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IFRS Developments

Lease term and useful life of leasehold improvements

What you need to know

- The IFRS Interpretations Committee recently discussed the determination of the lease term for cancellable or renewable leases and the useful life of non-removable leasehold improvements.
- A lease contract is not enforceable if the lease and the lessor each have the right to terminate the lease without permission from the other party with no more than an insignficant penalty.
- The term 'penalty' is broadly interpreted to include the broader economics, not just contractual termination payments.
- An entity applies IAS 16 in determining the useful life of non-removable leasehold improvements.

Highlights

During 2019, the IFRS Interpretations Committee (the Committee) discussed a question about how to determine the lease term for cancellable or renewable leases. Entities may enter into cancellable or renewable leases that do not specify a particular term, but which continue indefinitely until one party gives notice to terminate. For example, an entity may enter into a contract that includes an initial non-cancellable period of two years and continues monthly until either party provides notification to terminate the lease. The request asked how the lease term should be determined and whether the useful life of any related non-removable leasehold improvements is limited to the lease term determined applying IFRS 16 *Leases*.

Determining the lease term will depend on both the termination penalties in the contract and the broader economics of the contract.

An entity applies IAS 16 *Property, Plant and Equipment* in determining the useful life of non-removable leasehold improvements. An entity may often conclude that it will use and benefit from leasehold improvements only for as long as it uses the underlying leased asset.

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Background

The non-cancellable period of a lease is any period during which the lessee and the lessor are unable to terminate the contract with no more than an insignificant penalty. This is therefore the minimum lease term.

IFRS 16 *Leases* defines the lease term as:

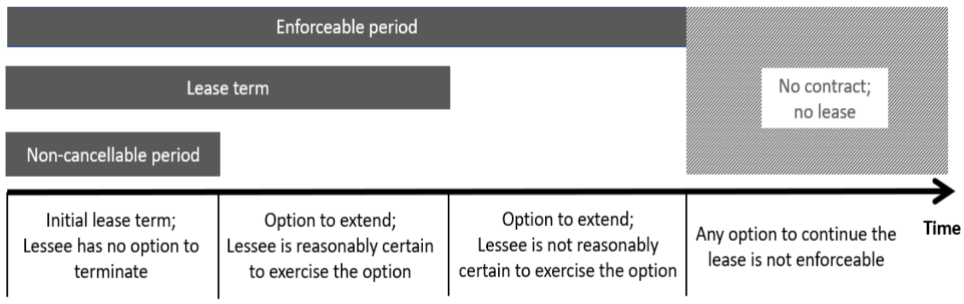
The non-cancellable period for which a lessee has the right to use an underlying asset, together with both:

a) Periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option; and

b) Periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option.

The enforceable period of a lease is the period for which enforceable rights and obligations exist between the lessee and the lessor and it is determined in accordance with paragraph B34 of IFRS 16. A contract is no longer enforceable when the lessee and the lessor each have the right to terminate the lease without permission from the other party with no more than an insignificant penalty.[1] Therefore, the enforceable period is the maximum lease term. Note, that if the contract has a defined end date with no option to extend or terminate early, then the period up to the end date of the contract is the lease term.

To determine the lease term, an entity determines the non-cancellable period and the enforceable period. It then determines where the lease term falls, depending on the likelihood of exercising the options to extend or terminate using the reasonably certain threshold. This is shown in the diagram below, taken from the Committee's agenda paper.[2]



IFRS Interpretations Committee observations and conclusions

Lease term

The Committee was asked how to determine the lease term of a cancellable lease or a renewable lease. Specifically, when applying paragraph B34 of IFRS 16's guidance on penalties, the Committee considered whether an entity is required to consider the broader economics of the contract and not only the contractual termination payments. Such a broader consideration might include the expected cost of abandoning or dismantling productive leasehold improvements.

The Committee noted that, in applying paragraph B34 and determining the enforceable period of the lease, an entity considers:

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[1] Paragraph B34 of IFRS 16.
[2] IFRS Interpretations Committee agenda paper 4, 26 November 2019.

- The broader economics and not only the contractual termination payments. For example, if either party has an economic incentive not to terminate the lease such that it would incur a penalty on termination that is more than insignificant, the contract is enforceable beyond the date on which the contract can be terminated

- Whether each of the parties has the right to terminate the lease without permission of the other party with no more than an insignificant penalty. Applying paragraph B34, a lease is no longer enforceable only when both parties have such a right. Consequently, if only one party has the right to terminate the lease without permission from the other party with no more than an insignificant penalty, the contract is enforceable beyond the date on which the contract can be terminated by that party

If an entity concludes that the contract is enforceable beyond the notice period of a cancellable lease, it applies paragraphs 19 and B37-B40 of IFRS 16 to assess whether the lessee is reasonably certain not to exercise the option to terminate the lease.

