STAFF PAPER

June 2014

REG FASB | IASB Meeting

Project	**Leases**		
Paper topic	Subleases		

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Purpose

1. The purpose of this paper is to discuss the accounting for, and presentation of, subleases by an entity that acts as an intermediate lessor (ie an entity that is both a lessee and a lessor of the same underlying asset).

2. The staff think it is important to discuss this topic before issuing the final leases standard in the light of (a) the changes to the lessee and lessor accounting models made by the Boards at the March 2014 joint Board meeting and (b) the feedback received on the 2013 ED.

3. This paper is structured as follows:

   (a) Background

   (b) Summary of staff recommendations

   (c) Summary of the proposals in the 2013 ED

   (d) Feedback received on the 2013 ED

   (e) Staff analysis

      (i) Accounting for a head lease and a sublease

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(ii) Presentation of lease assets and lease liabilities, lease income and lease expense.

Background

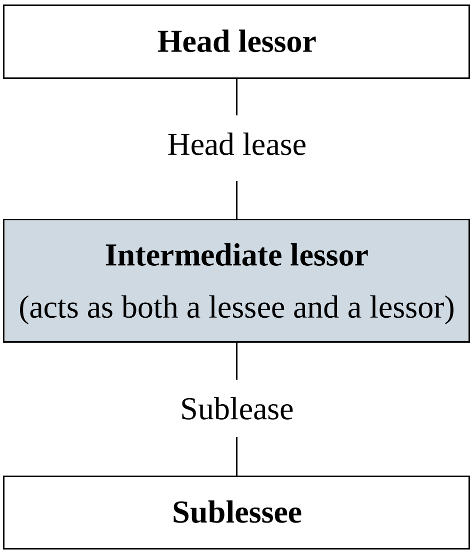
4. An entity sometimes acts as both a lessee and a lessor of the same underlying asset. For example, an entity (intermediate lessor) may:

   (a) Lease an asset from one party (head lessor), entering into a 'head lease'; and then

   (b) Sublease the same asset to another party (sublessee), entering into a 'sublease' for the same, or a shorter, lease term.

5. Under a sublease arrangement the intermediate lessor is both (a) a lessee, leasing an underlying asset from a head lessor, and (b) a lessor, subleasing the same underlying asset to a sublessee.

   This is illustrated in the following diagram.



6. Existing IFRS does not include specific guidance on the accounting for subleases. Existing U.S. GAAP includes guidance on capital and operating subleases that distinguishes between leases that relieve, or do not relieve, the intermediate lessor of the primary obligation under the head lease.

7. The staff think it is clear that there should be no special accounting treatment for a head lessor and a sublessee. For each of those parties, they are simply entering into a lease and may be unaware of the existence of the head lease or sublease to which they are not the counterparty. Consequently, the lease accounting applied by these parties should not be affected by the existence of the head lease (for the sublessee) or sublease (for the head lessor). Accordingly, the head lessor and the sublessee would classify the head lease and the sublease with reference to the underlying asset that, from each of their perspectives, is the subject of the lease.

8. With that in mind, the remainder of this paper discusses sublease accounting *only* from the perspective of the intermediate lessor.

Summary of staff recommendations

9. The staff recommend the following:

    (a) An intermediate lessor should account for a head lease and a sublease as two separate contracts (accounting for the head lease in accordance with the lessee accounting proposals and the sublease in accordance with the lessor accounting proposals), unless those contracts meet the contract combinations guidance adopted by the Boards at the April 2014 joint Board meeting;

    (b) When classifying a sublease:

        (i) If applying U.S. GAAP (the FASB dual model to lessee accounting (Type A and Type B)), the staff recommend that an intermediate lessor should determine lease classification of the sublease with reference to the underlying asset, rather than the ROU asset arising from the head lease;

        (ii) If applying IFRS (the IASB single model to lessee accounting (Type A)), some of the staff recommend that an intermediate lessor should determine lease classification of the sublease with reference to the ROU asset arising from the head lease. Other staff recommend that an intermediate lessor should determine lease classification of the sublease with reference to the underlying asset, rather than the ROU asset arising from the head lease;

(c) An intermediate lessor should not offset lease assets and lease liabilities arising from a head lease and a sublease that do not meet the respective IFRS and U.S. GAAP financial instruments requirements for offsetting; and

(d) An intermediate lessor should not offset lease income and lease expense related to a head lease and a sublease, unless it recognises sublease income as revenue and acts as an agent (assessed in accordance with the 'principal-agent' guidance in the recently-published revenue recognition standard).

