Australian Government
Department of Finance

Accounting for operating lease expenses and incentives

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Use of the Coat of Arms

Contact us

Please direct questions or comments about the guide to:

Budget Estimates and Accounting
Governance and APS Transformation
Department of Finance
1 Canberra Avenue
Forrest ACT 2603

Email: *accountingpolicy@finance.gov.au*

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Audience

This guide applies to all officials (e.g., finance teams) in Commonwealth entities that are involved with operating leases as the lessee, including those that are in receipt of lease incentives provided as an inducement to enter into an operating lease.

This guide is designed to be read in conjunction with relevant Australian Accounting Standards.

Key points

This guide:

- **purpose:** to provide guidance on the accounting for operating lease expenses by the lessee, including the treatment of fixed rental increases, contingent rent, and also lease incentives.
- **scope:** lessors and finance leases are excluded from the scope. However, in many instances the same principles might apply to lessors of operating leases, but would need to be considered from the lessor's perspective (e.g. decreases in cash to the lessee are increases to the lessor; expenses to the lessee are revenue to the lessor; reductions of rental expense to the lessee are reductions of rental income to the lessor). Lessors should also refer to the 'Resources' section below.

Resources

- *AASB 117 Leases*
- *Interpretation 115 Operating Leases – Incentives*

Introduction

1. A lessee's 'minimum lease payments' under an operating lease are recognised as an expense over the lease term using either the straight-line method or another systematic method.
2. Contingent rent (e.g., CPI) is excluded from the recognition of minimum lease payments as it is considered variable. Contingent rent is to be recognised as an expense in the period it occurs.
3. Lease incentives received are recognised as a reduction of rent expense over the lease term.

Part 1 – Guidance

4. A lessee's 'minimum lease payments' (see 'Definitions used' below) under an operating lease are recognised as an expense over the lease term using one of the following methods:
   - *The straight-line basis* – where the benefits received are expected to be spread evenly over the lease term; or
   - *Another systematic basis* – where the benefits reflect the time pattern of the user's benefit, even if the payments are not on that basis.

Practical guidance

⇨ *Examples* of which method might be appropriate:

Straight-line basis: a property lease where the same building is leased over several periods.

Another systematic basis: where the benefit is based upon the output from a machine, an approach such as the recognition of an expense based upon machine hours may be appropriate (see **Appendix 2 Illustrative example 3**).

5. A simplified outline of some of the components relating to operating lease expenses and their impact is below:

Operating lease expenses	
Increased by	'**Fixed rent increases**' (using an appropriate method)
*Exclude**	'**Contingent rent**'^ (requires separate treatment)
Reduced by	'**Lease incentives**'^ (using an appropriate method)

*See paragraph 8 of this Guide for when contingent rent may be included.

^See 'Definitions used' below.

Fixed rent increases and contingent rent

6. Contingent rent (e.g., CPI) is excluded from the recognition of minimum lease payments as it is considered variable due to factors other than the passage of time (e.g., future market rates of interest) (see **Appendix 1 Illustrative example 2**).

7. Where leases include a fixed rent increase and a variable rent increase (contingent rent), entities should consider both **Illustrative examples 1 (fixed) and 2 (variable) in Appendix 1**.

Practical guidance

⇨ If a lease includes, for instance, CPI + 1% to be increased annually for the life of the lease, this could be interpreted in one of two ways depending on the individual circumstance:

1. the 1% could be deemed to be fixed (reliant on this rate not changing) and hence included in the minimum lease payments (the CPI component would be excluded as it is a contingent rent); or

2. the 1% is based on the variable component (the CPI) and thus would not be fixed, and hence should not be included in the minimum lease payments as it would be recognised as contingent rent.

8. If contingent rent becomes certain or ‘crystallises’ (such as from the result of a market rent review), it may be included from that point and no separate expense would be recognised. In such instances, as shown in **Appendix 1 Illustrative example 3**, it may be appropriate to split the lease into separate leases based on when market rent reviews will occur.

