

IFRS® Interpretations Committee meeting

Project	Lease term and useful life of leasehold improvements (IFRS 16 and IAS 16)		
Paper topic	Agenda decision to finalise		
CONTACT	Kathryn Donkersley	kdonkersley@ifrs.org	+44 (0) 20 7246 6970
	Nicolette Lange	nlange@ifrs.org	+44 (0) 20 7246 6924

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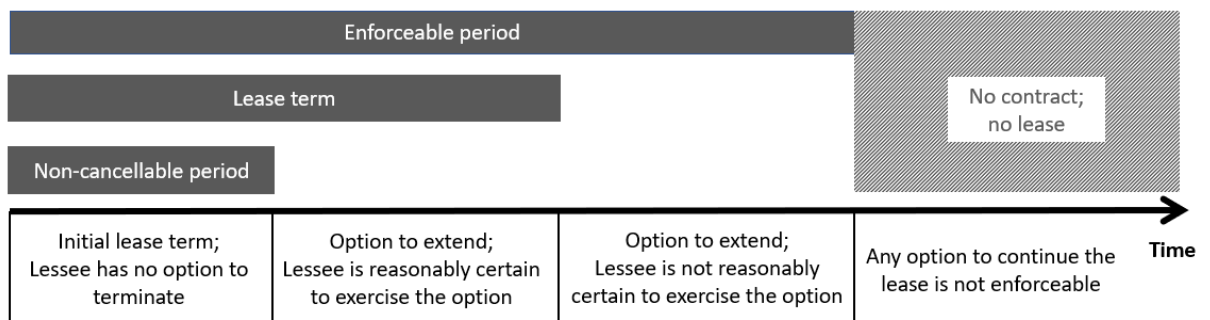
Introduction

1. In June 2019, the IFRS Interpretations Committee (Committee) published a [tentative agenda decision](#) on cancellable or renewable leases, and related non-removable leasehold improvements. The submission asked two questions:
 - (a) how to determine the lease term of a cancellable lease or a renewable lease. Specifically, the request asked whether, when applying paragraph B34 of IFRS 16 *Leases* and assessing ‘no more than an insignificant penalty’, an entity considers the broader economics of the contract, and not only contractual termination payments (*Question One*); and
 - (b) whether the useful life of any related non-removable leasehold improvements is limited to the lease term determined applying IFRS 16 (*Question Two*).

Context for the Committee’s consideration of the questions

2. The Committee noted the following regarding lease term in IFRS 16 when considering the questions above:
 - (a) the **non-cancellable period** of a lease is any period during which the lessee is unable to terminate the contract (paragraph B35 of IFRS 16). Consequently, any non-cancellable period in effect sets a minimum lease term.
 - (b) **lease term** is the non-cancellable period of a lease, together with any optional periods that the lessee is reasonably certain to use (paragraph 18 of IFRS 16); and
 - (c) the **enforceable period** of a lease is the period for which enforceable rights and obligations exist between the lessee and lessor (as described in paragraph B34 of IFRS 16). To be part of a contract, any optional periods that are included in the lease term must also be enforceable. Consequently, the enforceable period in effect sets a maximum lease term.

3. In a simple contract with no optional periods, the non-cancellable period, lease term, and enforceable period of a lease may all be the same. The diagram below depicts a more complex contract, with multiple optional periods:



4. Consequently, 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 Committee's consideration of the questions

5. In considering Question One, the Committee observed that, applying paragraph B34 to determine the enforceable period of a cancellable or renewable lease, an entity considers:
 - (a) the broader economics of the contract, and not only contractual termination payments. For example, if either party has an economic incentive not to terminate the lease such that it would incur a penalty on termination that is more than insignificant, the contract is enforceable beyond the date on which the contract can be terminated; and
 - (b) whether each of the parties has the right to terminate the lease without permission from the other party with no more than an insignificant penalty. Applying paragraph B34, a lease is no longer enforceable only when both parties have such a right. Consequently, if only one party has the right to terminate the lease without permission from the other party with no more than an insignificant penalty, the contract is enforceable beyond the date on which the contract can be terminated by that party.
6. The Committee also noted that if an entity concludes that the contract is enforceable beyond the notice period of a cancellable lease (or the initial period of a renewable lease), it then applies paragraphs 19 and B37–B40 of IFRS 16 to assess whether the lessee is reasonably certain not to exercise the option to terminate the lease.
7. In considering Question Two, the Committee observed that an entity applies paragraphs 56–57 of IAS 16 *Property, Plant and Equipment* when determining the useful life of non-removable leasehold improvements. If the lease term of the related lease is shorter than the economic life of those leasehold improvements, the entity considers whether it expects to use the leasehold improvements beyond that lease term. If the entity does not expect to use the leasehold improvements beyond the lease term of the related lease then, applying paragraph 57 of IAS 16, it concludes that the useful life of the non-removable leasehold improvements is the same as the lease term. The Committee observed that, applying paragraphs 56–57 of IAS 16, an entity

might often reach this conclusion for leasehold improvements that the entity will use and benefit from only for as long as it uses the underlying asset in the lease.

8. The objectives of this paper are to:
 - (a) analyse the comments on the tentative agenda decision; and
 - (b) in the light of the feedback received, ask the Committee whether:
 - (i) the principles and requirements in IFRS 16 (together with those in IAS 16 for Question 2) provide an adequate basis for an entity to determine its accounting for Question One and Question Two; or
 - (ii) a clarifying narrow-scope amendment to paragraph B34 of IFRS 16 (eg annual improvement) is required.
9. There are two appendices to this paper:
 - (a) Appendix A—possible wording of an agenda decision; and
 - (b) Appendix B—analysis of other comments relating to Question One.

Comment letter summary

10. We received 31 comment letters by the comment letter deadline. All comment letters received, including any late comment letters, are available on our [website](#)¹. This agenda paper includes analysis of only the comment letters received by the comment letter deadline.
11. Nine respondents agree with the Committee's decision not to add the matter to its standard-setting agenda for the reasons set out in the tentative agenda decision. All these respondents agree with the Committee's technical analysis and conclusions for both Question One and Question Two. These include an organisation representing a

¹ At the date of posting this agenda paper, there were no late comment letters.

group of regulators, four national standard-setters, two accounting firms, a preparer representative body and an individual.

12. Some of these respondents have suggestions about the scope and wording of the agenda decision (see paragraphs 62–68).
13. In respect of Question One, the remaining 22 respondents disagree with one or more aspects of the Committee’s technical analysis and conclusions. These include five national standard-setters, two accounting firms, one individual, five preparers and nine preparer representative bodies.
14. In particular, these respondents say they disagree with the Committee’s analysis of the requirements in paragraph B34 (and the associated requirements and explanation in paragraphs B37 and BC127 respectively). These respondents disagree with the Committee’s technical conclusions on:
 - (a) the application of the word ‘penalty’ in paragraph B34. Respondents highlight that the Standard does not define penalty and disagree that this term requires an entity to consider the broader economics of the contract;
 - (b) contract enforceability. Respondents are concerned:
 - (i) that the Committee’s conclusion is inconsistent with other areas of IFRS Standards that treat contract enforceability as a legal concept;
 - (ii) about the Committee’s conclusion that, in order for a lease to no longer be enforceable, *each* of the parties to the lease must have the right to terminate the lease without permission from the other party with no more than an insignificant penalty; and
 - (iii) that the rationale in the tentative agenda decision in effect requires a lessee to assess contract enforceability from the lessor’s point of view. These respondents say this could be practically difficult to implement.