Summary of the proposals in the 2013 ED

10. The 2013 *Leases* Exposure Draft (2013 ED) proposed that "leases of right-of-use (ROU) assets in a sublease" are within the scope of the new leases standard, but did not include any specific recognition and measurement guidance for subleases.

11. According to the Basis for Conclusions to the 2013 ED, an intermediate lessor should account for a head lease and a sublease as two separate contracts. This is because, generally, the obligations that arise from the head lease for the intermediate lessor are not extinguished by the terms and conditions of the sublease. In fact, an intermediate lessor generally negotiates each contract separately—with the counterparty to the sublease being a different entity from the counterparty to the head lease. Consequently, an intermediate lessor, as a *lessee* in a head lease and a *lessor* in a sublease, should account for a head lease and a sublease in accordance with the 2013 ED's proposals for lessees and lessors, respectively.

12. When classifying a sublease, the 2013 ED proposed that an intermediate lessor should evaluate the sublease with reference to the underlying asset (for example,

the item of property, plant or equipment that is the subject of the lease), rather than with reference to the ROU asset. According to the Basis for Conclusions to the 2013 ED, this was proposed, principally, to ensure similar transactions received similar accounting. The Boards noted that it may be difficult to understand and explain why a lessor would account for similar leases differently. That could occur if an entity were required to refer to the ROU asset when classifying a sublease. For example, if subleases were classified with reference to the ROU asset, a lessor that leases two similar properties on similar terms for five years could account for those leases differently if the lessor owned one of the properties and leased the other.

Feedback received on the 2013 ED

13. The Boards did not ask a specific question on the accounting for subleases in the 2013 ED. Nonetheless, the Boards received some feedback in this area.

14. Some constituents expressed concern about the interaction between the ROU model for a lessee and the proposed Type B lease accounting for a lessor in the context of subleases. These constituents noted that, if a sublease is classified as a Type B lease, both an intermediate lessor and a sublessee would present on its balance sheet a right to use the same underlying asset. This is because the intermediate lessor (as a lessee in the head lease) would recognise a lease liability for its obligation to make lease payments to the head lessor and a ROU asset. When accounting for the sublease, the intermediate lessor (as a lessor in the sublease) would not derecognise the ROU asset arising from the head lease while the sublessee would recognise a lease liability for its obligations to make lease payments to the intermediate lessor and a ROU asset. Some of these constituents suggested that the Boards either modify or provide an exception for subleases classified as Type B leases to ensure symmetrical accounting between the head lease and the sublease (by, for example, requiring the intermediate lessor to derecognise the ROU asset arising from the head lease).

15. Some constituents who provided feedback requested that the Boards provide additional guidance and illustrative examples regarding the accounting for, and presentation of, subleases. Most of these constituents questioned in particular whether any netting between lease assets and lease liabilities, or lease income and lease expense, would be permitted if the intermediate lessor acts as an agent.

16. Many of the constituents who provided feedback on subleases requested that the Boards provide additional guidance about subleases within the body of the standard (rather than the Basis for Conclusions), specifically about classification and presentation.

Staff analysis

17. The staff have identified two main issues with applying the proposals to subleases, which are discussed in the following sections:

    (a) How an intermediate lessor should account for a head lease and a sublease; and

    (b) How an intermediate lessor should present lease assets and lease liabilities, as well as lease income and lease expense related to a head lease and a sublease (ie gross or net).

Accounting for a head lease and a sublease

18. The 2013 ED proposed that an intermediate lessor would not consider the head lease when accounting for the sublease. This is because both leases are viewed as separate economic transactions between different parties.

