Guide to implementing AASB 16 Leases
Resource Management Guide (RMG) 110

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Audience

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

For ease of reference and presentation, in this guide ‘Commonwealth entities’ refers to Commonwealth departments, agencies and entities and Commonwealth companies as defined by the *Public Governance, Performance and Accountability Act 2013*.

Key points

This guide:

- assists Commonwealth entities with implementing *Australian Accounting Standards Board (AASB) 16 Leases* (AASB 16)
- provides Commonwealth entities with examples and tools to calculate lease balances for common scenarios.

Resources

This guide is available on the Department of Finance website.

Other relevant publications include:

- *Accounting for decommissioning, restoration and similar provisions (‘make good’) (RMG 114)*
- *Commonwealth Entities Financial Statements Guide (RMG 125)*
- other relevant *Australian Accounting Standards*, as referenced in this guide
- *AASB Glossary.*
Introduction

1. **Australian Accounting Standards Board (AASB) 16 Leases** (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.

2. AASB 16 is the Australian equivalent to the International Accounting Standard Board (IASB) **International Financial Reporting Standard 16 Leases** (IFRS 16), introduced to address concerns with the lack of transparency relating to lease rights and obligations. It is applicable for reporting periods commencing on or after 1 January 2019.

3. This guide:
   - summarises the major policy decisions of the Department of Finance (Finance) with regard to the application of AASB 16 and addresses the main issues raised by Commonwealth entities
   - aims to achieve consistency in accounting treatment of leases amongst Commonwealth entities, which is necessary for the preparation of the **Commonwealth Consolidated Financial Statements** (CFS).

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

1. Identifying a lease

5. Under paragraph 9 of AASB 16, a contract is a lease, 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 both the right to:
   - obtain substantially all of the economic benefits from use of the identified asset
   - direct the use of the identified asset.

**AASB 16 extract:**

**Paragraph B13:** An asset is typically identified by being explicitly specified in a contract. However, an asset can also be identified by being implicitly specified at the time that the asset is made available for use by the customer.

6. As noted in paragraph B13 of AASB 16, an asset is typically identified by being explicitly specified in a contract. However, under paragraph B14 of AASB 16, even where 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 period. This would only occur if the supplier:
   - has the practical ability to substitute alternative assets
   - could benefit economically from substituting the asset throughout the period of use.
7. Under paragraph B20 of AASB 16, a capacity portion of an asset would only be an identified asset if it is physically distinct.

8. For more information on:
   - assessing if a contract is, or contains, a lease, see paragraphs B9–B31 of AASB 16
   - the identification of lease arrangements, see IFRS 16 Illustrative Examples 1 – 10.

Note 1: Identification of a lease

Contracts only contain a lease if the contract both:
- conveys the right to control the use of an identified asset for a period of time
- requires an exchange of consideration.

1.1 Separating lease components

**AASB 16 extract:**

**Paragraph B32:** 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.

9. Entities may have a contract with separate lease components only where the underlying assets are not closely related.

**Example: Separate lease components**

Multiple floors in a leased building would normally be considered related, where it is important for the entity’s staff to be co-located. In such cases, the leased floors would usually be accounted for as a single lease rather than as separate lease components.

10. For more information on separating lease components within a contract, see paragraphs 12-16 and B32–B33 of AASB 16.
Note 2: **Separating lease components**

Contracts would only contain separate lease components where the underlying assets are not closely related.

1.2 Separating lease and non-lease components

11. Under paragraph 12 of AASB 16, where a contract is, or contains, 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 paragraph 15 of AASB 16 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.

AASB 16 extract:

**Paragraph 15:** As a practical expedient, a lessee may elect, by class of underlying asset, not to separate non-lease components from lease components, and instead account for each lease component and any associated non-lease components as a single lease component. A lessee shall not apply this practical expedient to embedded derivatives that meet the criteria in paragraph 4.3.3 of AASB 9 Financial Instruments.

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. For more information on separating lease and non-lease components within a contract, see paragraphs 9-16 and B9–B33 of AASB 16.

Note 3: **Separating lease and non-lease components**

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.

1.3 Short-term and low value exemptions

14. Under paragraph 5 of AASB 16, a lessee may elect not to comply with AASB 16 lease recognition requirements for:

- short-term leases (ie a lease that has a lease term of 12 months or less at the commencement date)

- leases for which the underlying asset is of low value.

15. Instead, the lessee would recognise the lease payments associated with those leases as an expense on either:
16. The exemptions, under paragraph 5 of AASB 16, reduce the administrative burden in implementing AASB 16. The election for:

- the short-term lease exemption must be made based by class of ROU asset
- low-value leases can be made on a lease-by-lease basis, in accordance with paragraph 8 of AASB 16.

