

Insights into IFRS 16

Lease term

Under IFRS 16 'Leases', determining the correct lease term is significant for a number of reasons. Firstly, the longer the lease term, the larger the lessee's right-of-use asset and lease liability will be. Secondly, the length of the lease term determines whether a lease qualifies for the short-term lease exemption. Finally, IFRS 16 contains additional application guidance on how to deal with periods covered by options to extend or terminate a lease. While this detailed guidance can be helpful, determining the lease term is not an easy task to undertake and we set out below what factors should be taken into consideration.

In our view, ascertaining the correct lease term is one of the most challenging issues in properly applying IFRS 16 because it does require a significant level of judgement.

'Lease term' is defined as the non-cancellable period for which a lessee has the right to use an underlying asset (including any periods covered by a lessor's termination option), plus:

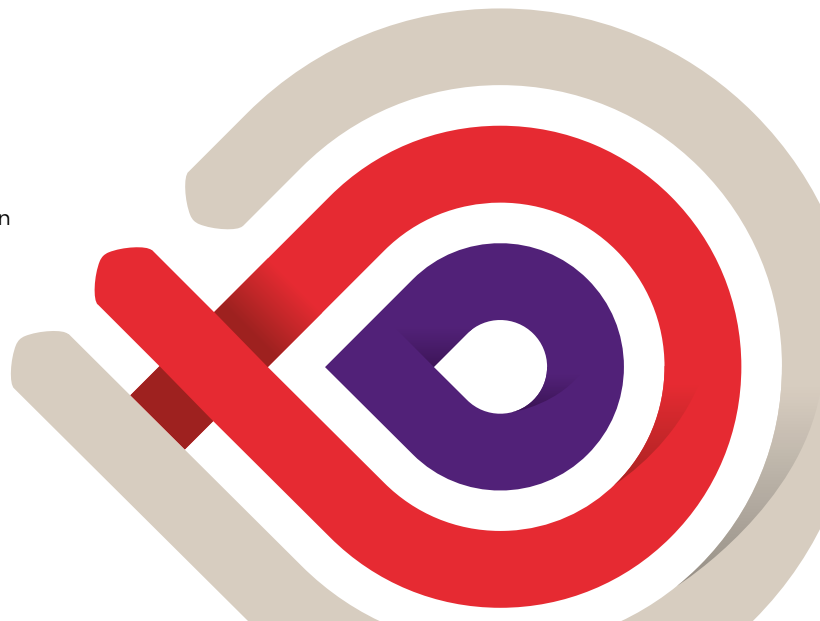
- periods covered by a lessee's extension option if extension is reasonably certain, and
- periods covered by a lessee's termination option if the lessee is reasonably certain not to terminate.

While the concept of 'reasonably certain' did not change when IFRS 16 was implemented, this is considered a fairly high hurdle and the application of this concept in practice requires consideration of all the facts and circumstances that create a significant economic incentive for a lessee to extend the lease (where a lessee has an extension option) or not to terminate a lease (where the lessee has a termination option). This is ultimately a judgement call that needs to take into consideration facts and circumstances specific to the asset being leased, the entity and the wider market. As these factors are wide ranging, we expect this will always be a challenging area in practice.

Purchase options need to be assessed in the same way as options to extend or terminate a lease. The International Accounting Standards Board (IASB) believes that a purchase option is economically similar to an option to extend the lease term for the remaining economic life of the underlying asset.

Enforceability

IFRS 16 defines a contract as an agreement between two or more parties that creates enforceable rights and obligations. In determining the lease term and assessing the length of the non-cancellable period of a lease, an entity needs to apply the definition of a contract and determine the period for which the contract is enforceable. A lease is no longer enforceable when both 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.



Initial assessment of the lease term

Entities are required to assess a lease's term at the lease 'commencement date' which is the date on which a lessor makes an underlying asset available for use by a lessee. It is important to contrast the lease commencement date with the lease 'inception date', which is the earlier of the date of a lease agreement and the date of commitment by both parties to the terms and conditions of the lease. A lease term begins at the commencement date and includes any rent-free periods provided to the lessee by the lessor.

