

CHAPTER 1

Lease term

This article aims to:

Discuss the key aspects relevant in determination of lease term when accounting for a lease contract



Background

A lease is a contractual agreement where one party (the lessor) grants another party (the lessee) the right to use an asset for a specified period in exchange for periodic payments. Leases are fundamental in various sectors, including real estate, equipment rental, and vehicle leasing, providing flexibility and financial efficiency for businesses and individuals alike.

The lease term is a critical aspect of lease agreements. It defines the duration for which the lessee has the right to use the leased asset. Accurately determining the lease term is essential because it impacts the financial reporting and classification of leases. Ind AS

116, *Leases* provides detailed guidance for determining the lease term since this is one of the key judgement area and can significantly affect the amounts recognised in the financial statements. Another accounting challenge arises when there is a change in the lease term during the lease tenure. Determining whether this change constitutes a modification or a change of estimate is crucial for accurate financial reporting to reflect the current lease obligations and provide transparency to stakeholders.

This article discusses the key aspects relevant in determination of lease term when accounting for a lease contract.

Lease term

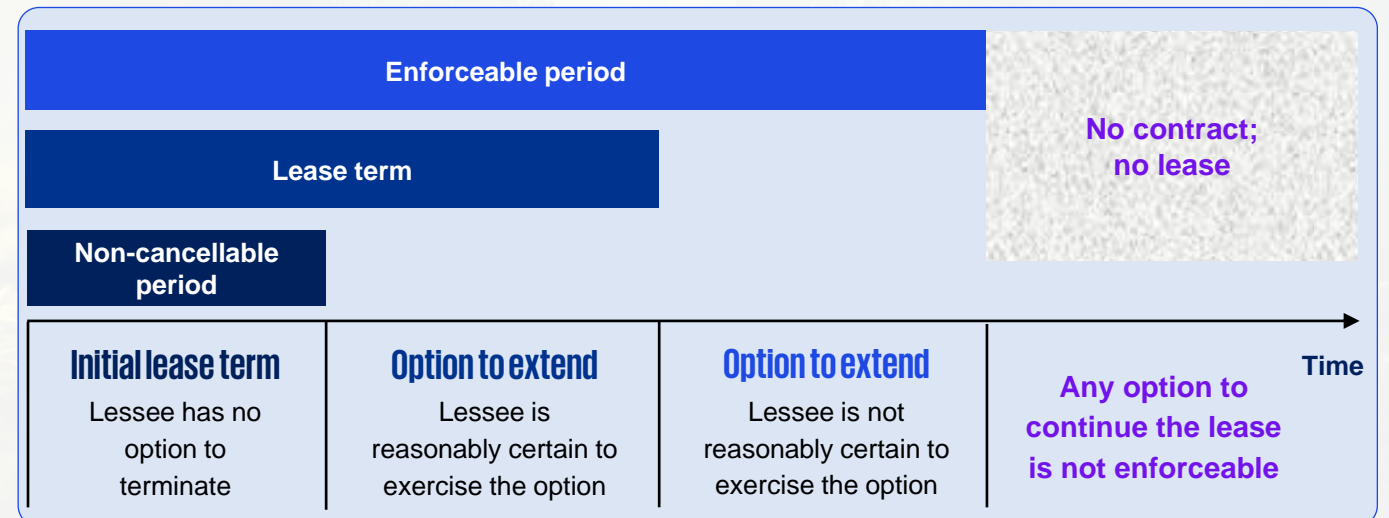
A lease term, as per Ind AS 116, refers to the non-cancellable period for which a lessee has the right to use an underlying asset.

This period includes:

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

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

The below diagram illustrates how the lease term may be determined:



Source: AP4: Lease term and useful life of leasehold improvements (IFRS 16 and IAS 16) Agenda decision to finalise (November 2019 IFRS Interpretations Committee Meeting Paper), issued by IFRS Interpretations Committee in November 2019



