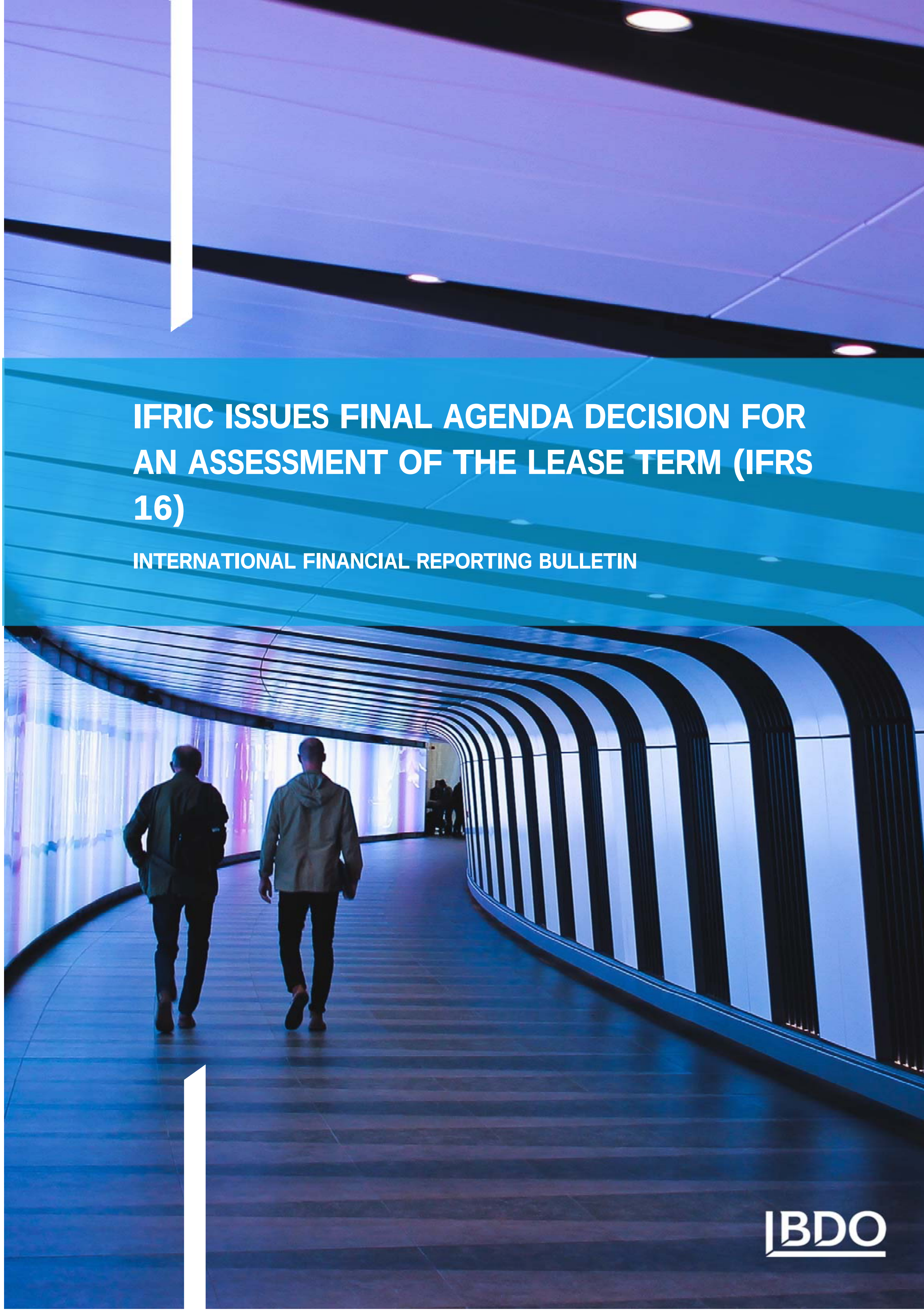
IFRIC ISSUES FINAL AGENDA DECISION FOR AN ASSESSMENT OF THE LEASE TERM (IFRS 16)

