CHEAT SHEET

ACCOUNTING FOR SUB-LEASES UNDER THE NEW LEASE ACCOUNTING STANDARD (NZ IFRS 16)

BACKGROUND

For 2020 reporting dates, the long-awaited new accounting standard on leases (NZ IFRS 16 *Leases*) comes into effect for *for-profit* entities who apply NZ IFRS.

As we have covered in previous *Cheat Sheets*, NZ IFRS 16 results in a fundamental change in the way that **lessees** will need to account for most of their lease agreements, with the concept of separate accounting treatments for *operating leases* and *finance leases* falling away.

When it comes to **lessors**, much of the status quo remains under NZ IFRS 16, in particular (unlike for **lessees**) the separate accounting treatments for *operating leases* and *finance leases* remains.

However, the change in treatment as **lessee** may now mean that certain **sub-leases** that would have previously been classified as (simple) *operating leases*, may now instead be *finance leases*.

This is because when assessing the classification indicators, the "asset being leased" is now made by reference to the (new) *Right-of-use asset* (*RoU asset*) that has been recognised with respect to the (head) lease agreements as lessee, rather than the actual, physical asset being leased (i.e. the property itself).

Because of this change in reference, certain significant indicators that a **sub-lease** is a *finance lease* may be more easily met than previously.

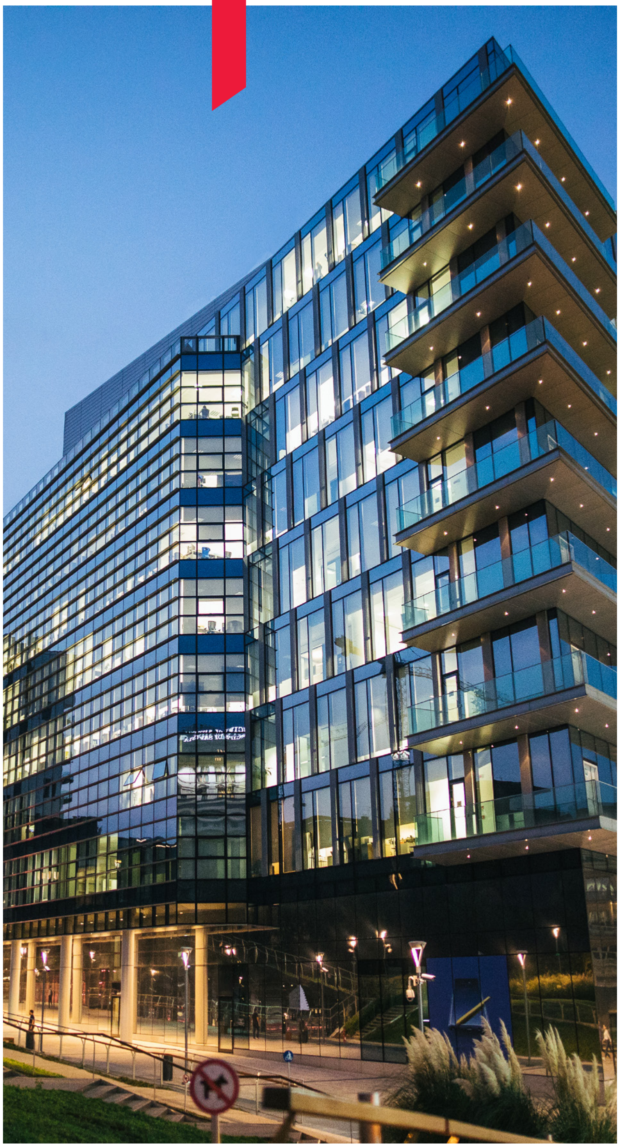
When adopting NZ IFRS 16, a lessor must re-assess all of its sub-leases to determine whether, under NZ IFRS 16, they are *operating leases* or *finance leases*.

This *Cheat Sheet* has been produced to provide a high-level overview of the impact of NZ IFRS 16 on sub-leases under NZ IFRS 16, following on from our original article in October 2018.

NEED ASSISTANCE WITH YOUR ADOPTION OF NZ IFRS 16?

BDO *IFRS Advisory* is a dedicated service line available to assist entities in adopting NZ IFRS 16.

Further details and contact information are provided at the end of this *Cheat Sheet* for your information.



WHAT IS COVERED IN THE *CHEAT SHEET*?

