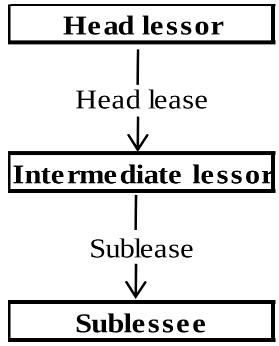
   (b) As a *lessor* in the sublease arrangement, it should account for its lease with the sublessee (sublease) in accordance with the decisions-to-date for all lessors.

6. In May 2011, the Boards tentatively decided that if there are two approaches to lessor accounting, distinguishing between those two approaches would be based on indicators relating to a definition of whether the lease transfers substantially all of the risks and rewards incidental to the ownership of the leased asset. If the Boards decide that there are two approaches to lessor accounting, to determine the lease classification the staff recommends that the principles and indicators should be applied by the intermediate lessor as a lessor in the sublease arrangement to the ROU asset it recognizes from the head lease.

Background

7. An entity will sometimes act as both a lessor and a lessee of the same underlying asset. For example, an entity may lease an item of equipment from one party (head lease) and then sublet the same item of equipment to another party (sublease).

8. Under a subleasing arrangement, an intermediate lessor will enter into leasing arrangements as both (a) a lessee, leasing an underlying asset from a head lessor, and (b) a lessor, subleasing the same underlying asset to a sublessee for the same or a shorter term.



9. Different types of sublease arrangements may include the following circumstances:

   (a) The head lease and the sublease commence on the same date, for the same term, and for the same lease payment amounts (possibly with a small amount being retained by an intermediate lessor). This is 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 intermediate lessor will intend to enter into more subleases once the initial sublease has expired).

   (c) The sublease commences some time after the head lease; for example, the intermediate lessor leases a property long term, occupies it for some time, and then decides it no longer needs the property but instead of cancelling the head lease, the intermediate lessor subleases the property.

Summary of proposals in the ED

10. The ED does not include any specific recognition and measurement guidance for sublease arrangements. However, the ED proposes that the intermediate lessor do the following:

    (a) As a *lessee* in a head lease arrangement, account for its lease with the head lessor (head lease), including the measurement of the ROU asset, in accordance with the ED's proposals for lessees.

(b) As a *lessor* in the sublease arrangement, account for its lease with the sublessee (sublease) in accordance with the ED's proposals for lessors.

11. The Basis for Conclusions notes that the Boards acknowledge that accounting for lessees and lessors could result in different measurements of assets and liabilities under a head lease and a sublease due to asymmetry in measurement for lessees and lessors under the proposals in the ED. That situation may arise because a lessor measures a lease asset only on the basis of lease payments that can be measured reliably, whereas a lessee does not consider measurement reliability when it determines the liability to make lease payments. Additionally, different discount rates may be used in each transaction. However, paragraph BC141 of the ED states that the Boards think that a head lease and a sublease are separate transactions and that entering into a sublease should not result in a different measurement basis compared with other leases.

12. The ED also includes specific presentation and disclosure requirements for sublease transactions. However, this paper does not discuss presentation and disclosure requirements.

Feedback received

13. The Boards did not ask a specific question on the accounting for subleases in the ED (except for a question on the presentation of assets and liabilities arising under a sublease); however, some respondents still commented on subleases. For example, some respondents pointed out the measurement inconsistencies related to subleases:

> The sublease guidance results in a different measurement basis for lessees and lessors. The lessor measures a lease asset only on the basis of lease payments that can be measured reliably, while a lessee does not consider measurement reliability when it determines the liability to make lease payment. The Boards have acknowledged that the accounting for lessees and lessors could result in different measurements of assets and liabilities arising under a head lease and a sublease because of the different measurement basis and discount rate used by the lessor and lessee. This type of accounting does not reflect economic reality. In addition, it is unclear from the exposure draft how this differential in values should be reflected in

> the financial statements. We request the FASB/IASB to provide additional guidance on this topic. (CL #476)