17. 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 Basis for Conclusions in IFRS 16.

18. For more guidance on low value assets, see paragraphs B3-B8 of AASB 16.

Note 4: Short term and low value exemptions

Commonwealth 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.

1.4 Intangible assets

AASB 16 extract:

**Paragraph 4:** A lessee may, but is not required to, apply this Standard to leases of intangible assets other than those described in paragraph 3(e).

19. Paragraph 4 of AASB 16 enables lessees to not apply AASB 16 to intangible assets. To facilitate AASB 16 implementation, Commonwealth entities are to select this application option.

Note 5: Intangible assets

Commonwealth lessees are not to apply AASB 16 to intangible assets.
2. Lease terms

AASB 16 extract:

**Paragraph B34:** In determining the lease term and assessing the length of the non-cancellable period of a lease, an entity shall apply the definition of a contract and determine 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 permission from the other party with no more than an insignificant penalty.

20. Lease term, as defined at Appendix A of AASB 16, is the non-cancellable period for which a lessee has the right to use an underlying asset, together with the periods covered by an option to:

- extend the lease, if the lessee is reasonably certain to exercise that option
- terminate the lease, if the lessee is reasonably certain not to exercise that option.

21. For options to either extend or terminate the lease, indicators of reasonable certainty include:

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

AASB 16 extract:

**Paragraph 40:** A lessee shall remeasure the lease liability by discounting the revised lease payments using a revised discount rate, if either:

(a) there is a change in the lease term, as described in paragraphs 20–21. A lessee shall determine the revised lease payments on the basis of the revised lease term; or

(b) there is a change in the assessment of an option to purchase the underlying asset, assessed considering the events and circumstances described in paragraphs 20–21 in the context of a purchase option. A lessee shall determine the revised lease payments to reflect the change in amounts payable under the purchase option.

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.

23. Re-measurement of lease liabilities from reassessment of lease terms should use a revised discount rate.
24. Paragraphs 18 to 21 of AASB 16 detail requirements for determining lease terms with application guidance provided at paragraphs B34 to B41 of AASB 16.

Note 6: **Lease terms**

Lease terms are:

- the non-cancellable period of the lease
- periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option
- periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option.
3. Right-of-use assets

3.1 Subsequent measurement of right-of-use assets

AASB 16 extract:

Paragraph 29:
After the commencement date, a lessee shall measure the right-of-use asset applying a cost model, unless it applies either of the measurement models described in paragraphs 34 and 35.

25. 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 and Equipment (AASB 116).

26. Under paragraph 37 of AASB 116, a class of PPE assets is a grouping of assets of a similar nature and use in an entity’s operations.

Examples: Separate classes of PPE assets

Examples of separate classes of PPE include land, land and buildings, machinery, ships, aircraft, motor vehicles, furniture and fixtures, office equipment and bearer plants.

27. The rights, obligations, risks and benefits of assets under lease contracts may differ substantially from corresponding assets that are owned outright. Lease ROU assets are therefore a distinct grouping of assets (to corresponding assets owned outright) and are separately disclosed in Commonwealth entity financial statements.

28. Lease ROU assets can therefore be classified by Commonwealth lessees as separate asset classes to corresponding assets owned outright. Because ROU assets are a separate asset class, 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 29 of AASB 16.

29. Peppercorn leases are those lease arrangements that are agreed for a nominal monetary amount to satisfy the requirements of creating a legal contract. Peppercorn leases, as defined by AASB 16, are leases that have significantly below-market terms and conditions principally to enable the entity to further its objectives. For more information, see paragraph Aus25.1 of AASB 2018-8 Amendments to Australian Accounting Standards – Right-of-Use Assets of Not-for-Profit Entities.

30. Commonwealth lessees should measure any peppercorn lease ROU assets at cost rather than at fair value, consistent with other ROU assets.
Note 7: Subsequent measurement of right-of-use assets

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.

3.2 Impairment of right-of-use assets

AASB 16 extract:

**Paragraph 30:** To apply a cost model, a lessee shall measure the right-of-use asset at cost:

(a) less any accumulated depreciation and any accumulated impairment losses; and
(b) adjusted for any remeasurement of the lease liability specified in paragraph 36(c).

31. Paragraph 30 of AASB 16 requires ROU assets held at cost to be measured after deducting accumulated depreciation and any accumulated impairment losses.

32. Under paragraph 33 of AASB 16, lessees are required to apply **AASB 136 Impairment of Assets** (AASB 136) to determine whether ROU assets held at cost are impaired and to account for any impairment losses.

