

IRAS Consultation

Income Tax Implications Arising from the Adoption of FRS 116 – Leases



INLAND REVENUE
AUTHORITY
OF SINGAPORE

Published by
Inland Revenue Authority of Singapore

Published on 8 August 2017

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Abbreviation

ASC	Accounting Standards Council
CA	Capital Allowance
FL	Finance Lease
FRS	Financial Reporting Standard
FRS 116	FRS 116 Leases
FRS 17	FRS 17 Leases
IDCs	Initial Direct Costs
ITA	Income Tax Act
Section 10D Regulations	Income Tax (Income from Finance Leases) Regulations
SEs	Small Entities
ST leases	Short-term Leases under FRS 116
OL	Operating Lease
ROU asset	Right-of-use Asset

Public Consultation on Income Tax Implications Arising from the Adoption of FRS 116 – Leases

1 Invitation to comment

- 1.1 The ASC issued FRS 116 on 30 June 2016. The FRS 116 applies to entities for their annual reporting periods beginning on or after 1 January 2019. Earlier application is permitted for entities that apply FRS 115 *Revenue from Contracts with Customers* at or before the date of initial application of FRS 116.
- 1.2 IRAS has examined the income tax implications that would arise from entities adopting FRS 116. This consultation paper sets out IRAS' proposed positions on the income tax implications arising from the adoption of FRS 116 (hereafter called "FRS 116 tax treatment").
- 1.3 We seek your comments on the proposed FRS 116 tax treatment, and in particular on the following:

Lessor

- (a) Do you think that the existing tax treatment should be retained for lessors given that there is no change in accounting treatment for lessors under FRS 116? Please provide explanation of your views. Are there challenges for the lessor if the existing tax treatment is retained? If so, how would you address the challenges?

Lessee

- (b) For lessees, the proposed default tax treatment is to delink from the accounting treatment by allowing tax deduction based on the contractual lease payments incurred by the lessees.
- (i) Do you foresee any challenges in applying the proposed default tax treatment and how would you address the challenges?
- (ii) Do you agree that allowing a tax deduction for the lease payments over the lease term instead of allowing the interest expense and depreciation based on the accounting treatment is essentially a matter of timing difference? Please state the reason for your view.

Sublease

- (c) Do you agree with the principles underlying the proposed tax treatments for an intermediate lessor as set out in paragraph 7.10? Please state the reason for your view.

Impact on industry

- (d) In your view, which are the sectors that would be most impacted by the adoption of FRS 116?

- (e) Given that some of the OL of a lessee under FRS 17 would now be reflected in the lessee's financial statement as ROU assets, what proportion of OL would you expect to be recognised as ROU assets under FRS 116 in your specific industry?

Withholding tax

- (f) If the proposed default tax treatment for lessees were to be adopted, are there withholding tax implications that you wish to highlight and challenges in terms of complying with withholding tax obligations. If so, what are the withholding tax implications and how can the challenges be mitigated?

Others

- (g) Are there any other tax issues (including GST) or concerns arising from the adoption of FRS 116 that you would like to bring to IRAS' attention? If so, please state the tax issues and concerns as well as your suggestions on how to address them.

2 Submission

- 2.1 To facilitate our review of your comments, please use examples to illustrate your basis and rationale where possible. Please also indicate the specific section of the consultation paper to which your comments relate. Your response should preferably not be more than four pages long.
- 2.2 We reserve the right to make public all or parts of any written submission made in response to this consultation paper and to disclose the identity of the contributor. We may also contact the contributor if we need further clarification on any comments provided. All comments received will be considered.
- 2.3 The closing date to submit your comments is 29 August 2017. Your submission should include your name, the organisation you work for or represent, your email address and telephone number. Please address your submission to:

Comptroller of Income Tax
Inland Revenue Authority of Singapore
Tax Policy & Ruling Branch
55 Newton Road
Singapore 307987

Or Email to: public_consultation@iras.gov.sg

3 Aim

- 3.1 This consultation paper sets out IRAS' proposed positions on the income tax implications arising from the adoption of FRS 116.
- 3.2 It would be relevant to you if you are a business entity that has leases within the scope of FRS 116¹.

