Appendix D: Leases Illustrative Examples

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Acronyms	Full form
DTF	Department of Treasury and Finance
FMA	*Financial Management Act 1995*
NT	Northern Territory
TD	Treasurer's Direction

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1. Accounting by Lessor

1.1. Finance Lease

The example below demonstrates how to account for a finance lease arrangement.

Scenario 1:

Entity A (lessor) acquires a motor vehicle and immediately enters into a non-cancellable lease agreement with Entity B (lessee) on the following terms:

1.	Initial direct costs	Nil
2.	Up-front payment	$5 000
3.	Lease payments of $11 000 per year which includes service cost of $1 000 per year	$11 000
4.	Lease term	4 years
5.	Present value of lease payments	$49 145
6.	Fair value of vehicle at the commencement date (price paid by Entity A to purchase the asset)	$49 145
7.	Interest rate	8%
8.	Unguaranteed residual value*	$15 000
9.	Useful life of asset	5 years

*At the end of the lease, Entity A (lessor) expects that motor vehicle to have a value of $15 000, although this amount is not guaranteed by Entity B (lessee), meaning Entity A (lessor) is bearing the risk related to any decline in the fair value of the machine.

Analysis

Entity A (lessor) will classify the lease as finance lease because an analysis of its substance shows that substantially all the risks and rewards incidental to ownership of the motor vehicle would pass to the Entity B (lessee). This is supported by the following features in the arrangement:

- the lease is non-cancellable
- the lease term is for the major part of the useful life of the motor vehicle (80% = 4 years / 5 years)
- the present value of the lease payments is equal to the fair value of the motor vehicle at the start of the lease.

Net investment in the lease calculation:

Lease Payments		Present Value factor (8%)	Present value of lease payments	Net investment
Up-front payment	$5 000	1.0000	$5 000	$5 000
Finance lease receivables				
Year 1 lease payment	10 000	0.9259	9 259	
Year 2 lease payment	10 000	0.8573	8 573	
Year 3 lease payment	10 000	0.7938	7 938	
Year 4 lease payment	10 000	0.7350	7 350	33 120
Residual asset				
Unguaranteed residual value	15 000	0.7350	11 025	11 025
Total	**$60 000**			**$49 145**

The net investment in lease calculation does not include service cost as it is considered a non-lease component of the arrangement and is to be accounted separately.

Schedule of finance lease receivable and residual asset below:

Year	Lease Receivables				Residual asset		
	Beginning balance A	8% Interest income B=A x 8%	Lease payment C	Ending balance D=A+B-C	Beginning balance E	8% Interest income F=E x 8%	Ending balance G=E+F
1	33 120	2 650	(10 000)	25 770	11 025	882	11 907
2	25 770	2 062	(10 000)	17 832	11 907	953	12 860
3	17 832	1 427	(10 000)	9 259	12 860	1 029	13 889
4	9 259	741	(10 000)	-	13 889	1 111	**15 000**

Accounting entries for a finance lease arrangement

The journal entries below show how a lessor will record transactions under a finance lease arrangement:

1. Journal to recognise initial acquisition of the vehicle by Entity A:

DR	Transport equipment - Acquisition (848110)	49 145	
CR	Cash (811110)		49 145

2. Journal to record the net investment in the lease by substituting the underlying asset for finance lease receivable and residual asset:

DR	Cash (811110)	5 000	
DR	Lease receivable – noncurrent - Purchases (837110)[1]	33 120	
DR	Residual asset – Receivables[2]	11 025	
CR	Transport Equipment – Sales (848120)		49 145

[1] *Adjustment to move balance from non-current to current portion must be done at a minimum annually.*
[2] *Account not yet set up in NTG chart of accounts, please contact Department of Treasury and Finance (DTF) if applicable.*

3. Journal to record receipt of first lease repayment including service income component:

DR	Cash (811110)	11 000	
CR	Service income (131000)		1 000
CR	Lease interest income (146100)		2 650
CR	Lease receivable noncurrent - Repaid (837120)		7 350

4. Journal to adjust the present value of the residual asset at the end of year 1:

DR	Residual asset – Receivables[3]	882	
CR	Lease interest income (146100)		882

[3] *Account not yet set up in NTG chart of accounts, please contact DTF if applicable.*

At the end of the lease term and after present value adjustments have been accounted for each year, the carrying amount of the residual asset comes to $15 000 which is the unguaranteed residual value. Once leasing arrangement have concluded, the residual asset – receivables would be reclassified to Property, Plant and Equipment.

5. Journal to reclassify residual asset receivables to Property, Plant and Equipment

DR	Transport Equipment – Acquisitions (848110)	15 000	
CR	Residual asset – Receivables		15 000

1.2. Operating Lease

The example below demonstrates how to account for an operating lease arrangement.

Scenario 2:

Entity A (lessor) leases 2 floors of an office building to Entity B (lessee) for an annual rent of $80 000 for a period of three years. The building is expected to have an economic useful life of 40 years.

The lease is classified as an operating lease because an analysis of its substance shows that substantially all the risks and rewards incidental to ownership of the floor space will not pass to Entity B (lessee). This is supported by the following features in the arrangement:

- there is no transfer of ownership or bargain purchase option
- the lease term represents only 7.5% (3 years / 40 years useful life) of the useful life of the asset
- and the present value of the lease payments is substantially less that the fair value of the office space at the start of the lease.