19. The staff think that an intermediate lessor should account for a head lease and a sublease as separate transactions, unless those contracts meet the contract combinations guidance adopted by the Boards at the April 2014 joint Board meeting. The staff are of this view mainly for the reasons included in the Basis for Conclusions to the 2013 ED, which are summarised as follows:

(a) The rights arising from the sublease create different risks compared to those arising from the head lease. This is because the counterparty to the sublease is generally a different entity from the counterparty to the head lease.

(b) The obligations arising from a head lease for the intermediate lessor are generally not extinguished by the terms and conditions of a sublease.

20. In the staff's view, there is no conceptual basis for requiring a head lease and a sublease to be accounted for as one transaction. The accounting is unlikely to reflect the economics of the transaction if an intermediate lessor is required to account for the sublease together with the head lease. In addition, such accounting would require the intermediate lessor to effectively combine two contracts (ie the head lease and the sublease) that do not meet the contract combination requirements the Boards tentatively decided to adopt at the April 2014 joint Board meeting.

21. The staff acknowledge, however, that accounting for the transactions separately may result in asymmetry in the classification of, and accounting for, the two contracts as a result of the Boards' tentative decisions regarding lessee and lessor accounting. The following paragraphs discuss this in more detail.

The consequences of accounting for the head lease and sublease separately

22. Based on the recent tentative decisions made by the Boards, from the perspective of an intermediate lessor, the staff note the following:

(a) *Head lease* — Under the IASB's tentative decisions, a head lease would be a Type A lease for the intermediate lessor as a lessee. Under the FASB's tentative decisions, a head lease would be either a Type A lease or a Type B lease for the intermediate lessor as a lessee, on the basis of whether the intermediate lessor is effectively purchasing the underlying asset as a result of the head lease (that is, the concept underlying existing IFRS and U.S. GAAP lessee accounting).

(b) *Sublease* — For both Boards, a sublease would be either a Type A lease or a Type B lease for the intermediate lessor as a lessor, on the basis of whether the sublease is effectively a financing arrangement or a sale, rather than an operating lease (that is, based on the concept underlying existing IFRS and U.S. GAAP lessor accounting).

23. The following table summarises the possible accounting outcomes of a head lease and a sublease for the intermediate lessor.

	Head lease (lessee accounting)		**Sublease (lessor accounting)**	
	Type A	**Type B** *(U.S. GAAP only)*	**Type A**	**Type B**
Asset	ROU asset		Net investment in the sublease ('lease receivable')[1]	
Liability	Lease liability			
Income			Amortisation of unearned income—interest on lease receivable (and, potentially, deferred profit)	Rental income
Expense	Amortisation of the ROU asset Interest on lease liability	Rental expense		

[1] For ease of reference, the term 'lease receivable' is used throughout the remainder of this paper. However, the entire net investment in a lease (or sublease) is not a financial receivable under U.S. GAAP where all, or a portion, of any residual value is not guaranteed.

24. The following examples demonstrate the accounting that results for the intermediate lessor when head lease and sublease classification is the same (ie both Type A leases or, for the FASB only, both Type B leases) and when it is different (ie the head lease is a Type A lease and the sublease is a Type B lease or, for the FASB only, the head lease is a Type B lease and the sublease is a Type A lease). When applicable, the discount rate used for these leases is 6 per cent (the

staff note, however, that in practice the discount rate that will be applied to the head lease and to a Type A sublease may not be the same rate).

(a) *Head lease* – An intermediate lessor enters into a 5-year lease for 10,000 square feet of office space with Entity A (the head lessor). The lease payments for the head lease are CU100,000 per year.

(b) *Sublease 1 – (assume classified as Type A lease)* – At commencement of the head lease the intermediate lessor subleases the 10,000 square feet of office space *for 5 years* to a sublessee. The lease payments for the sublease are also CU100,000 per year. In this scenario the head lease and the sublease are essentially the same (ie a 'through lease' for which the head lease and the sublease commence on the same date, for the same lease term, and for the same lease payments).

(c) *Sublease 2 – (assume classified as Type B lease)* – At commencement of the head lease, the intermediate lessor subleases the 10,000 square feet of office space *for 2 years* to a sublessee. The lease payments for the sublease are CU105,000 per year.

