ACT ACCOUNTING POLICY

Accounting for
Provision for Make Good Clauses
within a Lease Agreement

FOR THE REPORTING PERIODS ENDING ON OR AFTER

30 JUNE 2011

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1 Introduction

1.1 Application

1.1.1 Purpose

This ACT Accounting Policy: *Accounting for Provisions for Make Good Clauses within a Lease Agreement* provides general guidance to aid ACT Government agencies on the appropriate recognition and measurement of make good obligations to dismantle, remove and restore items of property, plant and equipment.

This policy is to be read in conjunction with the following:

- AASB 116 *Property, Plant and Equipment;*
- AASB 137 *Provisions, Contingent Liabilities and Contingent Assets;* and
- AASB Interpretation 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities.*

1.1.2 Relationship to International Financial Reporting Standards

ACT Accounting Policies are to be read in conjunction with applicable Australian Accounting Standards. Australian Accounting Standards incorporate International Financial Reporting Standards issued by the International Accounting Standards Board, with the addition of paragraphs on the applicability of each standard in the Australian environment. This policy assists agencies to apply the requirements within Australian Accounting Standards to make good obligations requiring the dismantling, removal and/or restoration of items of property, plant and equipment.

There is, however, no intention that the ACT Accounting Policies will replicate the Accounting Standards. Consequently, agencies should ensure that they have a thorough understanding of the content of the standards before reading and applying relevant ACT Accounting Policies.

1.1.3 Application Date

This ACT Accounting Policy applies to the reporting periods ending on or after 30 June 2011.

1.1.4 Agencies covered by this Policy

This policy applies to directorates and territory authorities.

1.1.5 Budgetary Implications

This policy does not address the issue of funding for make good obligations. Rather it seeks to guide agencies on the recognition and measurement of these obligations. Agencies should make sure that they are adequately providing for the effect of this potential outflow. In the relevant budget year when the actual costs need to be incurred, agencies may need to either seek additional funding through the budget process, or determine other appropriate sources of funding. In some cases an agency's obligation to fund make good clauses may be governed by a memorandum of understanding, and agreed to by the agency upon the commencement of a lease. Therefore, an agency should refer to this agreement when determining the responsibilities of each party for making sure that any expected outflow is appropriately provided for and funded.

1.1.6 Contact

If you have any questions regarding the content or application of this ACT Accounting Policy, please do not hesitate to contact the ACT Accounting Branch policy section to provide further clarification. Contact details are listed on the website: www.treasury.act.gov.au/accounting/html/contacts.htm.

2 Provision for Make Good Clauses

2.1 Background

ACT directorates and territory authorities may have obligations to dismantle, remove and restore items of property, plant and equipment. These obligations are often referred to as 'make good'. The most common example is contained within a building lease agreement, whereby the leasee agency is required, as per the contract, to restore the premises to its original condition at the conclusion of the lease.

Make good obligations are required to be recognised as a provision where the criteria, as mentioned in AASB 137.14 (and discussed below in paragraph 2.2), is met. In addition to this, in accordance with AASB 116.16(c) the initial estimate of the future cost of making good leasehold improvements forms part of the cost of the asset and is therefore required to be capitalised, depreciated and revalued in accordance with an agency's asset policies.

2.2 Is a provision for make good required?

A provision for make good is required to be recognised in accordance with AASB 137.14 when the following criteria are all met.

(a) An entity has a present obligation (legal or constructive) as a result of a past event.

(b) It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation.

(c) A reliable estimate can be made of the amount of the obligation.

If these conditions are not met, a provision should not be recognised.

Agencies must review their lease agreements, memorandums of understanding and any other arrangements made, in relation to their tenancies, in order to determine whether the above criteria are satisfied.

In accordance with AASB 137.36, the amount of the provision shall be the best estimate of the expenditure required to settle the present obligation, as at the end of the reporting period. The best estimate at the end of the reporting period, will usually take into account increases of costs, using the Consumer Price Index (CPI). The provision will be discounted (discussed below in paragraph 2.3.4) to reflect the present value of such expenditures where the time value of money is material (AASB 137.45).

