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Audience

This guide is relevant to Commonwealth officials responsible for the financial reporting of lease transactions.

Key Points

This guide assists Commonwealth entities with accounting for leases in accordance with Australian Accounting Standard Board 16 Leases (AASB 16), applicable for the 2019-20 and following financial years. The guide also provides a simple model to calculate lease balances and example journals for common scenarios.

Resources

This guide is available on the Department of Finance website at www.finance.gov.au. Other relevant publications include:

- AASB 16 Leases;
- AASB 2018-8 Amendments to Australian Accounting Standards – Right-of-Use Assets for Not-for-Profit Entities;
- AASB 137 Provisions, Contingent Liabilities and Contingent Assets;
- AASB 116 Property, Plant and Equipment;
- AASB 15 Revenue from Contracts with Customers; and
Introduction

1. AASB 16 removes the distinction between operating and finance leases for lessees and requires the recognition of a right-of-use (ROU) asset and lease liability on the balance sheet for most leasing arrangements. AASB 16 is the Australian equivalent to the International Accounting Standard Board’s (IASB’s) IFRS 16 Leases, which was introduced to address concerns regarding the lack of transparency relating to lease rights and obligations. AASB 16 is applicable for reporting periods commencing on or after 1 January 2019.

2. This guide summarises the Department of Finance’s (Finance’s) major policy decisions regarding the application of AASB 16 and the main issues raised by Commonwealth entities. The guide aims to achieve consistency in accounting treatment of leases amongst Commonwealth entities, which is necessary for the preparation of the Consolidated Financial Statements.

3. Application of all requirements is subject to the principles of materiality. Entities should document all assessments made in implementing the standard.

Part 1 – Identification of a Lease

Identification of a Lease

4. Paragraph 9 of AASB 16 states: “A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration”. The customer would only have the right to control the use of an identified asset where they have:

   (a) the right to obtain substantially all of the economic benefits from use of the identified asset; and

   (b) the right to direct the use of the identified asset1.

5. An identified asset is typically identified by being explicitly specified in a contract2. However, even if an asset is specified, a customer does not have the right to use an identified asset if the supplier has the substantive right to substitute the asset throughout the period3. This would only occur if the supplier has the practical ability to substitute alternative assets and could benefit economically from substituting the asset throughout the period of use. A capacity portion of an asset would only be an identified asset if it is physically distinct4.

6. Paragraphs 9-17 and B9–B31 of AASB 16 provide more guidance on whether a contract is, or contains, a lease. IFRS 16 Illustrative Examples 1 – 10 also cover identification of lease arrangements (available at https://www.aasb.gov.au/admin/file/content105/c9/IFRS16_IE_01-16.pdf)

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1 AASB 16(B9)
2 AASB 16(B13)
3 AASB 16(B14)
4 AASB 16(B20)
Contracts will only contain a lease if the contract:
(a) conveys the right to control the use of an identified asset for a period of time; and
(b) requires an exchange of consideration.

Separating lease components

7. Paragraph B32 of AASB 16 states: “The right to use an underlying asset is a separate lease component if both:
(a) the lessee can benefit from use of the underlying asset either on its own or together with other resources that are readily available to the lessee. Readily available resources are goods or services that are sold or leased separately (by the lessor or other suppliers) or resources that the lessee has already obtained (from the lessor or from other transactions or events); and
(b) the underlying asset is neither highly dependent on, nor highly interrelated with, the other underlying assets in the contract. For example, the fact that a lessee could decide not to lease the underlying asset without significantly affecting its rights to use other underlying assets in the contract might indicate that the underlying asset is not highly dependent on, or highly interrelated with, those other underlying assets”.

8. Entities may have a contract with separate lease components only where the underlying assets are not closely related. For example, multiple floors in a leased building would normally be considered related given it is important the entity’s staff are co-located. Therefore, the floors leased should usually be accounted for as a single lease rather than as separate lease components.

9. Paragraphs 12-16 and B32–B33 provide more guidance on separating lease components within a contract.

Separating lease and non lease components

10. Where contracts contain a lease, entities are required to account for each lease component within the contract separately from any non lease components, unless the practical expedient in AASB 16(15) is applied. Contract consideration should be allocated based on the stand alone prices of the lease and non lease components. Non lease components should be accounted for under relevant standards.

11. Paragraph 15 of AASB 16 states “As a practical expedient, a lessee may elect, by class of underlying asset, not to separate non lease components from lease

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5 AASB 16(12)
components, and instead account for each lease component and any associated non-lease components as a single lease component."

12. Commonwealth entities may only apply the single lease practical expedient when the non-lease component is assessed to be immaterial to the lease. This is to ensure that at a whole of government level, the recognition of non-lease components does not significantly alter lease measurement and associated expenses.

