Lease term

How long is the lease?

IFRS 16

July 2020

home.kpmg/ifrs

Contents

A critical estimate

Lease agreements vary from simple leases with no options to complex cancellable and renewable arrangements. If your business has leases, you probably have many questions about how to determine the lease term under IFRS 16 *Leases*.

Companies were also required to determine the lease term under IAS 17 *Leases* – but under IFRS 16, this critical estimate has new significance. For lessees, lease term affects the size of the lease liability. And for lessors it affects lease classification. It also determines whether a lease is eligible for the recognition exemption for 'short-term' leases for lessees.

The new guidance on lease term has proved controversial. In 2019, after many companies had published opening statements of financial positions including new lease assets and liabilities, the IFRS Interpretations Committee was asked to consider the lease term. In December 2019, the Committee published its conclusion that when determining the lease term a company always considers the broader economics of the contract – not just the narrow contractual terms. For some companies, this view could drive a change in accounting policy.

IFRS 16 requires companies to reassess the lease term during the life of a lease contract in specific circumstances. This requirement and that to reassess other key estimates and judgements if the lease term changes introduce financial statement volatility.

This publication contains practical guidance and examples showing how to determine the lease term on lease commencement and when to reassess it. It also discusses how to navigate the links between written contracts, laws and regulations and penalties. It covers some practical application issues and key disclosures.

We hope that you will find it helpful when assessing – and reassessing – the lease term.

Kimber Bascom
Brian O'Donovan
Marcio Rost
KPMG global IFRS leases leadership team
KPMG International Standards Group

1 At a glance

1.1 Key facts

IFRS 16.18

The lease term is the non-cancellable period of the lease, together with:

- optional renewable periods if the lessee is reasonably certain to extend; and
- periods after an optional termination date if the lessee is reasonably certain not to terminate early.

To determine the lease term, a company first determines the length of the non-cancellable period of a lease and the period for which the contract is enforceable. It can then determine – between those two limits – the length of the lease term.

At lease commencement date, a company

Determines the **non-cancellable** period
(See Chapter 2)

Determines the **enforceable** period
(See Chapter 3)

Determines the **lease term**
(See Chapter 4)

In addition, a company

Reassesses the lease term and options subsequently
(See Chapter 5)

Considers other application issues
(See Chapter 6)

Considers the appropriate disclosures
(See Chapter 7)

After the commencement date, a lessee reassesses whether it is reasonably certain to exercise an option to extend the lease or to purchase the underlying asset, or not to exercise an option to terminate the lease early, when one or more specified events or changes in circumstances occur. In addition, both a lessee and a lessor revise the lease term when there is a change in the non-cancellable period of a lease.

Lessees and lessors disclose critical accounting judgements and changes in the application of accounting policies, including those used when determining the lease term – e.g. whether the lessee is reasonably certain to exercise an extension option or not to exercise a termination option and what economic penalties have been considered when assessing the enforceable period.

1.2 Key impacts

Identifying all lease agreements and extracting lease data. The standard requires a substantial effort for companies to identify all leases with payments that should be included in the measurement of assets and liabilities and to determine the lease term based on the combined effects of the contractual arrangements and the relevant laws and regulations.

New estimates and judgements. The standard introduces new estimates and judgements that affect the determination of the lease term – e.g. determining the enforceable period and whether a lessee is reasonably certain either to exercise a renewal option or not to exercise a termination option. A company determines the lease term at the commencement date. A lessee is required to reassess the lease term on the occurrence of a significant event or change in circumstances that is within its control and directly affects whether it is reasonably certain to exercise (or not to exercise) an option included in the original contract. Both lessees and lessors revise the lease term if there is a change in the non-cancellable period. This requires ongoing monitoring and increases financial statement volatility (see Chapters 3, 4 and 5).

Volatility in the statement of financial position. Because of this requirement to reassess the lease term in some circumstances, volatility in assets and liabilities for lessees may increase. This may impact a company's ability to accurately predict and forecast results and requires ongoing monitoring (see Chapter 5).

Changes in contract terms and business practices. To minimise the impact of the standard, some companies may reconsider certain contract terms and business practices – e.g. changes in the structuring or pricing of a lease agreement, including the type of variability of lease payments and the inclusion and type of options in the contract. Therefore, the standard is likely to affect departments beyond financial reporting – including treasury, tax, legal, procurement, real estate, budgeting, sales, internal audit and IT.

New systems and processes. Companies should have adequate systems and processes in place that allow them to identify the commencement date of new leases (which will not always be a stated date), determine the lease term on lease commencement and identify events or circumstances that require subsequent reassessment of the lease term. This becomes even more important when leasing and related actions that could trigger a lease term reassessment are decentralised and undertaken by non-accountants.

Sufficient documentation. Companies will need to document the judgements, assumptions and estimates applied in determining the lease term at the commencement date and on reassessment. Appropriate disclosure is required in the financial statements, including disclosure of key judgements, accounting policies and changes in their application (see Chapter 7).

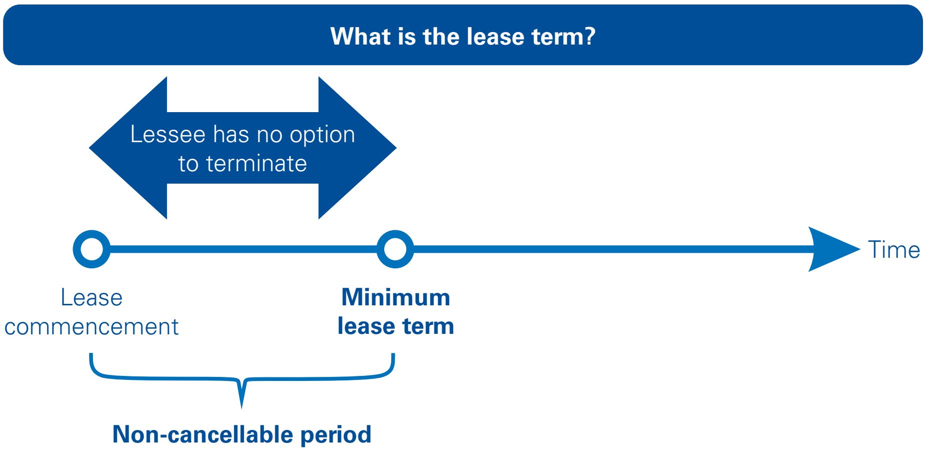
2 Non-cancellable period

The non-cancellable period determines the minimum possible lease term.

To determine the lease term, a company first determines the length of the non-cancellable period of a lease.

IFRS 16.B35, BC127–BC128

The 'non-cancellable period' is the period during which the lessee cannot terminate the contract. The lease term cannot be shorter than the non-cancellable period.



If a lessor can cancel the lease, does this affect the non-cancellable period?

IFRS 16.B35, BC128

No. If only the lessor has the right to terminate a lease, then the non-cancellable period of the lease includes the period covered by the lessor's option to terminate the lease. In this situation, 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.

Any non-cancellable period or notice period in a lease would meet the definition of a contract and be included as part of the lease term.

IFRS 16.BC127

Do notice periods affect the non-cancellable period?

Yes. Some leases include a clause requiring notice before the lessee or lessor can formally terminate a lease contract. When either the lessee or lessor has the right to terminate a lease at any time on giving notice to the other party, the non-cancellable period of the lease includes that notice period.

For example, a lease agreement may grant each party the unilateral right to terminate the lease, for any reason and with no more than an insignificant penalty (see Section 3.4), on giving 90 days' notice to the other party. This means that at any point in time before such notice is given by either party, enforceable rights and obligations for both parties exist for 90 days. Therefore, at lease commencement, and until either party gives notice of its decision to terminate the lease, the non-cancellable period of the lease is 90 days.

IFRS 16.B37, B37(e)

Does a contingent termination provision in a lease affect the non-cancellable period?

Yes; but the effect on the non-cancellable period depends on whether the contingency is within the lessee's control.

If the contingency *is* within the lessee's control, then the termination right is assessed in the same way as a non-contingent termination right. Therefore, it will affect the non-cancellable period.

If the contingency *is not* within the lessee's control, then whether the termination right affects the non-cancellable period depends on the likelihood that the triggering event will occur. This means that if the likelihood of the triggering event occurring is more than remote, then it will affect the non-cancellable period.

This distinction can be illustrated by the following two scenarios.

Scenario 1 – The contingency is within the lessee's control

- A lessee has the right to terminate a lease of a retail store with a 10-year stated non-cancellable period after five years if it decides to cease operations in the country where the store is located.
- This contingency is within the lessee's control: i.e. the lessee may decide to cease to operate as a retailer in that country because, for example, the retail space is not providing its desired return.

In this example, even though the lease contract has a stated non-cancellable lease period of 10 years, it appears that the contingent termination right should be considered when determining the non-cancellable period at the commencement date – i.e. a company should assess this in the same way as a non-contingent termination right. Therefore, the non-cancellable period of the lease is five years.

We believe that in this scenario, the lessee has a termination option at the end of Year 5, which it considers when determining the lease term (see Chapter 4).

Scenario 2 – The contingency is not within the lessee's control

- A lessee has the right to terminate a lease of a retail store with a 10-year stated non-cancellable period after five years if the government approves specific legislation that could damage the lessee's business.
- This contingency is not within the lessee's control because it depends on the government's actions.

In this example, even though the lease contract has a stated non-cancellable lease period of 10 years, it appears that the company should assess the likelihood of the triggering event occurring when determining the non-cancellable period at the commencement date, as follows.

- If the occurrence of the triggering event is remote, then the non-cancellable period is 10 years.
- If the occurrence of the triggering event is other than remote (e.g. possible or more certain than remote), then the non-cancellable period of the lease may only be five years – i.e. this becomes the minimum lease term.

We believe that in the latter case, the lessee has a termination option at the end of Year 5, which it considers when determining the lease term (see Chapter 4).

How does a company determine the non-cancellable period when it is not fixed at lease commencement?

In some lease arrangements, at commencement the non-cancellable period is not fixed, and becomes fixed only after the lease commencement date. For example, a company may lease an asset to use on a specific project and the lease will state that the period of use is for the duration of the project, with no termination or renewal options.

The standard does not specifically address situations in which the non-cancellable period of the lease is not fixed at lease commencement.

In these cases, it appears that a company should estimate the non-cancellable period at the commencement date. Subsequently, the company should reassess the lease term when the non-cancellable period becomes fixed (see Section 5.3).

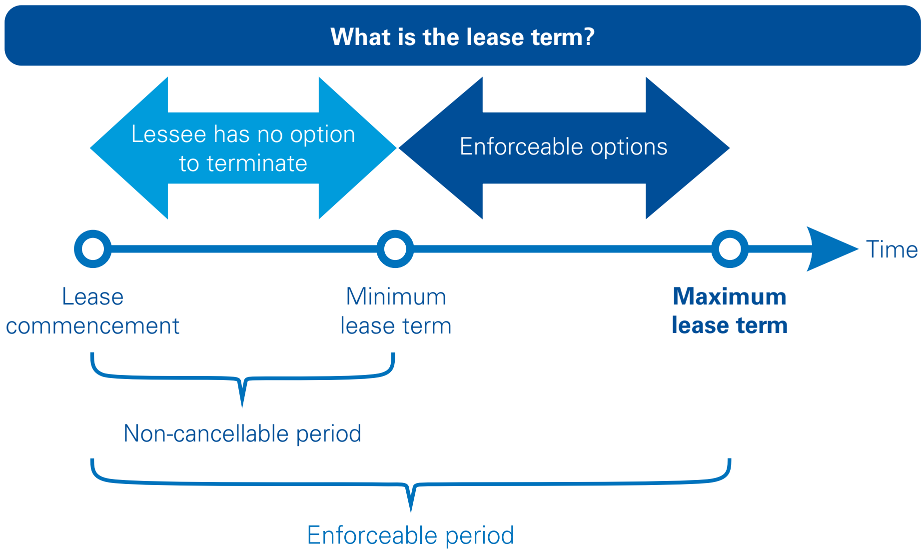
3 The enforceable period

Determining the enforceable period – i.e. the maximum potential length of the lease term – is key when assessing the lease term.