2.3 Initial recognition and measurement of provision

When recording the cost of an item of property, plant and equipment, AASB 116.16(c) requires the cost of such assets to include an initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located. An agency incurs this obligation either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

2.3.1 Overview of the process

The following diagram illustrates the process of calculating the initial recognition of the make good obligation.

Process	***Example***
1. Estimate the current cost of making good, as at the acquisition date. (Please refer to paragraph 2.3.2 below)	***Current make good*** *=$120 per m^2 x Office space of $400m^2$* = ***$48,000***
↓	↓
2. Determine the future outlay of the estimation by using the latest released CPI rate. (Please refer to paragraph 2.3.3 below)	**Future outlay** in 7 years indexed annually with 2% CPI 48,000 $(1+2\%)^7$ = **$55,137**
↓	↓
3. Discount the future outlay to present value using an appropriate Government bond rate, which most accurately approximates the time period required. (Please refer to paragraphs 2.3.4 and 2.3.5 below)	**Discount** using average of 5 & 10 year Government bond rate. $55,137 / $(1 + 4.91\%)^7$ = **$39,421**
↓	↓
4. Prepare journals recognising the capitalisation of the present value of the make good obligation. (Please refer to paragraph 2.3.7 below)[4]	***Please refer to paragraph 2.3.7 below***

2.3.2 *Estimating current costs*

In order to obtain a reliable estimate of the amount of the obligation, it is useful to first estimate the current costs.

An agency has the discretion to use the most appropriate estimation for the current cost of making good leasehold improvements.

Such methods to obtain an appropriate estimation may include (but are not limited to):

- sourcing quotes from service providers;
- seeking a valuation; and/or
- applying a reasonable market rate per m^2.

2.3.3 *Using Consumer Price Index (CPI) to forecast future outlays*

Once the current cost of make good outlay has been estimated it will need to be adjusted to determine the expected expenditure required at the end of the lease.

An agency should apply the current CPI rate to the estimated current costs in order to approximate the magnitude of the future outlay. The current CPI can be sourced from the Australian Bureau of Statistics (ABS)[1]. ([1] The latest CPI can be sourced from the Australian Bureau of Statistics website (www.abs.gov.au). The issue series is numbered 6401.0 and is released at the end of every quarter. The appropriate rate to use for forecasting expenses is the annual % change from last year for 'All Groups'.).

When applying the CPI the following formula is used:

Future outlay = Current Costs x $(1 + \text{CPI})^{\text{years}}$

Example

The estimated future outlay in 7 years, of a current cost of $48,000, increased annually by a CPI rate of 2% can be worked out as follows:

Future outlay = $48,000 x $(1+2\%)^7$
= $55,137

Therefore, using the above information an agency can expect to pay approximately $55,137 in 7 years time to make good the premises.

2.3.4 Selecting the appropriate discount rate

As the future make good cost has been estimated it now needs to be reflected in today's costs (present value). In order to calculate the present value, where the present value is materially different to the future outlay, an agency uses a discount rate.

For the purposes of valuing the present value of a future outlay for make good costings, agencies shall use an appropriate Government bond rate, which most closely matches the period of the future payment, as the discount rate (AASB 139.AG82(a)). The current bond rate can be sourced from the Reserve Bank of Australia (RBA)[2]. [1] The current Government bond rates can be sourced from the Reserve Bank of Australia (RBA) website (www.rba.gov.au/statistics/tables/xls/f02dhist.xls). They are updated daily.

As the RBA only provides rates for the periods of 2, 3, 5 and 10 years, the following methods for calculating a rate for obligations which are due to be outlaid at the end of 4, 6, 7, 8, 9 and 11+ years are detailed in the table below.