13. Paragraphs 9-16 and B9–B33 of AASB 16 provide more guidance on separating lease and non lease components within a contract.

The single lease practical expedient, which combines the lease component and the non lease component, should only be used by Commonwealth lessees when the non-lease component is considered immaterial to the lease.

**Short-term and low value exemptions**

14. A lessee may elect not to comply with AASB 16 lease recognition requirements for:
   
   (a) short-term leases (i.e. a lease that has a lease term of 12 months or less at the commencement date); or
   
   (b) leases for which the underlying asset is of low value.\(^6\)

15. Instead, the lessee would recognise the lease payments associated with those leases as an expense on either a straight-line basis over the lease term or another systematic basis.\(^7\) The election for the short-term lease exemption must be made based by class of ROU asset. The election for 'low value' leases can be made on a lease-by lease basis.\(^8\)

16. Low value is based on the value of individual assets when new. It is an absolute concept not related to an entity’s materiality threshold. Finance has determined a low value of AUD$10,000 per asset, consistent with the IFRS 16 Basis for Conclusions.

17. These exemptions will reduce the administrative burden from implementing AASB 16. AASB 16 contains guidance on low value assets in paragraphs B3-B8.

Entities are required to apply the ‘short-term’ or ‘low value’ exemption in accordance with AASB 16. Low value will be assets of AUD$10,000 or less.

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\(^6\) AASB 16, paragraph 5
\(^7\) AASB 16, paragraph 6
\(^8\) AASB 16, paragraph 8
Intangible Assets

18. Lessees may elect not to apply AASB 16 to intangible assets. To facilitate AASB 16 implementation, entities are required to select this application option.

Commonwealth lessees are required to not apply AASB 16 to intangible assets.

Part 2 – Lease Terms

Lease Terms

19. Lease terms are defined in Appendix A of AASB 16 as “The non-cancellable period for which a lessee has the right to use an underlying asset, together with both:

(a) periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option; and

(b) periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option.”

20. AASB 16(B34) states that the lease term is “the period for which the contract is enforceable. A lease is no longer enforceable when the lessee and the lessor each has the right to terminate the lease without the permission from the other party with no more than an insignificant penalty.”

21. Indicators that an option to extend may be ‘reasonably certain’ of being exercised or an option to terminate the lease is reasonably certain not to be exercised, include:

- a clear ongoing operational requirement for the underlying assets capability
- a lack of suitable alternative assets at similar price
- significant costs for alternative arrangements (e.g. negotiation costs, relocation or integration costs)
- significant leasehold improvements undertaken over the term of the lease; and
- precedent from previous practice.

22. After the commencement date, a lessee should reassess the lease term after a significant event or change in circumstances within their control, which affects whether the lessee is reasonably certain to exercise an option to extend or not to exercise an option to terminate. Re-measurement of lease liabilities from reassessment of lease terms should use a revised discount rate.

23. Determining lease terms are considered in paragraphs 18 to 21 and B34 to B41 of AASB 16.

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9 AASB 16 paragraph 4
10 AASB 16(40).
Lease terms are:
(a) the non-cancellable period of the lease;
(b) periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option; and
(c) periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option.

Part 3 – Right of Use Assets

Subsequent Measurement of Right of Use (ROU) Assets

24. Paragraphs 29 and 35 of AASB 16 require lessees to measure ROU assets at cost, unless the revaluation model is applied to ROU assets relating to a class of property, plant and equipment (PPE) measured at fair value under AASB 116 Property, Plant & Equipment.

25. Paragraph 37 of AASB 116 defines a class of PPE assets as “A class of property, plant and equipment is a grouping of assets of a similar nature and use in an entity’s operations. The following are examples of separate classes: (a) land; (b) land and buildings; (c) machinery; (d) ships; (e) aircraft; (f) motor vehicles; (g) furniture and fixtures; (h) office equipment; and (i) bearer plants”.

26. The rights and obligations and risks and benefits of assets under lease contracts may differ substantially from corresponding assets owned outright. Lease ROU assets are therefore a distinct ‘grouping of assets of a similar nature’ to corresponding assets owned outright and will be separately disclosed in Commonwealth entity financial statements.

27. Lease ROU assets can therefore be classified by Commonwealth lessees as separate asset classes to corresponding assets owned outright. Because ROU assets are separate asset classes and do not relate to a class of PPE to which Commonwealth entities already apply the revaluation model, ROU assets should be measured at cost under paragraph 35 of AASB 16.