33. Definitions at paragraph 6 or AASB 136, include:

- **impairment loss** – the amount by which the carrying amount of an asset or a cash-generating unit exceeds its recoverable amount
- **recoverable amount** – for an asset or cash generating unit, is the higher of its fair value less costs of disposal and its value in use
- **fair value** – 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 measurement date
- **costs of disposal** – incremental costs directly attributable to the disposal of an asset or cash generating unit, excluding finance costs and income tax expense.
- **value in use** – the present value of the future cash flows expected to be derived from an asset or cash generating unit.

34. Paragraph Aus5.1 of AASB 136 notes that, under **AASB 13 Fair Value Measurement** (AASB 13), the recoverable amount will generally equal fair value for many assets of not-for-profit entities that are held for continuing service capacity rather than to generate net cash inflows. Paragraph 53A of AASB 136 and paragraph 2 of AASB 13 note that fair value is market-based rather than an entity specific measurement.

35. Paragraph 9 of AASB 136 requires non-financial assets to be assessed for impairment indicators at the end of each reporting period. Where impairment indicators exist, the assets recoverable amount should be estimated.
36. Under paragraph 110 of AASB 136, where impairment losses have been previously recognised, entities are to assess whether there are indications that the impairment previously recognised has decreased. If so, the recoverable amount of that asset should be re-estimated.

37. For impairment indicators that are to be applied (as a minimum) by entities, see paragraph 12 of AASB 136.

38. Impairment indicators applicable to ROU assets include that:
   - 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
   - market interest rates have increased significantly since lease commencement, which would cause a re-rating of the relevant incremental borrowing rate (IBR).

39. 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 reflect estimated changes in market rates since lease commencement, or
   - the lease term is near completion, at which time both the fair value and the carrying value of the ROU asset will be nil.

40. Property indices may be available in some cases to estimate changes in market rental rates. Commonwealth 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 may not be reflected in a general index, separate management estimates or external valuations may be required.

41. Entities should also apply their estimated IBR as at the time of their recoverable amount calculation.

42. AASB 136 requires the discount rate, when estimating the value in use, to be a pre-tax rate that reflects current market assessments of the:
   - time value of money
   - risks specific to the asset for which the future cash flow estimates have not been adjusted.

43. Appendix A of AASB 136 allows the entity’s IBR to be used as an estimate of the discount rate in this case and includes guidance on estimating the discount rate when an asset-specific market rate is not directly available.

44. Surplus lease space should generally be accounted for under AASB 136 – rather than AASB 137 Provisions, Contingent Liabilities and Contingent Assets (AASB 137).
45. AASB 137 states, at:
   - paragraph 5, that when another accounting standard deals with a specific type of provision entities should apply that standard instead of AASB 137
   - paragraph 69, that 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).

46. 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 soon at a similar rent to the head lease.

47. AASB 137 will still be applicable to lease contracts where an ROU asset has not been recognised (e.g. lease contracts that become onerous before commencement date, or onerous short-term or low-value leases). AASB 137 defines onerous contracts as contracts 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.

Note 8: Impairment indicators

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
   - lease was recently subject to a market rent review
   - rent escalation factors applied to date, under the lease contract, approximate estimated changes in market rates since lease commencement, or
   - lease term has almost expired.
4. Variable lease payments

48. Variable lease payments, as defined at Appendix A of AASB 16, are 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.

49. Worksheet E in the Example lease journals illustrates accounting for variable lease payments.

4.1 Market reviews during lease term

50. Some leases have fixed annual increases over the lease term with one or more intervening market reviews – under AASB 16, these are variable lease payments.

AASB 16 extract:

Paragraph 28: 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.

Note: The London Interbank Offered Rate (LIBOR) is a benchmark interest rate at which major global banks lend to one another in the international interbank market for short-term loans.

51. Under paragraph 27(b) of AASB 16, lease liabilities should initially be measured incorporating variable lease payments at the rate applicable at commencement date (as described in paragraph 28 of AASB 16). Future changes to variable lease payments linked to an index, such as the Australian Consumer Price Index, should not be estimated at lease commencement.

52. Under paragraphs 36(c) and 42(b) of AASB 16, lease liabilities should be remeasured to reflect revised lease payments only when there is a change in the cash flows (ie as a result of a change in index or rate), using the same discount rate. This may require re-measurement of the lease liability each year as the index changes.