Duration (in Years)	**Appropriate Rate**
4	(Rate provided for 3 years + Rate provided for 5 Years) / 2
6	Use rate provided for 5 years
7	(Rate provided for 5 years + Rate provided for 10 years) / 2
8	(Rate provided for 5 years + Rate provided for 10 years) / 2
9	Use rate provided for 10 years
11+	Use rate provided for 10 years

2.3.5 Working out the present value

In order to calculate the present value, the following formula is used:

$$\text{Future Outlay} / (1 + \text{Discount rate})^{\text{time in years}} = \text{Present Value}$$

Example

An agency which is required to pay $55,137 in 7 years time will work out the present value of that $55,137 as follows:

Information:

Future Outlay = $55,137 5 year bond rate = 4.71%

Discount rate = (4.71% + 5.1%)/2 = 4.91%   10 year bond rate = 5.1%

Present Value
Present value = \$55,137 / $(1+4.91\%)^7$ = \$39,421

For a more extensive illustrative example of this, please refer to Attachment A: Illustrative Example 1

2.3.6 Materiality

In some instances the difference between the future outlay and the present value (as determined by applying the appropriate discount factor as mentioned above), may be immaterial. This will most often be the case, for instance, where the lease is only for a short duration.

Where the difference between the future outlay and present value is immaterial, agencies have the option of either:

- **recognising the future outlay of the make good provision straight up; or**
- **applying the discount factor and recognising the present value of the make good obligation.**

2.3.7 Preparing the journals

The following journals illustrate both the initial recognition of an asset and the capitalisation of the additional provision for make good.

DR Leasehold Improvements	XX	
CR Expense (directly attributable costs)[3] [1] AASB 116.17 provides a definition of directly attributable costs. If an agency has expensed these costs during the year, the agency will need to move the amounts to leasehold improvements i.e. credit expense, debit asset – leasehold improvements.		XX
CR Cash		XX
To recognise the purchase of leasehold improvements.		

DR Leasehold Improvements	39,421	
CR Provision for Make Good		39,421
To recognise the initial estimate of the costs to make good the premises at the cessation of the lease. Refer to 2.3.5.		

The above journal entries separate the make good proportion of the asset from the original purchase of the asset. Agencies will most likely find this the most convenient method as it will allow two separate entries in the asset register. Having separate entries in the asset register may assist agencies when applying revaluations and impairment requirements on the separate assets.

Alternatively, agencies may recognise the journals using one journal as follows:

DR Leasehold Improvements	XX	
CR Cash		XX
CR Provision for Make Good		39,421
CR Expense (directly attributable costs)		XX
To recognise the purchase of leasehold improvements and the provision for make good at the cessation of the lease.		

2.4 Changes in the measurement of an existing provision

At the end of each reporting period the provision must be reviewed and adjusted if necessary to reflect the current best estimate where material. Various events may affect the value of the provision. Details of these events and their treatment are listed below. If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision must be reversed (AASB 137.59). The following diagram illustrates the process for revising the make good provision at the end of each reporting period.

Process	***Example***
1. Use last year's formula and work out the unwinding of the discount portion by reducing the number of years until obligation is to be paid by 1. Expense the difference between this year and last year as a borrowing cost.	Last Year $55,137 / (1 + 4.91%)^7 = **$39,421** This year $55,137 / (1 + 4.91%)^6 = **$41,356** **Borrowing cost** = $41,356 - $39,421 = **$1,935**
2. Check whether other changes would produce a material adjustment to the level of the current provision for make good. Other changes may be: * changes in make good obligation costs; * changes in timing of outflows; * changes in CPI, or * changes in appropriate Government bond rate. If considered material, refer to events 1 and 2 below and apply treatment depending upon whether the assets are valued at cost or fair value.	Increased make good costs = $125 per m^2 x *400m*^{2} = **$50,000** Increased CPI = 3% Government bond rate remained the same = 4.91% Provision using updated information: Future outlay = $50,000 (1+3%)^6 = **$59,703** Discounted Value = $59,703 / (1 + 4.91%)^6 = **$44,781** **Material[4] $44,781 - $41,356 = $3,425?**