Accounting entries for an operating lease arrangement

The journal entry below shows how a lessor accounts for income received under an operating lease arrangement:

1. Journal to record income each year for the lease of office building:

DR	Cash (811110) / Accounts receivable (812110)	80 000	
CR	Rent income (152500)		80 000

1.3. Sublease arrangement

The scenarios below demonstrates how to assess and account for sublease arrangements:

Scenario 3: Sublease is material in proportion to the head lease

Agency A leases an office building from Company X (external to government) for five years (the head lease) that commences on 1 July 20X9. The annual rentals under the head lease are $50 000 paid at the beginning of each year. The interest rate implicit in the arrangement is 5%.

Agency A subsequently leases the office building to GOC Z, a government owned organisation, for five years under a sublease arrangement that commences on the same day as the head lease (1 July 20X9) and charges the same annual rent of $50 000.

Analysis

Agency A lease to GOC Z meets the sublease arrangement criteria due to the following:

- ✓ sublease is to a government owned corporation
- ✓ the whole office building is subleased to GOC Z, thus, it is material in proportion to the entire asset
- ✓ the rent charge to GOC Z is the same as the lease paid to Company X as such, it is not a peppercorn lease

Conclusion

In assessing the classification of the sublease, Agency A notes that the sublease is for the entire term of the head lease and considers the transaction as material to the agency. There are no other factors suggesting that Agency A has retained significant risks and rewards associated with the ROU asset.

Therefore, Agency A classifies the sublease as a finance lease under AASB 16.

Lease liability calculation:

Year	Lease Payments* A	Present Value factor (5%) B	Present Value of lease payments C=A x B
1	50 000	1.0000	50 000
2	50 000	0.9524	47 619
3	50 000	0.9070	45 352
4	50 000	0.8638	43 192
5	50 000	0.8227	41 135
Total	**250 000**		**227 298**

*The net investment (lease receivables) in lease calculation will equate to the lease liability from the head lease given the annual rent is the same.

	Lease liability/Lease receivable*				Right-of-use asset		
Year	Beginning balance A	Lease payment B	5% Interest C=(A-B) x 5%	Ending balance D=A-B+C	Beginning balance E	Amortisation F=ROU asset / lease term	Ending balance G=E-F
1	227 298	(50 000)	8,865	186 162	227 298	(45 460)	181 838
2	186 162	(50 000)	6 808	142 971	181 838	(45 460)	136 378
3	142 971	(50 000)	4 649	97 619	136 378	(45 460)	90 918
4	97 619	(50 000)	2 381	50 000	90 918	(45 460)	45 458
5	50 000	(50 000)	-	-	45 455	(45 458)	-

*The net investment (lease receivable) in lease calculation will equate to the lease liability from the head lease given the annual rent is the same.

Accounting entries for sublease arrangement

The journal entries below show how Agency A records the head lease and sublease arrangements:

1. Initial recognition of leased asset and liability under the head lease arrangement:

DR	Buildings under lease – Acquisition (872190)	227 298	
CR	Building lease liability non current – Received (941510)[1]		227 298

[1] *Adjustment to move balance from non-current to current portion must be done at a minimum annually.*

2. Initial recognition of net investment in sublease arrangement and reversal of ROU asset:

DR	Lease receivables non current – Transfer in/out (837130)	227 298	
CR	Buildings under lease – Transfers out (872140)		227 298

3. Record annual payment of lease at the beginning of Year 1 to Company X

DR	Building lease liability non current – Repaid (941520)	50 000	

CR	Cash (811110)		50 000

4. Record receipt of rent from GOC Z from the sublease arrangement at the beginning of Year 1

DR	Cash (811110)	50 000	
CR	Lease receivables non current – Repaid (837120)		50 000

5. Record interest expense from lease liability under the head lease and interest income from the lease receivables under the sublease arrangements

DR	Lease interest expense (512000)	8 865	
CR	Building lease liability non current – Repaid (941520)		8 865
DR	Lease receivables non current – Repaid (837120)	8 865	
CR	Lease interest income (146100)		8 865

The following journal entries show how <u>GOC Z</u> will record the sublease arrangement:

1. Initial recognition of leased asset and liability under the sublease arrangement:

DR	Buildings under lease - Acquisition (872190)	227 298	
CR	Building lease liability non current – Received[1] (941510)		227 298

[1] *Adjustment to move balance from non-current to current portion must be done at a minimum annually.*

2. Record annual payment of lease at the beginning of Year 1 to Agency A for the sublease arrangement:

DR	Building lease liability non current – Repaid (941520)	50 000	
CR	Cash (811110)		50 000

3. Record interest expense from lease liability at the end of Year 1.

DR	Lease interest expense (512000)	8 865	
CR	Building lease liability non current – Repaid (941520)		8 865

4. Record amortisation of the ROU asset at the end of Year 1.

DR	Amortisation expense (381300)	45 460	
CR	Accumulated amortisation - Buildings under lease (872210)		45 460

Scenario 4: Sublease is immaterial in proportion to the head lease

Agency B leases a block of land 2 000 square meters (sqm) from Company D for 5 years for $100 per sqm per annum ($200 000 per annum). The interest rate implicit in the lease is not readily determinable. Agency B's incremental borrowing rate is 5% per annum.