14. A few respondents asked the Boards to clarify the asset to be evaluated when a lessor is determining which lessor approach to apply: the derecognition approach or the performance obligation approach:

> There is little guidance on how to apply the proposed IFRS to subleases. For example, if one leases an asset from a head lessor for, say, five years (and this represents a small proportion of the asset's useful life) and one then enters into a sublease of the asset also for five years, would the […] sublease be accounted for under the performance obligation approach (because the lease is for a small proportion of the life of the underlying asset) or under the derecognition approach (because [the lessor] has not retained any significant risk or benefit relating to the right-of-use asset)? (CL #122)

15. Similarly, one respondent asked the Boards to clarify which asset the sublessor should derecognize under the derecognition approach:

> When the lessor is a sublessor and needs to apply the derecognition approach (…), it is not clear under the proposed guidance which asset the sublessor should derecognize. Since the sublessor does not own the underlying leased asset, the derecognition has to be applied to the right-of-use asset, which is the only asset related to the lease recorded in the sublessor's books. We ask the Boards to clarify this in the final standard, since there is no mention of this in the current proposed ED. (CL #593)

Staff analysis

Are the head lease and the sublease separate transactions?

16. Due to the recent decisions made by the Boards on the accounting for lessees and the pending decisions for lessors, the staff thinks it is possible that income statement volatility could result if the head lease and the sublease are accounted for as separate transactions. As a lessee in the head lease, the intermediate lessor will recognize amortization on the ROU asset and interest expense on the liability to make lease payments (lease liability) as proposed in the ED. However, depending on what the Boards decide for lessor accounting, the income recognition on the sublease may not match the expense recognized on the head lease by the intermediate lessor.

17. The staff also notes that, depending on the decisions the Boards make on lessor accounting, there could be a situation in which the intermediate lessor has a day 1 gain or loss on a sublease. That situation would occur when the intermediate lessor, as a lessor in a sublease (based on the staff recommendation in Question 3 of this paper) accounts for the head lease using the approach that transfers all the risks and rewards of the ROU asset (if there are two approaches for lessor accounting). The staff notes that a day 1 gain or loss could also occur if the Boards decide to apply one model for lessor accounting. The day 1 gain or loss occurs because the carrying amount of the ROU asset recognized for the head lease is different than the sublease receivable; the intermediate lessor would have a gain or loss on the sublease.

18. For example, consider a 30-year head lease of an aircraft with a useful life of 30 years. The lessee records interest expense on the liability and amortization expense on the ROU asset. Five years into the lease, the lessee becomes an intermediate lessor and subleases the entire aircraft for the remaining 25 years of the term of the head lease. The intermediate lessor would account for the sublease using the approach that represents the transfer of all the risks and rewards incidental to ownership of the asset, which could lead to a gain or loss on the sublease. If the sublease receivable is less than the carrying value of the intermediate lessor's ROU asset immediately prior to the sublease, the intermediate lessor records a loss for the difference.

19. Therefore, the staff is proposing the following approaches for the potential income statement volatility:

    (a) Approach 1: Account for the head lease and the sublease as separate transactions.

    (b) Approach 2: Do not account for the head lease and the sublease as separate transactions.

Approach 1: Account for head lease and sublease as separate transactions

20. Under Approach 1, the intermediate lessor would not consider the head lease when classifying the sublease. That is because in Approach 1, both lease arrangements are viewed as separate economic transactions between different

parties, which is consistent with the Boards' view in the ED and the Boards' redeliberations on sale and leaseback accounting.

21. As mentioned above in paragraphs 16–18, the staff notes that Approach 1 may result in income statement volatility. The intermediate lessor, as a lessee in the head lease, will recognize greater total expense in the beginning of the lease period than at the end of the lease period. As a lessor, the intermediate lessor, depending on the decision the Boards make for lessor accounting, could potentially recognize either a straight-line income pattern or a day 1 gain.

22. However, the staff does not view that as a significant issue because it thinks the head lease and the sublease are separate transactions and should be accounted for as such. The potential income statement volatility is a natural consequence of having potential differences in the accounting models for lessees and lessors.