In order to navigate through these areas of accounting, this *Cheat Sheet* is broken down into the following sections:

1. **Lessor accounting under NZ IFRS 16**
2. **Determining whether a (sub) lessor has an *Operating lease*, or, a *Finance lease***
3. **What changes under NZ IFRS 16 with respect to the *Operating lease* versus *Finance lease* indicators?**
4. **Sub-leases of portions of property (i.e. land and buildings)**
5. **What needs to be done?**

1. Lessor accounting under NZ IFRS 16

Under NZ IFRS 16, (sub) lessors must still determine whether the (sub) lease is either an:

	Asset being leased	Lease payments
Operating lease	Remains recognised.	Recognised as "(Sub)lease income in profit or loss.
Finance lease	Is derecognised and replaced with a "Lease payment receivable" for the *net investment* in the lease.	Recognised as reductions in the "Lease payment receivable".

2. Determining whether a (sub) lessor has an *Operating lease*, or a *Finance lease*

Rather than prescribing definitive criteria, NZ IFRS 16 provides examples of "indicators" that when taken together (or individually) assist an entity in determining whether the lease transfers substantially all the risks and rewards incidental to ownership of the underlying asset that is being leased (i.e. whether it is a *finance lease*), including:

	Indicator to consider	Description
	Primary:	
(a)	**Ownership**	*Ownership of the asset being (sub)leased transfers to the lessee at the end of the lease.*
(b)	**Option to purchase**	*The lessee has an option to purchase the asset at the end of the (sub)lease, and, is reasonably expected to do so (instances where the purchase price is sufficiently lower than the value of the asset at that point in time is a strong indicator).*
(c)	**Portion of economic life of asset**	*If the lease term is for a major part of the economic life of the asset being (sub)leased.*
(d)	**Fair value of asset**	*If the present value of the lease payments is substantially all of the fair value of the asset being (sub)leased.*
(e)	**Specialised asset**	*If the asset being (sub)leased is specialised such that no other lessee could benefit from it (without substantial modifications).*
	Secondary:	
(f)	**Cancellation costs**	*If upon cancelling the lease, the lessee has to cover the lessor's costs.*
(g)	**Reimburse for changes in value**	*Gains or losses from fluctuations in the fair value of the asset being leased accrue to the lessee.*
(h)	**Significantly favourable renewals**	*If there is an option to renew the lease as substantially favourable terms (i.e. such that* ***(c)*** *would be met where the favourable renewal term was included in determining the lease term).*

3. What changes under NZ IFRS 16 with respect to the *Operating lease* versus *Finance lease* indicators?

All of the indicators **(a)** – **(h)** above remain unchanged under NZ IFRS 16.

But what has changed is what the *"asset being leased"* now is in the case of sub-leases.

Previously, when the (head) lease as lessee was an *operating lease*, the was no asset recognised on the balance sheet of the lessee.

Accordingly, when determining the classification of the **sub-lease**, references to the *"asset being leased"* were made to the actual, physical asset being leased.

As such, and particularly in the case of sub-leases of property, many of the *finance lease* indicators would not be met (i.e. as the economic life and/or fair value of the property would far exceed the associated parameters of the sub-lease).

However, under NZ IFRS 16, there is now a *RoU asset* recognised with respect to the (head) lease as lessee.

As such, all references to the *"asset being leased"* are now made against the *RoU asset* (rather than to the actual, physical asset being leased).

Therefore, the parameters associated with indicators such as **(c)** and **(d)** above may in some cases be significantly "pulled back" and consequentially may have an increased likelihood of now being met.

Example 1

Details:

- Entity A leases an office building for 5 years $100k per year.
- The remaining useful life of the building is 30 years, and the market value of the building is $2m
- Entity A sub-leases the office building, in its entirety to Party X on the same terms (i.e. 5-year term with lease payments of $100k per year)

i. Prior to NZ IFRS 16 (i.e. under NZ IAS 17 Leases)

- The (head) lease as lessee would likely have been determined to be an *operating lease*, as:
  - The length of the lease (5 years) is not for a major part of the remaining useful life of the building (30 years) – i.e. indicator **(c)**.
  - The PV of the gross $500k of lease payments is not substantially all of the fair value of the building ($2m) – i.e. indicator **(d)**.
- The sub-lease as sub-lessor would have likely have also been determined to be an operating lease, for the same reasons as above.

ii. Subsequent to NZ IFRS 16

- The (head) lease is recognised on-balance sheet in accordance with NZ IFRS 16, resulting in the recognition of a *RoU asset*.
- Because the sub-lease is on (substantially) the same terms as the (head) lease, both indicators **(c)** and **(d)** will now be met with reference to the (smaller) parameters of the RoU asset (rather than the (larger) parameters of the actual, physical building).

  Accordingly, the sub-lease in this case is almost certainly a finance lease.