INTERNATIONAL FINANCIAL REPORTING BULLETIN



BACKGROUND

The questions submitted to the IFRS Interpretations Committee

IFRS 16 *Leases* was effective for annual reporting periods beginning on or after 1 January 2019. IFRS 16 results in most contracts that meet the definition of a lease being recorded on balance sheet for lessees (i.e. the recognition of a right-of-use asset and a lease liability). In measuring leases as a lessee, several areas of judgment are required, including the identification of leases, determining the lease term, and discounting lease payments using an appropriate discount rate.

At its 26 November 2019 meeting, the IFRS Interpretations Committee (the Committee) issued a final agenda decision on 'Lease term and useful life of leasehold improvements (IFRS 16 and IAS 16)'.

The submission to the Committee had asked two questions:

1. How to determine the lease term of a cancellable lease or a renewable lease. Specifically, the request asked whether, when applying IFRS 16.B34 and assessing 'no more than an insignificant penalty', an entity considers the broader economics of the contract, and not only contractual termination payments; and

2. Whether the useful life of any related non-removable leasehold improvements is limited to the lease term determined applying IFRS 16.

The focus of this Bulletin is question #1, as the Committee's conclusion that broader economic penalties must be considered in determining the 'enforceable period' of a lease may have broad implications for entities applying IFRS 16.

STATUS
Final

EFFECTIVE DATE
Immediate

ACCOUNTING IMPACT
Lessees must consider the broader economics of leases, including both contractual and economic penalties in determining the lease term and the enforceable period of a lease.

Effect of a Committee Agenda Decision

The Committee has the authority to interpret the requirements of existing IFRS standards. This includes, for example, how specific paragraphs should be interpreted based on questions submitted to the Committee. When the Committee analyses a submission, it must determine whether standard setting should be undertaken (e.g. issue an IFRS Interpretations (an 'IFRIC') or recommend other standard setting to the International Accounting Standards Board). To do this, the Committee considers whether the matter:

1. Is widespread/expected to have a material effect

2. Is necessary to change IFRS Standards

3. Can be resolved efficiently and is sufficiently narrow in scope

If any of these questions are determined to be 'no', then the Committee will issue an agenda decision. While an agenda decision is not an IFRS standard itself, it describes how IFRS should be applied, and they are typically viewed as having the same force and effect of IFRS standards themselves. Many regulators and enforcement entities worldwide view agenda decisions in this way and consider their application to be mandatory. BDO's global policy is that the analysis and conclusions set out in an agenda decision are required to be followed in order for an entity to assert compliance with IFRS.

DETERMINING THE LEASE TERM

The question: 'Cancellable' leases

The question submitted to the Committee related to cancellable or renewable leases. A cancellable lease is one that does not specify a particular contractual term, but continues indefinitely until either party to the contract gives notice to terminate. A renewable lease is one that specifies an initial period and renews indefinitely at the end of the initial period unless terminated by either of the parties to the contract. Such contracts may be referred to as 'month to month' leases.

The question asked how paragraph B34 of IFRS 16 should be applied to such contracts, and therefore, how the lease term should be determined. However, the Committee's conclusion is likely to have an impact that is applied more broadly to leases in general. In order to understand the nature of this question, the components that make up the lease term as defined in IFRS 16 must be understood.

Note that, although this publication focuses on the requirements primarily in the context of a lessee, they are equally applicable to lessors. The agenda decision could affect a lessor's assessment of whether a lease should be classified as a finance or operating lease and, for assets subject to operating leases, could affect the amortisation period for initial direct costs and the period over which a leased asset is depreciated.