Examples – Same classification

25. The staff think that there are no significant accounting issues if the classification of the sublease is the same as the head lease (ie both Type A leases or, for the FASB only, both Type B leases). This is because the intermediate lessor's accounting for the sublease in the income statement would be closely aligned with the accounting for the head lease, as illustrated in the following paragraphs.

<u>Example 1</u> – <u>Head lease Type A – Sublease Type A</u>

26. If the head lease and the sublease are both classified as Type A leases, the intermediate lessor would:

(a) Derecognise the ROU asset (relating to the head lease) that it transferred to the sublessee;

(b) Replace the ROU asset with the lease receivable under the sublease;

(c) Retain the lease liability (related to the head lease) on its balance sheet, which represents the lease payments still owed to the head lessor; and

(d) Recognise both interest income on the sublease and interest expense on the head lease.

Example 1 – Head lease Type A – Sublease Type A (using Sublease 1)							
CU/000	**0**	**yr1**	**yr2**	**yr3**	**yr4**	**yr5**	**Total**
Balance sheet							
Lease receivable	421.2	346.5	267.3	183.3	94.3	0.0	
Lease liability	(421.2)	(346.5)	(267.3)	(183.3)	(94.3)	(0.0)	
Income statement							
Interest income		25.3	20.8	16.0	11.0	5.7	**78.8**
Interest expense		(25.3)	(20.8)	(16.0)	(11.0)	(5.7)	**(78.8)**
Profit after interest		**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**

Example 2 – Head lease Type B – Sublease Type B (FASB-only)

27. If the head lease and the sublease are both classified as Type B leases, the intermediate lessor would:

(a) Retain both the ROU asset and the lease liability relating to the head lease on its balance sheet; and

(b) Recognise both lease income on the sublease and lease expense on the head lease typically on a straight-line basis.

Example 2 – Head lease Type B – Sublease Type B (using Sublease 2) *(FASB only)*							
CU/000	**0**	**yr1**	**yr2**	**yr3**	**yr4**	**yr5**	**Total**
Balance sheet							
ROU asset	421.2	346.5	267.3	183.3	94.3	0.0	
Lease liability	(421.2)	(346.5)	(267.3)	(183.3)	(94.3)	(0.0)	
Income statement							
Lease income		105.0	105.0	-	-	-	**210.0**
Lease expense		(100.0)	(100.0)	(100.0)	(100.0)	(100.0)	**(500.0)**
Profit before interest		**5.0**	**5.0**	**(100.0)**	**(100.0)**	**(100.0)**	**(290.0)**

Examples – Different classification

28. If the classification of the sublease is not the same as the head lease (ie the head lease is a Type A lease and the sublease is a Type B lease or, for the FASB only, the head lease is a Type B lease and the sublease is a Type A lease), the accounting that results would be as follows.

Example 3 – Head lease Type A – Sublease Type B

29. If the head lease is classified as a Type A lease and a sublease is classified as a Type B lease, the intermediate lessor would:

(a) Retain the lease liability and the ROU asset (relating to the head lease) on its balance sheet;

(b) Recognise amortisation of the ROU asset, typically on a straight-line basis, and interest expense on the lease liability (which results in a decreasing total expense pattern, higher in the earlier years and lower in the later years); and

(c) Recognise lease income from the sublease on a typically straight-line basis.

Example 3 – Head lease Type A – Sublease Type B (using Sublease 2)							
CU/000	**0**	**yr1**	**yr2**	**yr3**	**yr4**	**yr5**	**Total**
Balance sheet							
ROU asset	421.2	337.0	252.7	168.5	84.2	0.0	
Lease liability	(421.2)	(346.5)	(267.3)	(183.3)	(94.3)	(0.0)	
Income statement							
Lease income		105.0	105.0	-	-	-	**210.0**
Amortisation		(84.2)	(84.2)	(84.2)	(84.2)	(84.4)	**421.2**
Profit before interest		**20.8**	**20.8**	**(84.2)**	**(84.2)**	**(84.4)**	**(211.2)**
Interest expense		(25.3)	(20.8)	(16.0)	(11.0)	(5.7)	**(78.8)**
Profit after interest		**(4.5)**	**-**	**(100.2)**	**(95.2)**	**(90.1)**	**(290.0)**

30. The above table shows that, in this example, the intermediate lessor would recognise a loss after interest in year 1of the head lease. This is because the amount of lease income (recognised on a straight-line basis) would be lower than the combined amortisation and interest expense in year 1 of the head lease due to the decreasing Type A lease interest expense pattern over the lease term (higher in the earlier years and lower in the later years). In contrast, assume that this example is changed such that the intermediate lessor enters into a 2-year sublease at the beginning of year 3 of the head lease and the lease payments are CU100,000 in each year. In that case, the intermediate lessor would recognise a net profit after interest in years 3 and 4 of the head lease.