3.1 Overview

IFRS 16.2, B34, BC127

To determine the lease term, a company determines the period for which the lease is enforceable using the definition of a contract. The enforceable period is the maximum length of the lease term.



To determine the enforceable period, a company first assesses the contract broadly and considers:

- the terms and conditions included in the written contract; and
- relevant laws and regulations.

This includes considering the guidance on enforceability in paragraph B34 of IFRS 16, including the role of penalties in assessing the enforceable period.

The key steps to determine the enforceable period are as follows.

Assess the contract broadly – i.e. the combined effects of the following

↓

Consider the written contract terms and conditions (see Section 3.2) + Consider the relevant laws and regulations (see Section 3.2) + Consider penalties and termination rights – IFRS 16.B34 (see Sections 3.3, 3.4 and 3.5)

↓

Determine the enforceable period

3.2 Identifying the contract

IFRS 15.10, 16.A, 2

IFRS 16 does not itself define the term 'contract' but uses the contract definition in IFRS 15 *Revenue from Contracts with Customers*. IFRS 15 defines a contract as 'an agreement between two or more parties that creates enforceable rights and obligations' and specifies that enforceability is a matter of law. Contracts can be written, oral or implied by a company's customary business practices.

In assessing the enforceability of a lease contract, a company also considers all the relevant laws and regulations that stipulate and govern the parties' rights and obligations.

To determine the enforceability of the rights and obligations in a lease contract, a company considers:

– the written terms and conditions; and

– the applicable laws and regulations in the local jurisdiction that stipulate and govern the parties' rights and obligations.

Example 1 – Enforceable period: Law creates enforceable rights and obligations

Lessee B leases a property from Lessor C under the following terms.

– The written contract is for five years and does not contain any extension or termination options.

– Local law stipulates the parties' rights and obligations at the end of the written contract – e.g. local law grants B an enforceable right to renew for five years on the same terms as in the original contract.

Enforceable period

In this example, the enforceable period is 10 years. This is because local law stipulates additional enforceable rights and obligations of the parties in relation to using the property.

At the end of Year 5, B has the right to continue to use the property and C has an obligation to extend B's right to use the property.

If B exercises its right to continue to use the property, then it has an obligation to make lease payments and C has a right to receive lease payments.

What factors does a company consider in assessing whether a lease contract is enforceable?

IFRS 15.BC32

Assessing whether a contract exists focuses on the enforceability of rights and obligations based on relevant laws and regulations, rather than the form of the contract (oral, implied or written). This may require significant judgement in some jurisdictions and for some arrangements the assessment might differ between jurisdictions.

In cases of significant uncertainty about enforceability, a written contract and legal interpretation by qualified counsel may be required to support a conclusion that the parties to the contract have approved and are committed to performing under that contract – i.e. the lessee has the right to use the underlying asset and an obligation to make lease payments, and the lessor has a right to receive lease payments and the obligation to grant the lessee the right to use the underlying asset.

Can a lease be enforceable even if some terms and conditions remain open to negotiation between the parties?

It depends. Judgement is required to establish whether the combined effect of the written contract and applicable laws and regulations establishes terms and conditions under which the lease will continue after the date on which both parties can terminate the lease. For example, laws and regulations may establish some but not all of the terms and conditions under which a lease may continue after the date on which both parties can terminate the lease.

This is often the case for real estate leases under which the tenant has certain statutory rights to remain in occupation. In some cases, a tenant may also have an enforceable right to renew a lease but the rent in the renewal period will be subject to negotiation within broadly defined parameters. For example, the future rent may depend on market rent or changes in market property values, or be subject to independent arbitration if it is not mutually agreed.

Depending on the facts and circumstances, this type of arrangement may be considered akin to a renewal option subject to a market rent review. When this is the case, the future rents are variable payments that depend on an index or a rate. For more discussion on how to account for these variable payments, see our Lease payments publication.

3.3 Penalties and termination rights

IFRS 16.B34, BC127

The enforceable period of a lease is the period for which enforceable rights and obligations exist for the lessee and the lessor. To be part of a contract, any optional periods included in the lease term also need to be enforceable. The enforceable period represents the maximum potential length of the lease term.

IFRS 16.B34, BC127, IU 11-19

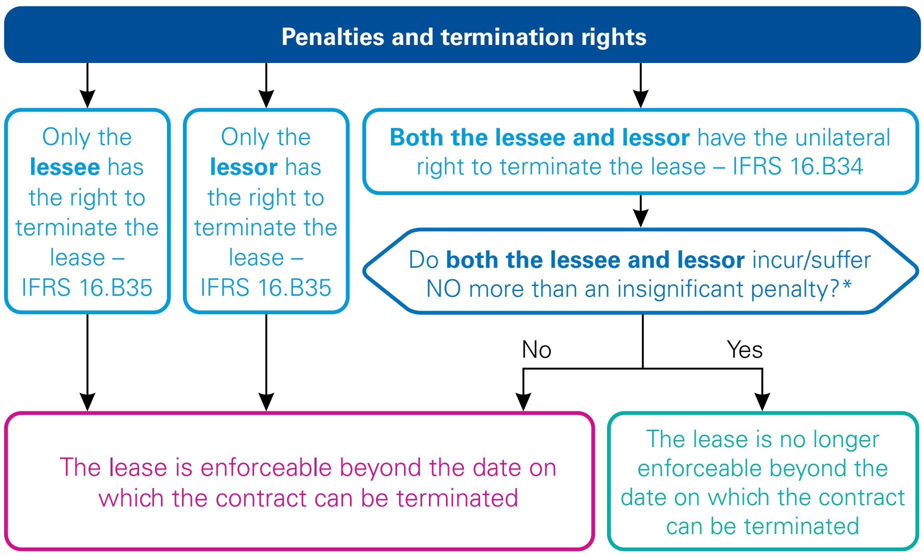
Although the standard does not define 'enforceability', paragraph B34 describes when a contract is (and is no longer) enforceable under the standard. A lease is no longer enforceable beyond the point at which both the lessee and the lessor have the unilateral right to terminate the lease without permission from the other party, and with no more than an insignificant penalty (see Section 3.4 for guidance on what constitutes a penalty).

Consequently, a contract is enforceable beyond the date on which the contract can be terminated if:

- both parties have the right to terminate but one party, or both, would incur a penalty on termination that is more than insignificant; or
- only one party has the right to terminate the lease without the permission of the other party.

The following summarises the impact of penalties and termination rights on the determination of the enforceable period.

IFRS 16.B34–B35, BC127–BC128, IU 11-19



* See Section 3.4 for guidance on what constitutes a penalty.

IFRS 16.B35, BC128

If only a lessee has the right to terminate a lease, then that right is considered to be an option available to the lessee to terminate the lease that a company considers when determining the lease term – i.e. a company applies the reasonably certain threshold assessment to the lessee's options under paragraphs 19 and B37 – B40 of the standard (see Section 4.2).

IFRS 16.B35, BC128

If only a lessor has the right to terminate a lease, then a company assumes that the lease will not be terminated – i.e. in this situation, the enforceable period goes beyond the date on which the contract can be terminated by the lessor 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.

Example 2 – Impact of termination rights on enforceable period

Scenario 1

Lessee B leases a retail store from Lessor C under the following terms.

- The written contract is for a stated maximum term of five years.
- B and C each have the unilateral right to terminate the lease at the end of Year 2 with no more than an insignificant penalty.
- Relevant laws and regulations that govern the transaction do not stipulate any other rights and obligations of the parties in addition to those in the written contract.

On lease commencement, the enforceable period is two years – regardless of how likely it is that both parties will decide to extend the lease beyond the end of Year 2.

Scenario 2

Lessee D leases a warehouse from Lessor E under the following terms.

- The written contract is for a stated maximum term of five years.
- After Year 1, D and E each have the unilateral right to terminate the lease, but a one-month notice period is required – i.e. the lease terminates one month after the termination notice is given. Notice cannot be given before the end of Year 1. If the lease is terminated in this way, then neither party will suffer a more than insignificant penalty.
- Relevant laws and regulations that govern the transaction do not stipulate any other rights and obligations of the parties in addition to those in the written contract.

On lease commencement, the enforceable period is 13 months.

What is the enforceable period when both the lessee and lessor have termination rights, but only one party would suffer a more than insignificant penalty?

IFRS 16.B34–B35, BC127, IU 11-19

The existence of a penalty affects the enforceable period in different ways, depending on which party would suffer a more than insignificant penalty. For a discussion on how such termination rights impact the lease term, see Section 4.2.

In the following scenarios, relevant laws and regulations that govern the transaction do not stipulate any other rights and obligations of the parties in addition to those in the written contract.

Scenario 1 – Both parties have termination rights without the permission of the other, but only the lessor's right gives rise to a more than insignificant penalty

In this case, the enforceable period ends when the lessor's exercise of its termination option no longer gives rise to a more than insignificant penalty – i.e. when both the lessee and the lessor have the unilateral right to terminate the lease with no more than an insignificant penalty.

In contrast, if the lessor's termination right will no longer result in a more than insignificant penalty before the lessee's termination option becomes exercisable, then the lessor's termination option is disregarded for accounting purposes until the lessee's termination option becomes exercisable. When the lessee's termination option becomes exercisable, both the lessee and the lessor have the unilateral right to terminate the lease with no more than an insignificant penalty, and the enforceable period does not extend beyond that point.

Scenario 2 – Both parties have termination rights without the permission of the other, but only the lessee's right gives rise to a more than insignificant penalty

In this case, the enforceable period ends when the lessee's exercise of its termination option no longer gives rise to a more than insignificant penalty.

If the lessor has the right to refuse a request from the lessee to extend the lease, then does this prevent the contract from being enforceable?

IFRS 16.B34–B35, BC127, IU 11-19

Not necessarily.

Some leases include a clause stating that the lessee may request a renewal of the lease, subject to agreement with the lessor.

The IFRS Interpretations Committee discussed this issue and observed that paragraph B34 of IFRS 16 applies because, in effect, the lessee's option not to request a renewal and the lessor's option to refuse the lessee's request are substantially equivalent to termination options. When discussing this, the Committee noted that the description of 'enforceable' in paragraph B34 of IFRS 16 is not strictly a legal concept, and includes reference to whether exercise of a termination option carries 'no more than an insignificant penalty'.

Therefore, in these cases a company considers whether the lessee or lessor would suffer a more than insignificant penalty to determine the enforceable period.

3.4

IU 11-19

What constitutes a penalty?

The standard does not define the term 'penalty'. Therefore, questions have arisen in practice about whether a company considers the broader economics of the contract or only contractual termination payments when applying paragraph B34 of the standard. The IFRS Interpretations Committee discussed this issue and noted that when determining the effect of termination rights under paragraph B34 of the standard, a company considers the broader economics of the contract and not only contractual termination payments.

Example 3 – Termination rights: No more than an insignificant penalty

IFRS 16.B34, IU 11-19

Lessee L enters into a five-year lease of a warehouse with Lessor M.

L designs and sells furniture internationally online, and is testing use of the warehouse as a showroom. The cost to fit out the warehouse space to serve as a showroom is not significant. If the showroom is unsuccessful, then L does not plan to use the space as a warehouse.

Under the lease agreement, L and M each have the right to terminate the lease without a contractual penalty on each anniversary of the lease commencement date.

L considers the following when evaluating whether it will incur a more than insignificant penalty if it terminates the lease.

- The leasehold improvements are minor. Therefore, L's loss of economic value if the contract is terminated before the end of their economic life is not significant.
- The cost to dismantle the leasehold improvements is not significant.
- The cost to restore the warehouse to its original condition is not significant.
- The potential impact of early termination on customer relationships is low. L mostly interacts with its customers through its website, with a small number expected to visit the showroom in person.

Enforceable period

Based on its analysis of the facts and circumstances, L determines that it can terminate the lease with no more than an insignificant penalty after one year. Assuming that M can also terminate with no more than an insignificant penalty after one year, the enforceable period consists of the one-year non-cancellable period. This is because – after both parties' termination rights become exercisable at the end of Year 1 – neither party has enforceable rights (i.e. L to use the warehouse or M to receive lease payments) or obligations (i.e. L to make lease payments or M to permit continued use of the warehouse).