A portion of the land (200 sqms), was sub-leased to NGO Z, a non-government organisation for 5 years for the same price per sqm as the head lease.

Analysis

Agency B's lease to NGO Z has been assessed against the following criteria:

✓ sublease to a non-government organisation, a party external to government

X subleased asset represents 10% (200 sqm/2000 sqms) and is not material in proportion of the entire asset

✓ sublease is not a peppercorn lease (rent charge is the same as the lease paid under head lease)

Conclusion

Given all criteria for recognition as a sublease have not been met. Agency B will continue to recognise the right-of-use asset and lease liability under the head lease arrangement. No adjustment required for the sublease arrangement and will continue to recognise rent income from NGO Z.

Lease liability calculation (head lease):

Year	Lease Payments* A	Present Value factor (5%) B	Present value of lease payments C=A x B
1	200 000	1.0000	200 000
2	200 000	0.9524	190 476
3	200 000	0.9070	181 406
4	200 000	0.8638	172 768
5	200 000	0.8227	164 540
Total	**1 000 000**		**909 190**

	Lease liability				Right-of-use asset		
Year	Beginning balance A	Lease payment B	5% Interest C=(A-B) x 5%	Ending balance D=A-B+C	Beginning balance E	Amortisation F=ROU asset / lease term	Ending balance G=E-F
1	909 190	(200 000)	35 460	744 650	909 190	(181 838)	727 352
2	744 650	(200 000)	27 232	571 882	727 352	(181 838)	545 514
3	571 882	(200 000)	18 594	390 476	545 514	(181 838)	363 676
4	390 476	(200 000)	9 524	200 000	363 676	(181 838)	181 838
5	200 000	(200 000)	-	-	181 838	(181 838)	-

The journal entries below show how Agency B records the head lease and sublease arrangements:

1. Initial recognition of leased asset and liability under the head lease arrangement:

DR	Land under lease – Acquisition (871190)	909 190	
CR	Land lease liability non current – Received (941810)[1]		909 190

[1] *Adjustment to move balance from non-current to current portion must be done at a minimum annually.*

2. Record annual payment of lease at the beginning of Year 1:

DR	Land lease liability non current – Repaid (941820)	200 000	
CR	Cash (811110)		200 000

3. Record interest expense from lease liability under the head lease arrangement at Year 1.

DR	Lease interest expense (512000)	35 460	
CR	Land lease liability non current – Repaid (941820)		35 460

4. Record amortisation of the ROU asset at the end of Year 1.

DR	Amortisation expense (381300)	181 838	
CR	Accumulated amortisation - Land under lease (871210)		181 838

5. Record annual lease income the sublease arrangement with NGO Z (200 sqm x $100).

DR	Cash (811110)	20 000	
CR	Rent income (152500)		20 000

Scenario 5: Sublease to an agency within general government sector

The Department of Corporate and Digital Development (DCDD) leases an office building from Company A for 5 years and sub-leases the whole building to DTF for the same amount it pays to Company A of $500 000 per annum for the same period.

Analysis

DCDD lease to DTF is assessed against the following criteria:

X sublease is not to a party external to government or to a GOC as DTF is an agency within the general government sector

✓ DCDD subleased the whole office building to DTF, as such, the lease arrangement is material in proportion to the entire asset

✓ DCDD charges DTF same rent as the lease paid to Company X thus not a peppercorn lease

Conclusion

Sublease recognition criteria not all met, thus, DCDD will continue to recognise the right-of-use asset and lease liability under the head lease arrangement. No adjustment required for the sublease arrangement and DCDD will continue to recognise notional rent income from DTF. Refer to scenario 4 for sample journal entries.

Scenario 6: Peppercorn sublease

Agency C leases 1,000 sqm of land in remote area from Company Z for 12 years for $100 per sqm. The land was subleased to NGO Y, a non-government organisation for $1 per annum for the delivery of service in that remote area.

Analysis

Agency C lease to NGO Z is assessed against the following criteria:

- ✓ Agency C lease is to a non-government organisation, a party external to government
- ✓ Agency C leases the entire land to NGO Y as such, the lease arrangement is material in proportion to the entire asset
- X rent is a peppercorn lease, thus, 3rd criteria is not met.

Conclusion

Sublease recognition criteria not all met, thus, Agency C will continue to recognise the right-of-use asset and lease liability under the head lease arrangement. No adjustment required for the sublease arrangement and will continue to recognise peppercorn rent income from NGO Y. Refer to scenario 4 for sample journal entries.

2. Accounting by Lessee

2.1. Recognition of lease payments for low-value assets

The following demonstrates how to recognise lease payments for low value assets:

Scenario 7:

Entity X leases office equipment for 5 years. The value of the equipment when new is $4 000.

Entity X has 1 year rent-free period at commencement of the lease. In addition, the lessor provides an upfront cash lease incentive with a value of $300. Lease payments schedule for each year is summarised below.