53. A lessee shall determine the revised lease payments for the remainder of the lease term based on the revised contractual payments. Under:

- paragraph 43 of AASB 16, in applying paragraph 42 of the AASB 16, a lessee shall use an unchanged discount rate, unless the change in lease payments results from a change in floating interest rates. In that case, the lessee shall use a revised discount rate that reflects changes in the interest rate
- paragraph B42(c) of AASB 16, 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.
Note 9: **Market reviews during lease term**

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.
5. Lease incentives

AASB 16 extract:

Paragraph 24: 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;
(c) any initial direct costs incurred by the lessee; and
(d) an estimate of costs to 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 to the condition required by the terms and conditions of the lease, unless those costs are incurred to produce inventories. The lessee incurs the obligation for those costs either at the commencement date or as a consequence of having used the underlying asset during a particular period.

5.1 Fitout incentives received on commencement date

54. Lease incentives, as defined at Appendix A of AASB 16, are 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.

55. Fitout expenditure undertaken or reimbursed by the lessor may be recognised as asset by either the lessee or lessor (ie to reflect the party that controls the economic benefits from the expenditure). Such expenditure may have been:

- promised by the lessor as an inducement for the lessee to enter the lease, or
- undertaken by the lessor independent of the lease contract.

56. Worksheet B in the Example lease journals illustrate accounting for lease incentives received on commencement after the transition date of 1 July 2019.

Note 10: Fitout incentives received on commencement date

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

- expenditure was promised in the lease contract as a condition for the lessee to enter the lease
- 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.
5.2 Fitout incentives received after commencement date

57. 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 that are outstanding at lease commencement differs from fitout incentives received on lease commencement.

AASB 16 extract:

**Paragraph 27(a):** 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

Note: For details on all lease payments, at the commencement date, to be included in the measurement of the lease liability, see paragraph 27 of AASB 16.

58. Lessee accounting for fitout incentives receivable:

- should reflect the substance of the arrangement
- should not differ whether the:
  - lessee purchases the fitout and is subsequently reimbursed by the lessor, or
  - lessor purchases the fitout directly on the lessee’s behalf.

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

60. Where the lessor purchases the 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.

**Note 11: Fitout incentives received after commencement date**

Fitout contribution incentives that 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.
6. Discount rates

6.1 Interest rate implicit in the lease

AASB 16 extract

**Paragraph 26:** At the commencement date, a lessee shall measure the lease liability at the present value of the lease payments that are not paid at that date. The lease payments shall be discounted using the interest rate implicit in the lease, if that rate can be readily determined. If that rate cannot be readily determined, the lessee shall use the lessee’s incremental borrowing rate.

61. For leases commencing on or after on the AASB 16 transition date, ie 1 July 2019, entities must adopt the interest rate implicit in the lease (IRI) to discount lease payments, where it is readily available.

62. IRI, as defined at Appendix A of AASB 16, is the rate of interest that causes the present value of (a) the lease payments and (b) the unguaranteed residual value to equal the sum of (i) the fair value of the underlying asset and (ii) any initial direct costs of the lessor, as show in the following diagram.

63. 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. This information is often not available to the lessee.

64. 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.

**Note 12 Interest rate implicit in the lease**

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

6.2 Incremental borrowing rate

65. A lessee’s IBR, as defined at Appendix A of AASB 16, 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 ROU asset in a similar economic environment.

66. Non-borrowing Commonwealth entities should use the Australian Government’s IBR, based on zero coupon bond parameters. The IBR parameters are issued quarterly by
Finance as the table of Leases - zero coupon discount rate. Entities should apply the quarterly parameters that precede the lease commencement date (e.g., for leases commencing 1 October to 31 December 2019, use the 30 September 2019 quarter IBR parameters).

67. The Simple lease calculation tool (available to Commonwealth officials from CBMS GovTEAMS):

- calculates monthly lease balances
- includes an Excel ‘Goal seek’ function to calculate the IBR for each lease, based on the relevant quarterly zero coupon bond parameters.

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

Note 13: Incremental borrowing rate

Non-borrowing Commonwealth entities should use the table of Leases - zero coupon discount rate to calculate their IBR. Commonwealth corporate entities who can borrow to fund their activities should identify their own IBR.

6.3 Changes in discount rate

69. Under paragraph 40 of AASB 16, 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.

70. Under paragraph 42 of AASB 16, lessees should re-measure lease liabilities using an unchanged discount rate where lease payments have changed due to:

- a change in the estimated residual value guarantee amount payable, or
- an index or a market review.

71. Worksheet D in the Example lease journals illustrates accounting for a reassessment of the lease term.

Note 14: Changes in discount rate

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.
6.4 Lease liability interest expense

72. In accordance with provisions at section 15 of the *Public Governance, Performance and Accountability (Financial Reporting) Rule 2015* (FRR), Finance has elected not to capitalise lease interest expense under *AASB 123 Borrowing Costs* (AASB 123).