31. The income statement outcomes noted above (in Example 3) regarding a Type A head lease and a Type B sublease would be similar to the outcomes under existing guidance when the head lease is a finance/capital lease and the sublease is an operating lease. This outcome would also arise when a lessor *owns* an underlying asset that it leases to a lessee under an operating/Type B lease and for which it has financed the purchase of the asset through borrowings. Consequently, these outcomes are not unique to sublease scenarios.

32. In addition, in practice, there will often be differences between lease income on a sublease and lease expense on a head lease, because it is relatively infrequent that the lease payments and other terms and conditions of those contracts would be the same. Accordingly, differences in the accounting for a head lease and a sublease would often arise for reasons other than the lessee and lessor accounting models.

33. The staff note, however, that, under the IASB's lessee accounting model, the outcomes noted above would apply to a larger population of subleases than under existing lease guidance. This is because they would apply to many leases for which the head lease would currently be classified as an operating lease.

<u>Example 4</u> – <u>Head lease Type B – Sublease Type A (FASB-only)</u>

34. If the head lease is classified as a Type B lease (FASB-only) and the sublease is classified as a Type A lease, the intermediate lessor would:

    (a) Derecognise the ROU asset (relating to the head lease);

    (b) Replace the ROU asset with the lease receivable under the sublease;

    (c) Retain the lease liability (relating to the head lease) on its balance sheet, which represents the lease payments still owed to the head lessor; and

    (d) Recognise both interest income on the sublease and lease expense on the head lease.

Example 4 – Head lease Type B – Sublease Type A (using Sublease 1) *(FASB only)*							
CU/000	**0**	**yr1**	**yr2**	**yr3**	**yr4**	**yr5**	**Total**
Balance sheet							
Lease receivable	421.2	346.5	267.3	183.3	94.3	0.0	
Lease liability	(421.2)	(346.5)	(267.3)	(183.3)	(94.3)	(0.0)	
Income statement							
Lease expense		(25.3)	(20.8)	(16.0)	(11.0)	(5.7)	**(78.8)**
Profit before interest		**(25.3)**	**(20.8)**	**(16.0)**	**(11.0)**	**(5.7)**	**(78.8)**
Interest income		25.3	20.8	16.0	11.0	5.7	**78.8**
Profit after interest		**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**

35. Accounting for the sublease as a Type A lease and the head lease as Type B lease could, therefore, have an effect on some performance measures of the intermediate lessor (eg profit before interest). This is because the intermediate lessor would include the lease expense on the head lease within operating expenses and interest income on the sublease within financial income.

36. This scenario, however, would be unlikely if the intermediate lessor classifies the sublease with reference to the underlying asset, rather than the ROU asset, which is discussed in the next section of this paper.

Classification of a sublease by the intermediate lessor

37. The classification of a sublease as a Type A lease or a Type B lease could differ depending on whether the intermediate lessor considers the underlying asset in the sublease to be:

    (a) The ROU asset arising from the head lease; or

    (b) The underlying asset (eg the item of property, plant, and equipment that is the subject of the lease).

38. If, for classification purposes, an intermediate lessor considers the underlying asset to be the ROU asset arising from the head lease, the intermediate lessor would classify more subleases as Type A leases than if classified with reference to the underlying asset. This is because the fair value and the economic life of the ROU asset are typically less than that of the underlying asset being leased, and

many subleases are for the remainder of the term of the head lease (eg when an entity abandons a property that it leases).

39. In considering whether an intermediate lessor should classify a sublease with reference to the ROU asset or the underlying asset, the staff think that that the following factors are relevant.