9. In summary, **Appendix 1** provides examples on the following:

- **Illustrative example 1** – fixed rent increases;
- **Illustrative example 2** – variable rent increases (contingent rent); and
- **Illustrative example 3** – mark-to-market (‘crystallises’) with fixed rent increases.

Lease incentives

10. Lease incentives received are recognised in the same manner as paragraph 1 of this Guide but as a reduction of rent expense over the lease term. **Appendix 2** provides examples on the following:

- **Illustrative example 1** – rent-free periods;
- **Illustrative example 2** – up-front cash payments;
- **Illustrative example 3** – lease incentive under a units of production method of recognition; and
- **Illustrative example 4** – lease incentive where the lease also has a mark-to-market clause.

11. Entities can refer to Example 1 of AASB Interpretation 115 for an example on capital incentives in the form of a payment of relocation costs. Entities should note that

relocation costs are recognised as an expense in the period in which they are incurred, regardless of whether or not they are reimbursed.

Practical guidance

⇨ In the case of a contribution of non-monetary assets, such as leasehold improvements, the above example can also be applied. However, instead of a ‘relocation expense’, an asset would be recorded and subsequently, will be accounted for using AASB 116 *Property, Plant and Equipment*.

12. Lease incentive liabilities are a mechanism to account for timing mismatches between lease expenses and cash payments. Where there is no timing difference between the recognition of lease expenses and making the payments, a lease incentive liability is not recorded.

Practical guidance

⇨ Where no timing mismatch between lease expenses and cash payments exists, for example, a lessor offering an incentive of a 5% reduction on the $10,000 base rent of a 5 year lease and the benefits received are expected to spread evenly over the lease term, the resulting journal entry for each of the 5 years would be:

Dr.	Minimum lease payment expense	$1,900	
Cr.	Cash		$1,900

Calculation:
$2,000 payment each year ($10,000 / 5 years)
Reduced by $100 lease incentive ($500 total lease incentive / 5 years)

Part 2 – Disclosure requirements

13. Disclosure is required by paragraph 35 of AASB 117, including separate disclosure of any contingent rent payment component.

Part 3 – Budget implications

14. Operating lease expenses will decrease (worsen) the fiscal balance (when due) and underlying cash balance (when paid) of an entity. Monetary lease incentives will increase (improve) the fiscal balance (when recognised) and underlying cash balance (when payment received) of an entity.

Part 4 – Definitions used

- *Contingent rent* is the portion of the lease payments that is not fixed in amount but is based on the future amount of a factor that changes other than with the passage of time (paragraph 4 of AASB 117). Types of contingent rent include:

  (a) future CPI escalation; and

  (b) future market rent review.

- *Lease incentives* are benefits offered by the lessor to induce another party to enter into, or renew, an operating lease. Examples include:
  (a) rent-free, or reduced rent, periods;
  (b) up-front cash payment to the lessee (including for the assumption of costs); and
  (c) capital incentives in the form of the assumption by the lessor of costs (i.e., relocation costs, leasehold improvements, and costs associated with a pre-existing lease commitment of the lessee) (adapted from paragraph 1 of Interpretation 115).
- *Minimum lease payments* are the payments over the lease term that the lessee is or can be required to make, excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor, together with for a lessee, any amounts guaranteed by the lessee or by a party related to the lessee (paragraph 4 of AASB 117).

Appendix 1 – Illustrative examples – fixed rent increases and contingent rent

Illustrative example 1: Fixed rent increases (averaging minimum lease payments)

Information:

An entity enters into a three year lease with an initial yearly rent of $20,000, which increases by a fixed 3% each year.

Answer:

The lease expense recognised each year is $20,606. This is derived by the total minimum lease payments to be made divided by the lease term calculated as:

*($20,000 + ($20,000 * 1.03) + ($20,000 * 1.03^2)) / 3 years = $20,606*

The journal entries would be:

	Debit $	**Credit $**
Year 1		
Dr. Minimum lease payment expense	20,606	
Cr. Rent payable (Lease expense *less* cash)		606
Cr. Cash		20,000
Year 2		
Dr. Minimum lease payment expense	20,606	
Cr. Rent payable (Lease expense *less* cash)		6
Cr. Cash ($20,000 * 1.03)		20,600
Year 3		
Dr. Minimum lease payment expense	20,606	
Dr. Rent payable (Lease expense *less* cash)	612	
Cr. Cash ($20,000 * 1.03^2)		21,218

Illustrative example 2: Variable rent increases (recognition of contingent rent)

Information:

Assume the same information as Appendix 1 Illustrative example 1, except that instead of the fixed increase, it increases by the CPI (assume 5%) each year.