Year	$ per Year
1*	0
2	1 500
3	1 500
4	1 650
5	1 650
Total	6 300

**Rent free period*

Analysis

The value of the equipment when new falls below the $10 000 low value threshold as such, entity X does not need to recognise a right-of-use asset and lease liability in the statement of financial position. Lease payments will be recognised as an expense on the comprehensive operating statement on a straight-line basis over the full lease term.

Lease expense recognised each year calculated as follows:

Total payments: $6 300 - $300 (lease incentive) = $6 000
Length of lease: 5 years (including the rent free period)
Lease expense per year: $1 200 ($6 000 / 5)

The journal entries below show how Entity X records the lease arrangement:

1. Record annual lease expense of Entity X on a straight-line basis.

		Year 1	Year 2	Year 3	Year 4	Year 5
DR	Lease expense	1 200	1 200	1 200	1 200	1 200
CR	Payable	1 200	1 200	1 200	1 200	1 200

2. Record receipt of upfront lease incentive from lessor.

		Year 1	Year 2	Year 3	Year 4	Year 5
DR	Cash	300	-	-	-	-
CR	Payable	300	-	-	-	-

3. Record payments of rent as per lease agreement.

		Year 1	Year 2	Year 3	Year 4	Year 5
DR	Payable	-	1 500	1 500	1 650	1 650
CR	Cash	-	1 500	1 500	1 650	1 650

2.2. Lessee measurement

The following example, reproduced from the illustrative examples accompanying International Financial Reporting Standard (IFRS) 16, illustrates how a lessee measures right-of-use assets and lease liabilities.

Scenario 8:

Lessee enters into a 10-year lease of a floor of a building, with an option to extend for five years. Lease payments are $50 000 per year during the initial term and $55 000 per year during the optional period, all payable at the beginning of each year.

To obtain the lease, lessee incurs initial direct costs of $20 000, of which $15 000 relates to a payment to a former tenant occupying that floor of the building and $5 000 relates to a commission paid to the real estate agent that arranged the lease. As an incentive to the lessee for entering into the lease, lessor agrees to reimburse to lessee the real estate commission of $5 000.

At the commencement date, lessee concludes that it is not reasonably certain to exercise the option to extend the lease and, therefore, determines that the lease term is 10 years.

The interest rate implicit in the lease is not readily determinable. Lessee's incremental borrowing rate is 5% per annum.

At the commencement date, lessee makes the lease payment for the first year, incurs initial direct costs, receives the lease incentives from lessor.

Calculation of lease liability at the commencement date as follows:

Year	Lease Payments* A	Present Value factor (5%) B	Present Value of lease payments C=A x B
1	50 000	1.0000	50 000
2	50 000	0.9524	47 619
3	50 000	0.9070	45 352
4	50 000	0.8638	43 192
5	50 000	0.8227	41 135
6	50 000	0.7835	39 176
7	50 000	0.7462	37 311
8	50 000	0.7107	35 534
9	50 000	0.6768	33 842
10	50 000	0.6446	32 230
Total	**500 000**		**405 391**

Payments are made at the beginning of the year

	Lease Liability				Right-of-use asset		
Year	Beginning balance A	Lease payment B	5% Interest expense C=A-B x 5%	Ending balance D=A-B=C	Beginning balance E	Amortisation F[2]	Ending balance G=E-F
1	405 391	(50 000)	17 770	373 161	420 391[1]	(42 039)	378 352
2	373 161	(50 000)	16 158	339 319	378 352	(42 039)	336 313
3	339 319	(50 000)	14 466	303 785	336 313	(42 039)	294 274
4	303 785	(50 000)	12 689	266 474	294 274	(42 039)	252 235
5	266 474	(50 000)	10 823	227 297	252 235	(42 039)	210 196
6	227 297	(50 000)	8 865	186 162	210 196	(42 039)	168 157
7	186 162	(50 000)	6 808	142 971	168 157	(42 039)	126 118
8	142 971	(50 000)	4 649	97 619	126 118	(42 039)	84 079
9	97 619	(50 000)	2 381	50 000	84 079	(42 039)	42 040
10	50 000	(50 000)	-	-	42 040	(42 040)	-

[1] Right-of-use asset = present value of lease payments + initial direct cost – lease incentives received
$420 391 = $405 391 + 20 000 – 5 000
[2]Amortisation expense = Right-of-use asset divided by the lease term of 10 years
$42 039 = $420 391 / 10 years

Accounting entries for lessee measurement

The journal entries below show lessee's initial recognition of assets and liabilities in relation to the lease:

1. Record the lease liability and the right-of-use asset for the underlying asset being leased:

DR	Buildings under lease – Acquisition (872190)	405 391	
CR	Building lease liability non current – Received[1] (941510)		405 391

[1] *Adjustment to move balance from non-current to current portion must be done as a minimum annually.*

2. Record the initial direct costs under the lease contract capitalised as part of the right-of-use asset:

DR	Buildings under lease – Capitalised Expenditure (872160)	20 000	
CR	Cash (811110)		20 000

3. Record receipt of lease incentive from the lessor as reduction to right-of-use asset:

DR	Cash (811110)	5 000	
CR	Buildings under lease – Sales/Lease incentives (872120)		5 000

