**Urgent Issues Group** **Interpretation 115**

July 2004

# Operating Leases – Incentives

Australian Government

Australian Accounting Standards Board

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ISSN 1449-8316

# PREFACE

## Reasons for Issuing UIG Interpretation 115

The Australian Accounting Standards Board (AASB) is implementing the Financial Reporting Council's policy of adopting the Standards of the International Accounting Standards Board (IASB) for application to reporting periods beginning on or after 1 January 2005. The AASB has decided it will continue to issue sector-neutral Standards, that is, Standards applicable to both for-profit and not-for-profit entities, including public sector entities. Except for Standards that are specific to the not-for-profit or public sectors or that are of a purely domestic nature, the AASB is using the IASB Standards as the "foundation" Standards to which it adds material detailing the scope and applicability of a Standard in the Australian environment. Additions are made, where necessary, to broaden the content to cover sectors not addressed by an IASB Standard and domestic, regulatory or other issues.

The same approach applies to UIG pronouncements. This Interpretation is part of the set of Australian equivalents to each International Accounting Standard (IAS), International Financial Reporting Standard (IFRS) and Interpretation of the IASB (collectively defined by the IASB as IFRSs). This set includes UIG Interpretations that correspond to the IASB Interpretations originated by the International Financial Reporting Interpretations Committee (IFRIC) or the former Standing Interpretations Committee (SIC).

## Main Features of this Interpretation

This Interpretation is applicable to annual reporting periods beginning on or after 1 January 2005. To promote comparability among the financial reports of Australian entities, early adoption of this Interpretation is not permitted.

Application of this Interpretation will begin in the first annual reporting period beginning on or after 1 January 2005 in the context of adopting all Australian equivalents to IFRSs. The requirements of Accounting Standard AASB 1 *First-time Adoption of Australian Equivalents to International Financial Reporting Standards*, the Australian equivalent of IFRS 1 *First-time Adoption of International Financial Reporting Standards*, must be observed. AASB 1 requires prior period information, presented as comparative information, to be restated as if the requirements of this Interpretation had always applied. This differs from previous Australian requirements where changes in accounting policies did not require the restatement of the income statement and balance sheet of the preceding period.

This Interpretation applies when an entity applies AASB 117 *Leases*. The Interpretation treats incentives for the agreement of new or renewed operating leases as an integral part of the net consideration for the use of the leased asset. Therefore, lessors and lessees are required to recognise lease incentives under operating leases as a reduction of rental income or rental expense, respectively, over the lease term. The reduction of rental income or rental expense is required to be on a straight-line basis unless another systematic basis is representative of the time pattern of the benefits of the leased asset. The Interpretation also addresses costs incurred directly by a lessee on its own behalf.

## Comparison with Superseded Requirements

UIG Interpretation 115 addresses the accounting for lease incentives by both lessors and lessees. This Interpretation supersedes UIG Abstract 3 *Lessee Accounting for Lease Incentives Under a Non-Cancellable Operating Lease*, which addressed only the accounting for lessees. Therefore, the requirements in this Interpretation for lessors are new requirements in Australia.

There are several differences between this Interpretation and Abstract 3, in relation to lessees. Whereas Abstract 3 dealt with non-cancellable operating leases, this Interpretation covers both cancellable and non-cancellable operating leases. Abstract 3 required a lessee to recognise the lease incentive as a liability, and allowed a choice for the lease payments to be allocated (a) between rental expense and reduction of the lease-incentive liability, or (b) between rental expense, interest on the lease-incentive liability, and reduction of the liability. Interpretation 115 does not specifically address the recognition of a liability, and requires a lessee to recognise the aggregate benefit of lease incentives as a reduction of rental expense over the lease term.

This Interpretation requires the reduction of rental expense to be recognised 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. Abstract 3 required the reduction of rental expense to be representative of the pattern of benefits derived by the lessee from the leased asset, whether that was a time-based pattern or some other pattern.

# COMPARISON WITH INTERNATIONAL PRONOUNCEMENTS

UIG Interpretation 115 is equivalent to Standing Interpretations Committee Interpretation SIC-15 *Operating Leases – Incentives*, issued by the IASB. Paragraphs that have been added to this Interpretation (and do not appear in the text of the equivalent SIC Interpretation) are identified with the prefix "Aus", followed by the number of the relevant SIC paragraph and decimal numbering.

Entities that comply with Interpretation 115 will simultaneously be in compliance with SIC-15.

International Public Sector Accounting Standards (IPSASs) are issued by the Public Sector Committee of the International Federation of Accountants. IPSAS 13 *Leases* (December 2001) does not address lease incentives.

# URGENT ISSUES GROUP

# INTERPRETATION 115

# *OPERATING LEASES – INCENTIVES*

## ISSUE

1. In negotiating a new or renewed operating lease, the lessor may provide incentives for the lessee to enter into the agreement. Examples of such incentives are an up-front cash payment to the lessee or the reimbursement or assumption by the lessor of costs of the lessee (such as relocation costs, leasehold improvements and costs associated with a pre-existing lease commitment of the lessee). Alternatively, initial periods of the lease term may be agreed to be rent-free or at a reduced rent.

2. The issue is how incentives in an operating lease should be recognised in the financial statements of both the lessee and the lessor.