Components of the Lease term

The lease term is defined in IFRS 16 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.*

In determining the lease term, IFRS 16.B34 includes the following requirements (emphasis added):

> *In determining the lease term and assessing the length of the non-cancellable period of a lease, an entity shall apply the definition of a contract and determine the period for which the contract is enforceable. A lease is* ***no longer enforceable when the lessee and the lessor each has the right to terminate the lease*** *without permission from the other party with* ***no more than an insignificant penalty.***

Therefore, IFRS 16 establishes three distinct time periods in a lease, which are the:

(1) Non-cancellable period: the period over which the lessee has no ability to terminate the lease contract. The non-cancellable period establishes the minimum in determining the lease term.

(2) Enforceable period: the period over which enforceable rights and obligations exist between the lessee and the lessor, as noted in B34 of IFRS 16. The enforceable period establishes a maximum in determining the lease term.

(3) Lease term: a period of time within the boundaries of the non-cancellable period and the enforceable period, which considers any optional periods that the lessee is reasonably certain to use.

In some leases, determining items (1) – (3) may be simple, and in some cases, all three might be identical. However, in many cases the analysis may not be straightforward.

<u>Example #1</u>

A lessee enters into a lease with a non-cancellable period of 5 years. The lease contains no options (contractual or implicit) to extend or terminate the lease and contains no penalties, contractual or otherwise (e.g. economic incentives or disincentives). In this case, the non-cancellable period, the enforceable period and the lease term are all 5 years.

The determination of these items may be more complex in some cases, which is illustrated through subsequent examples in this publication.

What does 'penalty' mean in the context of IFRS 16.B34?

As noted earlier, IFRS 16.B34 provides requirements to be applied when determining the point at which the enforceable period of a lease ends. The enforceable period of a lease ceases once 'the lessee and the lessor each has the right to terminate the lease without permission from the other party with no more than an insignificant penalty.' This means that both the lessor and the lessee have to satisfy this condition.

Therefore, in determining the enforceable period (i.e. the maximum lease term), an entity considers whether both it and the lessor has a right to terminate the lease without permission from the other party and, if so, whether that termination would result in more than an insignificant penalty. If a more than insignificant penalty exists, then the enforceable period extends until the point at which a no more than an insignificant penalty exists.

<u>Example #2</u>

A lessee enters into a lease with a 3 year non-cancellable period with two extension options. The first option would extend the lease for a further 2 years, and the second option would extend the lease by another 4 years. The non-cancellable period (i.e. minimum lease term), enforceable period (i.e. maximum lease term), and the lease term can be represented as follows:

<table>
<tr><td colspan="3">Enforceable period (3 + 2 + 4 = 9 years)</td><td rowspan="4">No enforceable rights and obligations exist; no contract</td></tr>
<tr><td colspan="2">Lease term (3 + 2 = 5 years)</td><td></td></tr>
<tr><td>Non-cancellable period (3 years)</td><td colspan="2"></td></tr>
<tr><td>In the first 3 years, no option exists to terminate the lease</td><td>First option to extend is assessed as being reasonably certain to be exercised</td><td>Second option to extend is <u>not</u> assessed as being reasonably certain to be exercised</td></tr>
</table>

The minimum lease term is the period over which the entity is unable to terminate the lease, and the enforceable period is the maximum, which includes both extension options. The enforceable period includes both extension options because this is the period over which the lessee has enforceable rights and obligations, regardless of the assessment of whether it is reasonably certain to exercise the options.

The lease term only includes the first option, because management of the lessee performs an analysis of all relevant facts and circumstances in accordance with IFRS 16.B37 and determines that it is reasonably certain to exercise the first option, but not the second. Determining the enforceable period is more challenging when the rights and obligations are less discrete and defined, as illustrated in Example #3.

<u>Example #3</u>

A lessee enters into a lease for retail space with a 5 year non-cancellable period. At the end of the non-cancellable period, the lease converts into a 'month-by-month' lease, whereas the lessee and the lessor may each terminate the lease with 1 month's notice with no contractual penalty owing. During this 'month-to-month' period, the lease payments are based on the last month's lease payment from the end of the non-cancellable period, indexed for inflation.