4. Record the first lease payment at the commencement date:

DR	Building lease liability non current – Repaid (941520)	50 000	
CR	Cash (811110)		50 000

Accounting entries at the end of year 1

The journal entries below show the lessee's recognition of interest on lease liability and amortisation of the asset at the end of year 1:

1. Record interest expense at the end of year 1:

DR	Lease interest expense (512000)	17 770	
CR	Building lease liability non current – Repaid (941520)		17 770

2. Record amortisation of right-of-use asset at the end of year 1:

DR	Amortisation expense (381300)	42 039	
CR	Current Amortisation – Buildings under lease (872210)		42 039

3. Remeasurement

3.1. Remeasurement due to change in the lease term

The example below demonstrates how to remeasure lease arrangement due to a change in lease term:

Scenario 9:

This scenario is an extension of scenario 8 in section 2.2.

In the sixth year of the lease, lessee decided to exercise the option to extend its original lease (additional 5 years).

Lessee's incremental borrowing rate at the end of Year 6 is 6% per annum, which reflects the fixed rate at which the lessee could borrow an amount similar to the value of the right-of-use asset, in the same currency, for a nine-year term, and with similar collateral.

Lessee expects to consume the right-of-use asset's future economic benefits evenly over the lease term and, thus, depreciates the right-of-use asset on a straight-line basis.

Change in the lease term triggers a remeasurement of the lease liability with a corresponding adjustment to the right-of-use asset. The lessee must remeasure the lease liability by discounting the revised lease payments using the revised discount rate for the remainder of the lease term.

The right-of-use asset and the lease liability from Year 1 to Year 6 are as follows:

Year	Lease Liability				Right-of-use asset		
	Beginning balance A	Lease payment B	5% Interest expense C=A-B x 5%	Ending balance D=A-B=C	Beginning balance E	Amortisation F=ROU asset / lease term	Ending balance G=E-F
1	405 391	(50 000)	17 770	373 161	420 391	(42 039)	378 352
2	373 161	(50 000)	16 158	339 319	378 352	(42 039)	336 313
3	339 319	(50 000)	14 466	303 785	336 313	(42 039)	294 274
4	303 785	(50 000)	12 689	266 474	294 274	(42 039)	252 235
5	266 474	(50 000)	10 823	227 297	252 235	(42 039)	210 196
6	227 297	(50 000)	8 865	**186 162**	210 196	(42 039)	**168 157**

Remeasurement of lease liability at the present value of the remaining lease payments (four payments of $50 000 followed by five payments of $55 000) using the revised discount rate as follows:

Year	Lease Payment A	Present Value factor (6%) B	Present Value of lease payments C=A x B
7	50 000	1.0000	50,000
8	50 000	0.9434	47,170
9	50 000	0.8900	44,500
10	50 000	0.8396	41,981
11	55 000	0.7921	43,565
12	55 000	0.7473	41,099
13	55 000	0.7050	38,773

Year	Lease Payment A	Present Value factor (6%) B	Present Value of lease payments C=A x B
14	55 000	0.6651	36,578
15	55 000	0.6274	34,508
Total	**475 000**		**378,174**
Lease liability at the end of Year 6			**186 162**
Adjustment			**192 012**

Accounting entry for remeasurement due to change in the lease term

The journal entry shows the adjustments to lease liability and right-of-use asset due to remeasurement:

1. Record increase in right-of-use asset and lease liability due to remeasurement (at remeasurement date):

DR	Buildings under lease – Reval increment/decrement (872150)	192 012	
CR	Building lease liability non current – Increment/decrement (941540)		192 012

Following the remeasurement, the carrying amount of right-of-use asset is $360 169 ($168 157 + $192 012). From the beginning of year 7, lessee calculates the interest expense on the lease liability at the revised discount rate of 6% per annum.

The right-of-use asset and the lease liability from Year 7 to Year 15 are as follows:

	Lease Liability				Right-of-use asset		
Year	Beginning balance A	Lease payment B	6% Interest expense C=A-B x 6%	Ending balance D=A-B=C	Beginning balance E	Amortisation[1] F	Ending balance G=E-F
7	378 174	(50 000)	19 690	347 864	360 169	(40 019)	320 150
8	347 864	(50 000)	17 872	315 736	320 150	(40 019)	280 131
9	315 736	(50 000)	15 944	281 680	280 131	(40 019)	240 112
10	281 680	(50 000)	13 901	245 581	240 112	(40 019)	200 093
11	245 581	(55 000)	11 435	202 016	200 093	(40 019)	160 074
12	202 016	(55 000)	8 821	155 837	160 074	(40 019)	120 055
13	155 837	(55 000)	6 050	106 887	120 055	(40 019)	80 036
14	106 887	(55 000)	3 113	55 000	80 036	(40 019)	40 017
15	55 000	(55 000)	-	-	40 017	(40 017)	-

[1]Amortisation calculated as follows:
Right-of-use asset balance at Year 7 of $360 169 divided by the remaining lease term of 9 years
*$360 169 / 9** = $40 019 per year*

3.2. Remeasurement from change in future lease payments due to change in index

This example is reproduced from the illustrative examples accompanying IFRS 16 and illustrates how a lessee accounts for remeasurement of lease liability due to change in index.