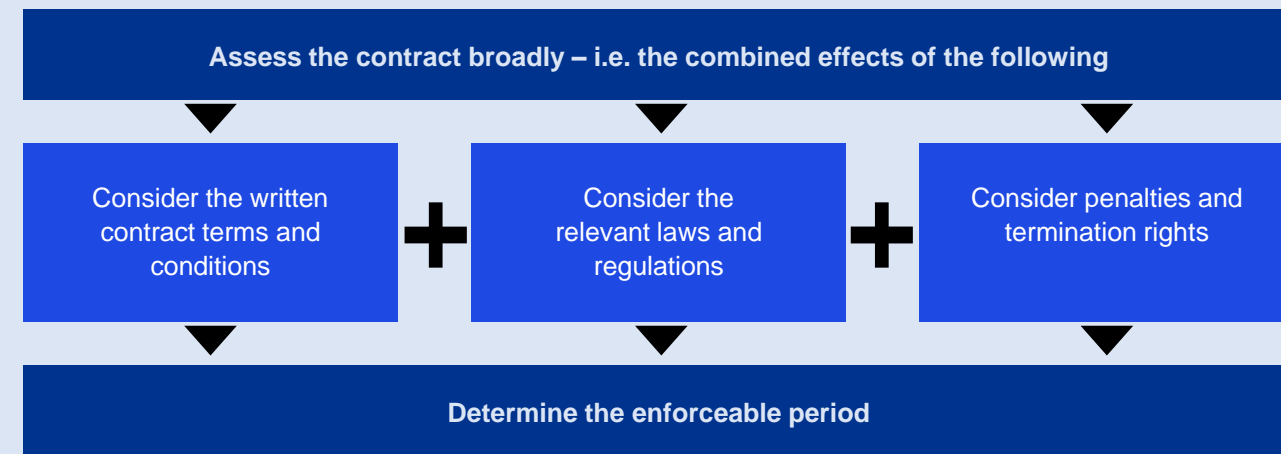
- The **non-cancellable period** under Ind AS 116 refers to the duration when the lessee cannot terminate the lease agreement. Consequently, lease term cannot be shorter than the non-cancellable period. A lease agreement may grant each party the unilateral right to terminate the lease, for any reason and with no more than an insignificant penalty by giving certain notice. The non-cancellable period of the lease in such cases includes the 'notice' period.
- An **enforceable period** is the maximum length of the lease term.

To determine the enforceable period of the lease, an entity applies the definition of a contract. An enforceable period under Ind AS 116 refers to the duration during which the lessee and the lessor have enforceable rights and obligations. This period is significant in determining the lease term, as it includes periods where the lease can be enforced by either party, even if the lessee has the option to extend or terminate the lease. A lease is no longer 'enforceable' when both the lessee and lessor have the right to terminate it without agreement from the other party with no more than an insignificant penalty.

To summarise, in determining the lease term, an entity first determines the enforceable period and non-cancellable period of the contract. It then determines where—within the range between the non-cancellable period (minimum lease term) and the enforceable period (maximum lease term)—the lease term falls.



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



Source: KPMG in India analysis, 2025 read with KPMG IFRG Limited's Handbook – Lease term, July 2020 edition

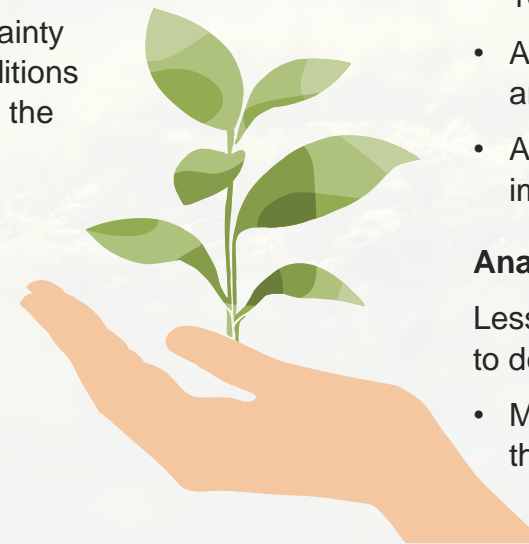
Key judgements involved when a lessee is required to determine lease term

Determining the lease term does require significant judgement. Some examples of judgements involved in determining the lease period include:

- Assessment of economic penalties to be considered in assessing the enforceable period since an entity applies the definition of a contract to determine the enforceable period. Enforceability is a matter of law in the relevant jurisdiction and each contract will need to be evaluated based on its terms and conditions;
- Evaluation of reasonable certainty of exercising the termination option. When determining the lease term, an entity is required to consider 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. For example –

- factors such as the significance of leasehold improvements
- importance of the leased asset to the lessee's operations
- past practice regarding the exercise of renewal or termination options
- market rentals for similar properties
- strategic reasons for the lessee to either stay in the current lease or relocate.

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 due to the increasing uncertainty of economic conditions and incentives as the date approaches.



Some of these principles are illustrated through by way of case studies to provide practical application of the guidance.