Factors relating to classification with reference to the ROU asset

(a) Because of the changes proposed to lessee accounting, a sublease could be viewed as the lease of the ROU asset arising from the head lease—this was proposed in the 2010 *Leases* ED. The intermediate lessor does not own the underlying asset that is the subject of the lease and does not recognise that underlying asset on its balance sheet. Instead, the intermediate lessor recognises its right to use the underlying asset arising from the head lease as a ROU asset. Consequently, on a conceptual level, there is a strong argument for basing the intermediate lessor's accounting on the asset *it* controls (that is, the ROU asset) rather than the underlying asset controlled by the head lessor.

(b) Similarly to an owned asset, a lessor's risks associated with a ROU asset can be converted into credit risk by entering into a lease (ie effectively converting the non-financial asset into a financial asset). Just as in a lease of a non-financial owned asset, the risks inherent in the non-financial ROU asset (eg whether the lease will contribute positively or negatively to the entity's cash flows) typically become solely credit-related if the sublease payments are for substantially all of the fair value of the ROU asset or the sublease term is for most of the term of the head lease. For example, in sublease 1 illustrated in Examples 1 and 4 earlier in this paper, the intermediate lessor leases an asset for 5 years and immediately subleases that asset for the entire 5-year term of the head lease. In that circumstance, the intermediate lessor no longer has any right to use the underlying asset—it has transferred that right to the sublessee—nor does it have any risk associated with generating sufficient cash flows from *using* the asset to cover the lease payments under the head lease. Having entered into the sublease, its only remaining risk is one of collection (or credit risk). Accounting for the sublease as a Type A lease (by classifying it with reference to the ROU asset) would reflect that risk (by recognising a lease receivable under the sublease rather than a ROU asset).

Factors relating to classification with reference to the underlying asset

(c) Classification of the sublease with reference to the ROU asset could lead to an intermediate lessor accounting for similar leases differently. As noted in the Basis for Conclusions to the 2013 ED, it may be difficult to understand why that would be the case. Again using sublease 1 illustrated in Examples 1 and 4 from earlier in this paper, the terms and conditions of the sublease are exactly the same as those of the head lease (ie identical underlying asset at the same point in its economic life, same lease term, and same lease payments)—also assume that the head lessor would classify the head lease as a Type B lease because the 5-year head lease term is for a relatively short portion of the economic life of the underlying asset. Some might question why, in this example, the head lessor would account for the head lease as a Type B lease (retaining the underlying asset on its balance sheet and recognising straight-line lease income) and, yet, the intermediate lessor would account for the identical sublease as a Type A lease (recognising a lease receivable and, potentially, a gain or loss and decreasing interest income). The rationale for classification with reference to the underlying asset may be further strengthened by the fact that most sublessees are unconcerned about whether the right to use an asset comes via a head lease or a sublease. In many cases, they may not even be aware that they are a sublessee.

(d) Classifying the sublease with reference to the ROU asset is expected to result in a change to the existing accounting for many subleases by an intermediate lessor—eg when property is subleased for most of the remaining term of a head lease and the head lease is *not* for most of the economic life of the property. This could be viewed as contradicting the intentions of the Boards not to fundamentally change existing lessor accounting. Requiring intermediate lessors to classify subleases by reference to the ROU asset would result in a significant change for these entities because the staff expect that a significant portion of subleases, which are almost entirely classified as operating leases under existing IFRS and U.S. GAAP, would be classified as Type A subleases.

(e) Classification of the sublease with reference to the underlying asset is likely to be less costly and complex for intermediate lessors than classifying subleases with reference to the ROU asset. This is because the staff would expect an intermediate lessor to classify many subleases as Type A leases if the underlying asset in the sublease is the ROU asset (ie many subleases cover the remaining term of the corresponding head lease). Type A lessor accounting is inherently more complex than Type B lessor accounting. This complexity may be greater for sublessors that are not lessors by business model and, therefore, do not have systems and processes in place for Type A lessor accounting.

Staff recommendations on the accounting for a head lease and a sublease

40. The staff recommend that an intermediate lessor account for a head lease and a sublease as two separate contracts (accounting for the head lease in accordance with the lessee accounting proposals and the sublease in accordance with the lessor accounting proposals), unless those contracts meet the contract combinations guidance adopted by the Boards at the April 2014 joint meeting.