4 At a glance

- 4.1 The ASC issued FRS 116 on 30 June 2016. FRS 116 applies to all leases, including leases of ROU assets in a sublease. It applies to entities with effect from annual reporting periods beginning on or after 1 January 2019. Early application is permitted with application of FRS 115 *Revenue from Contracts with Customers*.
- 4.2 IRAS has examined the income tax implications arising from the adoption of the FRS 116 and takes the following proposed FRS 116 tax treatment:

Lessor

- (a) To retain the existing tax treatment for lessors given that there is no change in accounting treatment for lessors.

Lessee

- (b) To allow a tax deduction to the lessee based on the contractual lease payments incurred, except under circumstances when a sale is regarded to have taken place. Under such circumstances, the lessee would be allowed to claim interest expense and CA for the ROU asset instead of contractual lease payments. For this purpose, we are adopting the conditions in paragraphs (a) to (e) of Regulation 4(1) of the Section 10D Regulations to treat a FL that gives rise to a ROU asset as a sale agreement; and
- (c) Not to allow lessee to elect to claim deduction on interest expense and depreciation based on the accounting treatment.

¹ FRS 116 shall be applied to all leases, including leases of ROU assets in a sublease, except the following:

- (a) leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources;
- (b) leases of biological assets within the scope of FRS 41 *Agriculture* held by a lessee;
- (c) service concession arrangements within the scope of INT FRS 112 *Service Concession Arrangements*;
- (d) licences of intellectual property granted by a lessor within the scope of FRS 115 *Revenue from Contracts with Customers*; and
- (e) rights held by a lessee under licensing agreements within the scope of FRS 38 *Intangible Assets* for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights.

Withholding tax

- (d) The withholding tax obligation would continue to be based on the legal characterisation of the payment as provided in the ITA, notwithstanding the change in the accounting treatment.
- 4.3 The FRS 116 tax treatment would apply regardless of whether the accounting treatment for leases under FRS 116 or the FRS for SEs is applied.

5 Current tax treatment

- 5.1 Under the current accounting standard FRS 17, lessors and lessees account for leases according to the terms of the leases as either OL or FL.
- 5.2 Tax treatment for leases under FRS 17 - Lessor

OL

- (a) FRS 17 requires lease income from an OL to be recognised as income on a straight-line basis over the lease term. This is known as the “effective rent method”. Currently, rental income received by a lessor under an OL is subject to tax on an accrual basis when the rental income becomes due and payable under the lease contract. CA is given to the lessor in respect of the leased asset, if the leased asset qualifies as a plant and machinery.
- (b) As an administrative concession, the lessor is allowed to be taxed on income from an OL as determined using the effective rent method under FRS 17 (“FRS 17 tax treatment”). The administrative concession is available on election by taxpayers, subject to meeting the following conditions:
 - (i) adopting FRS 39 tax treatment and other FRSs that Comptroller of Income Tax may allow adoption for tax purposes; and
 - (ii) applying the FRS 17 tax treatment consistently every year and across for all OLs.

Under the FRS 17 tax treatment, where lease expenses (such as incentive and IDCs) are not deductible, the entire non-deductible amount is disallowed in the first year of lease.

FL

- (c) Under the Section 10D Regulations, if a FL satisfies any of the conditions listed under Regulation 4(1), the FL would be treated as a sale agreement. When a FL is treated as a sale agreement, CA in respect of the leased assets would be made to the lessee if the leased assets qualify as plant and machinery. Under such circumstances, the lessor would be taxed on the interest income on an accrual basis.

- (d) For FL that is not treated as a sale agreement, the lessor would be taxed on the full lease income. The lessor would be entitled to claim CA on the leased assets if they qualify as plant and machinery. However, CA on such FL is allowed to be offset against income from finance leasing only. Offset against other income and transfer under the group relief system is allowed only at the time the finance leasing activities which give rise to the CA cease.

5.3 Tax treatment for leases under FRS 17 - Lessee

OL

- (a) The lessee is allowed to claim the contractual lease payments as deductions against his income in the basis period such payments are incurred provided the lease expenses are wholly and exclusively incurred in the production of his income under Section 14(1) of the ITA.

FL

- (b) Similar to the tax treatment of FL for a lessor, if a FL satisfies any of the conditions listed under Regulation 4(1) of the Section 10D Regulations, the FL would be treated as a sale agreement. When a FL is treated as a sale agreement, CA in respect of the leased assets which qualify as plant and machinery would be made to the lessee. Under such circumstances, the lessee would also be allowed a deduction of the interest expense on an accrual basis.
- (c) For FL that is not treated as a sale agreement, the lessee would be allowed a deduction on the full lease payments.

