



Snapshot

by Capital Markets & Accounting Advisory Services

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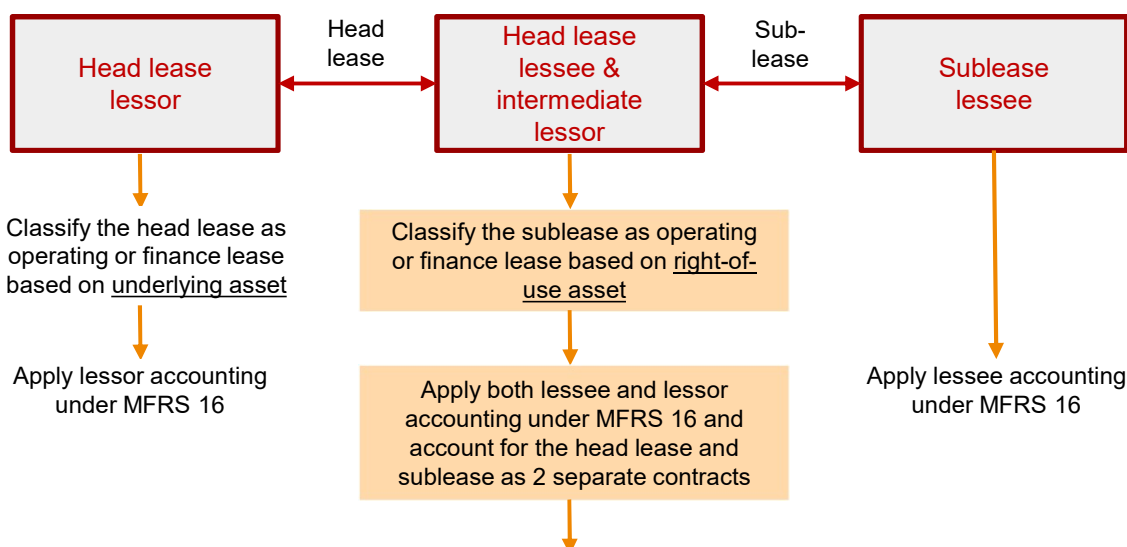
How would MFRS 16 change sublease accounting for intermediate lessors?

Applicable MFRS	MFRS 16 Leases
Effective date	Annual reporting periods beginning on or after 1 January 2019



Key provision

Lease classification will be based on the asset which the lessor controls. MFRS 16 requires that, when classifying a sublease, an intermediate lessor should evaluate the sublease by reference to the right-of-use asset arising from the head lease and not the underlying asset.



Head lease

Accounting as the lessee

Recognise a right-of-use asset and a lease liability

Sub-lease

Accounting as the intermediate lessor

Sublease classified as finance lease

- recognise a new asset representing a net investment in the sublease, which is the sum of present value of lease payments receivable by the intermediate lessor and the unguaranteed residual value of the right-of-use asset accruing to the intermediate lessor
- derecognise all or a portion of the right-of-use asset from the head lease

Sublease classified as operating lease

- retain the right-of-use asset from the head lease

If the intermediate lessor, as the head lease lessee applies the short-term lease exemption provided in MFRS 16, the sublease shall be classified as an operating lease.



Key provision (continued)

Reasons for the new guidance on sublease arrangements

1. The intermediate lessor controls the right-of-use asset and not the underlying asset which is controlled by the head lessor. Accordingly, the lease classification is made with reference to the right-of-use asset, and not the underlying asset.
2. Classification with reference to the right-of-use asset would reflect the risk that an intermediate lessor is exposed to. For example, a right-of-use asset could be converted into credit risk (of the sublessee) if the intermediate lessor transfers to the sublessee substantially all of the risks and rewards incidental to the right-of-use asset.



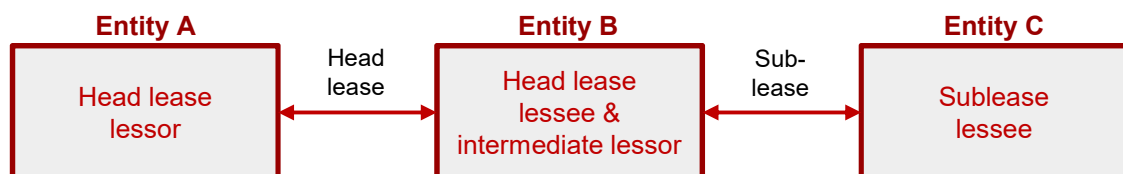
Key impact

More intermediate lessors will need to classify subleases as finance leases under MFRS 16.



Illustrative example

Background



Entity B enters into a head lease of a building with Entity A. At the same time, Entity B subleases the building to Entity C. This example assumes the following facts.

	Head Lease	Sub-lease
Lease term	10 years	8 years
Lease liability = present value of lease payments	RM1.0m	RM0.9m

Assessment by Entity B as the intermediate lessor

Entity B classifies the sublease based on the right-of-use asset.

Indicators considered include:

- comparing 8 years (sublease term) against 10 years (head lease term). The building's economic life of, say, 25 years is not relevant to Entity B's assessment; and
- comparing RM0.9m (PV of sublease payments) against RM1.0m (right-of-use asset fair value). The building's fair value of, say, RM3.0m is not relevant to Entity B's assessment.

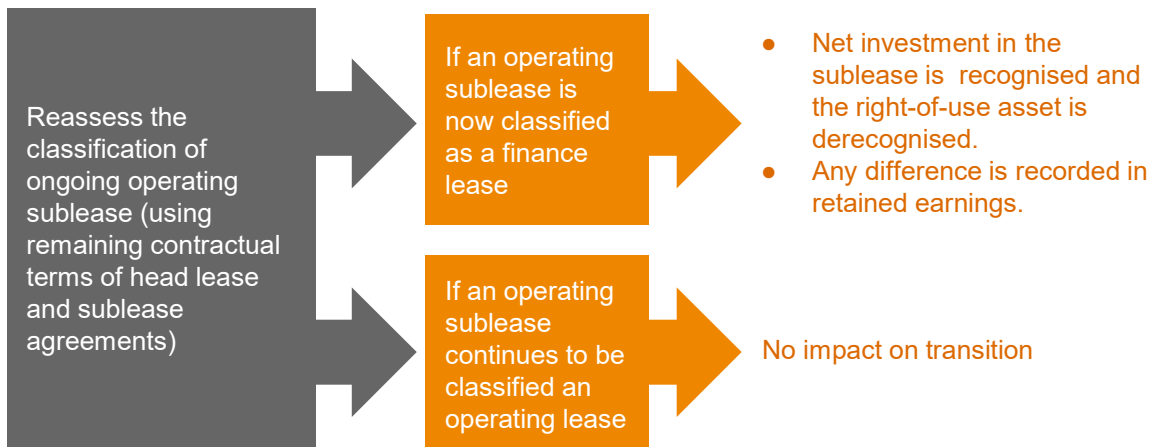
Conclusion

Entity B classifies the sublease as a finance lease on the basis that it has transferred substantially all the risks and rewards incidental to ownership of the right-of-use asset. This conclusion may be different for a previous assessment performed under MFRS 117 "Leases" (which was superseded by MFRS 16 with effect from 1 January 2019). For example, had Entity B compared the sublease term of 8 years against the building's economic life of 25 years, Entity B would have classified the lease as an operating lease.



Transition

At the date of initial application of MFRS 16, an intermediate lessor shall:



The change in sublease guidance must be considered for both:

- transition to MFRS 16; and
- new subleases entered into after the adoption of MFRS 16.