28. ‘Peppercorn’ leases are those lease arrangements that are agreed for a nominal monetary amount to satisfy the requirements of creating a legal contract. Under AASB 16, ‘peppercorn leases’ are defined as “leases that have significantly below-market terms and conditions principally to enable the entity to further its objectives”. Commonwealth lessees should measure any ‘peppercorn’ lease ROU assets at cost rather than at fair value, consistent with other ROU assets.

11 Paragraph 29 of AASB 116 allows measurement of PPE assets after initial recognition at cost or fair value, by class of PPE asset.
12 AASB 2018-8, Amendments to AASB 16, paragraph Aus25.1
ROU assets should be classified by Commonwealth lessees as separate asset classes to corresponding assets owned outright. ROU assets should continue to be measured at cost (not revalued to fair value) after initial recognition in Commonwealth entity financial statements.

Impairment of Right of Use Assets

29. AASB 16 requires ROU assets held at cost to be measured after deducting accumulated depreciation and any accumulated impairment losses\(^\text{13}\). Lessees should apply AASB 136 *Impairment of Assets* to determine whether ROU assets held at cost are impaired and to account for any impairment losses\(^\text{14}\).

30. AASB 136 requires that non-financial assets are assessed for impairment indicators at the end of each reporting period. Where impairment indicators exist, the assets recoverable amount should be estimated\(^\text{15}\). Where impairment losses have been previously recognised, AASB 136(110) also requires entities to assess whether there are indications that impairment previously recognised has decreased. If so, the assets recoverable amount should be re-estimated.

31. Impairment indicators are discussed in paragraph 12 of AASB 136. Indicators applicable to ROU assets include:

- cheaper alternatives to the leased space are available, due to either restructures or other changes in operational requirements or unexpected changes in market rental rates
- the leased space has become surplus; or
- market interest rates have increased significantly since lease commencement, which would cause a re-rating of the relevant Incremental Borrowing Rate (IBR).

32. AASB 136 defines impairment losses as the amount by which the carrying value of an asset exceeds its recoverable amount. ‘Recoverable amount’ is defined as the higher of fair value less costs of disposal\(^\text{16}\) and its value in use\(^\text{17}\). ‘Value in use’ is defined as “the present value of the future cash flows expected to be derived from an asset or cash generating unit”\(^\text{18}\). Paragraph Aus5.1 of AASB 136 notes that recoverable amount will generally equal fair value determined under AASB 13 *Fair Value Measurement* for many assets of not for profit entities that are held for their continuing service capacity rather than to generate net cash inflows.

33. Fair value is defined as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the

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\(^{13}\) Paragraph 30 of AASB 16

\(^{14}\) Paragraph 33 of AASB 16

\(^{15}\) Paragraph 9 of AASB 136

\(^{16}\) AASB 136(28) lists legal costs, stamp duty and other sale transaction fees as examples of costs of disposal.

\(^{17}\) Paragraph 6 of AASB 136

\(^{18}\) Paragraph 6 of AASB 136
measurement date”\textsuperscript{19}. AASB 136(53A) and AASB 13(2) notes that fair value is a market based rather than an entity specific measurement.

34. The recoverable amount of ROU assets will need to be estimated where impairment indicators exist. However, ROU asset carrying balances should generally already approximate fair value where:
   - the lease recently commenced and was negotiated on commercial terms
   - a market rent review was recently undertaken
   - the rent escalation factors applied under the lease contract closely reflects estimated changes in market rates since lease commencement; or
   - the lease term is near completion, at which time the fair value and the carrying value of the ROU asset will both be nil.

35. Property indices may be available in some cases to estimate changes in market rental rates. Entities can liaise with their Portfolio Department to see if a relevant property index is available. Where the property is specialised and has unique attributes which would not be incorporated in a general index, separate management estimates or external valuations may be required.

36. Entities should also apply their estimated IBR as at the time of their recoverable amount calculation. AASB 136 requires the discount rate when estimating the value in use to be a pre-tax rate that reflects current market assessments of: (a) the time value of money; and (b) the risks specific to the asset for which the future cash flow estimates have not been adjusted. Appendix A of AASB 136 provides additional guidance on estimating the discount rate when an asset-specific market rate is not directly available. Appendix A allows the entity’s IBR to be used as an estimate of the discount rate in this case.

37. Surplus lease space should generally be accounted for under AASB 136 rather than AASB 137 \textit{Provisions, Contingent Liabilities and Contingent Assets}. Paragraph 5 of AASB 137 states that when another standard deals with a specific type of provision, entities should apply that standard instead of AASB 137. Paragraph 69 of AASB 137 states “Before a separate provision for an onerous contract is established, an entity recognises any impairment loss that has occurred on assets dedicated to that contract (see AASB 136)”. Impairment for surplus lease space should not be recognised where the lease space is currently surplus but it is likely that the entity will be able to either use the space or sublet it at a similar rent to the head lease soon.