Scenario 10:

Lessee enters into a 10-year lease of property with annual lease payments of $50 000, payable at the beginning of each year. The contract specifies that lease payments will increase every two years on the basis of the increase in the Consumer Price Index (CPI) for the preceding 24 months. The CPI at the commencement date is 125. This example ignores any initial direct costs. The rate implicit in the lease is not readily determinable. Lessee's incremental borrowing rate is 5% per annum, which reflects the fixed rate at which lessee could borrow an amount similar to the value of the right-of-use asset, in the same currency, for a 10-year term, and with similar collateral.

Lessee expects to consume the right-of-use asset's future economic benefits evenly over the lease term and thus depreciates the right-of-use asset on a straight-line basis.

The right-of-use asset and the lease liability from Year 1 to Year 10 are as follows:

	Lease Liability				Right-of-use asset		
Year	Beginning balance A	Lease payment B	5% Interest expense C=A-B x 5%	Ending balance D=A-B=C	Beginning balance E	Amortisation F=ROU asset / lease term	Ending balance G=E-F
1	405 391	(50 000)	17 770	373 161	405 391	(40 539)	364 852
2	373 161	(50 000)	16 158	**339 319**	364 852	(40 539)	**324 313**
3	339 319	(50 000)	14 466	303 785	324 313	(40 539)	283 774
4	303 785	(50 000)	12 689	266 474	283 774	(40 539)	243 235
5	266 474	(50 000)	10 823	227 297	243 235	(40 539)	202 696
6	227 297	(50 000)	8 865	186 162	202 696	(40 539)	162 157
7	186 162	(50 000)	6 808	142 971	162 157	(40 539)	121 618
8	142 971	(50 000)	4 649	97 619	121 618	(40 539)	81 079
9	97 619	(50 000)	2 381	50 000	81 079	(40 539)	40 540
10	50 000	(50 000)	-	-	42 040	(40 539)	-

Accounting entries for remeasurement due to CPI increase

The journal entries below show the lessee's initial recognition of assets and liabilities in relation to the lease:

1. Record the lease liability and right-of-use asset at commencement date:

DR	Buildings under lease – Acquisition (872190)	405 391	
CR	Building lease liability non current – Received[1] (941510)		405 391

[1] *Adjustment to move balance from non-current to current portion must be done at a minimum annually.*

2. Record the first lease repayment at the beginning of the year

DR	Building lease liability – Repaid (941520)	50 000	
CR	Cash (811110)		50 000

During the first two years of the lease lessee recognised in aggregate the following related to the lease.

3. Record interest expense for Year 1 and 2 ($17 770 + 16 158):

DR	Lease interest expense (512000)	33 928	
CR	Building lease liability non current – Repaid (941520)		33 928

4. Record amortisation expense for Year 1 and 2 ($405 391 / 10 x 2 years):

DR	Amortisation expense (381300)	81 078	
CR	Current Amortisation – Buildings under lease (872210)		81 078

At the beginning of the second year, lessee makes the lease payment for the second year and recognises the following.

5. Record 2nd year lease payment:

DR	Building lease liability – Repaid (941520)	50 000	
CR	Cash (811110)		50 000

At the beginning of the third year of the lease the Consumer Price Index is 135.

The payment for the third year, adjusted for the CPI, is $54 000 ($50 000 × 135 ÷ 125). Because there is a change in the future lease payments resulting from a change in the CPI used to determine those payments, lessee remeasures the lease liability to reflect those revised lease payments, as such, the lease liability now reflects eight annual lease payments of $54 000.

At the beginning of the third year, lessee remeasures the lease liability at the present value of eight payments of $54 000 discounted at an unchanged discount rate of 5% per annum, which is $366 464.

The following table shows the present value calculations of the lease liability:

Year	Lease Payment A	Present Value factor (5%) B	Present Value of lease payments C=A x B
3	54 000	1.0000	54 000
4	54 000	0.9524	51 429
5	54 000	0.9070	48 979
6	54 000	0.8638	46 647
7	54 000	0.8227	44 426
8	54 000	0.7835	42 310
9	54 000	0.7462	40 296
10	54 000	0.7107	38 377
Total	**432 000**		**366 464**
Balance Year 2			**339 319**
Adjustment			**27 145**

The right-of-use asset and the lease liability from Year 3 to Year 10 are as follows:

	Lease Liability				Right-of-use asset		
Year	Beginning balance A	Lease payment B	5% Interest expense C=A-B x 5%	Ending balance D=A-B=C	Beginning balance E	Amortisation[2] F	Ending balance G=E-F
3	366 464	(54 000)	15 623	328 087	351 458[1]	(43 932)	307 526
4	328 087	(54 000)	13 704	287 792	307 526	(43 932)	263 594
5	287 792	(54 000)	11 690	245 481	263 594	(43 932)	219 662
6	245 481	(54 000)	9 574	201 055	219 662	(43 932)	175 730
7	201 055	(54 000)	7 353	154 408	175 730	(43 932)	131 798
8	154 408	(54 000)	5 020	105 429	131 798	(43 932)	87 866
9	105 429	(54 000)	2 571	54 000	87 866	(43 932)	43 934
10	54 000	(54 000)	-	-	43 934	(43 934)	-