In this case, the non-cancellable period is 5 years, but the lease term and the enforceable period are less clear. While no contractual penalty is owed by the lessee to terminate the lease, the question that was submitted to the Committee arises:

When applying B34 of IFRS 16 and assessing 'no more than an insignificant penalty', does an entity considers the broader economics of the contract, and not only contractual termination payments?

The broader economics of a contract would include, for a lessee, economic disincentives to terminate the lease, such as a significant investment in leasehold improvement that would become redundant if the lease were terminated, or difficulty in finding leases for other, similar underlying assets. For a lessor, a significant economic disincentives to terminate the lease might include difficulty in finding a replacement lessee, or difficulty in obtaining lease income which is at least equal to its current level.

THE COMMITTEE'S DECISION AND ITS CONSEQUENCES

'Penalty' has a broader definition

The Committee observed that in applying IFRS 16.B34, an entity considers the broader economics of the contract and not only contractual termination payments. Such considerations might include, for example, the cost of abandoning or dismantling leasehold improvements.

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 then 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.

Implication of the Decision – Illustrative Examples

<u>Example #3A (identical to Example #3 except for ***bolded text***)</u>

A lessee enters into a lease for retail space with a 5 year non-cancellable period. At the end of the non-cancellable period, the lease converts into a 'month-by-month' lease, whereas the lessee and the lessor may each terminate the lease with 1 month's notice with no contractual penalty owing. During this 'month-to-month' period, the lease payments are based on the last month's lease payment from the end of the non-cancellable period, indexed to inflation. **The lessee installed leasehold improvements with a useful life of 12 years as at the commencement date of the lease. Those leasehold improvements are not capable of being transferred to a different property.**

The assessment of the lease term can be summarised as follows:

<table>
<tr><td colspan="3">Enforceable period – at most 12 years, but may be less (see note below)</td><td rowspan="4">No enforceable rights and obligations exist; no contract</td></tr>
<tr><td colspan="2">Lease term – see note below</td><td></td></tr>
<tr><td>Non-cancellable period (5 years)</td><td colspan="2"></td></tr>
<tr><td>In the first 5 years, no option exists to terminate the lease</td><td>Lease term is between non-cancellable period and enforceable period</td><td>Enforceable period requires judgment to assess to point in time where the lessee has no more than an insignificant penalty, which may be into the ‘month-to-month’ period of the contract</td></tr>
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In contrast to Example #3, Example #3A contains a non-contractual penalty from the perspective of the lessee, in that the lessee installed leasehold improvements with a useful life of 12 years. If the lessee terminated the lease after 5 years have elapsed, it would incur a penalty (based on the interpretation of the Committee) in that they would have to abandon leasehold improvements with 7 years of useful life remaining. In determining the enforceable period (and therefore, the maximum potential lease term), the lessee would be required to consider at what point the abandonment of the leasehold improvements would constitute no more than an insignificant penalty. This may be a period less than 12 years, since the lessee may consider abandoning leasehold improvements with a useful life of say, 1-2 years, to be ‘no more than an insignificant penalty’.

Once the enforceable period is determined, the lease term would be somewhere within a period of time between the non-cancellable period and the end of the enforceable period. In determining the lease term, the lessee would consider the length of time it would continue with the lease on a ‘month-to-month’ basis, considering the broad types of potential penalties that would influence its decision on whether to terminate the lease.

It should be emphasised that B34 states that the enforceable period does not end until the <u>lessee and the lessor</u> each has the right to terminate the lease with no more than an insignificant penalty. This therefore requires entities to make an assessment of economic penalties from the perspective of both the lessee and the lessor.

<u>Example #4</u>

A uses an office building that is owned by its parent company. The subsidiary and the parent have no documented lease agreement in writing, however, a monthly amount is paid by the subsidiary to the parent for use of the office space. The subsidiary has used the office for a number of years and has an established head office at that location.