## CONSENSUS

**3. All incentives for the agreement of a new or renewed operating lease shall be recognised as an integral part of the net consideration agreed for the use of the leased asset, irrespective of the incentive's nature or form or the timing of payments.**

**4. The lessor shall recognise the aggregate cost of incentives as a reduction of rental income over the lease term, on a straight-line basis unless another systematic basis is representative of the time pattern over which the benefit of the leased asset is diminished.**

**5. 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.**

**6. Costs incurred by the lessee, including costs in connection with a pre-existing lease (for example costs for termination, relocation or leasehold improvements), shall be accounted for by the lessee in accordance with Australian Accounting Standards applicable to those costs, including costs which are effectively reimbursed through an incentive arrangement.**

## Application

**Aus6.1** **This Interpretation applies when Accounting Standard AASB 117 *Leases* applies.**

**Aus6.2** **This Interpretation applies to annual reporting periods beginning on or after 1 January 2005.**

**Aus6.3** **This Interpretation shall not be applied to annual reporting periods beginning before 1 January 2005.**

**Aus6.4** **The requirements specified in this Interpretation apply to the financial report where information resulting from their application is material in accordance with AASB 1031 *Materiality*.**

**Aus6.5** **When applicable, this Interpretation supersedes Abstract 3 *Lessee Accounting for Lease Incentives Under a Non-Cancellable Operating Lease*, as issued in August 1995.**

**Aus6.6** **Abstract 3 remains applicable until superseded by this Interpretation.**

# DISCUSSION

7. Paragraph 35 of the *Framework for the Preparation and Presentation of Financial Statements* explains that if information is to represent faithfully the transactions and events that it purports to represent, it is necessary that transactions and events are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors*, paragraph 10(b)(ii), also requires the application of accounting policies which reflect economic substance.

8. Paragraph 22 of the *Framework* and AASB 101 *Presentation of Financial Statements*, paragraph 25, require the preparation of financial statements under the accrual basis of accounting. AASB 117.33 and 117.50 specify the basis on which lessees and lessors respectively should recognise amounts payable or receivable under operating leases.

9. The underlying substance of operating lease arrangements is that the lessor and lessee exchange the use of an asset for a specified period for the consideration of a net amount of money. The accounting periods in which this net amount is recognised by either the lessor or the lessee is not affected by the form of the agreement or the timing of payments.

Payments made by a lessor to or on behalf of a lessee, or allowances in rental cost made by a lessor, as incentives for the agreement of a new or renewed lease are an inseparable part of the net amount receivable or payable under the operating lease.

10. Costs incurred by the lessor as incentives for the agreement of new or renewed operating leases are not considered to be part of those initial costs which are added to the carrying amount of the leased asset and recognised as an expense over the lease term on the same basis as the lease income in accordance with AASB 117.52. Initial costs, such as direct costs for administration, advertising and consulting or legal fees, are incurred by a lessor to arrange a contract, whereas incentives in an operating lease are, in substance, related to the consideration for the use of the leased asset.

11. Costs incurred by the lessee on its own behalf are accounted for using the applicable recognition requirements. For example, relocation costs are recognised as an expense in the income statement in the period in which they are incurred. The accounting for such costs does not depend on whether or not they are effectively reimbursed through an incentive arrangement as they are not related to the consideration for the use of the leased asset.

Date of SIC's Consensus: [Deleted by the UIG]

Effective Date of SIC-15: [Deleted by the UIG]

# APPENDIX

*This appendix accompanies, but is not part of, Interpretation 115.*

# EXAMPLE APPLICATION OF INTERPRETATION 115

Example 1

**An entity agrees to enter into a new lease arrangement with a new lessor. The lessor agrees to pay the lessee's relocation costs as an incentive to the lessee for entering into the new lease. The lessee's moving costs are 1,000. The new lease has a term of 10 years, at a fixed rate of 2,000 per year.**

The accounting is:

The lessee recognises relocation costs of 1,000 as an expense in Year 1. Net consideration of 19,000 consists of 2,000 for each of the 10 years in the lease term, less a 1,000 incentive for relocation costs. Both the lessor and lessee would recognise the net rental consideration of 19,000 over the 10 year lease term using a single amortisation method in accordance with paragraphs 4 and 5 of this Interpretation.

Example 2

**An entity agrees to enter into a new lease arrangement with a new lessor. The lessor agrees to a rent-free period for the first three years as incentive to the lessee for entering into the new lease. The new lease has a term of 20 years, at a fixed rate of 5,000 per annum for years 4 through 20.**

The accounting is:

Net consideration of 85,000 consists of 5,000 for each of 17 years in the lease term. Both the lessor and lessee would recognise the net consideration of 85,000 over the 20 year lease term using a single amortisation method in accordance with paragraphs 4 and 5 of this Interpretation.

# REFERENCES


***Australia***

The Urgent Issues Group discussed Issues Paper UIG/SIC 04/1 “Adoption of Various SIC Interpretations in Australia” in relation to this Interpretation at its meeting on 4 May 2004.

Accounting Standard AASB 101 *Presentation of Financial Statements*

Accounting Standard AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors*

Accounting Standard AASB 117 *Leases*

*Framework for the Preparation and Presentation of Financial Statements*

***International Accounting Standards Board***

International Accounting Standard IAS 17 *Leases*

Standing Interpretations Committee Interpretation SIC-15 *Operating Leases – Incentives*

***IFAC Public Sector Committee***

International Public Sector Accounting Standard IPSAS 13 *Leases*