Example 4 – Termination rights: Lessee and lessor both have a right to terminate but only the lessee's termination right gives rise to a more than insignificant penalty

IFRS 16.B34, BC127, IU 11-19

Lessee Y enters into a lease of equipment with Lessor Z with the following contractual terms.

- The non-cancellable period is one year. However, the lease will continue for up to four additional years unless it is terminated by either party.
- The lease payments are fixed and are on market terms at lease commencement.
- Each party can terminate the contract by giving notice to the other party at least 30 days before the end of each year. If Y terminates the contract, then Y has a contractual obligation to pay the costs of transporting the equipment back to Z's location.

In addition, the following facts are relevant.

- Equivalent pieces of equipment are readily available from other suppliers at a similar rental price and subject to similar contractual terms and conditions.
- The equipment should be installed before use. Installation costs are incurred each time a new piece of equipment is installed and the installation is a significant undertaking.
- The transportation costs that Y will incur to return the equipment to Z are substantial due to the location of Y's operations and the nature of the equipment.
- Y's operations depend on using this type of equipment.
- Y's operations will necessarily be interrupted if it changes equipment units. The shut-down would result in lost production revenue and idle time costs related to Y's operating crew, which would be substantial.

Although Y and Z each have the unilateral right to terminate the lease at the end of Year 1, Y cannot do so without incurring a penalty that would be more than insignificant. For example, the penalty would include:

- additional costs to install replacement equipment;
- transportation costs to return the equipment to Z's location; and
- shut-down costs.

Therefore, the lease is enforceable beyond the end of Year 1. The contract will be enforceable until it can be terminated by Y with no more than an insignificant penalty. Additional facts are needed to determine when this would occur. The enforceable period is the maximum potential length of the lease term.

Example 5 – Termination rights: Lessee and lessor both have a right to terminate with no more than an insignificant penalty

IFRS 16.B34, BC127, IU 11-19

Modifying Example 4:

- the equipment does not require significant installation efforts;
- transportation costs to return the equipment to Lessor Z's location are minor; and
- idle time incurred in switching the units is short because there is no significant installation process.

Based on the facts and circumstances, Lessee Y's termination option at the end of Year 1 does not give rise to a more than insignificant penalty and, accordingly, the non-cancellable period, enforceable period and lease term of that contract are all the same – i.e. one year.

After one year, Y has neither:

- a right to extend the lease beyond the end of Year 1 because Z has the right to terminate the lease at the end of Year 1 without incurring a more than insignificant penalty; nor
- an obligation to make lease payments beyond the end of Year 1 because it can terminate the lease without incurring a more than insignificant penalty.

Also, Z has neither:

- a right to receive lease payments (i.e. by requiring Y to extend the lease) beyond the end of Year 1 because Y has the right to terminate the lease at the end of Year 1 without incurring a more than insignificant penalty; nor
- an obligation to extend Y's right to use the underlying asset beyond the end of Year 1 because it can terminate the lease without incurring a more than insignificant penalty.

Example 6 – Termination rights: Only the lessor has a right to terminate

IFRS 16.B34–B35, BC128

Modifying Example 5, only Lessor Z has the right to terminate the lease at the end of Years 1 to 4.

Considering that only Z can elect to terminate the lease, the enforceable period is five years. Because the non-cancellable period always includes optional periods controlled by the lessor, the non-cancellable period is also five years.

Whether Z's option can be exercised without Z incurring a more than insignificant penalty is not relevant in this case.

Can the significance of a penalty change over time?

Yes. A penalty may expire or, over a period of time, the effect of a penalty that is initially more than insignificant may become insignificant. For example, a termination penalty that is more than insignificant if it is incurred after only one year of a lease may be insignificant if it is incurred after four or five years when considered in the context of the broader economics of the contract.

What are the consequences of misinterpreting what constitutes a penalty?

As mentioned above, 'penalty', as it applies to determining the enforceable period under the standard, encompasses broader economic penalties beyond a contractual requirement to pay the other party. Companies incorrectly interpreting what constitutes a penalty (e.g. by considering only contractual penalties) may incorrectly assess the lease term, leading to one or more of the following.

– Inaccurate measurement of lease assets and liabilities.

– Incorrect lease classification for lessors.

– Incorrect conclusions about eligibility for the short-term lease exemption for lessees.

For more discussion on how to account for a change in the interpretation of what constitutes a penalty, see Section 7.4.

3.5 The link between written contracts, laws and regulations and penalties

IFRS 16.A, 2, B34, BC127, 15.10

Enforceability is a matter of law in the relevant jurisdiction (i.e. the jurisdiction governing the lease) and each contract will need to be evaluated based on its terms and conditions. It appears that a company should consider the following when performing its analysis of the termination rights.

– If the combined effect of the written contract between the parties and applicable laws and regulations establishes the terms and conditions under which a lease will continue after the date on which both parties can terminate the lease, then the lease may be enforceable beyond that date. This means that the approach in paragraph B34 of the standard applies (see Section 3.3).

– Conversely, if the combined effect of the written contract between the parties and applicable laws and regulations does not establish the terms and conditions under which a lease will continue after the date on which both parties can terminate the lease, then the lease is not enforceable beyond that date. This means that the approach in paragraph B34 of the standard does not apply. Therefore, if the parties do in fact agree to extend the lease, they should apply the guidance on lease modifications to assess whether to account for a new lease or a modification of the existing lease.

Example 7 – Enforceable period: Limited to the period of the written contract

Lessee K leases a property from Lessor M under the following terms.

- The written contract is for five years and does not contain any extension or termination options.
- There are no applicable laws or regulations that create additional rights and obligations beyond that period. For example, there are no statutory provisions that permit K to continue to occupy the property beyond the term of the written contract.
- At the end of Year 5, because of the existence of significant economic incentives for each party to continue the lease for longer, K continues to occupy the property and make the lease payments. M accepts the payments and does not seek to evict K.

Enforceable period

In this example, we believe that the enforceable period cannot go beyond the written contract (i.e. five years). This is because the existence of significant economic incentives should be considered only in conjunction with a written contract and law that stipulates the enforceable rights and obligations of the parties in relation to the use of the property.

At the end of Year 5, K neither has the right to continue to use the property nor has an obligation to make lease payments, and M has neither a right to receive lease payments nor an obligation to extend K's right to use the property.

Lease modifications

If K continues to use the property and makes the lease payments, and M accepts the payments, then this is a change in the scope of a lease that was not part of its original terms and conditions. We believe that K and M should account for such a change applying the guidance on lease modifications. For more discussion on applying the lease modification requirements, see our Lease modifications publication.

Example 8 – Enforceable period: Extends beyond the written contract

Modifying Example 7, there is a local law that states that if Lessee K remains in occupation after the end of Year 5 then the terms of the original contract will continue to apply. This will be the case as long as K continues to make the lease payments and complies with its other obligations under the original contract with Lessor M. However, it remains the case that both parties have the unilateral right to terminate the contract at the end of Year 5 (i.e. because the written five-year contract expired).

Enforceable period

In this example, if either K or M would suffer a more than insignificant penalty if the lease were terminated after five years (see Section 3.3), then we believe that the enforceable period extends beyond that point.

Do significant penalties alone create enforceable options in a lease contract?

No. The existence of more than insignificant penalties should be considered only in conjunction with a written contract and applicable laws and regulations that create enforceable rights and obligations for the parties in relation to the use of the underlying asset.

This means that an economic incentive in the form of a penalty may provide evidence on the enforceable rights and obligations in a lease contract. However, an economic incentive alone is not sufficient to create enforceable rights and obligations.

A company determines the enforceable period in the same way, regardless of whether the counterparty is a related party. When there is no written contract, a company may need to apply significant judgement when making the assessment – e.g. in the case of some inter-company arrangements (see Section 6.1).

3.6 Cancellable and renewable leases – Application issues

IFRS 16.B34–B35, BC127–BC128, BC156, IU 11-19

Some lease contracts include:

– no specific contractual term, but continue indefinitely until either party gives notice to terminate it – i.e. cancellable leases; or

– a specific initial period and then renew indefinitely unless they are terminated by either party – i.e. renewable leases.

In these cases, a question arises on how to determine the enforceable period and the lease term when applying paragraph B34 of the standard.

The IFRS Interpretations Committee concluded that for renewable and cancellable leases, the analysis follows the same steps as for any other lease.

1. The parties apply paragraph B34 of the standard to estimate the enforceable period by considering the broader economics of the contract. If either party has an economic incentive not to terminate or exit the lease such that it would incur a penalty that is more than insignificant, or if only one party has the right to terminate the lease without permission from the other party with no more than an insignificant penalty, then the contract is enforceable beyond the date on which the contract can legally be terminated.

2. The parties apply paragraphs 19 and B37 to B40 of the standard to determine, within the boundaries of the enforceable period, whether the lessee is reasonably certain not to exercise its option (right) to terminate the lease (see Chapter 4).

Example 9 – Renewable lease: More than an insignificant penalty

IFRS 16.B34, IU 11-19

Continuing Example 8, at the end of Year 5, Lessee K can continue to occupy the property and make the lease payments to Lessor M. M will accept these payments and will not seek to evict K.

The significant economic incentives for K and M include the following.

– At commencement date, K undertakes significant, non-removable leasehold improvements. If the contract were terminated before the end of their economic life, then this would create a significant loss of economic value that would remain significant in the future beyond the end of Year 5.

– The property location is ideal for K's business (i.e. for strategic relationships with suppliers and customers) and cannot be replaced in the near term.

– The lease rentals that K will continue to pay are above current market rates: i.e. M may be unable to lease the property to another lessee on equivalent terms.

Enforceable period

Under paragraph B34 of the standard, K and M determine the enforceable period based on the broader economics of the contract. Considering the existence and significance of identified penalties, K and M determine at the commencement date that the enforceable period extends beyond five years and will extend as long as the termination penalties remain more than insignificant.

K and M apply their own judgement separately when making these assessments. They may need to consider additional factors in more complex arrangements.

IFRS 16.B34, IU 11-19

What factors should be considered when determining the enforceable period in practice?

Lease contracts in various industries (e.g. retail and telecom) may feature an initial contractual period and renew indefinitely on the same terms and conditions unless they are terminated by either party with some period of notice – i.e. renewable leases. In practice, it may be that the parties commonly extend the contract multiple times. The following examples illustrate some of the complexities and judgements involved in determining the enforceable period for renewable leases.

Example A – Telecom

Telecom Company S enters into a lease for space on a building roof to install a telecom tower.

There are many similar alternative locations available and any relocation would cause minimal business disruption costs. However, the costs of dismantling the tower to relocate and install it in a similar location constitutes a more than insignificant penalty.

Factors to consider when determining the enforceable period include, but are not limited to:

- the costs to dismantle, relocate and install the tower in a similar location;
- the useful life of the telecom tower (i.e. how long S expects to be able to use this tower before it needs to be dismantled and replaced); and
- the pace of technological change in the mobile industry (affecting how long this tower is expected to be suitable for S's needs).

Example B – Retailers

Retailer W enters into a lease of a retail premises. W constructs significant non-removable leasehold improvements. If the contract is terminated before the end of the non-removable leasehold improvements' economic life, then W would suffer a loss of economic value, which it considers a more than insignificant penalty.

Factors to consider when determining the enforceable period include, but are not limited to:

- the economic life of the non-removable leasehold improvements; and
- the cost of moving, including the cost of interruption to the business.

Example C – Head office

Company D, which operates in the creative industries, enters into a lease of a head office for its key personnel. The lease is in a fashionable location in the media district of a large city. There are many alternative office buildings available, although none is close to the current office. There are no significant leasehold improvements.

Factors to consider when determining the enforceable period include, but are not limited to:

- the useful life of the building;
- the expected costs of relocation; and
- the attractiveness of the location for key personnel.

4 The reasonably certain threshold

The lease term is based on the 'reasonably certain' threshold familiar from IAS 17.