38. AASB 137 will still be applicable to lease contracts where an ROU asset has not been recognised, such as lease contracts that become onerous before commencement date or onerous short term or low value leases. AASB 137 defines onerous contracts as “a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it.”

\textsuperscript{19} Paragraph 6 of AASB 136 and paragraph 9 of AASB 13. Although paragraph 6(b) of AASB 13 states that its measurement and disclosure requirements do not apply to lease transactions under AASB 16 \textit{Leases}, its principles are still relevant.
ROU assets with indicators of impairment should have their recoverable amount estimated under AASB 136. ROU asset balances should generally approximate fair values where the lease recently commenced and was negotiated on commercial terms, was recently subject to a market rent review, the rent escalation factors applied to date under the lease contract approximate estimated changes in market rates since lease commencement or the lease term has almost expired.

Part 4 - Variable Lease Payments

Market Reviews during Lease Term

39. Some leases have fixed annual increases over the lease term with one or more intervening market reviews. Market reviews are variable lease payments under AASB 16, which are defined in AASB 16 Appendix A as: “The portion of payments made by a lessee to a lessor for the right to use an underlying asset during the lease term that varies because of changes in facts or circumstances occurring after the commencement date, other than the passage of time”. Paragraph 28 of AASB 16 states “variable lease payments that depend on an index or a rate described in paragraph 27(b) include, for example, payments linked to a consumer price index, payments linked to a benchmark interest rate (such as LIBOR) or payments that vary to reflect changes in market rental rates”.

40. Paragraph 27(b) of AASB 16 states that lease liabilities should initially be measured incorporating variable lease payments at the rate applicable at commencement date. Future changes to variable lease payments linked to an index such as CPI should not be estimated at lease commencement.

41. Paragraphs 36(c) and 42(b) of AASB 16 states that lease liabilities should be remeasured to reflect revised lease payments due to a change in index or rate only when the lease payments have changed, using the same discount rate. This may require re-measurement of the lease liability each year as the index changes. Paragraph B42 of AASB 16 states that where there are more than one set of lease payments under a lease agreement that a lessee could realistically be required to make, the lessee should use the lowest realistically possible lease payments in measuring the lease liability.

Commonwealth entities should incorporate all fixed annual rate changes, both before and after market review dates, in the initial measurement of the lease liability. Market review lease payment adjustments should not be incorporated in the measurement of lease liabilities until they become effective.

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20 AASB 16, paragraphs 42,43.
Part 5 - Lease Incentives

Fitout Incentives Received on Commencement Date

42. Lease incentives are defined in Appendix A of AASB 16 as: “Payments made by a lessor to a lessee associated with a lease, or the reimbursement or assumption by a lessor of costs of a lessee”.

43. Paragraph 23 of AASB 16 states that lessees shall initially measure right-of-use assets at cost. Paragraph 24 of AASB 16 states that:

“The cost of the right-of-use asset shall comprise:

(a) the amount of the initial measurement of the lease liability, as described in paragraph 26;

(b) any lease payments made at or before the commencement date, less any lease incentives received;”

44. Fitout expenditure undertaken or reimbursed by the lessor may be recognised as an asset by either the lessee or lessor, depending on which party controls the economic benefits from the expenditure. The expenditure may also have been promised by the lessor as an inducement for the lessee to enter the lease, or may have been undertaken by the lessor independent of the lease contract.

Lessor reimbursements of lessee leasehold improvement expenditure, or direct lessor expenditure on leasehold improvements, should only be considered lease incentives under AASB 16, where:

a) the expenditure was promised in the lease contract as a condition for the lessee to enter the lease; and

b) the lessee rather than lessor primarily benefits from that expenditure and has consequently recognised the expenditure as a fitout asset.

These incentives received should be deducted from the ROU asset’s initial value, consistent with paragraph 24(b) of AASB 16.

Fitout Incentives Received after Commencement Date

45. Lessors may promise to provide fitout or to reimburse lessee fitout costs as an incentive for lessees to enter a lease, but the incentive remains outstanding at lease commencement. Lessee accounting for fitout incentives which remain outstanding at lease commencement differs from fitout incentives received on lease commencement (as outlined above).

46. Paragraph 27 of AASB 16 states: “At the commencement date, the lease payments included in the measurement of the lease liability comprise the following payments for the right to use the underlying asset during the lease term that are not paid at the commencement date:
(a) fixed payments (including in-substance fixed payments as described in paragraph B42), less any lease incentives receivable”.

Therefore, fitout incentives which remain receivable at lease commencement need to be offset against gross lease payments outstanding in calculating the initial lease liability.