When assessing whether a lessee is reasonably certain to exercise an option to extend the lease or to purchase the underlying asset, or not exercise an option to terminate the lease, the lessee considers all relevant facts and circumstances (both monetary and non-monetary) that create an economic incentive for the lessee to exercise or not exercise that option. It should include any expected changes in facts and circumstances from the commencement date until the exercise date of the option.

Examples of facts and circumstances that may create an economic incentive to exercise or not exercise an option

Contractual terms and conditions compared with market rates	<p>Whether contractual terms and conditions for the optional periods compare favourably with market rates, for example:</p> <ul style="list-style-type: none"> • the amount of lease payments in any optional period • the amount of any variable lease payments for the lease or other contingent payments (eg. termination penalties or residual value guarantees) • the terms and conditions of any options that are exercisable after initial optional periods (eg. a purchase option that is exercisable at the end of an extension period at a rate that is currently below market rates).
Significant leasehold improvements	<p>Significant leasehold improvements undertaken (or expected to be undertaken) over the term of the lease that are expected to have significant economic benefit for the lessee when the option becomes exercisable.</p>
Termination costs	<p>Costs relating to the termination of the lease, such as negotiation costs, relocation costs, costs of identifying another suitable asset, costs of integrating a new asset into the lessee's operations, or termination penalties and similar costs, including costs associated with returning the underlying asset in a contractually specified condition/ or location.</p>
Importance of the asset to the lessee	<p>The importance of the leased asset to the lessee's operations, considering, for example, its location, whether the underlying asset is specialised in nature, and whether suitable alternatives are available to the lessee. An entity that leases a specialised facility may have a significant economic incentive to exercise a purchase or renewal option if a suitable alternative facility is not readily available.</p>
Conditions for exercising the option	<p>Whether certain conditions must be met before the option can be exercised, together with an assessment of the likelihood that those conditions will exist.</p>
Relationship between options and other contractual features	<p>An entity assumes the lessee is reasonably certain to exercise an option to extend (or not to exercise an option to terminate) when the option has been combined with one or more other contractual features (eg. a residual value guarantee) to guarantee the lessor a minimum or fixed cash return that is substantially the same regardless of whether the option is exercised.</p>
Length of the non-cancellable period	<p>A lessee is more likely to exercise an option to extend the lease (or not to exercise an option to terminate the lease) when the non-cancellable period of a lease is shorter. This is because of the costs associated with obtaining a replacement asset are likely to be proportionately higher the shorter the non-cancellable period. A relatively short lease of a significant underlying asset may create a substantial economic incentive for the lessee to exercise a renewal or purchase option.</p>
Lessee's past practice	<p>An awareness of the period of time over which a lessee has used particular types of assets in the past (whether leased or owned), and its economic reasons for doing so, may provide insight as to whether the lessee is reasonably certain to exercise (or not exercise), an option.</p>

Example 1 – Early termination option held by lessor

XYZ Ltd, the lessee, enters into a contract to lease a floor of a building for ten years. The lessor, ABC Ltd has the option to terminate the lease after seven years.

Analysis

A lessor's right to terminate a lease is ignored in the calculation of the lease term. This is because the lessee has an unconditional obligation to pay for the right to use the asset for the period of the lease, unless and until the lessor decides to terminate the lease. In this case, XYZ is obligated to make payments for ten years unless ABC Ltd chooses to terminate early. In other words, the lessor can enforce the contract for the full ten-year period. Accordingly, the lease term in this case is ten years.

Example 2 – Long term lease with option to terminate every 12 months

Custom Trains Ltd (CTL) enters into a five-year lease with Locomotive Machinery Ltd (LML) for a machine that will form part of CTL's production process. The cost to install the machine in CTL's manufacturing facility is insignificant. CTL and LML each have the right to terminate the lease without a penalty on each anniversary of the lease commencement date.