Events that change the provision	Treatment when leasehold improvements are valued at cost	Treatment when leasehold improvements are valued at fair value
1. A change in the estimated outflow of resources embodying economic benefits required to settle the obligation (e.g. cash flows or change in CPI).	Increases or decreases in the provision shall be added or deducted from the cost of the asset in the current period. A decrease in the provision shall not exceed the carrying amount of the asset; otherwise the remainder shall go straight to profit or loss. If an increase in the provision occurs an agency should consider whether the increased asset is recoverable, otherwise a test for impairment should take place. Refer to paragraph 2.4.4	A **decrease** in the provision shall be recognised in other comprehensive income and increase the revaluation surplus within equity. Except to the extent that it reverses a previous increase[5], in which case it shall be recognised in profit or loss. An **increase** in the provision shall be recognised in profit or loss. Except to the extent that it reverses a previous decrease[5], in which case it shall be recognised in other comprehensive income and also reduces the revaluation surplus within equity.
2. A change in the market-based discount rate as defined in AASB 137.47 (e.g. a change in the Government bond rate).		
3. An increase that reflects the passage of time (also referred to as the unwinding of the discount).	The unwinding of the discount is measured and disclosed as a borrowing cost in the agency's Operating Statement.	

2.4.1 Provision no longer required

In some circumstances, usually within the re-negotiation of a lease, the requirement to make good leased premises may be withdrawn. In this event, the provision should be reversed in accordance with AASB 137.59. An event of this nature would fall within category 1 (above) being a change in the estimated outflow of resources embodying economic benefits required to settle the obligation, and as such the treatment would differ depending on how the assets were being valued either at cost or fair value. Please refer to paragraphs 2.4.4 and 2.4.5.

4(from previous page) Agencies are required to determine whether the amount is material.
5Not-for-profit agencies may assess the increase and decrease across the class of assets. However for-profit agencies can only apply any increases or decreases to single assets.

Once all associated outflows have actually occurred the balance of the provision (either positive or negative) shall be derecognised. This change to the provision is also treated in accordance with events in category 1. Refer to Attachment A Illustrative example 1.

2.4.2 Unwinding of the discount

In accordance with Interpretation 1.8, the unwinding of a discount cannot be capitalised. Therefore the periodic unwinding of the discount shall be recognised in the Operating Statement[6] as a borrowing cost[7] as it occurs.

The unwinding of the discount (based on last years' figures) should always be recognised first before revising the provision at year end due to other changes.

2.4.3 Valuation methodology

As per the *ACT Accounting Policy, Property Plant and Equipment*, leasehold improvements may be valued using cost or fair value, depending upon whether the asset (or class of assets) is used for managerial decisions. Agencies are to refer to the *ACT Accounting Policy, Property Plant and Equipment* for the appropriate valuation methodology.

2.4.4 Cost model

Under the cost model, an asset is initially measured at cost (AASB 116.15) and subsequently carried at cost less accumulated depreciation and impairment losses (AASB 116.30). Therefore any subsequent increase (decrease) in the associated provision for make good is added to (deducted from) the cost of the related asset in the current period (Interpretation 1.5(a)).

Increase in the provision for make good under the cost model

Similar to the initial recognition of the provision for make good, an increase in the provision leads to an increase in the cost of the related asset by debiting the asset leasehold improvements and crediting the provision for make good. Please refer to paragraph 2.4.7.

The increase in the cost of the asset may also be an indicator that the asset may not be fully recoverable. Should such an indication exist, the entity would be required to test for impairment in accordance with AASB 136 *Impairment of Assets*. Agencies should also refer to *ACT Accounting Policy, Impairment of Assets*.

6[1] AASB Interpretation 1.8 states that the unwinding of the discount should be recognised in 'profit or loss'. For the purposes of this policy items referring to 'profit or loss' in the accounting standards are substituted with the words 'Operating Statement' .
7The unwinding of the discount is usually considered by Australian Accounting Standards as a 'finance cost', however, as most agencies group finance costs with other borrowing costs in their financial statements, we have referred to this cost throughout this paper as a 'borrowing cost'.