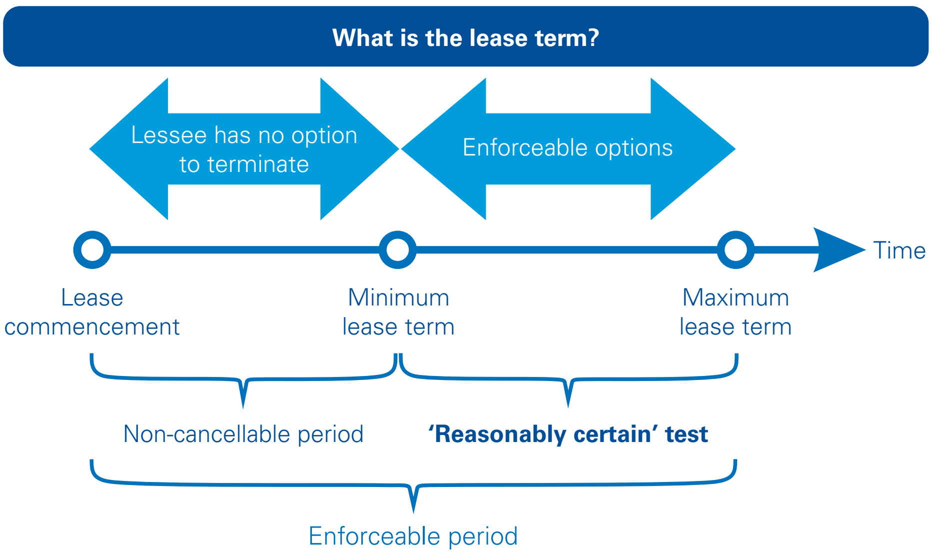
4.1 Overview

IFRS 16.18

The lease term is within the range between the non-cancellable period and the enforceable period. The lease term is the non-cancellable period of the lease together with:

– optional renewable periods if the lessee is reasonably certain to extend; and

– periods after an optional termination date if the lessee is reasonably certain not to terminate early.



IFRS 16.BC157

The concept of 'reasonably certain' is integral to determining the lease term.

IFRS 16 does not define 'reasonably certain' and there is no bright line when making the assessment. A company considers all of the relevant facts and circumstances that create an economic incentive for the lessee to exercise a renewal option, or not to exercise a termination option.

Example 10 – Lease with simple renewal options

A lease has an initial period of three years during which the lessee cannot terminate the lease. At the end of Years 3 and 6, the lessee has the contractual right to renew the lease for a further three years.

In this case, the non-cancellable period of the contract is three years and the enforceable period is nine years. If at the time of commencement of the lease it is reasonably certain that the lessee will exercise its options to extend at the end of Years 3 and 6, then the lease term is nine years.

Is the 'reasonably certain' threshold under IFRS 16 the same as that under IAS 17?

IFRS 16.BC157

Yes. The International Accounting Standards Board (the Board) decided to retain the concept used in IAS 17 that the lease term includes optional periods to the extent that it is reasonably certain that the lessee will exercise its option to extend (or not to terminate) the lease for those periods.

The Board observed that applying the concept of 'reasonably certain' requires judgement and, therefore, it decided to provide significantly more application guidance in IFRS 16 to help companies apply this concept. The guidance on the types of facts and circumstances to consider should help identify the relevant factors and reduce the risk of non-substantive break clauses being inserted in contracts solely to reduce the lease term beyond what is economically reasonable for the lessee.

Has lease term changed under IFRS 16?

Generally, no. IAS 17 already required lessees to determine the lease term. However, the significance of this critical estimate increases under IFRS 16 and becomes a key input into the measurement of the lease liability, because it determines which lease payments are included therein. IFRS 16 also introduces a requirement for lessees to reassess the lease term in certain situations (see Chapter 5), which lessees will need to monitor.

4.2 Factors to consider

IFRS 16.B37, B40

The standard provides examples of factors to consider when assessing whether it is 'reasonably certain' that a lessee will exercise an option to renew or not to exercise an option to terminate the lease. The assessment of the degree of certainty is based on the facts and circumstances at commencement of the lease, rather than on the lessee's intentions. The following table provides examples of factors that create an economic incentive either to exercise or not to exercise options to renew or terminate early.

Examples of relevant facts and circumstances

Contractual/market
- Level of rentals in any secondary period compared with market rates
- Contingent payments
- Renewal and purchase options
- Costs relating to the termination of the lease and the signing of a new replacement lease
- Costs to return the underlying asset

Asset
- Nature of item (specialised)
- Location
- Availability of suitable alternatives
- Existence of significant leasehold improvements

IFRS 16.B37, B40

When determining the lease term, a company considers all relevant facts and circumstances that create an economic incentive for the lessee to exercise an option to renew or not to exercise an option to terminate early. When assessing whether a lessee is reasonably certain to exercise an option to extend, or not to exercise an option to terminate early, the economic reasons underlying the lessee's past practice regarding the period over which it has typically used particular types of assets (whether leased or owned) may provide useful information.

Example 11 – Lessee not reasonably certain to exercise a renewal option: Machine

IFRS 16.B37

Lessee Y enters into a lease of a three-year-old machine. The non-cancellable period is 10 years. Y has the option to extend the lease after the initial 10-year period for optional periods of 12 months, each at market rents.

To determine the lease term, Y considers the following factors.

- The machine is to be used in manufacturing parts for a type of aircraft that Y expects will remain popular with customers until development and testing of an improved model are completed in approximately 10 years.
- The cost to install the machine in Y's manufacturing facility and the expected cost to install a replacement machine in the future are not significant.
- Y does not expect to be able to use the machine in its manufacturing process for other types of aircraft without significant modifications.
- The total remaining economic life of the machine is 25 years.

Y notes that it does not expect to have a business purpose for using the machine after the non-cancellable lease period without significant modifications. Y also notes that the terms for the optional renewal provide no economic incentive to renew that would exceed the cost of those modifications, and that its expected cost to install a replacement machine suited to its manufacturing process for newer models of aircraft does not create an incentive to modify and continue using the machine.

Therefore, Y concludes that it is not reasonably certain to exercise its renewal options and, consequently, the lease term consists of the 10-year non-cancellable period only.

Example 12 – Lessee not reasonably certain to exercise a renewal option: Warehouse

IFRS 16.B37

Lessee E enters into a five-year lease of a warehouse with Lessor R. The warehouse is not specialised and there are other similar warehouses available in the same geographic area.

As part of the contract, E has the option to renew the five-year lease for two additional five-year terms. The rents for each renewal period will be reset to a market rate at the date of exercising each renewal option. If E does not renew the lease, then it will not incur substantial relocation costs.

E has a track record of remaining in leased warehouse facilities for at least 10 years. It was in each of its previous three facilities for 15, 10 and 15 years respectively.

In this scenario, E and R conclude that E is not reasonably certain to exercise either of the five-year renewal options for the warehouse facility.

E's history of renewing its warehouse leases may suggest that it intends to exercise at least the first of the two five-year renewal options. However, the fact pattern does not suggest that there are economic incentives that make E reasonably certain to do so.

Example 13 – Lessee reasonably certain to exercise a renewal option: Building

IFRS 16.B37

Lessee X enters into a lease contract with Lessor L to lease a building. The non-cancellable period is four years and X has the option to extend the lease by another four years at the same rent.

To determine the lease term, X considers the following factors.

– Market rentals for a comparable building in the same area are expected to increase by 10% over the eight-year enforceable period. At commencement of the lease, rentals under the contract reflect the current market rates.

– X intends to stay in business in the same area for at least 10 years.

– The location of the building is ideal for relationships with suppliers and customers. Moving to an alternative building in the same vicinity would result in relocation costs and X would be unlikely to obtain similarly favourable below-market rentals.

– X undertakes non-removable significant leasehold improvements. Their estimated economic life is eight years.

X concludes that it has a significant economic incentive to extend the lease. Therefore, it is reasonably certain to exercise its four-year extension option and determines that the lease term is eight years.

IFRS 16.B37

Example 14 – Lessee reasonably certain to exercise a renewal option: Warehouse

Modifying Example 12, before moving into the leased facility, Lessee E constructs expensive, non-removable leasehold improvements with an economic life of 15 years.

These leasehold improvements will have significant economic value to E at the end of Years 5 and 10 that it will not be able to recover if it vacates the facility.

The construction of the significant leasehold improvements and the economic factors surrounding those improvements – e.g. that a significant portion of their substantial economic value will be lost if E relocates before the end of 15 years – provide a significant economic incentive for E to remain in the facility for the full 15 years permitted under the contract.

Therefore, E and Lessor R conclude that it is reasonably certain that E will exercise both of its five-year renewal options.

IFRS 16.B37

Example 15 – Lessee reasonably certain to exercise only one renewal option: Warehouse

Changing again the facts of Example 12, the warehouse is a highly specialised facility and there are no similar warehouses in the same geographic area. Having access to a specialised warehouse in this geographic area is vital to Lessee E's core operations.

However, there are significant economic disincentives for E to construct its own specialised warehouse facility. Construction would be expensive and would require significant time. In addition, doing so would invite one of E's competitors to operate in the area (i.e. by leasing the specialised warehouse from Lessor R).

It is unlikely that R or another company will construct a suitable alternative warehouse in the same geographic area during the five-year non-cancellable period.

In this scenario, E and R conclude that it is reasonably certain, based on an evaluation of the relevant economic factors, that E will exercise the first five-year renewal option.

However, it is not clear that the specialised warehouse will remain vital to E's operations beyond 10 years. Within that timescale, it is possible that new technology will make the warehouse obsolete or that E will relocate its operations.

Therefore, E and R conclude that it is not reasonably certain, at lease commencement, that E will exercise the second five-year renewal option. The same economic circumstances considered when determining whether E is reasonably certain to exercise the first five-year renewal option *might* exist 10 years from now; however, the extended period between lease commencement and the exercise date for that option – i.e. approximately 10 years – means that it is not *reasonably certain* that those same economic circumstances will exist.

IFRS 16.B37, IU 11-19

Does the existence of non-removable significant leasehold improvements impact the lease term?

Yes. The IFRS Interpretations Committee considered the interaction between determining the lease term and the useful life of non-removable significant leasehold improvements in the context of its discussion on cancellable and renewable leases.

When assessing whether it is reasonably certain to extend (or not to terminate) a lease, a company considers all relevant facts and circumstances that create an economic incentive for the lessee. This includes significant leasehold improvements (made or planned to be made) over the term of the contract that are expected to have significant economic benefit when the option to extend (or terminate) becomes exercisable.

IFRS 16.A, B37, IU 11-19

IAS 16.56–57

What is the difference between applying the 'reasonably certain' criterion under IFRS 16 and the 'expected to be available' criterion under IAS 16 *Property, Plant and Equipment*?

The level of certainty used in assessing optional periods under IFRS 16 is 'reasonably certain'; however, the level of certainty in determining the useful life under IAS 16 is 'expected to be available'. Therefore, if the levels of certainty were different, one may conclude that the useful life of the non-removable leasehold improvements may be longer than the lease term of the related asset.

When determining the useful life of non-removable leasehold improvements under IAS 16, a company considers any 'legal or similar limits on the use of the asset, such as the expiry dates of related leases'. The useful life of an asset 'is defined in terms of the asset's expected utility to the company' and 'may be shorter than its economic life'. If the lease term of the related lease is shorter than the economic life of the leasehold improvements, then a company considers whether it expects to use the leasehold improvements beyond that lease term. If a company does not expect to use the leasehold improvements beyond the lease term of the related lease, then it concludes that the useful life of the leasehold improvements is the same as the lease term.

Theoretically, it is possible that the threshold can be read as different; however, in practice it would be a rare outcome. It is difficult to identify a realistic fact pattern in which the lessee would both be expecting to use non-removable leasehold improvements during an optional period and not be reasonably certain to use the related asset during that optional period, having considered the factors described in paragraphs B37 to B40 of IFRS 16 (see Section 4.2).

How should a renewal or termination option be assessed if the lessee is obliged to choose between a renewal or termination option and another contractual feature such as a residual value guarantee?

IFRS 16.B38, BC158

A renewal or termination option may be combined with one or more other contractual features – e.g. a residual value guarantee. For example, a lessee may guarantee the lessor a minimum cash sum or a fixed return, regardless of whether a renewal option is exercised. In this case, the lessor is guaranteed to receive an economic inflow at least equivalent to the payments that would be made by the lessee during the optional renewal period.