73. Under AASB 123:

- borrowing costs may include AASB 16 lease liability interest expenses (see Appendix D of AASB16: Amendments to AASB 123, paragraph 6(d))
- not-for-profit public sector entities may elect to recognise borrowing costs as an expense when incurred (see AASB 123, paragraph Aus8.1).

Note 15: **Lease liability interest expense**

Commonwealth entities are required to expense lease interest costs.
7. Subleases

7.1 Classification of subleases

AASB 16 extract:

**Paragraph 62:** A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership of an underlying asset. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset.

74. Subleases are to be classified by the sublessor as operating or finance leases, based on whether the sublease transfers substantially all the risks and rewards of ownership of the underlying asset. Subleases are:

- **operating leases**, where substantially all the risks and rewards of ownership of the head lease ROU asset are not transferred to the sublessee. Where the sublease is classified as an operating lease:
  
  o lease income is recognised on either a straight-line or another systematic basis
  
  o costs related to the head lease ROU asset, such as depreciation and impairment, continue to be recognised by the sublessor as expenses.

- **finance leases**, where substantially all the risks and rewards of ownership of the head lease ROU asset are transferred to the sublessee. Where the sublease is classified as a finance lease:
  
  o the head lease asset is effectively transferred to the sublessee (derecognised by the sublessor and recognised by the sublessee)
  
  o instead of the head lease ROU asset, the sublessor recognises a net investment in the sublease, being the discounted lease payments receivable and any unguaranteed residual value
  
  o 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 sublessor's income statement
  
  o the sublessor recognises finance income on the outstanding balance of the investment in the sublease.

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

- sublease term is for the majority of the head lease term

- present value of sublease payments amounts to substantially all of the head lease ROU asset’s fair value, or
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).

76. A sublease should only be considered by the sublessor as a potential finance sublease when the ROU asset transferred comprises of 75 per cent or more of the underlying head lease ROU asset.

AASB 16 extract:

Paragraph B58: In classifying a sublease, an intermediate lessor shall classify the sublease as a finance lease or an operating lease as follows:

(a) if the head lease is a short-term lease that the entity, as a lessee, has accounted for applying paragraph 6, the sublease shall be classified as an operating lease.

(b) otherwise, the sublease shall be classified by reference to the right-of-use asset arising from the head lease, rather than by reference to the underlying asset (for example, the item of property, plant or equipment that is the subject of the lease).

77. The ROU asset transferred under the sublease should be assessed against the head lease ROU asset, rather than the physical underlying asset. Sublessors must classify short-term head leases as operating leases. In other circumstances, accounting judgement is to be applied and documented for audit purposes.

78. For requirements in considering lessor classification and accounting for leases, see paragraphs 61-87 of AASB 16. Worksheets C1 and C2 in the Example lease journals also illustrate accounting for sub lease arrangements.

Note 16: Classification of subleases

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

7.2 Consolidation of Commonwealth subleases

79. Subleases within the Commonwealth create related party transactions. As a result, Commonwealth 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.

80. Commonwealth entities should consult with each other to ensure related party information is consistent.

Note 17: Consolidation of Commonwealth subleases

Commonwealth entities should crosscheck related party information reported to Finance.
7.3 Memorandums of understanding

81. Under the definitions at Appendix A of AASB 16, a:
- **lease** is 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
- **contract** is an agreement between two or more parties that creates enforceable rights and obligations.

82. *AASB 15 Revenue from Contracts with Customers* (AASB 15) states that contracts can be written, oral or implied by an entity’s customary business practices.

83. Under paragraph F11 of AASB 15, a Commonwealth memorandum of understanding (MOU) would be considered an enforceable agreement where, outside the legal system, it establishes the right of a separate party to oblige the entity to act in a particular way or be subject to consequences. Where an MOU contains such conditions or other penalties to the other party, the arrangement would generally be considered a contract for the purposes of AASB 16.

**Note 18: Memorandums of understanding**

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

84. Under paragraph 16 of AASB 116 the cost of an item of PPE includes make good costs, where the obligation was incurred either when the item was acquired or as a consequence of having used the item.

Example: Make good costs

Examples of PPE make good costs may include the costs to:
- restore a leased building at end of lease term to its condition at lease commencement
- dismantle a piece of machinery to allow for its removal from the entity’s premises
- remove an aircraft, by transporting it to a disposal facility, due to a condition of purchase being that it must be disposed of in a particular manner.

8.1 Initial recognition of make good provisions

85. On initial implementation of AASB 16, on the 1 July 2019 transition date, make good accounting should remain unchanged for existing leases. A lessee should recognise a provision under AASB 137 for the expected make good costs at lease end and a corresponding leasehold improvements asset inclusive of capitalised make good costs under AASB 116.