15. Of the 22 respondents who disagree with the Committee’s technical analysis and conclusion for Question One:
- (a) seventeen respondents recommend standard-setting as an alternative to publishing an agenda decision.
 - (b) one respondent (Telefónica) suggests significant alterations to the wording of the agenda decision to reflect a different conclusion.
 - (c) one respondent (Intituto para Desenvolvimento do Varejo (IDV)) suggests that the Committee retract the tentative agenda decision and does not recommend standard-setting. This respondent is concerned about disrupting entities’ implementation of IFRS 16.
 - (d) the remaining respondents’ comment letters reflect their disagreement but do not provide a suggestion for the Committee.
16. In respect of Question Two, only three of the 22 respondents explicitly disagree with the Committee’s technical analysis and conclusion. These are two accounting firms and one preparer representative body. These respondents say an entity can expect to renew a lease without being reasonably certain to do so. In other words, ‘reasonably certain’ applying IFRS 16 is not the same as ‘expected to be available’ applying IAS 16.
17. This paper analyses comments on Question One and Question Two separately. Further details about the comments, together with our analysis, are presented below.

Staff analysis—Question One: Lease Term

Structure of our analysis

18. We have separately analysed the main comments that relate to:
- (a) the Committee’s technical analysis and conclusion on:
 - (i) application of the term ‘penalty’ in IFRS 16 (see paragraphs 20–32);
 - and

- (ii) the meaning of ‘enforceable’ in paragraph B34 (see paragraphs 33–42);
 - (b) practical concerns—assessment from the lessor point of view (see paragraphs 43–51);
 - (c) requests for standard-setting (see paragraphs 52–61); and
 - (d) additions and clarifications to the wording of the agenda decision (see paragraphs 62–68).
19. Appendix B to this paper analyses all other comments relating to Question One.

Application of the term ‘penalty’ in IFRS 16

Respondents’ comments

20. Seven respondents (the Organism Italiano di Contabilito (OIC), the Autorité des normes comptables (ANC), BusinessEurope, the 100 Group, the Institute of Chartered Accountants of India (ICAI), ACTEO/AFEP/MEDEF and Petróleo Brasileiro (Petrobras)) note that IFRS 16 does not define ‘penalty’. Consequently, in their view, use of that term in paragraph B34 is open to interpretation, and it is not possible to conclude that the term incorporates broader economics beyond payments of penalties.
21. Thirteen respondents (the OIC, the ANC, the Fédération Bancaire Française (FBF), Mazars, the Accounting Standards Board of Japan (ASBJ), Crédit Agricole Group, Société Générale, IFRScommunity.com, PHOENIX Group, A1 Telekom Australia Group, the ICAI, Deloitte and Petrobras) disagree with the Committee’s technical conclusion because, in their view, there is no clear link between paragraphs B34 and B37 of IFRS 16.
22. These respondents say an entity applies paragraph B34 in determining the enforceable period of a lease, and paragraph B37 in assessing whether a lessee is reasonably certain to use any optional periods available to it during that enforceable period. The respondents say these are two separate assessments and, with no cross reference between the two paragraphs, the criteria listed in paragraph B37 are irrelevant to the application of paragraph B34. These respondents therefore conclude that the term

‘penalty’ in paragraph B34 does not incorporate the kind of economic penalties listed in paragraph B37.

Staff analysis

23. As identified by respondents, IFRS 16 does not define the term ‘penalty’. Therefore, we agree that it is necessary to determine the meaning of that word in the context of IFRS 16, and that this requires additional analysis beyond reading the words in paragraph B34. However, we disagree that different meanings of the term are therefore possible. This is because of:
- (a) the requirements in IFRS 16 regarding ‘payments of penalties’;
 - (b) the dictionary definition of ‘penalty’; and
 - (c) the context for reading IFRS Standards.