41. The staff's views are split with respect to sublease classification for an intermediate lessor. Some of the staff recommend that an intermediate lessor applying IFRS should classify a sublease with reference to the ROU asset resulting from the head lease, while an intermediate lessor applying U.S. GAAP should classify a sublease with reference to the underlying asset. This is because, in their view, such a classification approach would result in outcomes that more closely align an intermediate lessor's accounting for a

sublease with its accounting for the corresponding head lease. For example, this approach for U.S. GAAP preparers would typically result in an intermediate lessor classifying a sublease as a Type B lease when the head lease is a Type B lease, while for IFRS preparers, an intermediate lessor would classify more subleases as Type A leases than it would if subleases were classified with reference to the underlying asset. Therefore, this approach would more frequently avoid the accounting outcomes that would result from classifying a sublease as a Type A lease when the corresponding head lease is a Type B lease as illustrated earlier in this paper in Example 4. These staff members think that such outcomes (ie the recognition of lease expense on the head lease within profit before interest, and interest income on the sublease (which would be excluded from that measure)) may be difficult to understand.

42. These staff members further think that, particularly under the IASB lessee accounting model:

(a) If a sublease is for all, or almost all, of the remaining term of the corresponding head lease, it is appropriate under a ROU model for an intermediate lessor to derecognise the ROU asset and recognise a lease receivable (for the sublease). This is because the intermediate lessor no longer has the right to use the underlying asset (the ROU asset in this case)—it has sold that right. These staff do not view this as a change to existing lessor accounting, per se. Rather, they think of it as a consequence of the significant change to lessee accounting, which an intermediate lessor would apply to the head lease.

(b) A lessor is in a different economic position depending on whether it owns or leases an asset that, in turn, it leases to other parties (assuming that the head lease is for a period shorter than the remaining economic life of the underlying asset). Accordingly, these staff think that any differences between an intermediate lessor's accounting for subleases and a lessor's accounting for leases of owned assets can be justified. In a sublease, the intermediate lessor has only a right to use the asset for a period of time and, if the sublease is for all of the remaining term of the head lease, the intermediate lessor has transferred that right to another party via the sublease. In a lease of an owned asset, the lessor owns the underlying asset and would expect to derive significant benefits from the underlying asset at the end of the existing lease term if the lease is a Type B lease.

(c) These staff expect the cost and complexity associated with applying Type A accounting to a sublease (ie determining the discount rate and accounting for the lease receivable, as well as any residual ROU asset, on a discounted basis) would not be excessive. An intermediate lessor would already account for the lease liability arising from the corresponding head lease on a discounted basis (the staff note, however, that the intermediate lessor will, in many cases, have to determine a *different* discount rate for the sublease based on the rate implicit in the sublease).

43. Other staff members do not think that the different lessee accounting models should result in different conclusions by each Board regarding the classification of a sublease. These staff members think that the advantages and disadvantages of each classification approach, as set out above, apply regardless of the lessee accounting model. They view classification of the sublease by the intermediate lessor as distinct and unrelated to the classification of the head lease entered into in a separate contract. These staff members acknowledge that either classification approach (ie classification with reference to the ROU asset and classification with reference to the underlying asset) can be justified. However, on balance, these staff members recommend that an intermediate lessor classify subleases with reference to the underlying asset, rather than the ROU asset, and recommend this approach regardless of whether the intermediate lessor applies IFRS or U.S. GAAP. For these staff members, the factors in paragraph 39 (c) - (e) provide a more compelling argument than those factors that would support the alternative.

Presentation of lease assets and lease liabilities, lease income and lease expense

44. As mentioned earlier in the paper, some constituents asked the Boards to clarify in the final leases standard whether an intermediate lessor would be permitted to offset, or net, amounts recognised relating to a head lease and a sublease of the same asset, both in the balance sheet and in the income statement. Some of these constituents indicated that, in some cases, an intermediate lessor may act as an agent and may intend to earn only a commission under a sublease.