Initial direct costs

- 5.4 IDCs, as defined under the FRS 116, are incremental costs of obtaining a lease that would not have been incurred if the lease had not been obtained, except for such costs incurred by a manufacturer or dealer lessor in connection with a FL. A manufacturer or dealer lessor shall recognise as an expense costs incurred in connection with obtaining a FL at the commencement date because they are mainly related to earning the manufacturer or dealer's selling profit.
- 5.5 Examples of IDCs are payments to a former tenant and commission paid to the real estate agent that arranged the lease. Such costs if incurred prior to the commencement of business² (in the case of a lessor) or to secure the first tenancy (in the case of a lessee) are not tax deductible. There is no change in the tax treatment of IDCs with the adoption of the FRS 116.

² Unless the concession for enterprise development provided for under Section 14U of the ITA is applied. The concession is not applicable to income which is subject to the provisions of section 10E.

Residual value guarantee

- 5.6 Residual value guarantee as defined under FRS 116, is a guarantee made to a lessor by a party unrelated to the lessor that the value (or part of the value) of an underlying asset at the end of a lease would be at least a specified amount. At the commencement date, the lease payments include amounts expected to be payable by the lessee under residual value guarantees.
- 5.7 The deductibility of residual value guarantee in the hands of a lessee depends on the nexus of the residual value guarantee incurred and the production of income to determine if such costs are tax deductible. Such payments may be considered for deductibility under section 14(1) of the ITA if the cost claimed:
- has been incurred by the lessee;
 - is contractually provided for in the agreement; and
 - the ownership of the underlying asset is not transferred to the lessee at the end of the lease.
- 5.8 Where the ownership of the underlying asset is transferred to the lessee at the end of the lease, such cost may form part of the capital expenditure incurred on plant and machinery and qualify for CA claim depending on whether the ROU asset is treated as a sale agreement.
- 5.9 The table below is a summary of the current tax treatment for both a lessor and a lessee.

Current tax treatment for Lessor and Lessee

	Lessor	Lessee
FL not treated as a sale agreement	<ul style="list-style-type: none">• Tax on lease income (i.e. interest and capital repayment)• CA allowed on leased asset (quarantined and offset against FL income only)	<ul style="list-style-type: none">• Lease payments (i.e. interest and capital repayment) deductible on incurred basis• No CA allowed on leased asset
FL treated as a sale agreement	<ul style="list-style-type: none">• Tax on interest income on accrual basis• Capital repayment not taxable• No CA allowed on leased asset	<ul style="list-style-type: none">• Interest portion of lease payment deductible• Capital repayment not deductible• CA allowed on leased asset

	Lessor	Lessee
OL	<ul style="list-style-type: none"> • Tax on lease income • CA allowed on leased asset 	<ul style="list-style-type: none"> • Lease payments deductible on incurred basis • No CA allowed on leased asset

6 Fundamentals and principles of FRS 116

6.1 Under FRS 17, a lease is a contract, or part of a contract, whereby the lessor conveys to the lessee the right to use an asset (the underlying asset) for a period of time in exchange for consideration. The definition of a lease under FRS 116 is similar to that under FRS 17. However, there is new guidance under FRS 116 on whether a contract is, or contains, a lease. FRS 116 provides that a contract is, 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.

6.2 If the contract is, or contains, a lease, the lessee has to capitalise the asset and the corresponding liability. If the contract is not, or does not contain, a lease, then FRS 116 would not be applicable.

6.3 A brief overview of the FRS 116 accounting treatment is provided in the Annex.

Lessor

6.4 FRS 116 substantially carries forward the lessor accounting requirements in FRS 17, with the exception of accounting for subleases and enhanced disclosures to be provided by the lessors that would improve information disclosed about a lessor's risk exposure. Accordingly, lessors would continue to classify leases as OLs or FLs.

Lessee

6.5 Under FRS 116, lessees would apply a single lessee accounting model. Unless exemption applies, a lessee is required to recognise a ROU asset representing its rights to use the underlying leased asset and a lease liability representing its obligation to make lease payments. Upon election by the lessee, ST leases and leases for which the underlying asset is of low value may be exempted from the requirement. If exemption applies, the lessee shall recognise the lease payments as an expense on either a straight-line over the lease term or another systematic basis.

