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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, it also means there is more to consider when determining the lease term.

In our view, ascertaining the correct lease term is one of the most challenging issues in applying IFRS 16 as it is likely to 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:

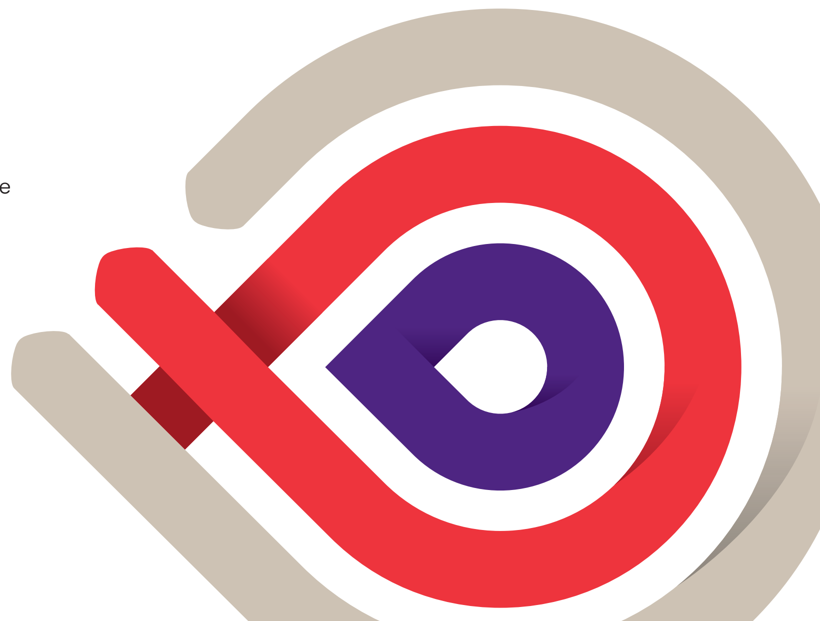
- periods covered by a lessee's extension option if extension is reasonably certain; and
- periods covered by a lessee's termination option if the lessee is reasonably certain not to terminate.

While the concept of 'reasonably certain' has not changed from IAS 17, 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 considering factors specific to the asset, the entity and the wider market. As these factors are wide ranging, we expect this to be a challenging area in practice.

Enforceability

IFRS 16 requires an entity to assess enforceability when considering the definition of a 'contract'. A contract is defined as 'an agreement between two or more parties that creates enforceable rights and obligations'. A lease is not 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. When interpreting the term 'penalty', there is currently some diversity of views as to whether it needs to be understood narrowly (only contractual penalties) or more broadly (both contractual penalties and economic disincentives). In the absence of detailed guidance on this point, our view is that entities have an accounting policy choice.

In order to be considered when assessing the lease term, options to extend or terminate the lease must be enforceable. This means that when a lessee exercises its option to extend or terminate the lease, the lessor cannot have the right to decline the request. If the lessor can decline a lessee's request to extend or terminate the lease, then the lessee's option is not enforceable and is ignored when assessing the lease term.



Example 1 – Extension option requiring approval by both lessee and lessor

ABC Ltd enters into a contract to lease a floor of a building for five years, with an option to extend for a further three-year period. Both ABC and the lessor must agree to extend the lease for a further three years. ABC is absolutely certain it will want to extend the lease.

Analysis

The non-cancellable portion is the five-year period, but is ABC's right to extend the lease enforceable? No, because the lessor has the ability to refuse to extend. It is important that when assessing the lease term, an entity determines the period for which the contract is enforceable. A lease is not enforceable when both the lessee and the lessor can exercise their right to terminate the lease without permission from the other party with no more than an insignificant penalty. In this case, ABC cannot force the lessor to lease to them for a further three-year period. Accordingly, the lease term is five years.

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 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 them 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	Whether contractual terms and conditions for the optional periods compare favourably with market rates, for example: • 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 (e.g, 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	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.
Termination costs	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 required condition and/or location.
Importance of the asset to the lessee	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.
Conditions for exercising the option	Whether certain conditions must be met before the option can be exercised, together with an assessment of the likelihood that those conditions will exist.
Relationship between options and other contractual features	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.
Length of the non-cancellable period	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.
Lessee's past practice	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.

Example 2 – Early termination option held by lessor
XYZ Ltd enters into a contract to lease a floor of a building for ten years. The lessor 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 the lessor 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 3 – 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.

Reassessment of lease term

After the commencement of the lease, the lessee must reassess whether it is reasonably certain to exercise an extension or termination option, if there is a significant event or change in circumstances that:

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

In principle, the IASB is of the view that regular reassessment of extension, termination and purchase options by lessees would provide more relevant and useful information to users of financial statements. However, recognising the potential costs associated with such regular reassessments, the IASB adopted a more balanced approach whereby reassessment is only required in the circumstances outlined above. However, reassessment cannot be made upon occurrence of significant events or changes in circumstances that are not in control of the lessee.

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
- 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 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 events the lessee:

- adjusts the lease liability by (i) including the lease payments over the revised term; (ii) 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)
- makes a corresponding adjustment to the right-of-use asset.

Example 4 – 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 5 – 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 a member of our local team below.

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