4. Sub-leases of portions of property (i.e. land and buildings)

While *Example 1* above is a scenario that you do see in practice (i.e. where an entire lease building is being sub-leased), the more common scenario is where an entity sub-leases out a portion of the asset that it is leasing (i.e. it will retain a portion of the leased asset for its "own use").

The question then arises, can (and should) the *RoU asset* from the (head) lease as lessee be split into separate components, and the *operating lease* versus *finance lease* assessment be made with respect to the separate components (i.e. looking at the sub-leased portion of the *RoU Asset* separately).

That is, what is a *RoU asset's* "unit of account" (i.e. where accounting treatments are applied).

Because (part of) the *RoU asset* of property sub-leased is being held to collect rental income, (part of) the *RoU asset* will meet the definition of an "Investment Property", and accordingly the requirements and guidance of NZ IAS 40 *Investment Property* (particularly with respect to "dual use" property) must be considered.

In relation to dual-use properties, NZ IAS 40 states that:

(1) If separate portions of the property (i.e. *RoU asset* from the (head) leases) cannot be sold separately, then an *Investment Property* can only exist for the property (i.e. *RoU asset*) in its entirety – i.e. there are no separate "units of account".

Comment

With respect to sub-leases, the ability to "sell" separate portions is made with reference to the actual contractual terms associated with the RoU asset from the (head) lease as lessee, rather than the hypothetical rights associated with the actual, physical property in question.

Therefore, the ability to "sell" a portion of a RoU asset will depend on whether the entity as lessee under the (head) lease has the unilateral right (i.e. without the permission or authority of the lessor) to assign portions of the building it is leasing to other third-parties.

It is important to note that a right to ***assign a lease*** *is very different to a right to sub-lease a lease – i.e. a right to assign acts to transfer (amongst other things) the obligation to make lease payments, and to make-good damage, from the original lessee to another party, whereas under a sub-lease, as far as the lessor is concerned, the original lessee (not the sub-lessee) still has the ultimate responsibility back to the lessor in all respects (i.e. there is no transfer of obligations).*

In our experience, most property lease agreements (in New Zealand) have an explicit clause that expressly prohibits the unilateral right of assignment of a lease (whether in full or in part).

Commercially, this makes sense, as lessors will ultimately want to "vet" the parties to which it is ultimately exposed to risk (i.e. credit risk (non-payment), damage to the property etc.).

(2) The entire property (i.e. *RoU asset* from the (head) lease) is treated as an *Investment Property* (i.e. as one unit of account) if, and only if, only an *insignificant portion* is retained for "own use".

Comment

Note that "insignificant portion" is not defined in NZ IAS 40 (or any other NZ IFRS).

In practice, quite a high threshold is applied (typically, where 5% or less is retained for "own use", it will ordinarily be determined that the entire property (RoU asset) is an Investment Property – i.e. one unit of account).

Comment

If more than an insignificant portion is retained for "own use", and ***(1)*** *above is not met, then the RoU Asset is still only one "unit of account" (i.e. it cannot be separated), it just means that it does not meet the definition of an Investment Property.*

Whether or not a RoU asset that is a single "unit of account" is an Investment Property is still an important distinction to make, as there are additional and consequential presentation and measurement requirements under NZ IFRS 16 for RoU assets that meet the definition of Investment Property.

Example 2(a) - "No assignment" clause, and <u>more</u> than an insignificant portion retained for own use

Details:

- Entity A leases a 25 floor office building for 5 years at $250k per year.
- Entity A sub-leases 1 floor of the office building for 5 years at $10k per year, and
- There is a "No assignment" clause in the (head) lease agreements as lessee.

Comments on the treatment to be applied:

- The presence of the "No assignment" clause indicates that the *RoU asset* associated with the leased office building would likely not be permitted to be split into separate components (i.e. individual floors).
- As more than an insignificant portion of the leased office building is retained for Entity A's "own use" (i.e. 24 of 25 floors).
  - The *RoU Asset* is not an *Investment Property* (in its entirety), and
  - The sub-lease does not meet the indicators to be a *finance lease* with reference to the *RoU asset* in its entirety, and as such, the sub-lease is (simply) accounted for as an operating lease.
  - The sub-lease as sub-lessor would have likely have also been determined to be an operating lease, for the same reasons as above.

Example 2(b) - Ability to assign, and more than an insignificant portion retained for own use

Details:

- Same as **2(a)** above, except that the (head) lease agreement as lessee does permit the entity to assign portions of the (head) lease unilaterally to other parties.