6.6 A "ST lease" is defined in FRS 116 as a lease that, at the commencement date of the lease, has a lease term of 12 months or less. A lease that contains a purchase option is not a short-term lease.

- 6.7 For low value leases, the FRS 116 provides guidance on the assessment of whether a lease is of low value. There is however no threshold set in the FRS 116. Examples of low-value underlying assets are tablets and personal computers, small items of office furniture and telephones.
- 6.8 Upon election for exemption from the requirement to recognise a ROU asset and a lease liability, lease payments for short-term leases and low value leases may be charged as an expense on either a straight-line basis over the lease term or another systematic basis which is more representative of the lessees' benefit.
- 6.9 The FRS 116 would supersede the following standards and interpretations of financial reporting standards (INT FRS):
- (a) FRS 17 *Leases*;
 - (b) INT FRS 104 *Determining whether an Arrangement contains a Lease*;
 - (c) INT FRS 15 *Operating Leases—Incentives*; and
 - (d) INT FRS 27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*.
- 6.10 Taxpayers who qualify for and have elected to comply with the FRS for SEs would apply Section 20 for leases. The principles contained in Section 20 are derived from those in the full set of FRS, i.e. FRS 17.
- 6.11 For more details on FRS 116, please refer to the Financial Reporting Standard – FRS 116: Lease. This is available on the Accounting Standards Council website in www.asc.gov.sg.

7 IRAS' proposed positions on income tax implications arising from the adoption of FRS 116

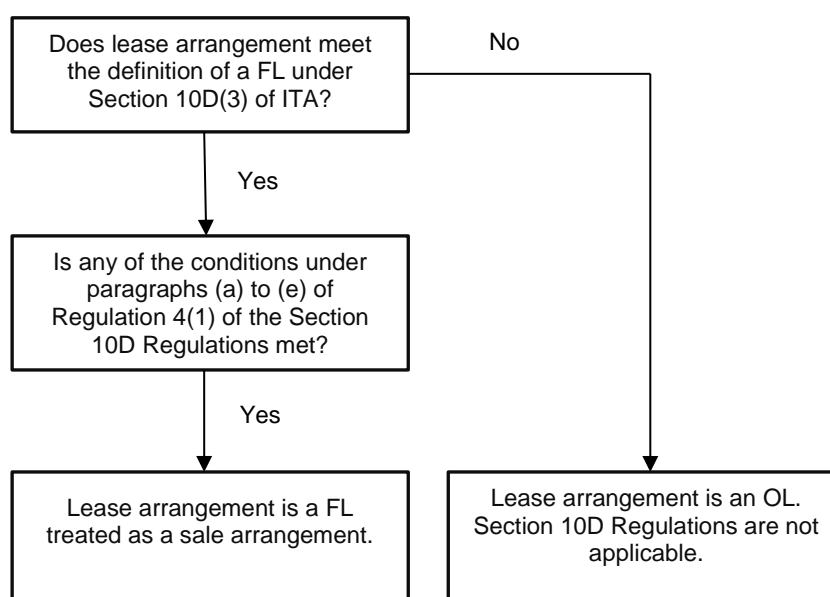
- 7.1 We have taken into consideration the following principles in formulating the proposed tax treatment:
- (a) Minimising changes to existing tax practices by allowing lessee to claim deduction based on contractual lease payments incurred;
 - (b) Allow lessee to claim interest and CA for the ROU asset instead of lease payments under certain circumstances such as when a sale is regarded to have taken place; and
 - (c) Apply consistent tax treatment regardless of whether FRS 116 or FRS for SEs is applied.

Lessor

- 7.2 Given that the lessor accounting remains substantially unchanged, the existing tax treatment for lessors, as set out in paragraph 5.2, would be retained.