A change in the value of the asset will also alter future depreciation charges and asset useful lives. Therefore, an agency will be required to amend its asset register and accurately assess the amounts to be applied for future depreciation.

Decrease in the provision for make good under the cost model

A decrease in the provision leads to a reduction in the cost of the related asset. The amount of the reduction is not permitted to exceed the carrying amount of the asset. Any excess over the carrying value is recognised in the Operating Statement.

2.4.5 Revaluation model

Under the revaluation model, an asset is initially measured at cost (AASB 116.15) and subsequently carried at fair value less any subsequent accumulated depreciation and impairment losses (AASB 116.31).

Not-for-profit agencies apply revaluations to a class of asset. Revaluation increases and decreases relating to individual assets within a class are allowed to be offset against one another within that class (i.e. net revaluation increase/decrease), but should not be offset by revaluations in different classes (AASB 116.Aus40.2).

2.4.5.1 Revaluations

In the event that an agency values its leasehold improvements using the fair value methodology, an agency should request its valuer, when completing the triennial valuations, to include an estimate (either net or gross) relating to the value of the provision for make good and leasehold improvements (assets).

Increase in the provisions under the revaluation model

An increase in the carrying amount of an asset, due to a revaluation, must be recognised in Other Comprehensive Income and accumulated in equity under the heading of Revaluation Surplus. However, in the event that the increase is reversing a prior net decrease for the same class of assets, the amount shall be recognised as a gain in the Operating Statement (AASB 116.39).

An increase in the provision for make good (similar to a revaluation decrease of the related asset) is recognised in the Operating Statement, except that it should be recognised in Other Comprehensive Income and reduce the revaluation surplus to the extent of any credit balance existing in respect of the related asset (Interpretation 1.6(a)(ii)).

Decrease in the provision under the revaluation model

A decrease in the carrying amount of an asset will be recognised as an expense in the Operating Statement. However, in the event that the decrease is reversing a prior net increase for the same class of assets, the amount shall be recognised in Other

Comprehensive Income and accumulated in equity under the heading of Revaluation Surplus to the extent of any credit balance existing in the respect of that asset (AASB 116.40).

A decrease in the provision for make good (similar to a revaluation increase of the related asset) is taken to the asset revaluation surplus unless the decrease reverses a previous revaluation decrease of the related asset that was previously recognised in the Operating Statement (Interpretation 1.6(a)(i)). However, if the decreases in the provision exceeds the amount that the asset would have been carried under the cost model (i.e. its depreciated cost), the excess is recognised in the Operating Statement (Interpretation 1.6(b)). This means that the maximum an asset can be reduced is the same under the cost model and the revaluation model.

As with the cost model, changes in the provision may be an indication that the asset (both the related asset and make good asset) may need to be revalued to ensure its carrying amount does not differ materially from its fair value at the reporting date (Interpretation 1.6c).

Consistent with the revaluation model requirements, not-for-profit entities shall account for increases and decreases the provision for make good in relation to the class of asset and are permitted to offset these changes within the class (Interpretation 1.Aus6.1).

2.4.6 Derecognising provisions

The adjusted depreciable amount of the asset is depreciated over its useful life (under both the cost and revaluation method). Where the related asset is at the end of its useful life, all subsequent changes are recognised in profit and loss (Interpretation 1.7).

2.4.7 Preparing the journals

The following journals illustrate the recognition of the unwinding of the discount and changes to the provision resulting from other changes. Figures are sourced from the example provided in paragraph 2.4.

DR Borrowing Costs	1,935	
CR Provision for Make Good		1,935
To recognise the unwinding of the discount		

Where the other changes are considered material, the following journal is required for leasehold improvements measured at cost:

DR Leasehold Improvements	3,425	
CR Provision for Make Good		3,425

To recognise the adjusted provision based on up-to-date best estimates.

Where the other changes are considered material, the following journal is required for leasehold improvements measured at fair value.

