STAFF PAPER

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IASB Meeting

Project	Leases		
Paper topic	Subleases sweep issue—discount rate		
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Introduction

1. This paper discusses the discount rate an intermediate lessor should use to account for its subleases.

Background

2. In June 2014, the IASB discussed Agenda Paper 3A/FASB Memo No. 286 and made a number of tentative decisions about subleases, including 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).

    (b) When classifying a sublease, an intermediate lessor should determine the classification of the sublease with reference to the ROU asset relating to the head lease.

3. The decision to classify a sublease with reference to the ROU asset relating to the head lease represents a change from current practice. IAS 17 *Leases* does not provide specific guidance on the accounting for subleases. This generally results in subleases

being classified by the intermediate lessor with reference to the underlying asset in the head lease.

4. The effect of the IASB's tentative decision would be that an intermediate lessor would classify more subleases as finance leases under the new leases standard as compared to IAS 17, especially for property leases. Take the example of an entity leasing a piece of property for five years as a lessee (which would be classified as an operating lease under IAS 17) and then subleasing the asset for the final two years of the head lease. The sublease would be classified as an operating lease under IAS 17 because the sublease would be classified with reference to the underlying property. However, the sublease would be classified as a finance lease under the new leases standard because the sublease would be classified with reference to the two-year ROU asset remaining when entering into the sublease.

Staff analysis and recommendation

5. During the June 2014 board meeting, a concern was raised with respect to the discount rate used by an intermediate lessor to account for a sublease. Under the IASB's tentative decisions to date, an intermediate lessor would be required to use the rate implicit in the sublease to account for any subleases classified as finance leases. Concerns were raised that it would be costly for an intermediate lessor to determine the rate implicit in the sublease. Although in some cases, an intermediate lessor would directly price subleases using an implicit interest rate, in many cases such an intermediate lessor would not. This is because such an intermediate lessor might often be an 'accidental' lessor, not in the business of leasing. In those cases, the intermediate lessor might enter into a sublease to reduce the overall rental costs associated with leased assets that are not being used without directly pricing the lease using an implicit interest rate (again, particularly in the case of property leases).

6. The staff understands these concerns and recommends that, if the rate implicit in the sublease cannot be readily determined, an intermediate lessor should be allowed to

use the discount rate used to account for the head lease[1] when accounting for the sublease. The staff is making this recommendation for cost/benefit reasons:

(a) As noted above, there would be costs involved in determining the rate implicit in the sublease for 'accidental' lessors, especially those that account for their subleases as operating leases under IAS 17.

(b) There will be no incremental cost involved in using the discount rate in the head lease to account for the sublease. This is because the intermediate lessor would have already had to determine this discount rate to account for the head lease.

(c) The staff acknowledge that there could be differences between the discount rate used for the head lease and the rate implicit in a sublease, particularly if a considerable period of time passes between commencement of the head lease and commencement of the sublease. Nonetheless, the staff does not think their recommendation would significantly decrease the overall benefit of improved information about leases because, for many intermediate lessors, subleasing is not a significant activity. Accordingly, for these lessors, using the head lease discount rate to account for their subleases would not be expected to result in a significant difference in terms of the amounts recognised in their financial statements.

Question for the boards

1) Do the boards agree with the staff recommendation to allow an intermediate lessor to use the discount rate used for the head lease to account for a sublease classified as a finance lease if the rate implicit in the sublease cannot be readily determined?

[1] If the IASB confirms the staff's recommendations on transition, the discount rate used to account for the head lease may be the incremental borrowing rate at the date of initial application for existing operating leases capitalised on transition to the new leases standard.