Lessee

- 7.3 For lessees, the proposed default tax treatment is to allow tax deduction based on the contractual lease payments incurred, except under circumstances when a sale is regarded to have taken place. This is the existing tax treatment which taxpayers are familiar with.
- 7.4 A lessee would be eligible to claim interest expense and CA for the ROU asset instead of lease payments when a sale is regarded to have taken place. For this purpose, the conditions in paragraphs (a) to (e) of Regulation 4(1) of the Section 10D Regulations would be adopted to regard a ROU asset that meets the definition of a FL in Section 10D(3) of the ITA as a sale agreement. Under Section 10D(3), a FL is defined to mean a lease of any machinery or plant (including any arrangement or agreement in connection with the lease) which has the effect of transferring substantially the obsolescence, risks or rewards incidental to ownership of such machinery or plant to the lessee.
- 7.5 A lease arrangement giving rise to a ROU asset for a lessee would need to meet the definition of FL in Section 10D(3) before the conditions under Regulation 4(1) of the Section 10D Regulations are applicable for the purpose of determining whether the ROU asset is to be treated a sale agreement as illustrated in the diagram below. A lease arrangement that does not meet the definition of a FL is an OL. The Section 10D Regulations are not applicable to an OL.



7.6 Further, to adhere to the tax principle of only allowing expenses when they are incurred, taxpayers would not be given the option to claim deduction on interest expense and depreciation based on the accounting treatment. Allowing a tax deduction of contractual lease payments instead of interest expense and depreciation as charged to the financial accounts is essentially a matter of timing difference.

Sublease

7.7 A sublease is a transaction for which an underlying asset is re-leased by a lessee (“intermediate lessor”) to a third party, and the lease (“head lease”) between the head lessor and lessee remains in effect. Where the lessee subleases or expects to sublease the underlying asset, the head lease does not qualify as a low-value asset.

7.8 In classifying a sublease, an intermediate lessor shall classify the sublease as a FL or OL as follows:

- (a) If the head lease is a ST lease that the entity, as a lessee has accounted for applying paragraph 6.8 above, the sublease shall be classified as an OL.
- (b) Otherwise, the sublease shall be classified by reference to the ROU asset arising from the head lease.

7.9 The proposed tax treatment for the lessee of the head lease is set out in paragraphs 7.3 to 7.5 above. However, in the event that the sublease is classified by reference to the ROU asset and a sale is regarded to have taken place, only the interest expense would be allowed to the lessee of the head lease. This is because the intermediate lessor would only be taxed on the interest income.

7.10 Based on the tax principles set out in paragraph 5.2 above, the proposed tax treatment for the intermediate lessor is as follows:

- (a) If the sublease is classified as an OL, the intermediate lessor would continue to be taxed based on the lease income;
- (b) If the sublease is classified by reference to the ROU asset and a sale is not regarded to have taken place, the intermediate lessor would continue to be taxed based on the lease income;
- (c) If the sublease is classified by reference to the ROU asset and a sale is regarded to have taken place, the intermediate lessor would continue to be taxed on the interest income on an accrual basis.

For paragraphs (a) and (b), the intermediate lessor/lessee of the head lease would be allowed either the contractual lease payments incurred or a single set of CA on the leased asset, as the case may be. This is because the intermediate lessor/lessee of the head lease would have been relieved on the capital cost of the leased asset either through a tax deduction given on the

lease payments or the CA granted on the leased asset. For paragraph (c), the intermediate lessor/lessee of the head lease would not be allowed any CA on the leased asset as he is providing a financing arrangement in respect of the sublease.

Withholding tax obligations

- 7.11 Under FRS 116, unless exemption under the standard applies, a lessee would recognise the leased assets and lease liabilities on the balance sheet, and recognise depreciation on the ROU assets and interest expense for lease liabilities in the profit or loss statement. The lessee is required to recognise a ROU asset representing its rights to use underlying leased assets and lease liability representing its obligation to make lease payments. Notwithstanding the accounting classification of the expenses in the profit or loss statement, the withholding tax obligations would be based on the legal characterisation of the payments. In other words, it would be based on the statutory description of the payment as provided in Sections 12(6) and 12(7) of the ITA, unless such payments are granted certain exemption such as under Sections 13(4) and 13(1)(oa) of the ITA.
- 7.12 Currently, where a FL of a lessee is treated as a sale agreement under Regulation 4(1) of the Section 10D Regulations, the interest portion of the lease payment is treated as a payment under Section 12(6) of the ITA. For an OL or a FL that is not treated as a sale agreement, the lease payment for the use of any movable property is treated as a payment under Section 12(7)(d) of the ITA. The lessee is required to withhold tax under Sections 45 and 45A of the ITA on any interest and lease payment (as the case may be) made to a non-resident lessor, unless exemption applies.
- 7.13 The current withholding tax treatment as set out in paragraphs 7.11 and 7.12 would continue to apply to the payments made by a lessee under FRS 116. For an ROU asset treated as a sale agreement, the interest portion of the lease payment is treated as a payment under Section 12(6) of the ITA. For ST leases and low value leases for which lessee has elected to be exempt from the requirement under the FRS 116, and ROU assets not treated as sale agreements, the lease payment for the use of any movable property is treated as a payment under Section 12(7)(d). The lessee is required to comply with the withholding tax obligations for the payments made to non-residents.