23. Additionally, the staff notes that this potential volatility is similar to the situation that arises under current standards in which the head lease is a finance/capital lease and the sublease is an operating lease or when the head lease is an operating lease and the sublease is a finance/capital lease. Therefore, accounting for those transactions separately would result in volatility similar to the volatility that occurs today.

Approach 2: Account for the head lease and sublease as one transaction

24. Under Approach 2, the intermediate lessor would account for the sublease and the head lease as one transaction. If the Boards choose Approach 2, it will be necessary for the staff to bring back another paper on the accounting for subleases, once the Boards have decided on the accounting model for lessors.

25. If the Boards agree that the head lease and the sublease should be accounted for as one transaction, the staff would plan to bring back a paper that would provide specific rules in sublease situations to avoid the income statement volatility (for example, require the profit and loss income on the sublease to mirror the profit and loss expense on the head lease).

Staff recommendation

26. The staff recommends Approach 1, that is, that the head lease and the sublease should be accounted for as separate transactions as if the intermediate lessor was in a nonsubleasing arrangement. The staff thinks that there is no conceptual basis for requiring the head lease and the sublease to be one transaction. In other words, the sublease may in fact warrant a different accounting approach than the head lease and if the sublease is required to be accounted for the same way as the head lease, the accounting may not reflect the economics of the transaction. The staff does not recommend prescribing any specific rules to align the profit and loss pattern in a sublease arrangement because that alternative lacks any conceptual basis.

Question 1
The staff recommends that the head lease and the sublease should be accounted for as separate transactions. Do the Boards agree? Why or why not?

Should the lessee's ROU asset and lessor's lease receivable in a sublease be accounted for as other lease assets and liabilities in a nonsubleasing arrangement?

27. The ED does not provide explicit guidance for the recognition and measurement of subleases but as previously mentioned, paragraph BC140 of the ED explains that an intermediate lessor in a sublease as a *lessee* in a head lease arrangement should account for its lease with the head lessor (head lease) in accordance with the model proposed in the ED. Also, the intermediate lessor, as a *lessor* in the sublease arrangement, should account for its lease with the sublessee (sublease) in accordance with the proposals in the ED.

28. There were some concerns raised by respondents on the accounting for subleases under the proposals in the ED because the accounting for lessees and lessors could result in different measurements of assets arising under a head lease and a sublease, in addition to the potential income statement differences described in Question 1 above. Consider, for example, a head lease and a sublease whose rentals are linked to usage and in which the terms of the head lease and the sublease are identical. In measuring the ROU asset the intermediate lessor under the proposals in the ED, as a lessee, would include an

estimate of the amounts payable for variable lease payments. However, the intermediate lessor, as a lessor in the sublease, would only include amounts payable for variable lease payments in the lease receivable if it could be measured reliably.

29. However, some of those concerns expressed above have been alleviated due to tentative decisions-to-date; the accounting for variable lease payments, renewal options, purchase options and residual value guarantees is now consistent for both lessees and lessors. Therefore, the issue described in the example above and many of the other concerns noted in the feedback section regarding differences in the measurement of the ROU asset and the lease receivable have been resolved. The discount rate determination is the only item that is not the same for lessees and lessors (see chart below). The decisions made on the measurement of the ROU asset and the lease receivable are summarized below.

Item	**Measurement As Part of:**	
	Right-of-Use Asset	**Lease Receivable**
Variable Lease Payments	Not included unless lease payments are in-substance fixed but structured as variable lease payments in form.	Same
Options to Extend or Terminate the Lease	Include rentals payable in optional periods when there is a significant economic incentive to exercise.	Same
Purchase Options	Include exercise price of purchase option if there is significant economic incentive to exercise.	Same
Residual Value Guarantees	Include amounts expected to be payable under residual value guarantees, except for amounts payable under guarantees provided by an unrelated third party.	Same
Discount Rate	Rate that the lessor charges the lessee when available; otherwise use the incremental borrowing	Rate that the lessor charges the lessee.

	rate.	