Requirements in IFRS 16 regarding ‘payments of penalties’

24. The submission identified two possible readings of ‘penalty’ in paragraph B34—the first is a narrow reading that would assume ‘penalty’ refers only to contractual termination payments; the second assumes an entity considers the broader economics of the contract and thus that ‘penalty’ is a broader concept that includes economic penalties.
25. IFRS 16 has a number of references to contractual termination payments—for example, within the definition of lease payments and also within the lease term requirements in paragraph B37. Each time that IFRS 16 refers to contractual termination payments, it uses the term ‘payments’—‘payments for penalties for terminating’ or ‘payments resulting from termination penalties’. The Board uses the same words within a Standard when it means the same thing. Therefore, if the Board had intended the reference to ‘penalty’ in paragraph B34 to mean only contractual termination payments, it would have used the term ‘payments’ as it did throughout the rest of IFRS 16. To assume otherwise results in analysis that relies on an assumption that the drafting may be imprecise.

26. The use of ‘penalty’ in paragraph B34 therefore indicates that it means something different from only contractual termination payments, and in this case refers to any economic penalty (that is more than insignificant) that might arise from termination.

Dictionary definition of penalty

27. IFRS Standards use many terms that are not defined. Consequently, their reading is necessarily subject to the ordinary definitions or meanings of those words.
28. As described in [Agenda Paper 3](#) presented at the Committee’s June meeting, the [Oxford English Dictionary](#) defines ‘penalty’ as follows:

A punishment imposed for breaking a law, rule or contract.

A disadvantage suffered as the result of an action or a situation.

29. A punishment or a disadvantage can take many forms; a monetary payment is only one example. Consequently, we note that the dictionary definition of ‘penalty’ is consistent with how the term is used in paragraph B34.²

Context for reading IFRS Standards

30. We think the comments described in paragraphs 20–22 are based on reading paragraph B34 in isolation. In contrast, the Committee’s conclusion in its tentative agenda decision was based on reading paragraph B34, and the term ‘penalty’ in particular, in the context of the rest of the Standard, including its objective and the Basis for Conclusions.
31. Prefacing IFRS 16—and all IFRS Standards—is a statement that ‘the Standard should be read in the context of its objective and the Basis for Conclusions, the *Preface to IFRS Standards* and the *Conceptual Framework for Financial Reporting*’. As noted above, it is necessary to determine the meaning of ‘penalty’ in IFRS 16 and the

² We also note that Topic 842 *Leases* in US GAAP includes equivalent requirements to those in paragraph B34—the requirements in Topic 842 state that ‘a lease is no longer enforceable when both the lessee and the lessor each has the right to terminate the lease without permission from the other party with no more than an insignificant penalty’. Topic 842 defines penalty to include consideration of the broader economics of the contract—that definition was carried forward from previous US GAAP requirements in place before the issuance of Topic 842. We note that lease term has not been identified as an area of divergence between IFRS 16 and Topic 842.

context, as outlined, is the basis for making such a determination. We continue to agree with the Committee that reading paragraph B34 in this context leads to the conclusion that ‘penalty’ refers to an economic penalty. This is because:

- (a) paragraph B34 includes requirements about lease term—it is within the section of the application guidance titled ‘lease term’ and the opening words of paragraph B34 states: ‘In determining the lease term...’. Paragraphs B34–B41 describe the application of the lease term requirements in paragraphs 18–21 of IFRS 16³; and accordingly, all these requirements about lease term are linked.
- (b) in developing the lease term requirements in IFRS 16, the Board placed importance on the economics of a contract and highlighted the need for an entity to make a holistic assessment of lease term that considers all relevant facts and circumstances. For example, paragraphs 19 and B37 require an entity to consider ‘all relevant facts and circumstances that create an economic incentive for the lessee’.
- (c) the Board’s explanations in the Basis for Conclusions about lease term and cancellable leases highlight the link between an entity’s determination of lease term and the economics of a contract. In particular:
 - (i) paragraphs BC127–BC129 refer to the economics of a contract;
 - (ii) paragraph BC156 refers to the Board’s view that ‘the lease term should reflect an entity’s reasonable expectation of the period during which the underlying asset will be used’;
 - (iii) paragraph BC155 explains the need to ‘mitigate the risk of lessees inappropriately excluding lease liabilities from the balance sheet (for example, by excluding lease payments in optional periods for which the lessee has a clear economic incentive to exercise those options)’; and

³ In particular, we note that the lease term section in IFRS 16 comprising paragraphs 18–21 includes a direct cross reference to paragraphs B34–B41 in the heading.