Answer:

As CPI increases are contingent rent they are not included in the calculation of minimum lease payments, and therefore the minimum lease payments expense each year is $20,000.

The journal entries would be:

	Debit $	Credit $
Year 1		
Dr. Minimum lease payment expense	20,000	
Cr. Cash		20,000
To record lease expense		
Year 2		
Dr. Minimum lease payment expense	20,000	
Dr. Contingent rent expense (Cash *less* lease expense)	1,000	
Cr. Cash (Prior year's cash payment x (1 + CPI))		21,000
To record lease expense and contingent rent		
Year 3		
Dr. Minimum lease payment expense	20,000	
Dr. Contingent rent expense (Cash *less* lease expense)	2,050	
Cr. Cash (Prior year's cash payment x (1 + CPI))		22,050
To record lease expense and contingent rent		

Illustrative example 3: Mark-to-market with fixed rent increases

Information:

An entity enters into a four year lease with an initial yearly rent of $20,000, which increases by 3% per year but has a mark-to-market clause at the end of the second year, at this time the yearly rent increased to $25,000.

Answer:

This lease has both a fixed escalation of minimum lease payments and a contingent rent component. However, the entity should average the lease payments using an appropriate method.

In this case, the total lease has been separated into two 2 year leases. For which each is averaged over its term (i.e., payments for years 1 and 2 are averaged over this period and payments for years 3 and 4 over this period).

- **Lease 1**: lease expense years 1 and 2 = (20,000 + 20,000*1.03)/2 = $20,300
- **Lease 2**: lease expense years 3 and 4 = (25,000 + 25,000*1.03)/2 = $25,375

The contingent rent does not become known until the end of the second year and therefore is not included as an expense in years 1 and 2.

In years 3 and 4 the contingent rent becomes certain or ‘crystallises’. This means that the entity will now be required to pay $25,000 in rent for the next two years (i.e., it is no longer contingent). As with years 1 and 2, the operating lease expense will be recognised on a straight-line basis over the remaining life of the lease; as the contingent component has crystallised no separate expense will be recognised.

The journal entries would be:

	Debit $	**Credit $**
Lease 1:		
Year 1		
Dr. Minimum lease payment expense	20,300	
Cr. Rent payable (Lease expense *less* cash)		300
Cr. Cash		20,000
Year 2		
Dr. Minimum lease payment expense	20,300	
Dr. Rent payable (Lease expense *less* cash)	300	
Cr. Cash ($20,000 * 1.03)		20,600
Lease 2:		
Year 3		
Dr. Minimum lease payment expense	25,375	
Cr. Rent payable (Lease expense *less* cash)		375
Cr. Cash		25,000
Year 4		
Dr. Minimum lease payment expense	25,375	
Dr. Rent payable (Lease expense *less* cash)	375	
Cr. Cash ($25,000 * 1.03)		25,750

Appendix 2 – Illustrative examples – lease incentives

Illustrative example 1: Rent-free period

Information:

A rent-free period of one year is received on a five year lease, with rent of $25,000 per year.

Answer:

The value of the incentive is obtained by dividing the total minimum lease payments to be made under the lease by the lease term:

($25,000 x 4) / 5 years = $20,000

The entity will initially recognise a liability and a matching asset*, and over the rent-free period the asset is expensed as the rent-free period is utilised.