Case Study 1 – Lessee's option to renew lease

Facts:

- Lessee A enters into a lease contract with Lessor L to lease a building.
- The non-cancellable period is 4 years
- A has the option to extend the lease by another 4 years at the same rent
- Market rentals for a comparable building in the same area are expected to increase by 10% over 8 years
- A intends to stay in business in the same area for at least 10 years.
- A has undertaken significant leasehold improvements with useful life of 9 years.

Analysis:

Lessor A should consider the following factors to determine the lease term:

- Market rentals for similar properties: At the commencement date, rentals under

the contract reflect the current market rates. Further, market rentals for a comparable building in the same area are expected to increase over the 8 year enforceable period

- Strategic reasons: A intends to stay in this business in the same area for at least 10 years. Further, the location of the building is ideal for relationships with suppliers and customers
- Leasehold improvements: The fact that A has undertaken non-removable significant leasehold improvements with an estimated useful life higher than the enforceable period.

Conclusion:

- Lessor A concludes that it has a significant economic incentive to extend the lease and therefore, is reasonably certain to exercise its 4 year extension option.
- Consequently, A determines that the lease term is 8 years.

Source: KPMG in India analysis, 2025 based on KPMG IFRG, Insights into IFRS, 21st edition 2024/25



In a different situation, if all the other facts of the case remain the same, except that the agreement states that the terms and conditions for the renewal of 4 additional years will be determined and mutually agreed at the time of renewal, it would be appropriate to conclude that there is no enforceable period. This is because there are no terms specified in the contract for the renewal period and both parties could choose to terminate the lease without any significant penalties. Accordingly, the lease term in that case would be 4 years.

Another common situation that requires analysis when there are alterations in lease terms – to determine whether it's a lease term reassessment or a lease modification. This assessment will impact the accounting of lease liability, and the right-of-use asset recognised on the balance sheet.



Lease modification

A lease modification is defined as a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease. Common examples are:

- adding or terminating the right to use one or more underlying assets

- extending or shortening the contractual lease term
- changing the consideration.

Although the lease modification guidance is complex, there are essentially two possible outcomes:

1. The modification is accounted as a separate lease if both conditions are satisfied:

- modification increases the scope of lease by adding right to use one or more underlying assets and
- consideration for the lease increases by the amount equivalent to the standalone price of increase in scope and appropriate adjustments to reflect contract specific circumstances

The lessee does not revise the discount rate for the original lease.

However, the lessee uses a new discount rate to account a separate lease. The new rate is determined at the effective date of modification. The lessee uses the interest rate implicit in the lease if it is readily determinable, otherwise the lessee uses its incremental borrowing rate.

2. The modification is not accounted as a separate lease

The lessee remeasures the lease liability using a revised discount rate

Modifications that decrease the scope of lease:

Remeasure lease liability by allocating consideration in the modified contract, determining the lease term of the modified lease and remeasuring lease liability by discounting payments using revised discount rate. The revised discount rate is determined as:

- the interest rate implicit in the lease for the remainder of the lease term, if can be readily determined, or
- the lessee's incremental borrowing rate at the effective date of the modification, if implicit interest rate cannot be readily determined.

Adjust carrying value of ROU to reflect partial/ full termination of lease and recognise in profit or loss any differential as gain/loss pursuant to partial/ full lease termination

Other modifications:

Remeasure lease liability and adjust carrying value of ROU

Source: KPMG in India analysis, 2025 based on KPMG IFRG Limited's Handbook – Lease term, July 2020 edition and Ind AS 116



Lessees must carefully evaluate the financial implications of lease modifications, considering factors such as the remaining lease term, the incremental borrowing rate, and any changes in lease payments. This process requires a detailed understanding of the lease agreement and the lessee's business operations, as well as the ability to make informed judgements about future economic benefits and obligations.

Below case study illustrates the above concepts:

Case Study 2

Facts:

- Entity X (lessee) enters into an arrangement to lease an office space measuring 2,000 sq. ft. for a period of 10 years.
- Entity X makes the annual lease payments of INR100,000 per annum
- The lessee's incremental borrowing rate at the commencement of the lease is 10% p.a.
- Entity X enters into a lease **modification** at beginning of year 6 whereby the total term

of the contract is reduced from 10 to 8 years.

- The annual lease payments for the space measuring 2,000 sq. ft. remains unchanged.
- The lessee's incremental borrowing rate at beginning of year 6 is 11% p.a.
- The carrying value at the beginning of the 6th year are as follows: Lease liability - INR379,078 and ROU asset - INR307,228

How will Entity X account for the changes in the terms of the lease?