47. Lessee accounting for fitout incentives receivable should reflect the substance of the arrangement and should not differ based on whether the lessee purchases the fitout and is subsequently reimbursed by the lessor or the lessor purchases the fitout directly on the lessee’s behalf.

- Where the lessee purchases the fitout and is subsequently reimbursed, the lessee should recognise a fitout asset when purchased and a corresponding increase in the lease liability when the lessor reimbursement is received.

- Where the lessor purchases fitout directly and the lessee recognises that fitout as their controlled asset, the lessee should also recognise a fitout asset and a corresponding increase in the lease liability.

Fitout contribution incentives which remain receivable to the lessee on lease commencement should be offset against gross lease payments outstanding in calculating the initial lease liability. The incentive should be recognised as an increase in the lease liability when received.

### Part 6 - Discount Rates

#### Interest Rate Implicit in the Lease (IRI)

48. For leases commencing on or after AASB 16 transition date, entities must adopt the ‘interest rate implicit in the lease’ (IRI) to discount lease payments where it is readily available\(^\text{21}\). To determine the IRI, the lessee must know the lessor’s initial direct costs in establishing the lease and the unguaranteed residual value of the leased asset at the end of the lease\(^\text{22}\). This information is often not available to the lessee.

49. Lessees should identify whether this information is included in the lease contract. If it is not, then lessees should apply their IBR in measuring the lease liability\(^\text{23}\).

Lessees should use the applicable IBR where the IRI cannot be readily determined.

\(^{21}\) AASB 16(26)
\(^{22}\) AASB 16, Appendix A.
\(^{23}\) AASB 16, paragraph 26.
Incremental Borrowing Rate

50. A lessee’s IBR is “the rate of interest that a lessee would have to pay to borrow over a similar term, with a similar security, the funds necessary to obtain an asset of a similar value to the right-of-use asset in a similar economic environment”24.

51. Non-borrowing Commonwealth entities should use the Australian Government’s IBR parameters. These zero coupon bond parameters are issued quarterly by the Department of Finance at https://www.finance.gov.au/government/financial-reporting-accounting-policy/financial-reporting-commonwealth-entities. Entities should refer to the quarterly parameters that precede the lease commencement date (eg. leases commencing between 1 October 2019 and 31 December 2019 should refer to the 30 September quarter IBR parameters).

52. Finance developed a Simple Lease Model (SLM) which calculates monthly lease balances and includes an Excel ‘Goalseek’ function to calculate the IBR for each lease based on the relevant quarterly zero coupon bond parameters. See Attachment B for the SLM.

53. Commonwealth corporate entities who can borrow to fund their activities should identify their own IBR.

Non-borrowing Commonwealth entities should use the zero coupon bond yields on the Finance website to calculate their IBR. Commonwealth corporate entities who can borrow to fund their activities should identify their own IBR.

Changes in Discount Rate

54. Lessees should only re-measure lease liabilities using a revised discount rate where there is a change in the:

   (a) estimated lease term; or
   
   (b) a re-assessment of an option to purchase the underlying asset25.

55. Lessees should re-measure lease liabilities using an unchanged discount rate where lease payments have changed due to an index or a market review or the estimated residual value guarantee amount payable has changed26.

Lessees should only re-measure lease liabilities using a revised discount rate where there is a change in the estimated lease term or a re-assessment of an option to purchase the underlying asset.

24 AASB 16, Appendix A Defined Terms.
25 AASB 16 paragraph 40.
26 AASB 16 paragraph 42.
Lease Liability Interest Expense

56. Finance has elected not to capitalise lease interest expense under AASB 123 Borrowing Costs\(^{27}\). Under AASB 123:

- borrowing costs include AASB 16 lease liability interest expenses\(^{28}\); and
- not-for-profit public sector entities may elect to recognise borrowing costs as an expense when incurred\(^{29}\).

Entities are required to not capitalise lease interest expense.

Part 7 - Subleases

Classification of Subleases

57. AASB 16 requires subleases to be classified by the sub lessor as operating or finance leases. Classification of the sublease by the sub lessor is based on whether the sublease transfers substantially all the risks and rewards of ownership of the underlying asset\(^{30}\).

58. Subleases are operating leases where substantially all the risks and rewards of ownership of the underlying asset are not transferred to the sub lessee. Lease income is recognised on either a straight-line or another systematic basis. Costs related to the leased asset, such as depreciation and impairment, continue to be recognised by the sub lessor as expenses.