The journal entries would be:

	Debit $	Credit $
Year 0 (lease inception)		
Dr. Lease asset (rent-free period)	20,000	
Cr. Lease incentive liability		20,000
To record lease asset (the rent-free period)		
Year 1		
Dr. Minimum lease payment expense	20,000	
Cr. Lease asset (rent-free period)		20,000
To record lease expense		

*In practice, entities might not recognise a lease asset for the rent-free period. Instead, these entities build up their lease incentive liability each month as they recognise the lease expense during the rent-free period. The above journal entries would be replaced by a monthly entry of:

Dr.	Minimum lease payment expense	$1,666.67	
Cr.	Lease incentive liability		$1,666.67

	Debit $	Credit $
Years 2 – 5 (this journal is repeated)		
Dr. Minimum lease payment expense	20,000	
Dr. Lease incentive liability (Cash *less* lease expense)	5,000	
Cr. Cash		25,000
To record lease expense and to reduce the liability		

The effect of the above journals is that $20,000 is recognised as a lease expense in each period.

Illustrative example 2: Up-front cash payment

Information:

The lessee receives an upfront cash payment of $2,400 to enter into a new lease. The new lease has a term of four years and a rent of $20,000 per year.

Answer:

The liability (incentive) is recognised as a reduction in lease expense over the life of the lease.

	Debit $	Credit $
Year 0 (lease inception)		
Dr. Cash	2,400	
Cr. Lease incentive liability		2,400
To record the upfront cash payment		
Years 1 – 4 (this journal is repeated)		
Dr. Minimum lease payment expense (Cash *less* liability)	19,400	
Dr. Lease incentive liability ($2,400 / 4 years)	600	
Cr. Cash		20,000
To record lease expense and to reduce the liability		

Illustrative example 3: – Units of production method

Information:

The lessee receives an upfront cash payment of $10,000 to enter a 2 year lease with an annual rent of $40,000 for machinery. The machinery can only be used for 30,000 hours in year 1 and only 10,000 hours in year 2 due to maintenance (total = 40,000 hours).

Answer:

The lease expense (under AASB 117) and the lease incentive (under Interpretation 115) should not be recognised on a straight-line basis, as the expected benefit from the asset varies not in accordance with time (i.e., year one: ¾ of the benefit, year two: ¼ of the benefit).

The lease expense and the reduction of the lease incentive are recognised on the basis of the benefit. To illustrate this, the transaction has been separated into two journals:

	Lease expense	Reduction of lease incentive
Year 1	¾ x ($40,000 x 2 years) = $60,000	¾ x $10,000 = $7,500
Year 2	¼ x ($40,000 x 2 years) = $20,000	¼ x $10,000 = $2,500

	Debit $	Credit $
Year 0 (lease inception)		
Dr. Cash	10,000	
Cr. Lease incentive liability		10,000
To record the upfront cash payment		
Year 1		
Dr. Minimum lease payment expense	60,000	
Cr. Rent payable (Lease expense *less* cash)		20,000
Cr. Cash		40,000
To record lease expense		
Dr. Lease incentive liability	7,500	
Cr. Minimum lease payment expense		7,500
To record lease incentive		
Year 2		
Dr. Minimum lease payment expense	20,000	
Dr. Rent payable (Lease expense *less* cash)	20,000	
Cr. Cash		40,000
To record lease expense		
Dr. Lease incentive liability	2,500	
Cr. Minimum lease payment expense		2,500
To record lease incentive		

Illustrative example 4: Lease incentives and a mark-to-market

Information:

Assume the same information as Appendix 1 Illustrative example 3 of this Guide (noting fixed rent increases and a mark-to-market clause). Additionally, the lessee receives an upfront cash payment of $2,400 to enter into the lease (similar to that in Appendix 2 Illustrative example 2 of this Guide).

Answer:

The entity should separate the treatment of the lease incentive from the lease, and account for the two as follows:

- **Lease expense** (incl. the fixed rent increases and the mark-to-market clause): accounted for as per Appendix 1 Illustrative example 3 (i.e., as two separate leases).
- **Lease incentive**: spread over the entire term of the lease (i.e., the full 4 years). The journal entry at inception is as per Appendix 2 Illustrative example 2. However, the journal entries for years 1 – 4 would instead be:

Dr.	Lease incentive liability	$600	
Cr.	Minimum lease payment expense		$600