Solution:

- The two conditions to determine whether a whether a modification results in a separate lease is analysed -
 - modification increases the scope of lease by adding right to use one or more underlying assets and
 - consideration for the lease increases by the amount equivalent to the standalone price of increase in scope and appropriate adjustments to reflect contract specific circumstances

- In the given case, since there is only decrease in lease term, both the conditions are not satisfied
- Thus, the lease modification does not amount to a separate lease
- Step 1:** After the modification (at the beginning of year 6), lessee remeasures the lease liability with remaining lease term of 3 years and incremental borrowing rate of 11%. The changed lease liability comes to INR244,371
- Step 2:** Calculate values of ROU and lease liability for the remaining term which is reduced from 5 to 3 years.

ROU

Carrying value of ROU before modification (A)	307,228
Carrying value of ROU after lease modification (B)	184,337 (307,228/5*3)
Difference in ROU adjusted in ROU (A-B)	122,891 (on account of reduction in lease term)

Lease Liability

Carrying value of lease liability before modification (P)	379,078
New PV calculated (Q)	248,686 (INR100,000 for 3 years discounted @ original interest rate 10%)
Difference in lease liability (P-Q)	130,392

- Difference in lease liability on account of reduction in lease term:** 130,392
- Gain on lease modification:** Income accounted at the beginning of year 6 on account of reduction in lease term amounts – **INR7,501** (130,392- 122,891)
- Effect of revised incremental borrowing rate adjusted in ROU asset:** The incremental borrowing rate increased from 10% to 11%. The effect of an increase in the interest rate from 10% to 11% on the lease liability amounts to **INR4,315** (2,48,686 - INR 244,371).

Source: Educational Material on Ind AS 116, Leases issued by the Institute of Chartered Accountants of India, January 2020

Lease reassessment

Lease modifications are different from lease reassessment. After the commencement date, lease reassessments take place when there are changes in certain contractual clauses included in the original contract. Common examples of such scenarios are:

- assessment of lease term
- whether a purchase option will be exercised
- variable lease payments becoming fixed or in-substance fixed payments.

A lessee does not reassess options at every reporting date just because market conditions change. Instead, they use judgement to spot major events or significant changes that require reassessment.

In case of lease term reassessment, after the commencement date, 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. The lessee does this 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.

Some of the examples of significant events and changes in circumstances include:

- 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 becomes exercisable
- a significant modification to, or customisation of, the underlying asset that was not anticipated at the commencement date,
- a business decision of 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 etc.

In addition, a lessee revises the lease term and remeasures the lease liability when there is a change in the non-cancellable period of a lease.



Accounting of reassessment of lease term is discussed by way of below cash study:

Case Study 3 – Lease reassessment

With the same facts as discussed in case study 2, if it was a reassessment of lease term from 10 years to 8 years, then the impact is only lease liability and ROU the lease liability is required to be remeasured at a revised discount rate.

Carrying value of lease liability at beginning of 6th year (A)	379,078
After the modification (at the beginning of year 6), the remeasured lease liability at the incremental borrowing rate of 11% (B)	244,371 <i>(with remaining lease term of 3 years)</i>
Difference in lease liability (A-B)	134,707

Above difference is debited to lease liability and credited to ROU.

Next steps

Determining the lease term requires significant judgement. This is because the lease term directly affects the recognition of lease liabilities and right-of-use assets on the balance sheet, which in turn impacts an entity's financial position and performance. An entity is expected to consider all relevant facts and circumstances that create an economic incentive as the lessee, when assessing whether it is reasonably certain to extend (or not to terminate) a lease – this includes significant leasehold improvements (taken or planned to be taken) over the term of the contract that are expected to have significant economic benefit when the option to extend (or terminate) becomes exercisable. Additionally, an entity considers the economics of the contract when determining the enforceable period of a lease – e.g. costs of abandoning or dismantling leasehold improvements, expectations that leasehold improvements will be used beyond the date on which a contract can be terminated – the existence of the leasehold improvements

indicates that an entity may incur more than an insignificant penalty.

These judgements require a thorough understanding of both the lease agreement and the lessee's business operations. Management must carefully evaluate all relevant factors to ensure that the lease term estimation aligns with the company's economic realities and strategic objectives. Appropriate qualitative and quantitative disclosures in relation to leases as required by Ind AS 116, including due to modifications and disclosures in relation to judgements applied and estimations done should be included in financial statements. Additionally, it is essential to continuously review and update these judgements to reflect any significant changes in circumstances or new information that may affect the lease term. This ongoing reassessment helps maintain the accuracy and reliability of the financial statements, ensuring that they provide a true and fair view of the company's lease obligations and financial position.