Useful life of non-removable leasehold improvements

An entity applies IAS 16 in determining the useful life of non-removable leasehold improvements. If the lease term of the related lease is shorter than the economic life of those leasehold improvements, the entity considers whether it expects to use the leasehold improvements beyond that lease term. If the entity does not expect to do so, then, applying IAS 16, it concludes that the useful life of the non-removable leasehold improvements is the same as the lease term.

Interaction between the determination of the useful life of non-removable leasehold improvements and lease term

In assessing whether a lessee is reasonably certain to extend a lease, paragraph B37 of IFRS 16 requires an entity to consider all relevant facts and circumstances that create an economic incentive for the lessee. In addition, an entity considers the economics of the contract when determining the enforceable period of a lease. This includes the costs of abandoning or dismantling non-removable leasehold improvements. If an entity expects to use non-removable leasehold improvements beyond the date on which the contract can be terminated, the existence of those leasehold improvements indicates that the entity might incur a more than insignificant penalty if it terminates the lease. Therefore, applying paragraph B34 of IFRS 16, an entity would consider whether the contract is enforceable for at least the period of expected utility of the leasehold improvements.

Conclusions

The Committee concluded that the principles and requirements in IFRS 16 provide an adequate basis for an entity to determine the lease term of cancellable and renewable leases and those in IAS 16 and IFRS 16 provide an adequate basis for an entity to determine the useful life of any non-removable leasehold improvements relating to such a lease. Therefore, the Committee decided not to add these items to its agenda.

Due Process Oversight Committee

Following the IFRS Interpretations Committee meeting in November 2019, the Due Process Oversight Committee (DPOC) received two letters from constituents expressing concerns about the due process relating to this Interpretations Committee agenda decision. This was discussed by the DPOC at a meeting on 16 December 2019. The DPOC concluded that due process had been followed. The DPOC will also consider an amendment to the Due Process Handbook in the future that would ask the Board to confirm that Board members do not object to the publication of an IFRS IC agenda decision.

Example on lease term

A lease has an initial non-cancellable period of two years. Neither the lessee nor the lessor can cancel the contract before the end of the second year. At the end of the second year, the contract automatically extends on a month-to-month basis for up to a further three years, unless either the lessor or the lessee exercises its unilateral right to terminate the contract. That is, after the second year, both the lessee and lessor have a right to terminate the lease without permission from the other party.

Further, assume the following at the lease commencement date:

- The terms and conditions for the lease (e.g., lease payments) for the monthly periods in years three through five are included in the contract.
- The lessor would not suffer a more than insignificant penalty, including any economic disincentives, if it terminated the contract at any time after the initial two years.
- Due to the unique purpose and location of the leased asset and the significance of the lessee's leasehold improvements, the lessee would suffer a more than insignificant economic disincentive if it were to exercise its termination rights before the end of the third year. The lessee also concludes it is reasonably certain not to terminate the lease before the end of the third year.

Analysis

The initial two-year non-cancellable period meets the definition of a contract. The first twelve monthly periods in year three are also included in the contract's enforceable period because the lessee would suffer a more than insignificant economic disincentive if it were to terminate the lease before the end of the third year. Additionally, because both the lessee and the lessor have the right to terminate the contract without permission from the other party and without a more than an insignificant penalty after the third year, the agreement does not create enforceable rights and obligations beyond the three-year period. Therefore, it would no longer meet the definition of a contract. In this scenario, the lease term is three years because the lessee concludes it is reasonably certain not to terminate the lease during the third year.

The evaluation of whether a lessee is reasonably certain not to terminate a contract considers all facts and circumstances, including any more than insignificant penalty the lessee would incur at each termination date. The more significant the penalty the lessee would incur, the greater the likelihood that the lessee would be reasonably certain not to terminate the contract.

Next steps

Entities that have entered into cancellable or renewable leases that do not specify a particular term, but which continue indefinitely until one party gives notice to terminate, may consider evaluating their current accounting policies and determine if any changes in accounting policies are required. The implementation of this agenda decision may require significant judgement.

Agenda decisions issued by the Committee do not have an application date. There has been some recent discussion about what an appropriate time period is for an entity to implement an agenda decision. The March 2019 *IFRIC Update* noted that 'the process for publishing an agenda decision might often result in explanatory material that provides new information that was not otherwise available and could not otherwise reasonably have been expected to be obtained'. Because of this, an entity might determine that it needs to change an accounting policy as a result of an agenda decision. The IASB expects that an entity would be entitled to sufficient time to make that determination and implement any change (for example, an entity may need to obtain new information or adapt its systems to implement a change)'. Sufficient time is entity specific and depends on the relevant facts and circumstances, but agenda decisions are expected to be implemented as soon and as quickly as possible. The IASB expects this to be months rather than years.

Entities may need to explain their implementation process and, if material, consideration should be given as to whether disclosure related to the accounting policy change is required, taking into account regulatory requirements.

EYG No. 005864-19Gbl

ED None