30. The staff acknowledges the potential differences that may result because of the application of a different discount rate to the measurement of assets and liabilities arising under a head lease and a sublease. For instance, the intermediate lessor, as a lessee in the head lease, will most likely use the incremental borrowing rate if it is not aware of the rate the lessor is charging. In the sublease, the intermediate lessor will most likely use the rate that it is charging as an intermediate lessor to measure the lease receivable. This rate may or may not be the same as the incremental borrowing rate used in the head lease. The staff thinks it is appropriate for the intermediate lessor to use different discount rates. This follows the recommendation in Question 1 that a head lease and sublease are separate transactions and that entering into a sublease should not result in different measurement basis compared with other leases.

Staff recommendation

31. The staff recommends that the Boards affirm the decision in the ED that an intermediate lessor, as a lessee in a head lease arrangement, account for its lease with the head lessor (head lease) in accordance with the decisions to date for all lessees and that, as a lessor in the sublease arrangement, the intermediate lessor account for its lease with the sublessee (sublease) in accordance with the decisions to date for all lessors. That is, entering into a sublease should not result in a different measurement basis as compared with other leases.

Question 2
The staff recommends that the Boards confirm the proposals in the ED for sublease arrangements. That is, ROU assets and lease receivables in a sublease should be accounted for consistently with ROU assets and lease receivables recognized in accordance with all other lease arrangements. Do the Boards agree? If not, why not?

If the Boards decide to have two approaches for lessors, to which asset should the leases principles and indicators be applied?

32. At the main joint meeting in June 2011, the Boards will continue discussing whether there should be one or two approaches to lessor accounting. In May 2011, the Boards tentatively decided that if there are two approaches to lessor accounting, distinguishing between those two approaches would be based on indicators relating to a definition of whether the lease transfers substantially all of the risks and rewards incidental to the ownership of the leased asset.

33. The feedback received on the ED included requests for the Boards to clarify which asset the intermediate lessor should assess to determine whether substantially all of the risks and rewards are transferred by the lease.

34. Therefore, the staff thinks that the Boards should clarify whether those risks and rewards indicators should be applied to the underlying asset or to the intermediate lessors' ROU asset.

35. The staff analyzed how the indicators should be applied by an intermediate lessor to determine which lessor accounting approach should be applied for the sublease transaction.

36. The staff thinks that the intermediate lessor should evaluate the ROU asset recognized under the head lease, instead of the underlying asset, to determine the appropriate lessor accounting approach to be applied to the sublease.

37. For example, a lessee leases an item of equipment for seven years. The equipment has a useful life of 25 years. At the end of year 2 in the head lease, the lessee becomes an intermediate lessor and subleases the equipment for 5 years, which is the remainder of the head lease. The asset still has some substantial value to the head lessor at the end of the sublease, which in this example is the same date as the end of the head lease.

38. In this example, the intermediate lessor, as a lessor, grants the remaining ROU to the sublessee through the sublease. That is, at the end of the sublease, the intermediate lessor returns the asset to the head lessor and derives no benefit from it other than what it collected on the sublease. However, even though the contract gives the remaining benefit of the ROU to the sublessee, it does not give the sublessee the remaining benefit of the underlying asset. Based on the

staff recommendation, the intermediate lessor would use the accounting approach that transfers substantially all the risks and rewards of the asset (the ROU asset).

Staff recommendation

39. The staff recommends that the intermediate lessor evaluate the ROU asset recognized under the head lease, instead of the underlying asset, to determine the appropriate lessor accounting approach to be applied to the sublease. The intermediate lessor would use the same principles and indicators as a lessor in a nonsublease arrangement.

40. In other words, when applying the principles and indicators between the two approaches, the intermediate lessor should consider what asset it has—the ROU asset—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 the underlying is not an asset of the intermediate lessor.

Question 3
The staff recommends that the intermediate lessor evaluate the ROU asset recognized under the head lease to determine the appropriate accounting approach by applying the principles and indicators used in all other lease arrangements. Do the Boards agree? Why or why not?