86. For leases commencing after the transition date, paragraph 24 (d) and paragraph 25 of AASB 16 specify that estimated make good costs must be included in the cost of the lessee’s ROU asset when the lessee incurs an obligation for those costs. However, where the make good obligation specifically relates to leasehold improvements undertaken by the lessee, the make good provision should continue to be capitalised as part of the lessee’s leasehold improvements asset rather than to the ROU asset.

87. For example, where the lease contract requires the lessee to remove any fit out work undertaken by the lessee at lease end, any make good provision relating to this obligation should be capitalised to the corresponding leasehold improvement asset, rather than the ROU asset. However, where the lease contract requires the lessee to undertake general restoration of the leased premises not related to specific lessee fitout, such as repainting, carpet cleaning and servicing of air conditioning and lift systems, any make good provision should be capitalised to the ROU asset.

Note 19: Initial recognition of make good provisions

No change is required to make good provisions relating to 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 lessee’s ROU asset. However, where the make good obligation specifically relates to leasehold improvements undertaken by the lessee, the make good provision should continue to be capitalised as part of the relevant leasehold improvement asset rather than to the ROU asset.
8.2 Changes to make good provisions

88. Changes in lease make good provisions should be accounted for in accordance with AASB 137, AASB Interpretation 1 Changes in Existing Decommissioning, Restoration and Similar Liabilities (Interpretation 1) and RMG 114. AASB 137 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.

89. Under Interpretation 1, accounting for changes in make good provisions, due to changes in estimates of the amount or timing of payments at settlement or from a change in the discount rate, depends on whether the related asset is:

- the ROU asset measured at cost (includes some make good provisions relating to leases which commenced after AASB 16 transition date), or
- a leasehold improvement asset measured at fair value (includes make good provisions on existing leases on initial implementation of AASB 16).

90. Where the make good provision is capitalised to a ROU asset measured at cost, Interpretation 1 requires changes in make good provision estimates to be adjusted against the ROU asset as follows:

- increases in the make good provision would increase the corresponding ROU asset
- decreases in the make good provision would decrease the corresponding ROU asset, except that decreases in excess of the carrying value of the ROU asset would be recognised as gains.

91. Where the make good provision is capitalised to a leasehold improvement asset measured at fair value, Interpretation 1 requires changes in make good provisions estimates to be treated as a revaluation adjustment as follows:

- increases in the provision would decrease the relevant asset revaluation reserve (ARR) balance or result in an expense where there is no ARR balance
- decreases in the provision would increase the ARR balance or result in a gain if reversing a previous devaluation expense for that asset class.

92. In both cases, where the related asset is at the end of their useful life, all subsequent changes in the make good provision should be recognised in the income statement as they occur. 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.

Note 20: Changes to make good provisions

Changes in lease make good provision estimates should be accounted for in accordance with Interpretation 1 and will depend on whether the make good is recognised as part of a leasehold improvement asset held at fair value or as part of the ROU asset held at cost.
9. Miscellaneous

9.1 Lease portfolios

93. Under paragraph B1 of AASB 16, an entity may apply AASB 16 to a portfolio of leases with similar characteristics where it is reasonably expected that the effects on the financial statements would not differ materially from applying AASB 16 to the individual leases within that portfolio.

**AASB 16 extract:**

**Paragraph B1:** This Standard specifies the accounting for an individual lease. However, as a practical expedient, an entity may apply this Standard to a portfolio of leases with similar characteristics if the entity reasonably expects that the effects on the financial statements of applying this Standard to the portfolio would not differ materially from applying this Standard to the individual leases within that portfolio. If accounting for a portfolio, an entity shall use estimates and assumptions that reflect the size and composition of the portfolio.

94. Lessees may account for a portfolio of similar leases as a group. Lessees must ensure that leases within the portfolio are have similar:

- remaining lease term
- class of underlying asset
- economic environment.

95. Entities shall use estimates and assumptions that reflect the size and composition of the portfolio. Lessees will need to provide supporting information to confirm that the portfolio outcome would not differ materially from applying AASB 16 to the individual leases within that portfolio.

**Note 21: Lease portfolios**

Commonwealth 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.
9.2 Net cash reconciliation disclosure

96. The net cash appropriation arrangements note, in annual financial statements and Portfolio Budget Statements, identifies whether Commonwealth entities have incurred or will incur operating losses, after adjusting for capital funded expenses.

Example: Disclosure in net cash appropriation note

Non-corporate Commonwealth entities that received Departmental capital budget (DCB) funding need to adjust their operating result for depreciation expenses on assets acquired using DCB funding.