8. Transitional tax adjustments

- 8.1 According to FRS 116, a lessee shall apply FRS 116 using one of the following methods:
- (a) retrospectively to each prior reporting period presented applying FRS 8 *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 (i.e. the start of the reporting period in which an entity first applies FRS 116).

Lessor

- 8.2 A lessor is not required to make any adjustments on transition except if the lessor is an intermediate lessor. Under FRS 116, an intermediate lessor is required to reassess subleases that were classified as operating leases applying FRS 17 and are ongoing at the date of initial application, to determine whether each sublease should be classified as operating lease or a finance lease applying FRS 116. For subleases that were classified as operating leases applying FRS 17 but finance leases applying FRS 116, the lessor is required to account for the sublease as a finance lease entered into at the date of initial application.
- 8.3 For tax purposes, no tax adjustment is needed since the proposed tax treatment is to retain the existing tax treatment for lessors. For intermediate lessors, please refer to the proposed tax treatment set out in paragraphs 7.9 and 7.10 above.

Lessee

- 8.4 If a lease was previously classified as an OL under FRS17 and the lessee elects to apply the FRS 116 Standard in accordance with paragraph 8.1(b), the lessee has to:
- (a) recognise a lease liability at the date of initial application and it shall be measured at the present value of remaining lease payments, discounted at lessee's incremental borrowing rate, and
 - (b) recognise ROU asset at initial application date on a lease-by-lease basis, at either:
 - (i) carrying amount as if the FRS 116 had been applied since the commencement date³, but discounted using lessee's incremental borrowing rate at date of initial application; or
 - (ii) lease liability amount adjusted for any prepaid or accrued lease payments immediately before date of initial application.
- 8.5 For tax purposes, no tax adjustment is needed since the proposed tax treatment is to continue allowing a tax deduction based on the contractual lease payments incurred. This is a carry forward from the current tax treatment where a lessee is given a tax deduction based on the lease payments incurred. Any adjustment to the beginning retained earnings would not be taxable or deductible.

³ Commencement date is the date on which the lessor makes an underlying asset available for use by a lessee.

9. Taxpayers not required to comply with FRS 116

- 9.1 For taxpayers that do not need to comply with FRS 116 for accounting purposes or are temporarily exempt by Accounting & Corporate Regulatory Authority from complying with FRS 116 for accounting purposes, the FRS 116 tax treatment would still be applicable for such taxpayers since the proposed tax treatment is based on tax principles and is not aligned with the accounting treatment.

Annex - A brief overview of the FRS 116 accounting treatment

Lessor Accounting

1. Lessor accounting under FRS 116 remains largely unchanged from FRS 17, with the exception of accounting for subleases and enhanced disclosures to be provided by the lessors.

Accounting for subleases

2. When classifying a sublease, an intermediate lessor should evaluate the lease by reference to the ROU asset arising from the head lease and not by reference to the underlying asset.
3. In classifying a sublease, an intermediate lessor shall classify the sublease as a FL or OL as follows:
 - (a) If the head lease is a ST lease that the entity, as a lessee has accounted for applying paragraph 6 of FRS 116, the sublease shall be classified as an OL.
 - (b) Otherwise, the sublease shall be classified by reference to the ROU arising from the head lease.
4. If the sublease is accounted for as an OL, the intermediate lessor would:
 - (a) retain the ROU asset and the lease liability relating to the head lease;
 - (b) provide for depreciation for the ROU asset;
 - (c) recognise interest expense on the lease liability for the head lease; and
 - (d) recognise lease income from the sublease.
5. If the sublease is accounted for as a FL, the intermediate lessor would:
 - (a) derecognise the ROU asset relating to the head lease and recognise the net investment in the sublease. Any difference arising from the derecognition of the ROU asset and net investment would be reflected in the profit or loss statement;
 - (b) recognise interest expense from the head lease; and
 - (c) recognise interest income from the sublease.
6. For a sublease classified as a FL, if implicit interest rate in sublease cannot be readily determined, the intermediate lessor is to use the discount rate of head lease (adjusted for any sublease's IDC) to measure net investment in sublease.