[1]Right-of-use asset = Right-of-use asset balance at Year 2 + remeasurement adjustment
$351 458 = $324 313 + 27 145

[2]Amortisation expense = Right-of-use balance after remeasurement divided by the remaining lease term of 8 years
$43 932 = $351 458 / 8 years

The journal entries below shows remeasurement due to CPI increase:

6. Record increase in right-of-use asset and lease liability due to remeasurement (at remeasurement date):

DR	Buildings under lease – Reval increment/decrement (872150)	27 145	
CR	Building lease liability non current – Increment/decrement (941540)		27 145

7. Record lease payment for the third year:

DR	Building lease liability non current – Repaid (941520)	54 000	
CR	Cash (811110)		54 000

8. Record interest expense for Year 3:

DR	Lease interest expense (512000)	15 623	
CR	Building lease liability non current – Repaid (941520)		15 623

9. Record amortisation expense for Year 3:

DR	Amortisation expense (381300)	43 932	
CR	Current Amortisation – Buildings under lease (872210)		43 932

4. Lease modifications

This example is reproduced from the illustrative examples accompanying IFRS 16 and illustrates how a lessee accounts for lease modifications.

4.1. Modification that is a separate lease

Scenario 11:

Lessee enters into a 10-year lease for 2 000 square metres of office space.

At the beginning of Year 6, lessee and lessor agree to amend the original lease for the remaining five years to include an additional 3 000 square metres of office space in the same building. The additional space is made available for use by lessee at the end of the second quarter of Year 6.

The increase in total consideration for the lease is commensurate with the current market rate for the new 3 000 square metres of office space, adjusted for the discount that lessee receives reflecting that lessor does not incur costs that it would otherwise have incurred if leasing the same space to a new tenant (for example, marketing costs).

Lessee accounts for the modification as a separate lease, separate from the original 10-year lease. This is because the modification grants lessee an additional right to use an underlying asset, and the increase in consideration for the lease is commensurate with the stand-alone price of the additional right-of-use adjusted to reflect the circumstances of the contract.

In this example, the additional underlying asset is the new 3 000 square metres of office space. Accordingly, at the commencement date of the new lease (at the end of the second quarter of Year 6), lessee recognises a right-of-use asset and a lease liability relating to the lease of the additional 3 000 square metres of office space.

Lessee does not need to make any adjustments to the original lease of 2 000 square metres of office space as a result of this modification.

4.2. Modification that decreases the scope of the lease

Scenario 12:

Lessee enters into a 10-year lease for 5 000 square metres of office space.

The annual lease payments are $50 000 payable at the end of each year. The interest rate at the commencement date is 6% annum.

Schedule of lease liability and right-of-use asset below:

	Lease Liability				Right-of-use asset		
Year	Beginning balance A	Lease payment B	6% Interest expense C = A-B x 6%	Ending balance D=A-B+C	Beginning balance E	Amortisation F=ROU asset / lease term	Ending balance G=E-F
1	368 004	(50 000)	22 080	340 085	368 004	(36 800)	331 204
2	340 085	(50 000)	20 405	310 490	331 204	(36 800)	294 403
3	310 490	(50 000)	18 629	279 119	294 403	(36 800)	257 603
4	279 119	(50 000)	16 747	245 866	257 603	(36 800)	220 803

	Lease Liability				Right-of-use asset		
Year	Beginning balance A	Lease payment B	6% Interest expense C = A-B x 6%	Ending balance D=A-B+C	Beginning balance E	Amortisation F=ROU asset / lease term	Ending balance G=E-F
5	245 866	(50 000)	14 752	**210 618**[(a)]	220 803	(36 800)	**184 002**[(b)]
6	210 618	(50 000)	12 637	173 255	184 002	(36 800)	147 202
7	173 255	(50 000)	10 395	133 651	147 202	(36 800)	110 401
8	133 651	(50 000)	8 019	91 670	110 401	(36 800)	73 601
9	91 670	(50 000)	5 500	47 170	73 601	(36 800)	36 800
10	47 170	(50 000)	2 830	-	36 800	(36 800)	-

At the beginning of Year 6, lessee and lessor agree to amend the original lease to reduce the space to only 2 500 square metres of the original space starting from the end of the first quarter of Year 6.

The annual fixed lease payments (from Year 6 to Year 10) are $30 000. Lessee's incremental borrowing rate at the beginning of Year 6 is 5% per annum.

At the effective date of the modification (at the beginning of Year 6), lessee remeasures the lease liability based on: (a) a five-year remaining lease term, (b) annual payments of $30 000 and (c) lessee's incremental borrowing rate of 5 per cent per annum.

Year	Lease Payment A	Present Value factor (5%) B	Present Value of lease payments C=A x B
6	30 000	0.9524	28 571
7	30 000	0.9070	27 211
8	30 000	0.8638	25 915
9	30 000	0.8227	24 681
10	30 000	0.7835	23 506
Total	**150 000**		**129 884**

Lessee determines the proportionate decrease in the carrying amount of the right-of-use asset on the basis of the remaining right-of-use asset (2 500 square metres corresponding to 50% of the original right-of-use asset).