Where there is no current revaluation surplus for leasehold improvements:

DR Leasehold Improvements Expense / Make Good Expense	3,425	
CR Provision for Make Good		3,425
To recognise the increase in make good provision.		

Where there is a current revaluation surplus for leasehold improvements:

DR Revaluation Surplus	3,425	
CR Provision for Make Good		3,425
To recognise the increase in make good provision.		

2.5 Disclosure requirements

Disclosure requirements (as required by most agencies) for provisions for make good are detailed in the ACT Model Financial Statements (Model). Please refer to the current year's Model for appropriate disclosure requirements. In the event that an agency's situation differs from that of 'Example Agency' in the Model, agencies are required to adequately determine the appropriate disclosure by referencing the Australian Accounting Standards.

Attachment A: Illustrative Examples

The following illustrative examples provide practical application of the accounting for the provision of make good:

- Illustrative example 1: *Recognition of provision to make good a building at the end of an operating lease.*
- Illustrative example 2: *Recognising an increase in make good provisions in the Operating Statement.*
- Illustrative example 3: *Recognising an increase in make good provisions in the asset revaluation surplus.*

While these examples illustrate changes in a make good provision resulting from a revision in the estimated amount required to settle the obligation, the same accounting requirements would be applied if the change in the provision was the result of a revision to the discount rate.

In addition, although the examples illustrate changes in a provision where the related asset is measured using the revaluation model, the same accounting requirements would be applied under the cost method except that changes in the provision would be added to or deducted from the carrying amount of the related asset, rather than recognised in the asset revaluation surplus or in the Operating Statement.

Illustrative example 1 – Recognition of provision to make good a building at the end of an operating lease

Information:

An entity enters into an operating lease for an office block on 1 July 20X0 for a period of 7 years and makes $200,000 worth of leasehold improvements. The contract specifies that the entity must make good the premises at the end of the lease term.

Depreciation: The agency depreciates PPE on a straight-line basis

Discount rate: The Government bond rate for a 5 year bond is 4.71% and for a 10 year bond it is 5.10%

A rate for 7 years is approximated as follows:
(4.71+5.1)/2 = 4.91%

Inflation: CPI is 2.1% at 1 July 20X0

Recognition:

In accordance with AASB 116.16(c) the cost of the asset, being the leasehold improvements of $200,000, will include an estimate of the cost of making good the premises at the end of the lease.

The entity estimates that at 1 July 20X0 it would cost approximately $40,000 to return the building to its original condition. To determine the expenditure required at the end of the lease (30 June 20X7), the entity projects the current value using an inflationary measure (such as CPI or building index) of 2.1%.

$$\text{Future Outlay} = \text{Present Value x } (1 + \text{inflation rate})^{\text{Years}}$$
$$\text{Future Outlay} = \$40{,}000 \text{ x } (1 + 0.021)^{7}$$
$$= \$46{,}264$$

The agency considers the time value of money in this instance is material (i.e. $46,264 - $33,077 = $13,187), therefore the provision will be discounted to its present value. In the event that the agency didn't consider the time value of money as being material, they could record the whole provision in the first instance.

1 July 20X0 – Recognition of Asset/Provision	**Debit**	**Credit**
DR Leasehold Improvements CR Provision for Make Good CR Cash (or Accounts Payable) $\$46{,}264 / (1.0491)^7 = \$33{,}077$	233,077	 33,077 200,000

30 June 20X1 – Unwinding of Discount		
DR Borrowing Cost CR Provision for Make Good $\$46{,}264 / (1.0491)^6 - \$46{,}264 / (1.0491)^7 = \$1{,}624$	1,624	 1,624

30 June 20X2 – Unwinding of Discount		
DR Borrowing Cost CR Provision for Make Good $\$46{,}264 / (1.0491)^5 - \$46{,}264 / (1.0491)^6 = \$1{,}704$	1,704	 1,704

30 June 20X3 – Unwinding of Discount		
DR Borrowing Cost CR Provision for Make Good $\$46{,}264 / (1.0491)^4 - \$46{,}264 / (1.0491)^5 = \$1{,}787$	1,787	 1,787