In this situation, a company assumes that the lessee is reasonably certain to exercise the option to extend or not to terminate the lease.

Is the concept of penalty used in determining the enforceable period similar to the economic incentive concept used in determining the lease term?

IFRS 16.B34, B37

Yes. The concept of penalty in paragraph B34 of the standard considers the broader economics of the contract, including the economic incentives to renew or not to terminate the lease, and not only the contractual termination payments (see Section 3.4). Foregoing an economic incentive to renew – e.g. forfeiting significant remaining economic value in non-removable leasehold improvements – is to incur a penalty. Therefore, if either party has an 'economic incentive' not to terminate the lease (such that it would suffer a penalty that is more than insignificant), then the contract is enforceable beyond the date on which the contract can be terminated.

Similarly, when determining the lease term a company considers all relevant facts and circumstances that create an economic incentive for the lessee to exercise a renewal option or not to exercise a termination option when assessing whether the lessee is reasonably certain to exercise, or not to exercise, that option.

Therefore, regardless of the different words ('penalty' vs 'economic incentive'), similar factors are considered when determining the enforceable period (and assessing the significance of penalties), and when determining the lease term (and applying the reasonably certain criterion). Therefore:

- When a lessee concludes that it is reasonably certain to renew (or not to terminate) a lease under paragraph B37 of the standard, this generally suggests that the lessee cannot terminate the contract with no more than an insignificant penalty. This is because 'reasonably certain' is a higher bar than 'no more than an insignificant penalty'.
- In the absence of a more than insignificant penalty under paragraph B34 of the standard (i.e. a more than insignificant economic incentive), generally the lessee would conclude that it is not reasonably certain to renew (or not terminate) the lease.

Can different conclusions be reached on lease term for leases that contain identical contractual options?

Yes. Different conclusions can be reached on whether a lessee is reasonably certain to exercise an option to renew or not to exercise an option to terminate early, for options with similar terms (e.g. the same strike price and the same expected fair value of the underlying asset) that relate to different leases, depending on the particular facts and circumstances of a lease. For example, the following factors may affect the analysis.

- The longer the period until the option exercise date, the more compelling the evidence needs to be that the lessee will exercise the option. This is because estimates about economic conditions and incentives that may exist at the option date will be less precise. Such estimates include, but are not limited to, the fair value of the underlying asset, the availability of suitable alternative assets and the tax environment.
- The nature of the underlying asset may significantly affect the assessment. Depending on the nature of the underlying asset, it may be more difficult for a company to predict its future fair value – e.g. because the estimate may be subject to significant volatility or technological uncertainty – or the availability of suitable alternative assets.
- The location of the underlying asset could significantly affect relocation costs or the availability of alternative assets. For example, even for two identical underlying assets, considerations about relocation costs or available alternative assets could vary widely if one is deployed in a remote area and the other in an easily accessible area.
- The jurisdiction governing the lease could significantly affect the assumptions about laws and regulations (including tax consequences) affecting the assessment of the option – e.g. laws and regulations in some countries may be more stable and predictable than in other countries.

Can lessees and lessors reach different conclusions about whether it is reasonably certain that an option will be exercised?

Yes. Lessees and lessors may reach different conclusions about whether the lessee is reasonably certain to exercise an option to renew or not to exercise an option to terminate early.

Lessees and lessors may also reach different conclusions about lease term, because of information asymmetry and the judgemental nature of the assessment. The assessment of reasonably certain is based on judgements (e.g. about the importance of an underlying asset to the lessee) and estimates (e.g. of the fair value of the underlying asset in the future). In addition, lessors will not necessarily be familiar with the lessee's specific facts and circumstances, which may result in a different conclusion.

What is the lease term when both the lessee and lessor have termination rights, but only one party would suffer a more than insignificant penalty?

IFRS 16.B34–B35, B37, BC127, IU 11-19

The existence of a lessee's more than insignificant termination penalty affects the lease term; however, the lessor's more than insignificant termination penalty alone does not affect the lease term.

For a discussion on how these termination rights affect the enforceable period, see Section 3.3.

Scenario 1 – Both parties have termination rights without the permission of the other, but only the lessor's right gives rise to a more than insignificant penalty

When the lessor's termination right becomes exercisable at the same time as or after the lessee's termination option, the lease term is the shorter of the period from the lease commencement until:

- the lessor's exercise of its termination option no longer gives rise to a more than insignificant penalty; or
- the lessee's termination option becomes exercisable plus any periods after that for which the lessee is reasonably certain not to exercise the option.

In this scenario, even if the enforceable period extends to when the lessor's exercise of its termination option no longer gives rise to a more than insignificant penalty, then under paragraph B37 of the standard the lease term would generally not include periods after the lessee's termination option becomes exercisable. This is because, in the absence of a more than insignificant penalty from termination, the lessee would not be reasonably certain to extend the lease beyond the optional termination date.

Scenario 2 – Both parties have termination rights without the permission of the other, but only the lessee's right gives rise to a more than insignificant penalty

If the lessee's termination right results in a more than insignificant penalty, regardless of when the lessor's becomes exercisable, then the lease term is the shorter period from the lease commencement until:

a. the lessee's exercise of its termination option no longer gives rise to a more than insignificant penalty; or

b. the lessee's termination option becomes exercisable (regardless of the penalty) plus any periods after that for which the lessee is reasonably certain not to exercise the option.

Generally, (b) will be equal to or shorter than (a). Therefore, it will generally be unnecessary for a company to calculate both (a) and (b).

4.3 Evergreen leases

Evergreen leases are leases that automatically renew on a day-to-day, week-to-week or month-to-month basis – i.e. they are cancellable leases as described in Section 3.6. For these leases, once the enforceable period is established the lease term is determined in the same manner as for all other leases. This involves considering whether the lessee is reasonably certain to exercise one or more of the renewal options. The assessment is based on all relevant facts and circumstances that create an economic incentive for the lessee to exercise the option to renew.

IFRS 16.B39

The shorter the non-cancellable period of a lease, the more likely a lessee is to exercise an option to extend the lease or not to exercise an option to terminate the lease. This is because the costs associated with obtaining a replacement asset are likely to be proportionately higher for a shorter non-cancellable period.

Example 16 – Leases with no stated term

IFRS 16.B37, B39

Lessor R leases equipment to Lessee E. There is no stated duration for the lease in the contract. E can terminate the lease at any time by returning the underlying asset to R's location. For each day that the asset remains in E's possession, E will pay a fixed fee to R for the right to use that asset.

The non-cancellable period of the lease is one day because E could elect to return the asset to R's location before the start of Day 2. If E has an ongoing need to use an asset similar to the underlying asset in its business, then the costs to E of terminating the lease (e.g. returning the underlying asset to R's location) and entering into a new lease (e.g. identifying another asset, entering into a different contract and training employees to use a different asset) may provide a compelling economic reason for E to continue to use the same asset for a period that is longer than the non-cancellable period – i.e. the lease term may be more than one day.

How does the assessment of reasonably certain differ for evergreen leases?

IFRS 16.A, B37, B39

It does not differ. The lease term for evergreen leases is determined in the same manner as for all other leases, which means considering whether the lessee is reasonably certain to exercise one or more available renewal options.

Determining whether a lessee is reasonably certain to exercise a renewal option in an evergreen lease may involve significant judgement. In general, the shorter the non-cancellable period of a lease, the more likely it is that a lessee is reasonably certain to exercise one or more renewal options. This is because, in many cases, it may be prohibitive to continually substitute leased assets.

For example, if a lessee is leasing a piece of construction equipment on a monthly basis and expects to need a substantially similar piece of equipment for the duration of an 18-month project, then there may be a significant economic incentive to renew the lease rather than continually substitute that asset throughout the period.

IFRS 16.A, B39

Does an evergreen lease always qualify for the short-term lease exemption?

No. A short-term lease is a lease that, at commencement, has a lease term of 12 months or less. A lessee assesses the lease term for leases that could qualify as a short-term lease and be eligible for the exemption. Potential short-term leases include evergreen leases – i.e. those on a day-to-day, week-to-week or month-to-month basis.

5 Reassessment

Reassessment of the lease term introduces volatility to assets and liabilities.

5.1 Overview

IFRS 16.20

After the commencement date and in certain circumstances, a lessee reassesses whether it is reasonably certain to exercise an option to extend the lease or not to exercise an option to terminate the lease early (see Section 5.2).

This requirement to reassess the key estimates and judgements when determining the lease term introduces financial statement volatility.

The lessee does this only when there has been a significant event or a significant change in circumstances that:

- is within its control; and
- affects whether it is reasonably certain to exercise those options.

IFRS 16.21

In addition, both a lessee and a lessor revise the lease term when there is a change in the non-cancellable period of a lease (see Section 5.3).

After the lease commencement date, a company reassesses the lease term and options

Lessee
- Significant event or change in circumstances within lessee control
- Change in the non-cancellable period

Lessor
- Change in the non-cancellable period

When there is a change in the lease term, a lessee remeasures its lease liability using a revised discount rate and, generally, makes a corresponding adjustment to the right-of-use asset (see Section 5.4).

For more discussion on reassessing the lease term in the event of a lease modification that is not accounted for as a separate contract, see our Lease modifications publication.

5.2 Lessee reassessment of renewal and termination options

IFRS 16.BC185(b), BC186

A lessee does not reassess renewal and termination options at each reporting date solely in response to changes in market conditions or circumstances. Instead, the lessee applies judgement in identifying significant events or significant changes in circumstances that trigger a reassessment.

IFRS 16.B41

The standard provides the following examples of significant events and changes in circumstances that are within the control of the lessee and may change its assessment of whether it is reasonably certain to exercise, or not to exercise, renewal and termination options:

- significant leasehold improvements that the lessee did not anticipate at the commencement date, if it expects them to have a significant economic benefit when the option to extend or terminate the lease, or to purchase the underlying asset, becomes exercisable;
- a significant modification to, or customisation of, the underlying asset that was not anticipated at the commencement date;
- the inception of a sub-lease of the underlying asset for a period beyond the end of the previously determined lease term; and
- a business decision by the lessee that is directly relevant to exercising, or not exercising, an option – e.g. a decision 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 used.

Example 17 – Leasehold improvements and reassessment of lease term

Retailer W leases a shop from Landlord L.

The lease has a non-cancellable term of five years and W can renew the lease for a further five years – i.e. the lease has a potential maximum term of 10 years.

Initial assessment at commencement

At lease commencement, W assesses that it is not reasonably certain to exercise the renewal option and therefore determines that the lease term is five years.

Subsequent reassessment of certainty that option will be exercised

During Year 3, W undergoes significant rebranding – changing its logo, colour scheme and target market. At this time, W installs significant leasehold improvements, which include a store fascia, shelving and other branded material. Based on its experience at other stores, W believes that these materials have a useful life of 10 years once they are installed; they cannot be repurposed to other stores because they would be damaged in being removed.

IFRS 16.B37(b)

W notes that it was its decision to install the leasehold improvements and the improvements are evidence that it has a significant economic incentive to renew the lease. W updates its overall assessment and notes that it is now reasonably certain to extend the lease.

Accordingly, W reassesses the lease term and determines that the remaining lease term is seven years. W remeasures the lease liability using a revised discount rate and makes an equal adjustment to the right-of-use asset.

Example 18 – Lessee termination option: Reassessing if reasonably certain not to be exercised

Lessee B enters into a 10-year lease of a floor of an office building.

There is no renewal option but B has the option to terminate the lease early after Year 5 with a penalty equal to three months' rent of 25,000.

The annual lease payments are fixed at 100,000 per annum.

At the commencement date, the building is brand new and is technologically advanced compared with other office buildings in the surrounding business area, and the lease payments are consistent with the market rental rate.

Initial assessment at commencement

At the commencement date, B concludes that it is reasonably certain not to exercise the option to terminate the lease early. Therefore, it excludes the termination penalty from its lease liability and determines the lease term as 10 years.

Subsequent reassessment of certainty that option will be exercised

During Year 4, B sells a significant component of its business and reduces its headcount by 50%.

At the end of Year 4, similar office buildings in the area that meet B's needs for a smaller workforce are available for lease from Year 6 for annual payments of 55,000. B estimates that the cost to move its workforce would be 40,000.

