STAFF PAPER

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REG IASB Meeting

Project	**Leases**
Paper topic	Transition – Subleases

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Objective

1. The purpose of this paper is to discuss the transition requirements for 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. This paper does not address IFRS 1 *First-Time Adoption of International Financial Reporting Standards*. This is because a first-time adopter would need to retrospectively account for *all* of its lessor arrangements. This is different from an existing IFRS lessor for whom lessor accounting is unchanged under the new leases standard. Accordingly, providing transition relief for first-time adopters only with respect to subleases would not provide the same benefit as it would to an existing IFRS lessor (because it would not remove the requirement to perform *any* retrospective accounting). It would also add complexity in that a first-time adopter would use two different approaches to lessor accounting on adoption of IFRS—one approach for contracts in which it is head lessor and another for contracts in which it is intermediate lessor.

3. This paper is structured as follows:

   (a) Summary of staff recommendations

   (b) Background

   (c) Staff analysis

      (i) Reassessment of sublease classification

(ii) Lessor accounting for a finance sublease that was previously classified as an operating sublease

(d) Staff recommendations and questions for the IASB

4. Throughout this paper, the ‘date of initial application’ is used to describe the first day of the annual reporting period in which a lessee first applies the requirements of the new leases standard.

Summary of Staff Recommendations

5. With respect to the transition requirements for subleases, the staff recommend that the new leases standard requires an intermediate lessor to:

(a) reassess each existing operating sublease at the date of initial application to determine whether it is classified as an operating lease or a finance lease under the requirements of the new leases standard (this assessment would be made with reference to the ROU asset associated with the head lease and *not* with reference to the underlying asset as would be the case under IAS 17 *Leases*);

(b) base this reassessment on the remaining contractual terms of the head lease and the sublease (rather than performing a retrospective reassessment);

(c) for those subleases that were classified as operating leases under IAS 17 and are classified as finance leases under the new leases standard, account for the sublease as a new finance lease entered into on the date of initial application.

Background

6. The IASB discussed the accounting for subleases in their June 2014 board meeting. At that meeting, the IASB tentatively decided that:

(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 model and the sublease in accordance with the lessor accounting model);

(b) when classifying a sublease, an intermediate lessor should determine the classification of the sublease with reference to the ROU asset associated with the head lease and not with reference to the underlying asset;

(c) an intermediate lessor should not offset lease assets and lease liabilities associated with a head lease and a sublease that do not meet the financial instruments requirements for offsetting. Similarly, an intermediate lessor should not offset lease income and lease expense related to a head lease and a sublease.

7. In the light of these tentative decisions, an intermediate lessor would address the transition of the head lease (as lessee) and the sublease (as lessor) to the new leases standard separately. Accounting for the transition to the new requirements for the head lease would be captured by the analysis in Agenda Paper 3A. General transition guidance for lessors is not required in the new leases standard because the IASB previously decided to retain the IAS 17 accounting model for lessors.

8. Nonetheless, for an intermediate lessor, classifying the sublease with reference to the ROU asset is expected to result in a change to the existing accounting for many subleases. This will arise, for example, 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. Under IAS 17, the intermediate lessor is likely to classify this sublease as an operating lease whereas, under the new leases standard, it is likely to be a finance lease. Consequently, it is necessary to consider the transition requirements for an intermediate lessor when a sublease that was previously classified as an operating lease under IAS 17 is classified as a finance lease under the new leases standard.

Staff Analysis

Reassessment of sublease classification

9. Agenda paper 3A from the June 2014 board meeting noted that, when a sublease term covers substantially all of the remaining term of the head lease, the intermediate lessor no longer has any right to use the underlying asset because it has transferred that right to the sublessee. The decisions made at the June 2014 board meeting mean that the intermediate lessor would account for this sublease as a finance lease and, as such, derecognise the ROU asset. This treatment would reflect the fact that the intermediate lessor no longer has any right to use the underlying asset.

10. One possible transition approach for an intermediate lessor would be to continue to account for the sublease as it did under IAS 17. This approach would be the least costly because it would require no reassessment. However, in some cases this approach would result in an intermediate lessor continuing to account for a sublease with a term covering substantially all of the remaining term of the head lease as an operating lease. Consequently, the intermediate lessor would continue to recognise the ROU asset associated with the head lease despite the fact that it no longer has a right to use the underlying asset. The staff think that this could be misleading for investors and analysts and that it is important that the classification of existing operating subleases is reassessed by the intermediate lessor on the date of initial application of the new leases standard. We acknowledge that there would be a cost for intermediate lessors of reassessing their sublease classifications, however we think that the benefits in terms of reported information would justify that cost.

11. Furthermore, the staff think that this reassessment should be based *only* on the *remaining* contractual terms of the head lease and the sublease as at the date of initial application. In other words, we do not think that an intermediate lessor should be required to perform a retrospective reassessment of what the sublease classification *would* have been if the new leases standard had applied from the inception of the sublease. This is for the following reasons:

    (a) performing the reassessment on a retrospective basis would potentially be costly for an intermediate lessor. This is because an intermediate lessor would need to retrospectively assess what the ROU asset associated with the head lease *would* have been at inception of the sublease and then assess the classification of the sublease relative to that ROU asset;

(b) the staff think that assessing the classification of the sublease based only on the remaining term of the contract would generally lead to the same conclusion as a retrospective reassessment. Therefore, we do not think that the costs associated with retrospective reassessment are justified.

12. The staff do not think that an intermediate lessor should reassess the classification of existing finance subleases. This is because we expect existing finance subleases to continue to be classified as finance leases under the requirements of the new leases standard.

Lessor accounting for a finance sublease that was previously classified as an operating sublease

13. If the IASB adopt the staff recommendation to require an intermediate lessor to reassess the classification of its subleases at the date of initial application, this would mean that some subleases that were previously classified as operating leases would be classified as finance leases following application of the new leases standard.

14. In these cases, we do not recommend requiring an intermediate lessor to retrospectively account for 'new' finance leases at the date of initial application (ie we do not recommend that an intermediate lessor should apply finance lease accounting as if the new leases standard had been applied from the inception of the contract). The staff think that retrospective accounting could be costly for intermediate lessors and would not lead to a significant difference in outcome in terms of reported information.

15. Instead, the staff recommend that an intermediate lessor should account for the sublease as a new finance lease entered into on the date of initial application. This accounting would be based on the remaining contractual terms of the sublease at that date. Under this approach, an intermediate lessor would derecognise the

ROU asset that has been subleased and recognise a finance lease receivable. Any gain or loss arising on the sublease arrangement would be included within the cumulative catch up transition adjustment to retained earnings (or other component of equity).

Staff Recommendations and Questions for the IASB

Questions: Transition – Subleases

1. Does the IASB agree with the staff recommendation to require an intermediate lessor to reassess each existing operating sublease at the date of initial application to determine whether it is classified as an operating lease or a finance lease under the requirements of the new leases standard?
2. Does the IASB agree with the staff recommendation that an intermediate lessor should base this reassessment only on the *remaining* contractual terms of the head lease and the sublease (rather than performing a retrospective reassessment)?
3. Does the IASB agree with the staff recommendation that, for those subleases that were classified as operating leases under IAS 17 and are classified as finance leases under the new leases standard, an intermediate lessor should account for the sublease as a new finance lease entered into on the date of initial application?