30 June 20X4 – Unwinding of Discount		
DR Borrowing Cost CR Provision for Make Good $\$46{,}264 / (1.0491)^3 - \$46{,}264 / (1.0491)^4 = \$1{,}876$	1,876	 1,876

30 June 20X5 – Unwinding of Discount		
DR Borrowing Cost CR Provision for Make Good $\$46,264 / (1.0491)^2 - \$46,264 / (1.0491)^3 = \$1,967$	1,967	 1,967

30 June 20X6 – Unwinding of Discount		
DR Borrowing Cost CR Provision for Make Good $\$46,264 / (1.0491)^1 - \$46,264 / (1.0491)^2 = \$2,064$	2,064	 2,064

30 June 20X7 – Unwinding of Discount		
DR Borrowing Cost CR Provision for Make Good $\$46,264 / (1.0491)^0 - \$46,264 / (1.0491)^1 = \$2,165$	2,165	 2,165

<u>Provision less than actual outlay</u>

At 1 July 20X7 the actual cost to make good the premises was $50,000. As the provision as at 30 June 20X7 was less than this amount, the following journal would be required:

01 July 20X7 – Derecognise provision		
DR Provision for Make Good DR Make Good Expense CR Cash (or Accounts Payable) To derecognise provision as premises is made good	46,264 3,736	 50,000

<u>Provision greater than actual outlay</u>

At 1 July 20X7 the actual cost to make good the premises was $43,000. As the provision as at 30 June 20X7 was greater than this amount, the following journal would be required:

01 July 20X7 – Derecognise provision		
DR Provision for Make Good CR Make Good Expenses (or Other Revenue) CR Cash (or Accounts Payable) To derecognise provision as premises is made good	46,264	 3,264 43,000

Illustrative example 2 – Recognising an increase in make good provisions in the Operating Statement

Information:

An entity enters into an operating lease on 1 July 2004 for a period of 20 years (i.e. until 1 July 2024). The entity makes $500,000 of leasehold improvements. The expected cost to make good the premises at the end of the lease is $100,000. A discount rate of 10% applies.

On 1 July 2008 the entity makes changes to the building, creating a number of new offices/meeting rooms, which leads to an increase of $70,000 in the expected cost to make good the premises, as the entity will now need to remove the internal structures upon vacating the premises.

As the entity uses the value of PPE for management decisions, the entity measures PPE under the revaluation model and no credit balance exists in the asset revaluation surplus in respect to leasehold improvements.

Recognition:

At 1 July 2004 the entity recognises a provision for make good of:

$$\$100,000 / (1.10)^{20} = \$14,864.$$

1 July 2004 – Recognition of Asset/Provision	**Debit**	**Credit**
DR Leasehold Improvements CR Provision for Make Good CR Cash (or Accounts Payable) $\$500,000 / (1.10)^5 = \$31,046$	514,864	 14,864 500,000

Unwinding of Discount	**30/06/05**	**30/06/06**	**30/06/07**	**30/06/08**
DR Interest Expense CR Provision for restoration	1,487 1,487	1,635 1,635	1,798 1,798	1,979 1,979
Total Provision	16,351	17,986	19,784	21,763

See Illustrative example 1 for an example of the calculation required for the periodic unwinding of the discount i.e. the 30/06/05 calculation is [$\$100,000 / (1.10)^{19}$] – [$\$100,000 / (1.10)^{20}$] = 1,487.

At 1 July 2008 the entity must increase the provision to reflect the increase of $70,000 in expected cost to make good the premises. As the balance of the provision at 30 June 2008 is $21,763, the entity must recognise the difference, that being:

$$[\$170,000 / (1.10)^{16}] - \$21,763 = \$15,234$$

As Interpretation 1.6(a)(ii) outlines, an increase in the liability shall be recognised in the Operating Statement, except where any credit balance exists in the revaluation surplus in respect of that asset. Therefore, as no revaluations exist for the leasehold improvements, the entity must recognise the increase in the provision in the Operating Statement.