CTL is currently in final stages of introducing its state-of-the-art next generation trains and the production of this new model requires substantial changes to its manufacturing process. This means the specific machinery leased from LML will be of no use to CTL once production commences for its next generation of trains.

Analysis

In this case, the lease term is the one-year non-cancellable period because both CTL and LML have a substantive termination right. Both parties can terminate the lease without penalty and the cost to install a new machine in CTL's manufacturing facility is insignificant. Accordingly, CTL will be eligible to elect the short-term lease exemption for this lease arrangement under which a right-of-use asset and lease liability are not recognised.

Cancellable and renewable leases

As noted above, IFRS 16 (in paragraph B34) states that a lease is no longer enforceable when both 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. If only a lessee has the right to terminate a lease, that right is considered to be an option to terminate the lease available to the lessee that an entity considers when determining the lease term. If only a lessor has the right to terminate a lease, the non-cancellable period of the lease includes the period covered by the option to terminate the lease.

When interpreting the term 'penalty', when applying the previous lease accounting standard there had been some diversity of views as to whether it needs to be interpreted narrowly (only contractual penalties) or more broadly (both contractual penalties and economic disincentives). IFRS 16 requires an entity to consider all relevant facts and circumstances that create an economic incentive for the lessee to exercise (or not) the option, as noted above, which leads to a broad interpretation.

In November 2019, the IFRS Interpretations Committee (IFRIC) finalised an agenda decision titled 'Lease term and useful life of leasehold improvements (IFRS 16 and IAS 16)'. This related to a submission to IFRIC that asked two questions:

- How does an entity determine the lease term of a cancellable lease or a renewable lease? Specifically, when applying paragraph B34 of IFRS 16 and assessing 'no more than an insignificant penalty' whether an entity considers the broader economics of the contract and not only contractual termination payments, and
- Is the useful life of any related non-removable leasehold improvements limited solely to the lease term determined by applying IFRS 16?

A 'cancellable lease' is one that does not include a specific contractual period but continues indefinitely until either party to the contract gives notice to terminate. A 'renewable lease' is one that includes a specific initial period and renews indefinitely at the end of the initial period until either party to the contract gives notice to terminate. Both cancellable and renewable leases have the effect that they continue for an indefinite period of time after the initial non-cancellable period until either the lessee or lessor terminates the lease.

The IFRIC observed that in applying paragraph B34 and determining the enforceable period of the lease, an entity needs to consider:

- the wider economics of the contract, and not only termination payments as stated in the contract. For example, if either party has an economic incentive not to terminate the lease such that it would incur an economic penalty on termination that is not insignificant, the contract is enforceable past the date that the contract can be terminated, and
- whether each of the parties has the right to terminate the lease without permission from the other party with no more than an insignificant penalty. Only when both parties have such a right, the lease is no longer enforceable. Consequently, if only one party has this right the contract is enforceable past the date that 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 (or the initial period of a renewable lease), it must then apply IFRS 16.19 and the application guidance in B37-B40 to assess whether the lessee is reasonably certain not to exercise a termination option.

IFRIC's decision that broader economic penalties should be considered in determining the 'enforceable period' of a lease may have quite broad implications for entities applying IFRS 16.

The IFRIC noted that in assessing whether a lessee is reasonably certain to extend (or not to terminate) a lease, IFRS 16.B37 requires an entity to consider all relevant facts and circumstances that give the lessee an economic incentive. This includes major leasehold improvements carried out (or expected to be carried out) over the contract term that are expected to have high economic benefit for the lessee when extension or termination options become exercisable.

Application in specific circumstances

The application of IFRS 16 to 'cancellable' and 'renewable' leases also applies to lease contracts that may be referred to using various terms, including 'month-to-month', 'holdover', 'rolling', 'perpetual' or 'evergreen', if the presences of these create enforceable rights and obligations. The nature of such leases is that there is generally no fixed lease term and the contract continues until one party gives notice to terminate it after a usually short notice period.