59. Subleases are finance leases where substantially all the risks and rewards of ownership of the underlying asset are transferred to the sub lessee. Where the sublease is classified as a finance lease, the head lease asset is effectively transferred to the sublessee (derecognised by the sub lessor and recognised by the sub lessee). Instead of the head lease ROU asset, the sub lessor recognises a net investment in the sublease, being the discounted lease payments receivable and any unguaranteed residual value. Any difference between the head lease ROU asset transferred and the net investment in sublease recognised should be recorded as a gain or loss in the sub lessors income statement. The sub lessor recognises finance income on the outstanding balance of the investment in the sublease.

60. Indications that a sublease could be classified as a finance sublease include:

- the sublease term is for the majority of the underlying assets economic life;
- the present value of sublease payments amounts to substantially all of the underlying assets fair value; or

\(^{27}\)Section 15 of the Finance Reporting Rule.
\(^{28}\)AASB 16, Appendix D, amendments to AASB 123, paragraph 6.
\(^{29}\)AASB 123, paragraph Aus8.1.
\(^{30}\)AASB 16 Paragraph 62.
• the sublease transfers ownership of the underlying asset to the sublessee by the end of the lease term (ie. the lessee has a bargain purchase option).

61. A sublease should only be considered by the sub lessor as a potential finance sublease when the ROU asset transferred comprises of 75% or more of the underlying head lease ROU asset. The ROU asset transferred under the sublease should be assessed against the head lease ROU asset, rather than the physical underlying asset. Short-term head leases must be classified by sub lessors as operating leases. Accounting judgement should be applied in other circumstances and documented for audit purposes.


A sublease should only be considered by the sub lessor as a potential finance sublease when the ROU asset transferred comprises of 75% or more of the head lease ROU.

Consolidation of Commonwealth Subleases

63. Subleases within the Commonwealth create related party transactions. As a result, entities are required to identify and report related party sublease transactions to Finance to allow elimination as part of the Whole-of-Government consolidation process. Entities should consult with each other to ensure related party information is consistent.

Entities should cross check related party information reported to Finance.

Memorandums of Understanding

64. AASB 16 defines a lease as “A contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration”. A contract is defined as “An agreement between two or more parties that creates enforceable rights and obligations”. AASB 15 Revenue from Contracts with Customers states that

65. contracts can be written, oral or implied by an entity’s customary business practices.

66. A Commonwealth Memorandum of Understanding (MOU) would be considered an ‘enforceable agreement’ when “a mechanism outside the legal system that establishes the right of a separate party to oblige the entity to act in a particular way or be subject to consequences” exists. Where a MOU contains such conditions or other penalties

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31 AASB 16 Paragraph B58.
32 AASB 16 Paragraph B58.
33 AASB 16, Appendix A, Defined terms.
34 AASB 16, Appendix A, Defined terms.
35 AASB 15, Appendix F11.
to the other party, the arrangement would generally be considered a ‘contract’ for purposes of AASB 16.

Commonwealth MOU’s would generally be considered contracts under AASB 16.

Part 8 – Make Good

Initial Recognition of Make Good Provisions

67. On initial implementation of AASB 16 on the 1 July 2019 transition date, make good accounting should remain unchanged for existing building leases. A lessee should recognise a provision for expected make good costs at the end of the lease under AASB 137 Provisions, Contingent Liabilities and Contingent Assets and a corresponding leasehold improvements asset under AASB 116 Property, Plant and Equipment.

68. For leases commencing after transition date, AASB 16 specifies that estimated make good costs that will be incurred by the lessee in dismantling and removing the underlying asset, restoring the site on which it is located or restoring the underlying asset must be included in the initial cost of the ROU asset, when the lessee incurs an obligation for those costs. A provision will still need to be recognised in compliance with AASB 137.

No change is required to make good provisions reported for existing leases on AASB 16 transition date. For new leases commencing after transition date, AASB 16 requires estimated make good costs to be included in the ROU assets initial measurement.

Changes to Make Good Provisions

69. Changes in lease make good provisions should be accounted for in accordance with AASB Interpretation 1 Changes in Existing Decommissioning, Restoration and Similar Liabilities and RMG 114 Accounting for Decommissioning, Restoration and Similar Provisions (Make good). AASB Interpretation 1 requires Commonwealth entities to review make good provisions annually to reflect current best estimates of the timing and the amount required to settle the obligation and the appropriate discount rate.

70. Under Interpretation 1, accounting for changes in make good provision estimates will depend on whether the underlying asset is held at cost or fair value. This will differ for leases which existed on transition date and for leases which commenced after transition date.

36 AASB 137, paragraph 14.
37 AASB 16, paragraph 24 (d) and paragraph 25.
• For leases on transition date, any make good will be recognised as a property, plant and equipment asset separate from the ROU asset and will be measured at fair value.

• For leases which commenced after transition date, any make good will be recognised as a component of the ROU asset and will be measured at cost.