1 July 2008	Debit	Credit
DR Make Good Expenses CR Provision for Make Good *To recognise the increase in the provision in the Operating Statement*	15,234	 15,234

The entity would be required in accordance with Interpretation 1.8 and as illustrated in example 1, to recognise the unwinding of the discount in profit or loss as a borrowing cost as it occurs. The periodic unwinding of the discount will now be recognised in respect of the increased amount ($170,000). For example:

Unwinding of Discount	30/06/09	30/06/10	30/06/11	30/06/12
DR Borrowing Cost	3,700	4,069	4,477	4,924
CR Provision for restoration	3,700	4,069	4,477	4,924
Total Provision	40,697	44,766	49,243	54,167

See Illustrative example 1 for details of the calculation required for the periodic unwinding of the discount. I.e. the 30/06/09 calculation is [$\$170,000 / (1.10)^{15}$] – [$\$170,000 / (1.10)^{16}$] = *$3,700*

A change in the provision may be an indication that the asset (leasehold improvements and the make good asset) may need to be revalued.

When conducting a regular revaluation, entities must comply with the requirements of AASB 116. In conducting regular revaluations entities must determine whether the carrying amount of the asset is materially different from its fair value at reporting date. Where the asset is revalued this will require changes in the provision for make good and valuers should be requested to address this issue.

Illustrative example 3 – Recognising an increase in make good provisions in the asset revaluation surplus

Information:

Assume the same information as illustrative example 2, except that there is a credit balance of $5,234 existing in the asset revaluation surplus at 1 July 2008 in respect of the leasehold improvements.

Recognition:

In accordance with Interpretation 1.6(a)(ii), to the extent of any credit balance that exists in the asset revaluation surplus in respect of the leasehold improvements, the entity would be required to recognise the increase in liability in the asset revaluation surplus. As a balance of $5,234 exists in respect of leasehold improvements, the entity will be required to reduce this balance. The remaining balance will be recognised in the Operating Statement as a make good expense.

1 July 2008	**Debit**	**Credit**
DR Asset Revaluation Surplus DR Make Good Expense CR Provision for Make Good *To recognise the increase in the provision in the Operating Statement*	5,234 10,000	 15,234

Attachment B: Checklists

Taking up the Provision for Make Good at Lease Start

Action	Completed
Determine whether there is an obligation to make good leased premises upon cessation of the lease. • Refer to lease agreement and/or memorandum of understanding.	
Source a current valuation of the cost of dismantling and restoring the leased premises (in current prices). • This could be a block quote, or a quote per square metre.	
Apply a current CPI rate to this current cost to determine total future cost • The CPI can be sourced from the Australian Bureau of Statistics (ABS). • Refer to Attachment A Illustrative example 1 to see how this is applied.	
Source the current Government bond rate, matching the lease duration and apply that to the future outlay, to arrive at the present value of the lease as at commencement of lease. • The Government bond rate can be sourced from the Reserve Bank of Australia (RBA) • Refer to Attachment A Illustrative example 1 to see how this is applied.	
Assess whether these two figures, i.e. the future outlay and the present (discounted) value are material.	
If material, capitalise the present value (as leasehold improvements within the agencies assets) and recognise the provision. • Prepare asset addition forms (including the present value amount of the provision for make good)	
If immaterial, capitalise the future outlay (as leasehold improvements within the agencies assets) and recognise the provision. • Prepare asset addition forms (including the future outlay amount of the provision for make good)	

Reporting and measuring the provision at the end of the reporting period

Action	Completed
No changes in provision	
Where the provision was previously discounted, the winding back of the discount must occur. • Refer to Attachment A Illustrative example 1 to see how this is applied. • This figure is recognised in the Operating Statement, and can't be capitalised.	
Changes to the provision resulting from, revaluations, change in discount rate, change in CPI	
Change value of the provision, dependent on whether leasehold improvements are valued at cost or at fair value. Refer to paragraphs 2.4.4 and 2.4.5 respectively.	