97. 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 at Part 9.5 of RMG 125, the note should:

- add back depreciation of lease ROU assets, and then
- deduct lease principal repayments (which is accounted for through the balance sheet).

98. Other technical losses may occur due to the implementation of AASB 16. For example:

- entity 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.

99. In such cases, the net cash reconciliation note should not be amended. However, a footnote can be added explaining the extent to which they contributed to the overall operating loss. For more information on Commonwealth entity financial statements requirements, see RMG 125.

100. For Commonwealth entities, Finance may determine that approval by the Minister for Finance is not required where technical operating losses are outside the entity’s control in the 2019-20 financial year, and the loss does not impact the entity’s financial sustainability. To be considered a technical loss, entities will need to demonstrate that the:

- loss was solely due to the de-recognition of AASB 117 Leases (AASB 117) lease incentive provisions on AASB 16 transition date and
- the entity had saved sufficient cash reserves to manage outstanding lease payments.

Note 22: Net cash reconciliation disclosure

All Commonwealth entities that have leasing transactions should include a net cash appropriation arrangements note in their annual financial statements.
10. Transition

10.1 Retrospective application of AASB 16

**AASB 16 extract:**

**Paragraph C5:** A lessee shall apply this Standard to its leases either:

(a) retrospectively to each prior reporting period presented applying AASB 108 Accounting Policies, Changes in Accounting Estimates and Errors; or

(b) retrospectively with the cumulative effect of initially applying the Standard recognised at the date of initial application in accordance with paragraphs C7–C13.

**Paragraph C7:** If a lessee elects to apply this Standard in accordance with paragraph C5(b), the lessee shall not restate comparative information. Instead, the lessee shall 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.

101. Under paragraph C6 of AASB 16, a lessee is required to apply its selected option under paragraph C5 consistently to all its leases.

102. To facilitate implementation of AASB 16, Finance requires that Commonwealth entities apply the ‘modified model’ at paragraphs C5(b) and C7.

**Note 23: Retrospective application of AASB 16**

Commonwealth entities are required to apply the modified model (at paragraphs C5(b) and C7) on initial application of AASB 16.

10.2 Identification of leases

**AASB 16 extract:**

**Paragraph C3:** As a practical expedient, an entity is not required to reassess whether a contract is, or contains, a lease at the date of initial application. Instead, the entity is permitted:

(a) to apply this Standard to contracts that were previously identified as leases applying AASB 117 Leases and Interpretation 4 Determining whether an Arrangement contains a Lease. The entity shall apply the transition requirements in paragraphs C5–C18 to those leases.

(b) not to apply this Standard to contracts that were not previously identified as containing a lease applying AASB 117 and Interpretation 4.
103. Commonwealth entities should not reassess previous contracts on transition to AASB 16 – this must be applied to all contracts and disclosed. However, in accordance with paragraph 11 of AASB 16, entities will be required to reassess whether a contract contains a lease where contractual terms subsequently change.

Note 24: Identification of leases

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

10.3 Right-of-use assets previously accounted for as operating leases

AASB 16 extract:

**Paragraph C8(b):** If a lessee elects to apply this Standard in accordance with paragraph C5(b), the lessee shall:

(b) recognise a right-of-use asset at the date of initial application for leases previously classified as an operating lease applying AASB 117. The lessee shall choose, on a lease-by-lease basis, to measure that right-of-use asset at either:

(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.

104. When AASB 16 is applied retrospectively under paragraph C5(b) on the transition date, lessees can initially recognise ROU assets under paragraph C8(b) on a lease-by-lease basis. However, paragraph 2 of AASB 16 requires the standard to be applied consistently to contracts with similar characteristics and in similar circumstances. Therefore, lessees will need to justify to their audit team where the implementation options under **paragraph C8(b) of AASB 16** are not consistently applied to all leases.

105. Finance recommends the implementation option at paragraph C8(b)(ii) of AASB 16 as it is likely to be a simpler method of calculating the ROU asset on transition. Where the implementation option at paragraph C8(b)(i) is applied, the impact on the opening equity as at transition date will need to be included in the 2019-20 Supplementary Reporting Pack (SRP), so Finance can report all leases under option C8(b)(ii) in the CFS.

Note 25: Right-of-use assets previously accounted for as operating leases

Where the implementation at option **C8(b)(ii) of AASB 16** is not applied to all leases on transition, entities will need to:

- justify to their audit team how their approach remains consistent with AASB 16(2)
• include details of the adjustments to opening equity on transition date in the SRP, to allow consistency in preparing consolidated financial statements.