IFRS 16.20

B concludes that the change in circumstances is significant, was within its control and affects whether it is still reasonably certain not to exercise the termination option.

To evaluate whether it is still reasonably certain that it will not terminate the lease early, B compares the future cash outflows as follows.

Year	Existing lease ('000)	New lease ('000)
6	100	120*
7	100	55
8	100	55
9	100	55
10	100	55
Total	**500**	**340**

* *Determined as annual lease (55) + penalty (25) + moving costs (40) = 120.*

B makes an overall assessment of whether it now continues to have an economic incentive not to terminate the lease early, including considering the cost savings of moving to a smaller office space.

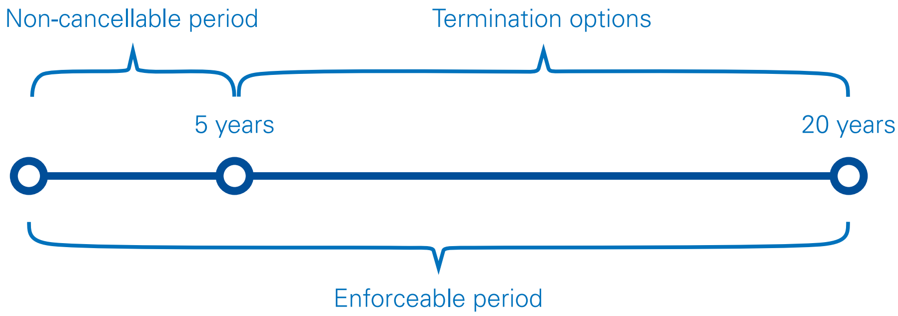
Because the cost savings of moving to a smaller office space far exceed the penalty for early termination, at the end of Year 4, B concludes that it is no longer reasonably certain not to exercise the option to terminate early at the end of Year 5. For simplicity, this example ignores the time value of money but in practice B would consider this when making its assessment.

B includes the termination penalty (25,000) in its lease payments and determines that the remaining lease term has been reduced to one year.

B remeasures its lease liability using a revised discount rate and makes an equal adjustment to the right-of-use asset. However, if the amount of the adjustment to the lease liability exceeds the carrying amount of the right-of-use asset, then B remeasures the right-of-use asset to zero and recognises the excess in profit or loss.

Example 19 – Lessee termination option: Reassessing if reasonably certain not to be exercised: Continuous management review

IFRS 16.20–21, BC185(b), BC186



Retailer (lessee) X enters into leases of retail stores, which include the following terms.

- The enforceable period is 20 years.
- The non-cancellable period is five years.
- After four and half years, X can terminate each lease by giving six months' notice.

Initial assessment at commencement

To determine the lease term at the commencement date, X assesses whether it is reasonably certain not to exercise the termination option.

Subsequent reassessment that termination option will not be exercised

Subsequently, X continually monitors trading at each store. If there are no negative indicators – e.g. trading at the store continues to meet initial expectations – then X continually resets its operational planning horizon for the store to five years from the current date.

Continued trading at expected levels and reset of the operational planning horizon do not, in isolation, trigger reassessment of the lease term. Accordingly, X does not automatically reset the remaining lease term to five years on a rolling basis at each reporting date. Instead, X assesses whether there is a change in the non-cancellable period of the lease or another trigger for reassessing the lease term.

What is the impact of having to reassess the lease term?

IFRS 16.20

The requirement in the standard for the lessee to reassess the lease term – i.e. on the occurrence of a significant event or significant change in circumstances within the lessee's control – is an important change from IAS 17. It is no longer possible for companies to compute a lease amortisation schedule at lease commencement and roll that schedule forward at each reporting date without additional consideration.

Instead, each time they report companies need to consider whether one or more triggering events have occurred since the last reporting date that would require them to reassess their key judgements and remeasure their lease balances.

Remeasurements during the lease term, when they are required, provide more up-to-date information to users of financial statements. However, they also introduce new volatility in reported assets and liabilities, which may impact the ability to accurately predict and forecast future financial performance. Additional resources will be focused on lease accounting not only at lease commencement, but also at and between each reporting date.

Significant judgement is likely to apply when determining whether there is a change in relevant factors or a change in the lessee's economic incentive to exercise or not to exercise renewal or termination options. Companies may need to develop indicators for identifying triggers for reassessment to ensure consistent application.

A lessee's reassessment of key judgements may, in some cases, have a significant impact on the lease amounts recognised in the statement of financial position and the statement of profit or loss and other comprehensive income.

Can events that significantly affect economic activity – e.g. the COVID-19 pandemic – trigger a reassessment of renewal or termination options?

IFRS 16.20, B41, BC156(b)

Events that significantly affect economic activity – e.g. the COVID-19 pandemic – may disrupt business operations, supply chains and production lines, which in turn affect whether a lessee has an economic incentive to exercise or not to exercise a renewal or termination option.

However, it is important to note that the COVID-19 pandemic is not in and of itself a triggering event for lease reassessment. Instead, the key point is that companies may take actions that affect their lease contracts in response to the uncertainty caused by these events.

They may need to reassess lease contracts containing renewal and termination clauses to determine whether there is any change to the lease term as a result of their actions taken. This means that a company's actions may trigger a lease term reassessment even though the COVID-19 pandemic itself will not. Any changes in the lease term could have a significant impact on the carrying amount of lease assets and liabilities.

A lessee applies judgement when identifying significant events or significant changes in circumstances that trigger reassessment of these options, recalling that those events or changes in circumstances should be within its control and reflect actions taken that extend beyond changes to management intent. It then considers the effect of current economic incentives to determine whether it is reasonably certain to exercise or not to exercise each option.

For example, a retailer concludes that actions taken to execute revised commercial plans developed in response to the COVID-19 pandemic trigger a reassessment of renewal options in its store leases (e.g. actions undertaken to close one store may have a direct effect on whether the lessee will renew the lease for another store). In assessing whether it is reasonably certain to exercise the renewal options for store leases subject to a triggering event, the retailer considers the economic incentives existing at the date of the reassessment.

Is the lessee allowed to reassess the lease term based on changes in events or circumstances that are not within its control?

IFRS 16.20, BC185(b)

No. The standard requires a lessee to reassess whether it is reasonably certain to exercise an option only if the significant event or significant change in circumstances is within its control. This is reinforced in the standard's basis for conclusions.

For example, Lessee D leases a retail store from Lessor E for a non-cancellable period of five years, with two five-year renewal options each at market rentals. At lease commencement, D concludes that it is not reasonably certain to exercise either of the five-year renewal options. Therefore, the lease term at commencement is five years.

At the end of Year 3 of the five-year lease term, a major renovation of the building's surrounding neighbourhood is announced. The renovation is expected to increase consumer traffic in the area significantly, which in turn is expected to substantially affect the revenue that the retail store will generate.

In this example, D does not reassess the lease term because the significant event and change in circumstances relating to the building were not within its control.

Market-based factors that are not within the lessee's control do not, in isolation, trigger a reassessment of a lessee option. However, when D gives notice to E that it will exercise the renewal option at the end of five years, this will cause a change in the non-cancellable period and D revises the lease term accordingly (see Section 5.3).

Does an asset impairment triggering event automatically trigger a reassessment of the lease term for the lessee?

No. Only a significant event or change in circumstances within the lessee's control will trigger a reassessment of the lease term. A change in market-based factors does not, in isolation, trigger a reassessment of the lease term.

Impairment triggering events under IAS 36 *Impairment of Assets* can be solely market-based and not within a company's control. Examples include a significant decline in market value and an adverse effect in the economic environment.

Therefore, an impairment triggering event may or may not trigger a reassessment of the lease term, depending on the nature of the event.

Example of impairment indicator triggering a reassessment of the lease term

A significant change by the lessee in the extent or manner in which it is using the underlying asset is an example of an impairment triggering event. Because it is an action within the lessee's control, it would also cause the lessee to reassess whether it is reasonably certain to exercise a renewal option.

Example of impairment indicator not triggering a reassessment of the lease term

The poor performance of a retail location is a market-based condition that is outside the lessee's control. It is an indicator of impairment but in isolation is not a trigger for the lessee to reassess the lease term. If a lessee takes no action – e.g. to vacate the retail location – then it does not reassess the lease term but it may need to recognise an impairment loss.

Does entering into a sub-lease with a longer term than the remaining head lease term trigger a remeasurement of the head lease?

Yes. Two parties may enter into a sub-lease in which the non-cancellable period of the sub-lease or the sub-lease term – i.e. including one or more optional periods – exceeds the lease term for the head lease. Because the act of entering into the sub-lease is a significant event within the intermediate lessor's control, it reassesses the head lease term. This will result in the term of the head lease being equal to or longer than the term of the sub-lease. If this represents a change in the term of the head lease, then this will trigger a remeasurement of the intermediate lessee's liability under the head lease.

Is a lessor required to reassess the lease term when the lessee reassesses whether it is reasonably certain to exercise an option?

IFRS 16.20–21

No. Lessors reassess the lease term and remeasure the lease payments only when there is a change in the non-cancellable period of the lease, as described in paragraph 21 of the standard. In contrast, paragraph 20 requires reassessment in additional circumstances, but this applies only to lessees.

The Board intended to minimise changes to lessor accounting under IAS 17, under which lessors generally determined the lease term at commencement and did not reassess unless there was a change in the contract. IFRS 16 provides detailed guidance on the lessor accounting for lease modifications (see our Lease modifications publication).

In our experience, it may often be difficult for a lessor to assess when there is an event or change in circumstances causing the lessee to reassess whether it is reasonably certain to exercise an extension or termination option, because these essentially relate to changes in the lessee's economic incentives.

5.3 Change in the non-cancellable period

IFRS 16.21

A company revises the lease term when there is a change in the non-cancellable period of a lease. This requirement applies to both lessees and lessors. For example, the non-cancellable period of a lease will change if:

– the lessee exercises an option that was not previously included in the company's determination of the lease term;

– the lessee does not exercise an option that was previously included in the company's determination of the lease term;

– an event occurs that contractually requires the lessee to exercise an option that was not previously included in the company's determination of the lease term; or

– an event occurs that contractually prohibits the lessee from exercising an option that was previously included in the company's determination of the lease term.

Example 20 – Date of the change in the non-cancellable period

IFRS 16.21

Lessee L leases a retail store from Lessor R. The lease is non-cancellable for 10 years and includes a five-year renewal option. L is required to notify R if it intends to exercise the renewal option by the end of Year 9. At lease commencement, L concludes that it is not reasonably certain to exercise the renewal option and, therefore, the lease term is 10 years.

The retail location performs better than expected for reasons not anticipated at lease commencement. In Year 7, L decides that it will exercise the renewal option. However, L decides not to notify R until it is required to do so – i.e. at the end of Year 9.

In this case, the better-than-expected trading performance is a market-based factor, which does not in isolation trigger a reassessment of the lease term. Therefore, L reassesses the lease term only when it formally notifies R that it will renew the lease – i.e. at the end of Year 9.

If the non-cancellable period becomes fixed only after the lease commencement, then should a company reassess the lease term?

IFRS 16.21, BC184, BC187

Yes, if the fixed period is different from the initial estimate.

As discussed in Chapter 2, if the non-cancellable period of the lease is not fixed at lease commencement, then the company should estimate the non-cancellable period. In this case, it appears that a company should reassess the lease term when the non-cancellable period of the lease becomes fixed and differs from the initial estimate.

We believe that not updating the lease term could result in counter-intuitive accounting results. For example, the lessor might recognise lease income (or lease expense for the lessee) over a period that is unrelated to the non-cancellable period of the lease.

5.4 Lessee remeasurement

IFRS 16.30(b), 36(c), 39–40

After the commencement date, a lessee remeasures the lease liability using revised lease payments and a revised discount rate when the lease term changes.

A lessee adjusts the carrying amount of the right-of-use asset for remeasuring the lease liability. If the carrying amount of the right-of-use asset has already been reduced to zero and there is a further reduction in the measurement of the lease liability, then a lessee recognises any remaining amount of the remeasurement in profit or loss.