If both the lessee and lessor can terminate the contract without more than an insignificant penalty at any time after the end of any non-cancellable term, then there are no enforceable rights and obligations beyond that non-cancellable term, and therefore the lease term is limited to any non-cancellable term. However, if the broader economics indicate that either party would incur more than an insignificant penalty beyond any non-cancellable

term, then there are enforceable rights and obligations beyond that non-cancellable term, and the lease term continues for the period that more than an insignificant penalty applies.

In addition, an entity considers the wider economics of the contract when determining the enforceable period of the lease. This includes, for example, the costs of leaving or dismantling non-removable leasehold improvements. If an entity expects to use these leasehold improvements after the date when the contract can be terminated, the existence of those leasehold improvements indicates the entity may incur a more than insignificant penalty if it terminates the lease. Consequently, applying IFRS 16.B34, an entity considers whether the contract is enforceable for at least the period of expected usage of the leasehold improvements.

term, then there are enforceable rights and obligations beyond that non-cancellable term, and the lease term continues for the period that more than an insignificant penalty applies.

It is relatively common for related parties, including not-for-profit entities, to enter into arrangements where one entity permits another to use its land and buildings without any written agreement between the two. Such arrangements may involve the payment of 'peppercorn' rent or other below market amounts, or no consideration. There is usually no particular expected period for such arrangements, but both parties often expect these to continue for a substantial period. The lessee would normally have a significant economic incentive to continue the arrangement because other suitable premises are not available for similar consideration. The lessee needs to determine the appropriate lease term. In practice, this is likely to be for a long period, which may be the estimated useful life of the building.

Example 3 - Renewable lease

A contract to lease a floor of a building has an initial non-cancellable period of one year, with an extension for an additional year if both parties agree. There is no significant penalty for either party if they do not agree to extend for the additional year.

Analysis

The initial one-year non-cancellable period meets the definition of a contract because it creates enforceable rights and obligations. The one-year extension period does not meet the definition of a contract because both the lessor and lessee could individually elect to not extend the arrangement without a more than insignificant penalty. At lease commencement, neither party has enforceable rights and obligations beyond the initial non-cancellable period.

Example 4 – Renewable lease

A contract to lease a floor of a building has an initial non-cancellable period of five years, with an extension for an additional three years at market price if both parties agree. Before lease commencement, the lessee pays for non-movable leasehold improvements. The leasehold improvements are expected to have significant value after five years and a useful life of eight years.

Analysis

At lease commencement, the lessee determines that it is reasonably certain to use the extension because it would incur a significant economic penalty if it abandoned the leasehold improvements at the end of the initial non-cancellable period. At lease commencement, the lessee concludes that the lease term is eight years.

Example 5 – Cancellable lease

A contract for a school entity to lease land and buildings from a property trust exists between these two related parties. It has no specific term but continues on a year-to-year basis if both parties agree. The amount payable is substantially below market. The school entity could not afford to pay commercial rent elsewhere and there are no other suitable premises available in the area. The school entity expects to stay long-term.

Analysis

Theoretically, the lessor could ask the school entity to leave at any time on a year's notice. The school entity has a significant economic incentive to stay long-term.

The school entity therefore needs to assess the lease term. This is likely to be the useful life of the main buildings, allowing for expected repairs and maintenance.

The conclusion would likely be the same if there was no written agreement between the entities.

Reassessment of lease term

After the commencement of the lease, the lessee must reassess whether it is reasonably certain to exercise an extension option, or not exercise a termination option, if there is either a significant event or change in circumstances that:

- is within the lessee's control, and
- affects whether exercise (or non-exercise) is reasonably certain.

Examples of significant events or changes in circumstances that would trigger a reassessment of the lease term include:

- making major leasehold improvements not anticipated at the lease commencement date, that are expected to have significant economic benefit for the lessee when the option becomes exercisable
- making major changes to (or customising) the underlying asset that were not initially predicted
- establishing a sub-lease of the underlying asset which extends beyond the end of the lease term, or
- making a business decision that is directly relevant to exercising (or not) an option. For example, deciding to extend the lease of a complementary asset, to dispose of an alternative asset or to dispose of a business unit within which the right-of-use asset is employed.