10.4 Right-of-use assets previously accounted for as finance leases

106. ROU asset classes may include some leases that were previously accounted for as finance leases under AASB 117. Prior to 2019-20, these ROU assets were included in non-financial asset classes measured at fair value, under clause 17 of the FRR.

107. 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 (AASB 108).

108. Under paragraph 19 of AASB 108, changes in accounting policy resulting from the initial application of an Australian accounting standard should be applied in accordance with the transitional provisions in that standard. The Australian Government is applying AASB 16 retrospectively with the cumulative effect of initially applying the standard recognised at the date of initial application, under paragraphs C5 and C7 of AASB 16.

109. Under paragraph C11 of AASB 16, ROU assets previously recognised by lessees as finance leases under AASB 117 are 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 deemed cost of the ROU asset on the transition date under AASB 16.

Note 26: Right-of-use assets previously accounted for as finance leases

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 at their existing carrying values. The reclassification should occur on the AASB 16 transition date of 1 July 2019. Disclosure of the accounting policy change should be made, as required by paragraph 28 of AASB 108.

10.5 Lease incentive provisions

110. Where AASB 16 transitional option C8(b)(ii) is applied in initially recognising ROU assets, Commonwealth 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.

111. The election by Finance to apply the modified model on initial application of AASB 16, requires lessees to recognise the cumulative effect of initially applying AASB 16 as an adjustment to the opening balance of retained earnings at the date of initial application.
112. Lease incentive and lease straight-lining provisions that are outstanding on transition date are not assessed to be accrued lease payments for the purposes of paragraph C8(b)(ii) of AASB 16. Therefore, these balances should be cleared to retained earnings on transition.

113. Worksheet A in the Example lease journals illustrates accounting for lease incentive provisions on transition date.

Note 27: **Lease incentive provisions**

Where the AASB 16 transitional option at paragraph C8(b)(ii) is applied, lessees are to adjust retained earnings for the de-recognition of lease incentive and straight-lining provisions previously recognised under AASB 117 and Interpretation 115.

### 10.6 Impairment on AASB 16 transition

**AASB 16 extract:**

**Paragraph 33:** A lessee shall apply AASB 136 Impairment of Assets to determine whether the right-of-use asset is impaired and to account for any impairment loss identified.

114. Paragraph 33 of AASB 16 requires a lessee to apply AASB 136 for determining if the ROU asset held at cost is impaired. However, paragraph C10 of AASB 16 provides options for retrospectively applying the standard in accordance with paragraph C5(b) of AASB 16 to leases previously classified as operating leases applying AASB 117.

**AASB 16 extract:**

**Paragraph C10(b):** a lessee may rely on its assessment of whether leases are onerous applying AASB 137 Provisions, Contingent Liabilities and Contingent Assets immediately before the date of initial application as an alternative to performing an impairment review. If a lessee chooses this practical expedient, the lessee shall adjust the right-of-use 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.

Note: For all the practical expedients in this paragraph, see paragraph C10 of AASB 16.

115. If the lessee elects to use the AASB 137 assessment, they 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. Entities will need to justify to their audit team how the standard has been applied consistently under paragraph 2 of AASB 16 where the implementation option at paragraph C10(b) of AASB 16 has not always been applied.
116. Worksheet A in the Example lease journals illustrates accounting for impairment of ROU assets on transition date.

Note 28: Impairment on AASB 16 transition

On AASB 16 transition date, entities may rely on their previous assessment on whether a lease is onerous, rather than performing an impairment review. Commonwealth entities should disclose where they have not always applied the implementation option at paragraph C10(b) of AASB 16 when available.
# Appendix A: Examples and tools to download

<table>
<thead>
<tr>
<th>Download:</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>IFRS 16 Leases - Illustrative</td>
<td>This document provides examples that accompany, but are not part of, IFRS 16. They illustrate aspects of IFRS 16 but are not intended to provide interpretative guidance.</td>
</tr>
<tr>
<td>Examples</td>
<td></td>
</tr>
<tr>
<td>Example lease journals</td>
<td>This spreadsheet provides several illustrative examples of common lease scenarios using the CBMS. Application of illustrative examples to specific entity lease details should be confirmed with audit teams as soon as possible.</td>
</tr>
<tr>
<td>Simple lease calculation tool</td>
<td>This tool, available to Commonwealth officials from CBMS GovTEAMS, is designed to calculate the lease balances required for monthly financial reporting. Application of tool may not be suitable for all specific entity lease cases (eg some variations in lease modification scenarios), so it is recommended that model calculations be confirmed with audit teams as soon as practicable.</td>
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</tbody>
</table>