50% of the pre-modification right-of-use asset ([(b)] $184 002) is $92 001. 50% of the pre-modification lease liability ([(a)] $210 618) is $105 309.

Consequently, lessee reduces the carrying amount of the right-of-use asset by $92 001 and the carrying amount of the lease liability by $105 309.

Lessee recognises the difference between the decrease in the lease liability and the decrease in the right-of-use asset ($105 309 – $92 001 = $13 308) as a gain in profit or loss at the effective date of the modification (at the beginning of Year 6).

Lessee recognises the difference between the remaining lease liability of $105 309 and the modified lease liability of $129 884 (which equals $24 575) as an adjustment to the right-of-use asset reflecting the change in the consideration paid for the lease and the revised discount rate.

5. Sale and leaseback

The following example demonstrates how to account for sale and leaseback transaction:

Scenario 13:

Entity A owns an office building that has a carrying amount of $2 400 000 ($4 million cost - $1.6 million accumulated depreciation) as 1 July 20X7.

On 1 July 20X7, Entity A has entered into an agreement with Entity B to sell the building for $3.2 million (which is also its fair value) and lease it back from that day for a period of seven years.

Entity A determines that the transfer is a sale and will pay annual lease payments of $500 000 in arrears, with the first payment to be made on 30 June 20X8.

Entity B classifies the lease as an operating lease and estimates that the office building has a remaining useful life of 15 years.

The interest rate in the lease is 5%.

Analysis

Scenario above is considered as sale and leaseback transaction. Entity A (seller-lessee) sells the office building to Entity B (buyer-lessor) and simultaneously leases it back.

Entity A (seller-lessee) shall:
- Derecognise underlying asset
- Recognise right-of-use asset (proportion of previous carrying amount)
- Recognise lease liability
- Gain/loss on sale of rights transferred

Calculation:

(a) Lease liability = Present value of lease payments $500 000 x 7 years (paid in arrears) @ 5%
Annuity factor based on 5% interest rate for 7 years is 5.7864

$2 893 200 = $500 000 x 5.7864

(b) Gain on sale = Notional gain* x $\frac{\text{(Sale consideration at fair value – lease liability)}}{\text{Sale consideration at fair value}}$

**Notional gain = Sale consideration at fair value – carrying amount of asset before sale*
$800 000 = $3.2 million - $2.4 million

Gain on sale = $800 000 x $\frac{\text{(\$3.2 million - \$2 893 200)}}{\text{\$3.2 million}}$

Gain on sale = $76 700 gain on sale

This portion of the gain is recognised because it reflects the rights that have been transferred to the buyer-lessor.

(c) Measurement of the right-of-use asset

Right-of-use asset = Carrying amount of asset before sale X $\frac{\text{Total lease liability}}{\text{sale consideration at fair value}}$

$$\text{Right-of-use asset} = \$2.4 \text{ million} \times \frac{\$2\,893\,200}{\$3\,200\,000}$$

Right-of-use asset = $2 169 900

This asset reflects the rights that have been retained by the seller-lessee.

Alternatively, the right-of-use asset can be calculated by subtracting the $ unrecognised portion of the notional gain ($800 000 - $76 700 = 723 300) from the lease liability value of $2 893 200.

Accounting entries for seller-lessee

The journal entries below shows how seller-lessee (Entity A) will record a sale and leaseback transaction:

1. Record the sale of office building, entering into lease transaction and gain recognised in profit or loss:

DR	Cash (811110)	3 200 000	
DR	Buildings under lease - Acquisition[2] [(c)]	2 169 900	
DR	Accumulated depreciation – Buildings Sales (842220)	1 600 000	
CR	Buildings – Sales (842120)		4 000 000
CR	Building lease liability non current – Received[1 2] [(a)]		2 893 200
CR	Gain on sale[2] [(b)]		76 700

[1] *Adjustment to move balance from non-current to current portion must be done at a minimum annually.*
[2] *Please contact DTF for the appropriate account.*

2. Record lease payment on 30 June 20X8, representing interest and reduction in the lease liability ($2 893 200 x 5%):

DR	Lease interest expense (512000)	144 660	
DR	Building lease liability non current – Repaid (924520)	355 340	
CR	Cash (811110)		500 000

3. Record annual amortisation of the right-of-use asset over the 7 years ($2 169 900 / 7)

DR	Amortisation expense (381300)	309 986	
CR	Current Amortisation – Buildings under lease (872210)		309 986

Entity B (buyer-lessor) shall:

- Recognise purchase of asset
- Apply lessor accounting (i.e. recognise operating lease income)

Accounting entries for buyer-lessor

The journal entries below shows how buyer-lessor will record a sale and leaseback transaction:

1. Recognise the acquisition of the office building under the agreement with Entity A:

DR	Buildings – Acquisitions (842110)	3 200 000	
CR	Cash (811110)		3 200 000

2. Recognise the operating lease payment (first payment):

DR	Cash (811110)	500 000	
CR	Rent Income (152500)		500 000

3. Record depreciation of the office building over its 15-year useful life ($3 200 000 / 15):

DR	Depreciation expense (381100)	213 333	
CR	Accumulated depreciation – Buildings (842210)		213 333