The lease term is also revised if it is concluded there is a change to the non-cancellable period of a lease. For example, the non-cancellable period of a lease will change if:

- the lessee exercises an option which was not previously incorporated into the lease term
- the lessee does not exercise an option which was previously included in the lease term
- an event occurs resulting in a contractual obligation for the lessee to exercise an option not previously included in the lease term
- an event occurs that contractually prohibits the lessee from exercising an option previously included in the lease term.

To account for these any of these events the lessee:

- adjusts the lease liability by first:
 - a including the lease payments over the revised term, and
 - b applying a revised discount rate (the interest rate implicit in the lease for its remaining term if readily determinable, or the lessee's incremental borrowing rate at the date of reassessment if not), and then
- makes a corresponding adjustment to the right-of-use asset. However, if the carrying amount of the right-of-use asset is reduced to zero, the lessee should any put remaining amount in the profit or loss.

Example 6 – Reassessment of an extension option

A restaurant operator enters into a five-year lease of real estate on 1.1.20X1 (the commencement date). The annual rental is CU5,000 payable in advance. The contract contains an option for the operator to extend the lease for a further five years at an annual rental of CU6,000. At the commencement date, management concludes that exercise of the extension option is not reasonably certain. This takes account of all relevant facts and circumstances, including that:

- the site will be used for a new restaurant format that is not yet proven in the local market
- leasehold improvements are expected to be at the end of their useful economic lives by the end of year five; and
- the rentals during the extension period are not expected to be below market rates.

Accordingly, management concludes that the lease term is five years. On 1.1.X1 the operator recognises a right-of-use asset and lease liability using its incremental borrowing rate of 4% (having concluded that the interest rate implicit in the lease is not readily determinable):

1.1.20X1	Debit (CU)	Credit (CU)
Right-of-use asset	23,150	
Lease liability		18,150
Cash		5,000

The right-of-use asset will be depreciated on a straight-line basis over five years.

After three years, on 31.12.20X3, it is evident that the new restaurant brand has been unsuccessful. Management decides to make a significant investment in rebranding the site to another format that has been very successful. Management determines that this is a significant change of circumstances that makes exercise of the extension option reasonably certain. Accordingly, management reassesses the total lease term to be ten years, of which seven years remain. At the date of reassessment, the operator's incremental borrowing rate is 3% (the interest rate implicit in the lease for its remaining term is not readily determinable).

Analysis

As a result, the lease liability is re-measured at 31.12.20X3. The new liability is the present value of two payments of CU5,000 due on 1.1.X4 and 1.1.X5, plus five payments of CU6,000 due from 1.1.X6 to 1.1.X10, discounted at 3% (CU36,533). The lease liability at 31.12.20X3 before reassessment is CU9,808. The increase (CU26,725) is added to the lease liability and the right-of-use asset:

31.12.20X3	Before reassessment (CU)	Adjustment (CU)	After reassessment (CU)
Right-of-use asset	9,260	26,725	35,985
Lease liability	9,808	26,725	36,533

Subsequently, the revised right-of-use asset is depreciated over its revised useful life (eg straight-line over seven years). The revised lease liability is measured using the new effective interest rate of 3%.

Example 7 – lease term for intermittent period of use

A retailer has a ten-year lease to rent a shop for three months of each year from 1 October to 31 December to sell Christmas products.

Analysis

The lease term is considered to be the total time period for which the property is leased. The retailer has the right-to-use the shop for three months every year for ten years, so the lease term is 30 months.

Focus is placed on period the lessee has the right-to-use the asset rather than the contractual term. Another retailer could lease the shop for the other nine months of the year, so this period should not be included in the lease term.

Contact us

We hope you find the information in this article helpful in giving you some detail into aspects of IFRS 16. If you would like to discuss any of the points raised, please speak to your usual Grant Thornton contact or visit www.grantthornton.global/locations to find your local member firm.



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