Accounting Update

Operating Leases – Top 10 Practical Accounting Questions

In this edition of Accounting Update we consider some of the practical accounting questions surrounding operating leases.

1. Should a fixed annual 5% increase be straight lined?

Yes[1].

Example

Entity A entered into a 3 year operating lease at a lease payment of $5,000 per month, with a fixed annual increase of 5%.

What is the operating lease expense for the first year?

Suggested Solution

Payments year 1 ($5,000 x 12 months)	60,000
Payments year 2 ($5,000 x 1.05 x 12 months)	63,000
Payments year 3 ($5,000 x 1.05 x 1.05 x 12 months)	66,150
Total payments over the lease period	189,150
Operating lease expense for year 1 (189,150 ÷ 3 years)	63,050

2. Should an annual CPI increase be straight lined?

No, because the operating lease payments cannot be determined/quantified.

Example

Entity A entered into a 3 year operating lease at a lease payment of $5,000 per month, with a fixed annual CPI increase.

The CPI-linked increases amounted to $500 at the end of year 1 and $800 at the end of year 2.

What is the operating lease expense for the first year?

Suggested Solution

Payments year 1 ($5,000 x 12 months)	60,000
Payments year 2 ($5,500 x 12 months)	66,000
Payments year 3 ($6,300 x 12 months)	75,600
Total payments over the lease period	201,600
Operating lease expense for year 1	60,000

1 AASB 117 *Leases* paragraph 34 states that "For operating leases, lease payments (excluding costs for services such as insurance and maintenance) are recognised as an expense on a straight-line basis unless another systematic basis is representative of the time pattern of the user's benefit, even if the payments are not on that basis". IFRIC Agenda Decision IAS 17-3 states that "The IFRIC noted that recognising income or expense from annual fixed inflators as they arise would not be consistent with the time pattern of the user's benefit".

3. Should an annual increase of the higher of 5% or CPI be straight lined?

Yes, because the minimum amount of the increase can be determined/quantified.

Example

Entity A entered into a 3 year operating lease at a lease payment of $5,000 per month, with an annual increase of the higher of 5% or CPI.

The CPI-linked increases amounted to $500 at the end of year 1 and $800 at the end of year 2.

What is the operating lease expense for the first year?

Suggested Solution

Payments year 1 ($5,000 x 12 months)	60,000
Payments year 2 ($5,000 x 1.05 x 12 months)	63,000
Payments year 3 ($5,000 x 1.05 x 1.05 x 12 months)	66,150
Total payments over the lease period	189,150
Lease expense for year 1 (189,150 ÷ 3 years)	63,050

4. Over what period should the operating lease payments be straight lined?

Example

Entity A entered into a 2 year operating lease at a lease payment of $5,000 per month. Entity A spend the first two months of the operating lease to fit new shelves and only started trading from the premises 2 months after the commencement of the operating lease.

What is the operating lease expense for the first year?

Suggested Solution

Payments year 1 ($5,000 x 12 months)	60,000
Payments year 2 ($5,000 x 12 months)	60,000
Total payments over the lease period	120,000
Lease expense for each year (120,000 ÷ 2 years)	60,000

The operating lease expense must reflect the time pattern of the use of the leased asset. In this example, entity A had access to and used the premises from the date of the commencement of the lease.

5. How should we account for a 'lease free' period?

AASB Interpretation 115 *Operating Leases – Incentives* paragraph 5 states that "The lessee shall recognise the aggregate benefit of incentives as a reduction of rental expense over the lease term, on a straight-line basis unless another systematic basis is representative of the time pattern of the lessee's benefit from the use of the leased asset".

Example

Entity A entered into a 3 year operating lease at a lease payment of $5,000 per month from month 7 to 36, that is, a 6 month lease free period.

What is the operating lease expense for the first year?

Suggested Solution

Payments year 1 ($5,000 x 6 months)	30,000
Payments year 2 ($5,000 x 12 months)	60,000
Payments year 3 ($5,000 x 12 months)	60,000
Total payments over the lease period	150,000
Operating lease expense for year 1 (150,000 ÷ 3 years)	50,000

6. How should we account for review clauses in operating lease contracts?

AASB 117 paragraph 4 defines the lease term as "… the non-cancellable period for which the lessee has contracted to lease the asset together with any further terms for which the lessee has the option to continue to lease the asset, with or without any further payment, when at the inception of the lease it is reasonably certain that the lessee will exercise the option".