71. Where make good assets are measured at cost, Interpretation 1 requires changes in make good provisions due to changes in estimates to generally be adjusted against the cost of the related asset. Increases in make good provisions would increase the corresponding lease ROU asset and decreases in make good provisions would decrease the corresponding lease ROU asset. Decreases in make good provisions in excess of the carrying value of the related ROU assets should be recognised as gains in the income statement.

72. Where assets are measured at fair value, Interpretation 1 requires changes in make good provisions due to changes in estimates to be treated as a revaluation adjustment. Increases in make good provisions would decrease the Asset Revaluation Reserve (ARR) balance or result in an expense where there is no ARR balance. Decreases in make good provisions would increase the ARR balance or result in a gain if reversing a previous devaluation expense.

73. In both cases, where the make good assets are at the end of their useful life, all subsequent changes to provisions should be recognised in the income statement as they occur. Periodic unwinding of the present value of make good provisions should be recognised as interest expense (unwinding of restoration and decommissioning provision expense) as it occurs.


Changes in lease make good provision estimates should be accounted for in accordance with AASB Interpretation 1 and will depend on whether the underlying make good asset is recognised as a property, plant and equipment asset held at fair value (leases which existed on transition) or as part of the ROU asset held at cost (leases which commenced after transition date).

Part 9 - Miscellaneous

Lease Portfolios

75. Lessees may account for a portfolio of similar leases as a group. Lessees must ensure that leases within the portfolio are for “a similar remaining lease term, for a similar class of underlying asset in a similar economic environment”38. Lessees will need to provide

38 AASB 16, Appendix C, paragraph C10(a)
supporting information to confirm that the portfolio outcome would not differ materially from applying AASB 16 to the individual leases within that portfolio\(^{39}\).

Entities can group leases within a portfolio when each lease has a similar remaining lease term and is for a similar class of underlying asset in a similar economic environment, subject to the outcome not being materially different to the individual leases within that portfolio.

Net Cash Reconciliation Disclosure

76. The Net Cash Appropriation Arrangements note in the annual financial statements and Portfolio Budget Statements identifies whether entities have incurred or will incur operating losses, after adjusting for capital funded expenses. For example, non corporate entities that received Departmental Capital Budget (DCB) funding need to adjust their operating result for depreciation expenses on assets acquired using DCB funding.

77. Commonwealth entities with leasing transactions should also adjust the Net Cash Appropriation Arrangements note to remove the impact of AASB 16 on their operating result. As outlined in Estimates Memorandum (EM) 2020-02 – *Consideration of Operating Loss Applications*, the note should add back depreciation of lease ROU assets and then deduct lease principal repayments (which is accounted for through the Balance Sheet).

78. Other technical losses may occur due to the implementation of AASB 16. For example, entity’s expenses may have increased under AASB 16 due to the clearing of lease incentive and straight-lining provisions on transition, or foreign exchange losses may be incurred on lease liabilities. The Net Cash Reconciliation Note should not be amended in these cases. However, a footnote can be added explaining the extent to which they contributed to the overall operating loss. As outlined in EM 2020-02, the Department of Finance may determine that the Finance Minister’s approval is not required for technical operating losses which are outside the entity’s control in the current financial year and the loss does not impact the entity’s financial sustainability.

79. Entities should refer to RMG 125 and EM 2020-02 for more information.

All Commonwealth entities that have leasing transactions should include the Net Cash Appropriation Arrangements note in their annual financial statements.

\(^{39}\) AASB 16, Appendix B, paragraph B1.
Part 10 - Transition

Retrospective Application of AASB 16

80. Paragraphs C5 and C7 of AASB 16 Appendix C provides that a lessee may:

(a) apply AASB 16 “retrospectively to each prior reporting period presented applying
AASB 108 Accounting Policies: Changes in Accounting Estimates and Errors”
(the full retrospective model); or
(b) “recognise the cumulative effect of initially applying this Standard as an
adjustment to the opening balance of retained earnings (or other component of
equity, as appropriate) at the date of initial application (DIA)” (the modified
model).

81. A lessee is required to apply the selected option above consistently to all its leases40. To facilitate implementation of AASB 16, Finance requires that entities apply the modified model.

Entities are required to apply the modified model on initial application of AASB 16.

Identification of Leases

82. Paragraph C3 of AASB 16 permits entities:

(a) to apply AASB 16 to contracts that were previously identified as leases under
AASB 117 Leases and Interpretation 4 Determining whether an Arrangement
Contains a Lease; and
(b) not to apply AASB 16 to contracts that were not previously identified as
containing a lease under AASB 117 and Interpretation 4.