A lack of a written contract does not necessarily mean that a lease does not exist. IFRS 16 defines a contract in the same way as IFRS 15, *Revenue from contracts with customers.* A contract is defined as ‘an agreement between two or more parties that creates enforceable rights and obligations.’ IFRS 15.10 clarifies that contracts may be written, oral or implied through customary business practices. In this example, the subsidiary is habitually utilising space provided by the lessor with a set monthly payment. A contract appears to exist. In determining the period over which the lease remains enforceable, a similar analysis would be required as in Example #3A. The subsidiary would be required to consider the broader economics of its arrangement with its parent, including both contractual and economic penalties for both the parent and its subsidiary if the subsidiary were to vacate the leased premises. The fact that the lessor is the parent of the subsidiary does not modify the requirements of IFRS 16.

Conclusion

The Committee's final agenda decision establishes that the determination of the enforceable period of the lease and the lease term itself consider broad economic circumstances beyond purely contractual terms. This is in contrast to other IFRS standards, such as IAS 32, *Financial Instruments – presentation*, where it has long been established that economic compulsion does not affect the classification of a financial instrument.

The final agenda decision is consistent with the basis for conclusions to IFRS 16 (IFRS 16.BC156, emphasis added): 'the lease term should reflect **an entity's reasonable expectation of the period during which the underlying asset will be used** because that approach provides the most useful information.'

IMPLEMENTATION OF THE AGENDA DECISION

The Committee finalised its agenda decision on 26 November 2019, shortly before 31 December 2019, the first annual reporting period under IFRS 16 for entities with calendar year-ends. Given the short period of time available to implement the effect of the final agenda decision, preparers are reminded of article published by the IASB and written by Sue Lloyd, Vice-Chair of the IASB and Chair of the IFRS Interpretations Committee, which is available here.

IFRIC agenda decisions establish the appropriate interpretation of the requirements of IFRS by the IFRS Interpretations Committee. Many regulators and enforcers worldwide consider IFRIC agenda decisions to be mandatory requirements. While IFRIC agenda decisions do not have effective dates or transitional provisions, preparers are expected to implement their requirements as soon as possible. Despite this, entities should have 'sufficient time' in order to assess the impact of IFRIC agenda decisions and to implement their effects on an entity's selection and application of accounting policies.

The question of what constitutes 'sufficient time' will depend on the extent of change, and level of complexity, that arises from an IFRIC agenda decision. However, it is necessary for preparers to deal with any required changes as quickly as practicable. 'Sufficient time' does not permit an entity to delay its work in making the changes that are required.

For entities with a relatively small number of leases, it may be considered that they have sufficient time to implement the effects of this IFRIC agenda decision before the finalisation of their 31 December 2019 financial statements. For entities with large numbers of leases that are affected (say, hundreds or thousands), this may not be feasible, however, the period of time before implementation should be completed is generally limited (i.e. the next interim reporting period). In situations where an entity is not able to implement the effects of an IFRIC agenda decision before the financial statements are finalised, clear disclosure should be made of this fact, along with any quantitative information that is available (e.g. the potential impact expressed as a range or a maximum).

Entities should also consider the views of their local regulators concerning the timeline for implementation of IFRIC agenda decisions.

IFRS 16 RESOURCES

For further information on IFRS 16 as well as other IFRS standards, please refer to BDO's IFRS Reporting website, which may be accessed here. The website includes extensive resources relating to IFRS 16, including IFRS 16 In Practice, At a Glance, and online training.

Included as an appendix to this publication is a flowchart that may be used to determine the lease term under IFRS 16, which incorporates the guidance from this publication. The flowchart is also available as an appendix in IFRS 16 In Practice.

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Appendix - Determining the Lease Term under IFRS 16 (Extract from IFRS 16 In Practice - 2019/2020)