IFRIC Agenda Decision IAS 17-2 states that the IFRIC "… did not accept an argument that the lease expense of a lessee after an operating lease repriced to market ought to be comparable with the lease expense of an entity entering into a new lease at the same time at market rates. Nor did the IFRIC believe that the repricing of itself would be representative of a change in the time pattern …".

The main consideration is therefore whether at the inception of the lease it is **reasonably certain** that the lessee will exercise the option. If the answer is yes, then the operating lease payments should be straight lined over the initial lease period and the option/renewal period. If the answer is no, then the operating lease payments should be straight lined over only the initial lease period.

Example

Entity A entered into a 5 year operating lease at a lease payment of $5,000 per month for the first 2 years. The operating lease payments will be reset to market prices at the end of the second year.

What is the operating lease expense for the first year?

Suggested Solution

Payments year 1 ($5,000 x 12 months)	60,000
Payments year 2 ($5,000 x 12 months)	60,000
Payments year 3 ($5,500 x 12 months[2])	66,000
Payments year 4 ($5,500 x 12 months)	66,000
Payments year 5 ($5,500 x 12 months)	66,000
Total payments over the lease period	318,000
Lease expense for each year (318,000 ÷ 5 years)	63,600

7. When do we need to create a 'make good provision'?

An entity should create a 'make good provision' when the entity causes the damage that leads to the present obligation to 'make good' the property at the end of the operating lease. The mere requirement in the lease contract to 'make good' the property is not enough to create a 'make good provision'. The main consideration is whether the damage has already been caused?

Example

Entity A leased an office building for a period of 10 years. At the end of the second year of the operating lease, entity A constructed a stair case between levels 3 and 4 of their leased office building. The lease contracts states that the stair case should be removed at the end of the lease term.

When should entity A recognise a 'make good provision'?

Suggested Solution

The 'make good provision' in relation to the removal of the stair case at the end of the lease term should be created at the end of the second year of the operating lease, that is, at the date that the stair case is constructed. Only after the construction of the stair case the entity has a legal obligation in terms of the operating lease contract to remove the stair case.

2 At the inception of the operating lease the entity estimated that the operating lease payments will reset to a market price of $5,500 per month at the end of year 2.

8. Can a 'make good provision' be capitalised to the leasehold improvements?

A 'make good provision' contained in an operating lease can potentially be capitalised to the related leasehold improvements. AASB 116 *Property, Plant and Equipment* paragraph 16(c) states that the cost of an item of property, plant and equipment comprises, amongst other things, the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located.

Example (continued from the previous example)

At the end of the second year of the operating lease, the net present value of the total expected cost to remove the stairs and repair the damage caused at the end of the operating lease contract is estimated at $500,000.

What journal entry should be processed by entity A at the end of the second year of the operating lease contract to create the 'make good provision'?

Suggested Solution

Dr	Leasehold improvements		$500,000	
	Cr	Make good provision		$500,000

9. What about changes in 'make good provisions'?

If the related asset is measured using the cost model, changes in the 'make good provision' shall be added to, or deducted from, the cost of the related asset in the current period (AASB Interpretation 1 *Changes in Existing decommissioning, restoration and Similar Liabilities* paragraph 5(a)).

Example (continued from the previous example)

At the end of the third year of the operating lease, the net present value of the total expected cost to remove the stairs and repair the damage caused at the end of the operating lease contract is estimated at $650,000 due to unforeseen changes in the expected cash flows. (Ignore the unwinding of the discount.)

What journal entry should be processed by entity A at the end of the third year of the operating lease contract to adjust the 'make good provision'?

Suggested Solution

Dr	Leasehold improvements		$150,000	
	Cr	Make good provision		$150,000

10. How do we unwind the discount on the 'make good provision'?

AASB Interpretation 1 paragraph 8 states that "The periodic unwinding of the discount shall be recognised in profit or loss as a finance cost as it occurs". The IFRIC also concluded that the unwinding of the discount is not a borrowing cost as defined in AASB 123 *Borrowing Costs*.

Example (continued from the previous example)

At the end of the fourth year of the operating lease, the net present value of the total expected cost to remove the stairs and repair the damage caused at the end of the operating lease contract is estimated at $670,000 due to the unwinding of the discount.

What journal entry should be processed by entity A at the end of the fourth year of the operating lease contract to adjust the 'make good provision'?

Suggested Solution

Dr	Profit and loss		$20,000	
	Cr	Make good provision		$20,000

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