83. Commonwealth entities should not reassess previous contracts on transition to
AASB 16. This option must be applied to all contracts and disclosed. Entities will
however be required to reassess whether a contract contains a lease where
contractual terms subsequently change41.

Entities are required to apply the ‘no reassessment of previous leases’ option provided
in paragraph C3 of AASB 16.

ROU Assets Previously Accounted for as Operating Leases

84. Under paragraph 8(b) in Appendix C of AASB 16, when AASB 16 is applied
retrospectively with the cumulative effect of applying the standard recognised on

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40 AASB 16 Appendix C, Paragraph C6
41 AASB 16(11)
transition date (the modified model), a lessee can choose to measure ROU assets for its existing operating leases, on a lease-by-lease basis, at:

“(i) its carrying amount as if the Standard had been applied since the commencement date, but discounted using the lessee’s incremental borrowing rate at the date of initial application; or

(ii) an amount equal to the lease liability, adjusted by the amount of any prepaid or accrued lease payments relating to that lease recognised in the statement of financial position immediately before the date of initial application.”

85. Commonwealth lessees may apply either of these options on transition. However, Finance recommends implementation option C8(b)(ii) as it is likely to be a simpler method of calculating the ROU asset on transition.

AASB 16 allows entities to apply the implementation options under C8(b) on a lease by lease basis. Therefore, adjustments will not be required in entity or the Commonwealth’s consolidated financial statements to ensure all ROU assets on transition are calculated using the same C8(b) implementation option.

**ROU Assets Previously Accounted for as Finance Leases**

86. ROU asset classes may include some leases which were previously accounted for as finance leases under AASB 117 *Leases*. Prior to 2019-20, these ROU assets were included in non financial asset classes measured at fair value.

87. Reclassifying those ROU assets into separate ROU specific asset classes held at cost under AASB 16 is a change in accounting policy under AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors*. Paragraph 14 of AASB 108 states that entities can only voluntarily change accounting policies if it results in the financial statements providing more reliable and relevant information. Under paragraph 19 of AASB 108, voluntary changes in accounting policies should be applied retrospectively.

88. Paragraph C11 of AASB 16 requires ROU assets previously recognised by lessees as finance leases under AASB 117 to be initially recognised on AASB 16 transition date at the carrying amount of those lease assets under AASB 117 immediately prior to transition. These amounts reflect the ROU asset’s deemed cost on transition date under AASB 16.

ROU assets previously recognised by Commonwealth lessees as finance leases under AASB 117 should be reclassified into the separate ROU asset classes created under AASB 16.

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42 Clause 17 of the Finance Reporting Rule (FRR)
Lease Incentive Provisions

89. Where AASB 16 transitional option C(8)(b)(ii) is applied in initially recognising ROU assets, entities have sought clarification on whether outstanding lease incentive and straight-lining provisions on transition date carried over from AASB 117 and Interpretation 115 Operating Leases – Incentives should be:

- offset against the relevant ROU asset balances; or
- cleared to opening retained earnings.

90. Finance’s election to apply the modified model (i.e. paragraphs C5(b) and C7) on initial application of AASB 16 requires lessees to recognise the cumulative effect of initially applying this Standard as an adjustment to the opening balance of retained earnings at the date of initial application.

91. Lease incentive and lease straight-lining provisions which are outstanding on transition date are not assessed to be “accrued lease payments” for purposes of AASB 16 paragraph C8(b)(ii). Therefore, these balances should be cleared to retained earnings on transition.

Where AASB 16 transitional option C(8)(b)(ii) is applied, lessees are required to adjust retained earnings for the de-recognition of lease incentive and straight-lining provisions previously recognised under AASB 117 and Interpretation 115.

Impairment on AASB 16 Transition

92. For ROU assets held at cost, AASB 16 requires a “lessee to apply AASB 136 Impairment of Assets to determine whether the right-of-use asset is impaired and to account for any impairment loss identified”43. However, a lessee can elect on a lease-by-lease basis to “rely on its assessment of whether leases are onerous applying AASB 137 Provision, Contingent Liabilities and Contingent Assets immediately before the date of initial application as an alternative to performing an impairment review.”44 If the lessee elects to use the AASB 137 assessment, it must adjust the ROU asset “at the date of initial application by the amount of any provision for onerous leases recognised in the statement of financial position immediately before the date of initial application.”45

Entities may rely on their previous assessment on whether a lease is onerous, rather than performing an impairment review.

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43 AASB 16 paragraph 33
44 AASB 16 Appendix C Paragraph C10(b)
45 AASB 16 Appendix C Paragraph C10(b)
Appendices

Attachment A: Example Lease Journals
Attachment B: Revised Simple Lease Model
Attachment C: Lease Transactions in CBMS http://LeaseTransactionsinCBMS