Lease assets and lease liabilities

45. Under both IFRS and U.S. GAAP, an entity recognises assets and liabilities separately. In particular, an entity cannot offset non-financial assets and non-financial liabilities. An entity is required or permitted to offset a financial asset and a financial liability under IFRS and U.S. GAAP if the entity has a legally enforceable right to offset the recognised financial asset and financial liability and meets other criteria.

46. As mentioned earlier in the paper, the obligations arising from a head lease for an intermediate lessor are typically not extinguished by entering in a sublease, even when the terms and conditions of the two agreements are almost identical. In these circumstances, the staff think that the intermediate lessor's exposure to the lease receivable and lease liability is different from having a single net lease receivable or lease liability. Therefore, offsetting the lease receivable and lease liability could provide misleading information about an intermediate lessor's financial position.

47. In the staff's view, offsetting generally does not meet the objective of financial reporting as set out in the Boards' respective conceptual frameworks. The objective of general purpose financial reporting is to provide financial information about an entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. Presenting items on a net basis could obscure the existence of some transactions and change the size of the financial statements of an entity.

48. Accordingly, the staff do not recommend permitting an intermediate lessor to offset lease assets and lease liabilities that do not meet the respective IFRS and U.S. GAAP financial instruments requirements for offsetting.

Lease income and lease expense

49. An entity does not offset items of income and expenses unless an IFRS (IFRS) or a codification topic or subtopic (U.S. GAAP) permits or requires an entity to do so. This is because offsetting detracts from the ability of investors and analysts both to understand the transactions and to assess an entity's future cash flows, except when offsetting reflects the substance of the transaction or other event.

50. Some constituents questioned whether an intermediate lessor, acting as an agent, could present lease income and lease expense together by netting the amount charged to the sublessee against the amount paid to the head lessor.

51. The staff think that, generally, an intermediate lessor should not offset lease income and lease expense, for the reasons discussed in this paper regarding the accounting for the head lease and the sublease separately and offsetting lease assets and lease liabilities.

52. Nonetheless, if an intermediate lessor recognises sublease income as revenue, the staff think that the intermediate lessor should apply the 'principal-agent' guidance in the recently-published revenue recognition standard in determining whether to present sublease revenue on a gross or net basis. The staff anticipate that an intermediate lessor would not often be considered to be an agent according to that guidance. Nonetheless, if it is the case, the staff think that it would be appropriate to present sublease revenue on a net basis.

53. At the same time, the staff note that an intermediate lessor might act as an agent in some scenarios for which both the head lease and the sublease are classified as Type A leases. In those scenarios, as illustrated earlier in this paper, the intermediate lessor would recognise a lease receivable and a lease liability and the corresponding interest income and interest expense. Accordingly, the intermediate lessor would apply the applicable financial instruments guidance to the

presentation of interest income related to the sublease and interest expense related to the head lease, rather than the revenue recognition principal-agent guidance.

54. In summary, the staff recommend that an intermediate lessor should not offset lease income and lease expense related to a head lease and a sublease, unless it recognises sublease income as revenue and acts as an agent (assessed in accordance with the 'principal-agent' guidance in the recently-published revenue recognition standard).

Questions 1-4: Subleases

Question 1 – Do the Boards agree with the staff recommendation that an intermediate lessor should account for a head lease and a sublease as two separate contracts, unless those contracts meet the contract combination guidance adopted by the Boards at the April 2014 joint meeting? If not, what do the Boards prefer?

Question 2 – Do the Boards prefer for an intermediate lessor to classify a sublease with reference to the underlying asset or with reference to the ROU asset arising from the head lease?

Question 3 – Do the Boards agree with the staff recommendation that an intermediate lessor should not offset lease assets and lease liabilities arising from a head lease and a sublease that do not meet the respective IFRS and U.S. GAAP financial instruments requirements for offsetting? If not, what do the Boards prefer?

Question 4 – Do the Boards agree with the staff recommendation that an intermediate lessor should not offset lease income and lease expense related to a head lease and a sublease, unless it recognises sublease income as revenue and acts as an agent (assessed in accordance with the 'principal-agent' guidance in the recently-published revenue recognition standard)? If not, what do the Boards prefer?