Lessee Accounting

7. Under FRS 116, lessees would apply a single lessee accounting model. Unless exemption applies, a lessee is required to recognise a ROU asset representing its rights to use underlying leased assets and lease liability representing its obligation to make lease payments. Upon election by the lessee, ST leases and leases for which the underlying asset is of low value may be exempted from the requirement. If exemption applies, the lessee shall recognise the lease payments as an expense on either a straight-line over the lease term or another systematic basis.

Initial measurement of the ROU asset

8. At commencement date, the cost of the ROU asset shall comprise:
 - (a) the initial amount of lease liability;
 - (b) any prepaid lease payments, less any lease incentive received;
 - (c) any IDCs (incremental costs of obtaining a lease that would not have been incurred if lease was not obtained) received; and
 - (d) estimated costs to dismantle, remove, restate.

Subsequent measurement of the ROU asset

9. After the commencement date, a lessee shall measure the ROU asset applying a cost model, unless it applies either of the measurement models as described in paragraphs 34 and 35 of FRS 116.
10. To apply a cost model, the ROU asset should be measured at cost less any accumulated depreciation and accumulated impairment losses. If the ownership of the underlying asset is transferred, or is reasonably certain to be transferred, at the end of the lease term, the ROU asset is depreciated over the asset's useful life. Otherwise, it should be depreciated over the shorter of the asset's useful life and lease term.

Initial measurement of the lease liability

11. At commencement date, a lessee shall measure the lease liability at present value of unpaid lease payments. The lease payments shall be discounted using the interest rate implicit in the lease. If the rate cannot be readily determined, the lessee shall use the lessee's incremental rate.
12. The unpaid lease payments comprise the following payments:
 - (a) fixed payments (including in-substance fixed payments) less any lease incentives receivable;
 - (b) variable lease payments that depend on an index or rate (measured at commencement date);

- (c) amounts expected to be payable under the residual value guarantees;
- (d) exercise price of a purchase option if the lessee is reasonably certain to exercise that option; and
- (e) penalty payments for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.

Subsequent measurement of the lease liability

13. After the commencement date, a lessee shall measure the lease liability by:
- (a) increasing the carrying amount to reflect interest on the lease liability;
 - (b) reducing the carrying amount to reflect the lease payments made; and
 - (c) re-measuring the carrying amount to reflect any reassessment or lease modifications, or to reflect revised in-substance fixed lease payments.
14. There is subsequent reassessment of lease liability under FRS 116 due to:
- (a) a change in the lease term;
 - (b) a change in the assessment of an option to purchase the underlying asset;
 - (c) a change in expected payment amount for a residual value guarantee; and
 - (d) a change in lease payments arises from change in an index or rate (including change in market rental rates);
15. In applying re-measurement of lease liability for paragraphs 14(a) and (b) above, a lessee shall use a revised discount rate (implicit rate for remaining lease term, or if not readily available, lessee's incremental borrowing rate at reassessment rate).

Example

- A enters into a 5 year lease for 6,000 square metres of office space.
- The annual lease payments are \$60,000 payable at the end of each year.
- The interest rate implicit in the lease cannot be readily determined. A's incremental borrowing rate at the commencement date is 6% per annum.
- A measures the lease liability at the present value of the 5 payments of \$60,000 discounted at the interest rate of 6% per annum, which is \$252,742.

	Lease payment	Interest expense (6%)	Principal repaid	Ending balance
Start of year 1				252,742
End of year 1	60,000	15,165	44,835	207,907
End of year 2	60,000	12,474	47,526	160,381
End of year 3	60,000	9,623	50,377	110,004
End of year 4	60,000	6,600	53,400	56,604
End of year 5	60,000	3,396	56,604	0
Total	300,000	47,258	252,742	

Initial recognition and measurement of the lease by A (lessee):

	Accounting entry	Dr	Cr
Start of year 1	Dr ROU asset Cr Lease liability	\$252,742	\$252,742
End of year 1	Dr Interest expense Dr Lease liability Cr Cash (1 st lease payment)	\$15,165 \$44,835	\$60,000
	Dr Depreciation (252,742/5) Cr Accumulated depreciation	\$50,548	\$50,548