Example 21 – Remeasurement by a lessee and accounting for a change in assessment of the lease term

Lessee E enters into a non-cancellable five-year lease with Lessor R for the right to use office space. E has an option to renew the five-year lease for an additional five-year period. Annual lease payments are fixed at 1,000 and are paid at the end of each year. The rents for the renewal period are also 1,000 per year. E's incremental borrowing rate is 5%.

Assessment of reasonably certain at commencement date

At the commencement date, E concludes that it is not reasonably certain to exercise the renewal option. This is because there are similar office buildings available to rent nearby at similar rentals and relocation costs would be low. Consequently, the lease term consists of the five-year non-cancellable period only. Therefore, E measures its lease liability as 4,330[1].

At the commencement date, the lease liability and right-of-use asset are expected to be amortised as follows.

Year	Lease liability				Right-of-use asset		
	Beginning	**Lease payment**	**Interest**	**Ending**	**Beginning**	**Deprecia-tion**	**Ending**
1	4,330	(1,000)	217	3,547	4,330	(866)	3,464
2	3,547	(1,000)	177	2,724	3,464	(866)	2,598
3	2,724	(1,000)	136	1,860	2,598	(866)	1,732
4	1,860	(1,000)	93	953	1,732	(866)	866
5	953	(1,000)	47	-	866	(866)	-

Note

1. Calculated as $\frac{1,000}{1.05} + \frac{1,000}{1.05^2} + \frac{1,000}{1.05^3} + \frac{1,000}{1.05^4} + \frac{1,000}{1.05^5}$

Reassessing if reasonably certain

At the end of Year 3, E constructs significant non-removable leasehold improvements with an expected useful life of seven years. This decision is within E's control and represents a significant change in circumstances. E assesses that it now has a significant economic incentive to exercise the renewal option.

Accordingly, E concludes that it is now reasonably certain to exercise the renewal option. Therefore, the remaining lease term at the end of Year 3 is seven years.

IFRS 16.40

Remeasuring the lease liability and right-of-use asset

Because the remeasurement of the lease liability results from a change in the lease term, E is required to use a discount rate for the lease determined at the remeasurement date (i.e. at the end of Year 3). E's incremental borrowing rate at the end of Year 3 is 6%. Using the revised discount rate of 6% at the end of Year 3, E remeasures the lease liability from 1,860 to 5,582[(2)] and the right-of-use asset from 1,732 to 5,454[(3)], and records the following entries.

	Debit	*Credit*
Right-of-use asset	3,722	
Lease liability		3,722
To measure liability at end of Year 3		

The lease liability and right-of-use asset are expected to be amortised/ depreciated as follows.

Year	**Lease liability**				**Right-of-use asset**		
	Beginning	**Lease payment**	**Interest**	**Ending**	**Beginning**	**Deprecia-tion**	**Ending**
4	5,582	(1,000)	335	4,917	5,454	(779)	4,675
5	4,917	(1,000)	295	4,212	4,675	(779)	3,896
6	4,212	(1,000)	253	3,465	3,896	(779)	3,117
7	3,465	(1,000)	208	2,673	3,117	(779)	2,338
8	2,673	(1,000)	160	1,833	2,338	(779)	1,559
9	1,833	(1,000)	110	943	1,559	(779)	780
10	943	(1,000)	57	-	780	(780)	-

Notes

2. Calculated as $\frac{1,000}{1.06} + \frac{1,000}{1.06^2} + \frac{1,000}{1.06^3} + \frac{1,000}{1.06^4} + \frac{1,000}{1.06^5} + \frac{1,000}{1.06^6} + \frac{1,000}{1.06^7}$
3. Calculated as 1,732 + 3,722

6 Application issues

6.1 Inter-company leases

Under IFRS® Standards, related party transactions are accounted for under the requirements of relevant standards. However, transactions between related parties are not always documented, which raises particular issues – e.g. with inter-company arrangements.

For example, a company may occupy a building owned by another company in the same group, with little or no formal documentation of the arrangement. It may also be the case that there is no amount payable that is identified as a lease payment, but instead a 'management charge' or similar is payable each year. If the company concludes that this arrangement is an inter-company lease, then a key question is how to determine the lease term.

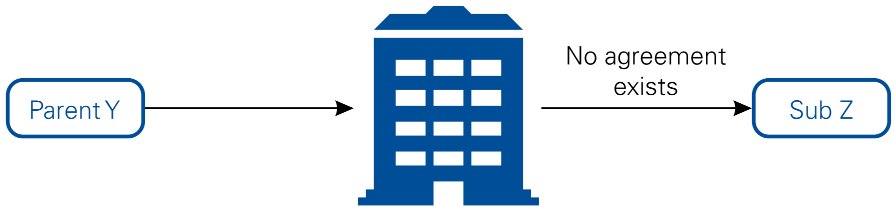
Under IFRS 16, a company determines the enforceable period in the same way, regardless of whether the counterparty is a related party – i.e. assessing the enforceable rights and obligations is based on the contract and the applicable laws and regulations.

Example 22 – Group leases where no contract exists

Parent Y owns a building that is occupied by its subsidiary Z.

Z has occupied the whole of the building for 10 years and it expects to remain in occupation for the foreseeable future.

- Z pays an annual fee to Y for using the building.
- Y determines an annual fee each year.
- No written agreement exists between Y and Z.



In this example, Y and Z assess whether there is a contract and, if so, whether it contains a lease.

In assessing whether there is a contract, Y and Z consider all of the relevant evidence, including:

- the documentation of the arrangement included in board minutes and correspondence;
- the long-standing occupation of the building by Z;

- the practice of Y charging, and Z paying, for occupation of the building;
- penalties that either Y or Z might suffer if the arrangement were to be terminated; and
- the relevant laws and regulations in the jurisdiction that stipulate the rights and obligations that arise when one party occupies a building owned by another.

How do you determine the enforceable period in inter-company property leases?

The standard does not provide specific guidance for related parties. Therefore, the enforceable period and the lease term are determined in the same way whether the contract is with unrelated or related parties.

However, transactions with related parties may bring additional challenges – e.g. when there is a lack of written documentation.

For example, a parent company leases land to its subsidiary with the following terms.

- The written contract is for 12 months and contains no extension options.
- The subsidiary will use the land to construct a manufacturing plant that has a 30-year useful life.

When determining the enforceable period, both companies consider facts and circumstances beyond the 12-month written agreement, including the following.

- Are there relevant laws and regulations in place that would determine the parties' rights and obligations beyond the 12-month period – e.g. would the law permit the parent not to renew the lease after 12 months and to evict the subsidiary with no penalties?
- What is the economic rationale for having a 12-month contract when both the parent and subsidiary know about the construction of this manufacturing plant and the intention of extending beyond the contractual terms?
- Are there other sources of enforceable rights beyond the written agreement – e.g. oral agreements, written communications or other forms of representations between the parties (e.g. letters of support)?
- What will happen with the plant constructed if the lease is not renewed after 12 months and what is the impact on the plant's useful life and depreciation period?
- At the commencement of the original lease, were there negotiations on the terms and conditions relating to continuing the lease?

Facts and circumstances may provide evidence that the lease is enforceable beyond the end of the original non-cancellable period. Companies need to apply judgement to evaluate the enforceable period and it may be appropriate to seek legal advice to determine the enforceable rights in some circumstances.

6.2 Non-consecutive periods of use

IFRS 16.A

The 'period of use' is the total period of time over which an asset is used to fulfil a contract with a customer. This includes any non-consecutive periods of time. Therefore, the lease term is evaluated on the basis of the aggregate period of use – i.e. the sum of the non-consecutive periods.

In leases that include non-consecutive periods of time, it appears that a lessee should depreciate the right-of-use asset on a straight-line basis over the non-consecutive periods in which the asset is used. Conversely, we believe that a lessee should accrue the interest expense on the outstanding lease liability over the whole period from the lease commencement to the end of the lease term, and not only during the non-consecutive periods that comprise the lease term.

Example 23 – Period of use: Non-consecutive periods

Football Team V has an exclusive right to use a specific stadium for the months of September to May each year during its playing season. The contract runs for 10 years. From June to August, the owner of the stadium uses it to hold concerts and other events.

In this example, the period of use consists of 90 non-consecutive months. This is because V can use the stadium for nine months each year over the 10-year contract. The owner's use in the remaining months of the year does not prevent the contract from being a lease (provided that the other aspects of the definition are met).

Example 24 – Lease term: Non-consecutive periods

Continuing Example 23, provided that neither Football Team V nor the stadium owner can terminate the lease before the end of the 10-year period without permission from the other party and with no more than an insignificant penalty, the lease term is 90 months – i.e. the sum of the non-consecutive periods of use.

We believe that V should depreciate the right-of-use asset on a straight-line basis over the periods of use – i.e. from September to May each year. It should not recognise any depreciation when it does not use the underlying asset – i.e. from June to August each year.

However, we believe that interest expense should accrue on the outstanding lease liability over the whole period from lease commencement to the end of the lease term, and not only during the non-consecutive periods that are included in the lease term.

Is the short-term exemption available when the period of use comprises non-consecutive periods of time?

Yes, assuming the lease does not include an option for the lessee to purchase the underlying asset. If the sum of those non-consecutive periods of time is 12 months or less, then the lease is a short-term lease and is eligible for the lessee short-term lease recognition exemption (if it is elected by the lessee).

For example, if a retailer enters into a three-year agreement to lease a store in a mall in October, November and December for each year of the contract period, then the lease term is nine months and the retailer can elect the short-term lease exemption.

6.3 Lease term start date

IFRS 16.A, B36

The lease term starts when the lessor makes the underlying asset available for use by the lessee – i.e. at the commencement date. It includes any rent-free periods provided to the lessee by the lessor after the commencement date.

Example 25 – Lease term: Identifying the commencement date

Company B leases a retail store from Lessor C. C makes the store available for B on 1 April 2020.

B is not required to pay rent in April, May and June. After that, rents are payable quarterly in advance and the first rent payment is due on 1 July.

Although C makes the store available to B on 1 April 2020, B chooses to customise and refurbish the interior of the property before opening so that its design and branding conform to B's other stores. B starts customisation work on 1 May 2020, the earliest date its contractors are free to begin work at the store. B opens the store to customers on 1 June 2020.

In this example, the commencement date of the lease is 1 April 2020. This is because C made the underlying asset available for use by B on 1 April 2020.

6.4 Perpetual arrangements

IFRS 16.9

A company may enter into an arrangement with another company that allows it to use an asset for a very long period. In some cases, the arrangement may be perpetual; in others, it may feature multiple renewal options that the lessee is expected to exercise.

Questions arise about whether perpetual arrangements are in fact leases and, if so, how a company might determine the lease term.

Does a perpetual arrangement meet the definition of a lease?

No. This is because a lease conveys the right to control the use of an identified asset for a specified period of time in exchange for consideration. It appears that 'perpetual' is not a specified period of time when identifying a lease. Therefore, we believe that a perpetual arrangement lacks an essential characteristic of a lease – i.e. it does not meet the definition of a lease because it does not convey a right to use an underlying asset for a specified period of time. Instead, we believe that a perpetual arrangement is effectively a form of ownership interest in an asset that lasts forever.

For example, a landowner may grant the right to a power company to place a pipeline on its land in perpetuity. Because the arrangement is perpetual and does not relate to a specified period of time, it is not a lease, even if the other parts of the lease definition are met.

What is the difference between a 'perpetual' arrangement and an arrangement with 'no stated term'?

A perpetual arrangement is an arrangement that lasts forever. Therefore, it is similar to an ownership interest.

An arrangement with 'no stated term' is an arrangement that is renewable on a period-by-period basis or continues until it is cancelled. It is also referred to as an 'evergreen' arrangement. In this case, although the period of use may be uncertain and subject to considerable estimation uncertainty, it is not perpetual. This type of arrangement is a lease if the other parts of the definition are met (see Section 4.3).

7 Disclosure

Lessees and lessors need to disclose critical accounting judgements and changes in the application of their accounting policies.

7.1 Overview and general disclosure objective

IFRS 16.51, 89, BC215–BC216, BC251–BC252

The standard specifies an overall disclosure objective for lessees and lessors – i.e. they should disclose information that provides a basis for users of financial statements to assess the effects that leases have on their financial position, financial performance and cash flows.