Comments on the treatment to be applied:

- The presence of the unilateral ability to assign portions of the (head) lease indicates that the *RoU asset* associated with the office building would likely be permitted to be split into separate components (i.e. separate floors).
- Accordingly, in this case, the *RoU asset* would be split between:
  - An "own use" portion (apportioned 24 / 25ths), and
  - A "sub-lease" portion (apportioned 1 / 25th).
- Accordingly, the "Sub-lease" portion of the *RoU Asset*:
  - Is an *Investment Property*, and
  - Does appear to meet the indicators to be a *finance lease* with reference to the "sub-lease portion of the *RoU asset*, as:
    - ➢ The term of the sub-lease (5yrs) is for a major part of "sub-lease" portion of the RoU asset (also 5yrs in this case), and/or
    - ➢ The present value of the sub-lease payments will be substantially all[1] of the portion of the (head) lease payments apportioned to the floor being sub-leased.

Example 3(a) - "No assignment" clause, and less than an insignificant portion retained for own use

Details:

- Entity A leases a 25 floor of office building for 5 years at $250k per year.
- Entity A sub-leases 24 floors of the office building for 5 years at $240k per year, and
- There is a "No assignment" clause in the (head) lease agreements as lessee.

Comments on the treatment to be applied:

- The presence of the "No assignment" clause indicates that the *RoU asset* associated with the leased office building would likely not be permitted to be split into separate components (i.e. floors).
- As an insignificant portion of the office building is retained for "own use" (i.e. 1 of 25 floors).
  - The *RoU Asset* is an *Investment Property* in its entirety, and
  - The sub-lease will likely meet the indicators to be a finance lease with reference to the *RoU asset* in its entirety, as:
    - ➢ The term of the sub-lease (5yrs) is for a major part of "sub-lease" portion of the *RoU asset* (also 5yrs in this case), and/or
    - ➢ The present value of the sub-lease payments will be substantially all[2] of the portion of the (head) lease payments apportioned to the floor being sub-leased.

Example 3(b) - Ability to assign, and less than an insignificant portion retained for own use

Details:

- Same as 3(a) above, except that the (head) lease agreement as lessee does permit the entity to assign portions of the (head) lease unilaterally to other parties.

Comments on the treatment to be applied:

- The presence of the unilateral ability to assign portions of the (head) lease indicates that the *RoU asset* associated with the office building would likely be permitted to be split into separate components (i.e. floors).
- However, because less than an insignificant portion has been retained for Entity A's "own use" means that the entire *RoU asset* balance associated with the office building is accounted for as an *Investment Property* in its entirety.
- Accordingly, the same treatment as **3(a)** above is applied.

5. What needs to be done?

When adopting NZ IFRS 16, where an entity is leasing an asset as lessee and then sub-leasing (a portion of) that leased asset, the entity needs to reassess whether the previous *operating lease* or *finance lease* determination still stands given that NZ IFRS 16 results in a change to what the "*asset being leased*" is referencing to (i.e. now the *RoU asset* as lessee that is on-balance sheet) with respect to the assessment of the *finance lease* classification indicators.

If your entity is going through the adoption of the NZ IFRS 16 as part of the 2020 year end process (i.e. after the fact), then you will need to ensure that this determination is undertaken at the beginning of the process, so that the correct accounting treatment of both the sub-lease, and (head) lease, is applied.

If there is a change in the classification of an entity's sub-leases (i.e. from an *operating lease* to a *finance lease*) then these will need to be applied during the current period (and any prior periods to which NZ IFRS 16 is being applied).

The "mechanics" of the accounting treatment for *finance leases* as (sub) lessor under NZ IFRS 16 is unchanged from what was in place previously under NZ IAS 17, and therefore entities should refer back to previous issued guidance in this respect.

BDO IFRS ADVISORY

Members of BDO's *IFRS Advisory* department come ready with real life experience in applying IFRS and are therefore well placed to provide entities with the expertise and assistance they require.

For more information as to how BDO *Accounting Advisory Services* might assist with your entity in navigating this and other areas of IFRS application, please contact James Lindsay at BDO *Accounting Advisory Services* (james.lindsay@bdo.co.nz ☎ +64 9 366 8041), and visit our webpage below.

https://www.bdo.nz/en-nz/ifrs-advisory

Also, visit our dedicated "Adopting NZ IFRS 16 webpage" for more information and resources on NZ IFRS 16.

https://www.bdo.nz/en-nz/nz-ifrs-16

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[1] Given that they are the same in terms of the gross amount per year (i.e. $10k vs [(1/25) x $250k]), and the lease is for the same length of time (5 years).
[2] Given that they are $240k per year versus $250k per year, and the lease is for the same length of time (5 years).