

IFRIC agenda decision: Lease term

Reporting Update

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IFRIC finalises decision on lease term – lease term could be beyond the contract terms

Highlights

- IFRIC's agenda decision
- Implications on financial reports

IFRIC's agenda decision

What is the issue?

In November 2019, the International Financial Reporting Standards Interpretations Committee (IFRIC) clarified how lease term should be determined for arrangements that automatically renew until one of the parties gives notice to terminate.

Examples of contracts with this automatic renewal clause include:

- Example 1: A lease of office space with a non-cancellable period of three years with an option to extend for 2 years, containing the following clause:
"If the Tenant of the office continues to occupy the space after the Expiry Date (5 years after the commencement of the lease) with the Landlord's approval it does so under a monthly tenancy. Either party may terminate by giving one month's notice."
- Example 2: An equipment lease with a non-cancellable period of three years, containing the following clause:
"On the expiry of the Fixed Term of 3 years, this agreement will be automatically extended until the expiry of 6 months written notice given by either party of its intention to terminate."

The IFRIC agenda decision also covers arrangements that do not contain a specific non-cancellable period, and instead continue until either party to the contract gives notice to terminate, for example, a contract that provides a party the right to use the asset on a day-to-day basis.

When assessing whether a contract could be renewed until either party gives notice to terminate, consideration should be given to legislations or regulations that protect the rights of the lessor or the lessee. For example, under the NSW Retail Leases Act 1994, the lessee has the right to automatically extend the lease unless the lessor provides written notice of its intention to terminate.

Consider economic penalty when assessing enforceability

How does the decision affect the assessment of lease term?

'Lease term' is the non-cancellable period for which a lessee has the right to use an asset, together with any optional periods that the lessee is reasonably certain to exercise.

The lease term of an arrangement depends on whether the arrangement is considered to be enforceable. Under AASB 16, a lease is no longer enforceable when **both** the lessee and the lessor have the right to terminate the lease without incurring more than an insignificant penalty.

IFRIC observed that an arrangement can be determined to be enforceable beyond the date on which it can be terminated by either party without a contractual penalty. Once the arrangement is determined to be enforceable beyond this date, the entity, that is, either the lessee or the lessor, will then determine whether the lessee is reasonably certain to exercise the option to extend the lease.

Using Example 1 again, let's assume that the tenant (the lessee) has installed highly specialised costly non-removable equipment in the office space which has a useful life of 15 years. Accordingly, it is reasonably certain that the lessee will exercise its options to extend the lease. However, the tenant is likely to incur an economic penalty if it terminates the arrangement at the end of the five years as it would incur additional cost to purchase new equipment.

Applying the IFRIC decision, even though the lessor may not incur any economic penalty if the contract terminates at the end of five years, the contract is considered to be enforceable beyond that date as one party, in this case, the lessee, suffers an economic penalty if it ends on that date. In this case, the enforceable period of the contract could be viewed as 15 years (the useful life of the specialised equipment).

In assessing the lease term, it is expected there will be a more technologically advanced equipment available in 10 years' time. In this case, it may be argued it is reasonably certain based on facts and circumstances at commencement date of the lease that the lessee will exercise the option to terminate the lease after 10 years. Applying the IFRIC agenda decision, the lease term is likely to be 10 years.

The IFRIC agenda decision can be accessed on the [IASB's website](#).

"Determining lease term is a judgemental area. The IFRIC decision has the potential to increase total assets and liabilities, depreciation and interest expense. Entities may have to implement a process to ensure consistency between the assumptions in their business plans and estimation of lease terms."

Patricia Stebbens

Partner, Department of Professional Practice

Was there diversity prior to the IFRIC decision?

Prior to the IFRIC decision, there were various views on how penalties should be assessed when determining the enforceable period.

Under one view, the enforceable period of a contract would not extend beyond the non-cancellable period and periods covered by options which allow the lessee to continue to use the asset. This was on the basis that no party could enforce the contract beyond that date given either party could terminate the contract without incurring any contractual penalty after that date. For example, a lessee does not have the contractual right to extend beyond that date without the agreement of the lessor.

The other view was that the enforceable period could extend beyond the non-cancellable period and periods covered by options which allow the lessee to continue to use the asset if the broader economics of the contract were considered when assessing whether “penalties” would be incurred. For example, a lessee is considered to have the right to extend beyond that date notwithstanding the lessor could terminate without any penalties.

Implications on financial reports

Force of IFRIC agenda decisions

Entities should apply IFRIC agenda decisions in a timely manner if their accounting policies are inconsistent with a specific IFRIC agenda decision. Any resulting changes would be accounted for as a change in accounting policy in accordance with AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors*. That is, the change in accounting policy is applied retrospectively, with the cumulative changes recognised in opening retained earnings of the earliest comparative period presented.

For more information, refer to our Reporting Update [19RU-009 IFRIC agenda decisions: renewed focus](#).

Impact for December 2019 reporting

Entities that had only considered contractual penalties when assessing enforceable periods of the lease will need to re-assess taking into account the broader economics of the arrangement. The facts and circumstances of each lease arrangement must be considered to identify factors that indicate the enforceable period could extend beyond the date on which the contract can be terminated by either party.

The IASB expects that the implementation of this agenda decision may require substantial time and effort for some entities. Entities that are unable to adopt this clarification in their 31 December 2019 financial statements should consider including a disclosure explaining the nature of the change and the expected impact or, the fact that the impact is not reasonably estimable and the expected timing of implementation.

Reflect impact of decision in December 2019 reporting

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For further information about recent agenda decisions issued by the IFRIC, refer to our publication [IFRS Interpretations Committee agenda decisions](#).

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