IFRS 16.53–57, 90–91, BC217

The Board decided that there are particular items of information that, if they are material, should be disclosed by lessees and lessors to meet this objective. For example:

– a lessee discloses quantitative information about its right-of-use asset, expenses and cash flows related to leases; and

– a lessor discloses information about its lease income for operating leases; and selling profit or loss, finance income and income related to variable lease payments for finance leases.

For an illustration of disclosures under the standard, see our Guide to annual financial statements – Illustrative disclosures (September 2019).

Why does the standard request that lessees and lessors focus on the disclosure objective, not on a fixed checklist?

IFRS 16.BC215–BC216

The Board aims to improve the interpretation and implementation of the disclosure requirements by including a general disclosure objective. This is intended to be a benchmark for lessees and lessors to assess whether the overall quality and informational value of their lease disclosures are sufficient.

Lessees and lessors also apply the concept of materiality to determine what should be disclosed. Therefore, it appears that the necessary disclosures could be less or more than those listed in the standard, depending on the individual situation. This is in line with the Board's overall approach in its disclosure initiative project.

IFRS 16.59, 92, B48–B52

The standard contains specific considerations for lessees to determine whether additional quantitative and qualitative information should be disclosed and lists various examples of these disclosures. Similar considerations apply to lessors. However, the guidance in the standard on additional disclosures for lessors is limited compared with that for lessees.

7.2 Company-specific qualitative and quantitative disclosures

IFRS 16.59, 92

To meet the disclosure objective, lessees and lessors also disclose qualitative and quantitative information about their leasing activities in addition to the general disclosure requirements.

IFRS 16.59, BC224–BC225

Many leases contain more complex features – e.g. termination and extension options. In some circumstances, those features are particularly complex or are unique. The standard requires disclosure of any material company-specific information that is necessary to meet its disclosure objective. Judgement applies in determining the most relevant and useful disclosures in specific circumstances.

What additional quantitative information may a lessee disclose?

IFRS 16.59(b), BC224

A lessee might disclose information that helps users of the financial statements assess a lessee's potential future cash outflows that are not reflected in the measurement of its lease liabilities – e.g. exposure to not reasonably certain extension options and reasonably certain termination options.

Illustrations of additional company-specific information

The following are extracts from our Guide to annual financial statements – Illustrative disclosures (September 2019).

IFRS 16.51, 59

Leases as lessee

The Group leases warehouse and factory facilities. The leases typically run for a period of 10 years, with an option to renew the lease after that date. Lease payments are renegotiated every five years to reflect market rentals. Some leases provide for additional rent payments that are based on changes in local price indices. For certain leases, the Group is restricted from entering into any sub-lease arrangements.

IFRS 16.59(b)(ii), B50, IE10 Ex.23

Extension options

Some property leases contain extension options exercisable by the Group up to one year before the end of the non-cancellable contract period. Where practicable, the Group seeks to include extension options in new leases to provide operational flexibility. The extension options held are exercisable only by the Group and not by the lessors. The Group assesses at lease commencement whether it is reasonably certain to exercise the extension options. The Group reassesses whether it is reasonably certain to exercise the options if there is a significant event or significant changes in circumstances within its control.

The Group has estimated that the potential future lease payments, should it exercise the extension option, would result in an increase in the lease liability of 120.

IFRS 16.90–91

Leases as lessor

The Group leases out its investment property consisting of its owned commercial properties as well as leased property. All leases are classified as operating leases from a lessor perspective with the exception of a sub-lease, which the Group has classified as a finance sub-lease.

IFRS 16.92(a)

Finance lease

During 2019, the Group has sub-leased a building that has been presented as part of a right-of-use asset – property, plant and equipment.

IFRS 16.92(a)

Operating lease

The Group leases out its investment property. The Group has classified these leases as operating leases because they do not transfer substantially all of the risks and rewards incidental to the ownership of the assets.

7.3 IAS 1 disclosures

IAS 1.117–133

In addition to specific disclosure requirements under IFRS 16, companies should also consider disclosure requirements in other standards. For example, IAS 1 *Presentation of Financial Statements* requires disclosure of:

- significant accounting policies comprising the measurement basis (or bases) used in preparing the financial statements and other accounting policies relevant to an understanding of the financial statements;
- judgements that management has made in applying the company's accounting policies and that have the most significant effect on the amounts recognised in the financial statements; and
- information about the assumptions made about the future and other major sources of uncertainty at the reporting date that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next fiscal year.

Examples of judgements made when determining the lease term

IFRS 16.A, 19, B34, B37

When applying a company's accounting policies, management makes a number of judgements that can significantly affect the amounts recognised in the financial statements. A company discloses the judgements that have the most significant effects. Examples of judgements made when determining the lease term include:

- what economic penalties have been considered in assessing the enforceable period – i.e. when applying paragraph B34 of IFRS 16; and
- whether the lessee is reasonably certain to exercise an extension option or not to exercise a termination option – i.e. when considering the factors that create an economic incentive in paragraph B37 of the standard.

7.4 IAS 8 disclosures – Change in the interpretation of 'penalty' under paragraph B34 of IFRS 16

IFRS 16.B34, BC127, IU 11-19

As mentioned in Section 3.4, the IFRS Interpretations Committee discussed the interpretation of 'penalty' and noted that in applying paragraph B34 of IFRS 16 and determining the effect of termination rights, a company considers the broader economics of the contract and not only the contractual termination payments. Therefore, if either party has an economic incentive not to terminate the lease – i.e. it would incur a penalty on termination that is more than insignificant – then the contract is enforceable beyond the date on which the contract can be terminated.

How do you account for a change in the interpretation of penalty when determining the enforceable period?

IFRS 16.B34, IAS 8.19–22

A company may have previously interpreted paragraph B34 of the standard differently from the Committee in its agenda decision. For example, a company may have considered only contractual termination payments as penalties. Following the Committee's agenda decision, the company needs to reassess the lease term for its leases using the broader definition of penalty. This reassessment may result in a longer enforceable period. It may also result in a longer lease term if the lessee is reasonably certain to exercise an extension option or not to exercise a termination option.

This represents a change in accounting policy, which is applied retrospectively with comparative amounts restated.

How and when should changes in accounting policy resulting from agenda decisions be implemented?

In December 2018, the Board confirmed its view that companies should be entitled to 'sufficient time' to implement changes in accounting policy that result from an agenda decision. Although 'sufficient time' depends on a company's particular facts and circumstances, the Board expects that any necessary accounting policy changes are implemented on a timely basis – i.e. as soon as possible.

When a company is affected by an agenda decision, the expectation is that the company:

- implements the resulting changes in a timely manner;
- accounts for the resulting changes as a change in accounting policy under IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* – i.e. retrospectively;

- considers the disclosures similar to those in paragraphs 30 and 31 of IAS 8 if the accounting policy change resulting from an agenda decision has not been applied in financial statements issued after the publication of an agenda decision; and
- considers the requirements or expectations of local regulators on the timing of implementation of agenda decisions.

For example, Company T has a 31 December 2019 annual reporting date. In November 2019, the IFRS Interpretations Committee publishes an agenda decision that results in a change in accounting policy for T. The financial statements are authorised for issue in March 2020.

Scenario 1 – T is able to implement the agenda decision in its 2019 financial statements

T needs to implement the agenda decision in a timely manner – i.e. in the next financial statements authorised for issue after the publication date of the agenda decision. In the absence of facts and circumstances indicating that more time is needed, T should implement the agenda decision in the annual financial statements for 31 December 2019.

Scenario 2 – T needs more time to implement the agenda decision

T determines that it needs more time to implement the agenda decision – e.g. the impact of the agenda decision is extensive and T needs time to collect additional information to apply the new policy and needs to change processes or systems significantly. T includes appropriate disclosures about the resulting changes, the expected impact and implementation plan in its 2019 financial statements. T implements the agenda decision as a change in accounting policy in its 2020 financial statements, restating the comparative amounts accordingly.

Appendix I – IFRS 16 at a glance

Topic	Key facts
Lease definition	– New lease definition with an increased focus on control of the underlying asset
Lessee accounting model	– Single lease accounting model – No lease classification test – Most leases on-statement of financial position: - lessee recognises a right-of-use asset and lease liability - treated as the purchase of an asset on a financed basis
Lessor accounting model	– Dual lease accounting model for lessors – Lease classification test based on IAS 17 classification criteria – Finance lease accounting model based on IAS 17 finance lease accounting, with recognition of net investment in lease comprising lease receivable and residual asset – Operating lease accounting model based on IAS 17 operating lease accounting
Practical expedients and targeted reliefs	– Optional lessee exemption for short-term leases – i.e. leases for which the lease term as determined under IFRS 16 is 12 months or less and that do not contain a purchase option – Portfolio-level accounting permitted for leases with similar characteristics if the effect on the financial statements does not differ materially from applying the requirements to individual leases – Optional lessee exemption for leases of low-value items – e.g. underlying assets with a value of USD 5,000 or less when they are new – even if they are material in aggregate
Effective date	– Accounting periods beginning on or after 1 January 2019 – Early adoption is permitted if IFRS 15 is also adopted – Date of initial application is the beginning of the first annual reporting period in which a company first applies the standard

Appendix II – List of examples

About this publication

This publication has been produced by the KPMG International Standards Group (part of KPMG IFRG Limited).

This edition considers the requirements of IFRS 16 *Leases* published by the Board in January 2016 and amended in May 2020.

The text of this publication refers to IFRS 16 and to selected other current standards in issue at 31 May 2020.

Further analysis and interpretation will be needed for a company to consider the impact of the standard in light of its own facts, circumstances and individual transactions. The information contained in this publication is based on initial observations developed by the KPMG International Standards Group and these observations may change. Therefore, neither this publication nor any of our other publications should be used as a substitute for referring to the standards and interpretations themselves.

Acknowledgements

We would like to acknowledge the efforts of the following members of the KPMG International Standards Group, who were the principal authors of this publication: Anushree Agrawal, Sashank Gopalswami, Sylvie Leger, Mostafa Mouit, Brian O'Donovan and Sinead Slattery.

We would also like to thank the members of KPMG's global IFRS leases topic team for their contribution:

Kimber Bascom (leader)	US
Archana Bhutani	India
Judit Boros	Hungary
Yen San Chan	Singapore
Úna Curtis	Ireland
Andrew Marshall	UK
Scott Muir	US
Brian O'Donovan (deputy leader)	UK
Emmanuel Paret	France
Marcio Rost	Brazil
Volker Specht	Germany
Patricia Stebbens	Australia
Mag Stewart	Canada
Alwyn Van Der Lith	South Africa
Beth Zhang	China

Keeping in touch

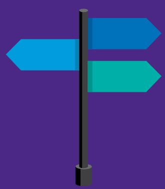
Follow ‘KPMG IFRS’ on LinkedIn or visit home.kpmg/ifrs for the latest news.

Whether you are new to IFRS Standards or a current user, you can find digestible summaries of recent developments, detailed guidance on complex requirements, and practical tools such as illustrative disclosures and checklists.

IFRS Today

News

COVID-19 financial reporting resource centre



KPMG IFRS on LinkedIn

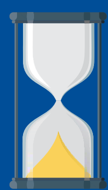
IFRS toolkit

Insights into IFRS®

Helping you apply IFRS Standards to real transactions and arrangements

Guides to financial statements

Illustrative disclosures and checklists



Newly effective standards web tool

IFRS compared to US GAAP

Q&A: Fair Value Measurement

Combined and/or carve-out financial statements

Major new standards

Leases

Revenue

Financial instruments

Insurance contracts

Other topics

Earnings per share handbook

Share-based payments handbook

Business combinations and consolidation

Better communication in financial reporting

Sector updates

Banks

IFRS app

IFRS app

For access to an extensive range of accounting, auditing and financial reporting guidance and literature, visit KPMG's Accounting Research Online. This web-based subscription service is a valuable tool for anyone who wants to stay informed in today's dynamic environment. For a free 30-day trial, go to aro.kpmg.com and register today.

home.kpmg/ifrs

Publication name: *Lease term*

Publication number: 137182

Publication date: July 2020