- (iv) paragraph BC157 explains that, when developing requirements on lease term, the Board was looking to ‘reduce the risk of non-substantive break clauses being inserted within contracts solely to reduce the lease term beyond what is economically reasonable for the lessee’.

32. For similar reasons, the absence of an explicit cross reference between paragraphs B34 and B37 does not mean the two paragraphs are unrelated. In fact, as noted above, paragraphs B34–B41 describe the application of paragraphs 18–21, which all contain requirements for determining lease term. Although such a cross reference might have enhanced the link between the paragraphs, its absence does *not* mean that paragraphs of an IFRS Standard should be read in isolation. Instead, all paragraphs should be read in the context described in paragraph 31 above as required in the preface to each Standard. Applying this context, in our view IFRS 16 requires consideration of contract economics when determining the enforceable period and, ultimately, the term of a lease. In other words, a broader reading of the word penalty is consistent with this context, whereas a narrow reading would be inconsistent with this context and would risk undermining the economic perspective sought by the Board as outlined above.

The meaning of ‘enforceable’ in paragraph B34 of IFRS 16

Respondents’ comments

33. Fifteen respondents (the ANC, the FBF, Telefónica, Mazars, the ASBJ, the Korea Accounting Standards Board (KASB), Crédit Agricole Group, Société Générale, the Korea Listed Companies Association, David Hardidge, the 100 Group, PHOENIX Group, A1 Telekom Australia Group, the ICAI and Deloitte) say other areas of IFRS Standards demonstrate that enforceability is a legal—not economic—concept. Many of these stakeholders identify IFRS 15 *Revenue from Contracts with Customers* and paragraph BC127 of IFRS 16 as examples. These respondents say the Committee’s conclusion is inconsistent with other areas of IFRS Standards.

34. Furthermore, fourteen respondents (BusinessEurope, Telefónica, Mazars, the ASBJ, the KASB, Crédit Agricole Group, Société Générale, the Korea Listed Companies Association, IFRScommunity.com, the 100 Group, PHOENIX Group, A1 Telekom Australia Group, Deloitte and ACTEO/AFEP/MEDEF) think the Committee’s technical conclusion contradicts paragraph BC127. This paragraph states (emphasis added):

...If optional periods are not enforceable, for example, *if the lessee cannot enforce the extension of the lease without the agreement of the lessor*, the lessee does not have the right to use the asset beyond the non-cancellable period.... In assessing the enforceability of a contract, an entity should consider *whether the lessor can refuse to agree to a request from the lessee to extend the lease*.

35. These respondents are particularly concerned about a circumstance in which the lessor—but *not* the lessee—can terminate the contract without incurring more than an insignificant penalty. Applying the tentative agenda decision, such a contract is enforceable. However, respondents disagree with this conclusion because:
- (a) the lessee cannot enforce extension without the agreement of the lessor; and
 - (b) the lessor can refuse to agree to a request from the lessee to extend the lease.

Staff analysis

36. ‘Enforceable’ is not a defined term in IFRS 16, nor any other IFRS Standard. Accordingly, a lessee applies this term in the context of IFRS 16 as a whole, including its objective and the Basis for Conclusions (consistent with our analysis of the application of the term ‘penalty’ in paragraphs 20–32 above).
37. However—and importantly—although not a defined term, paragraph B34 describes when a contract is, and is no longer, enforceable for the purposes of IFRS 16. Irrespective of the discussion of the meaning of the word ‘penalty’, the description in paragraph B34 is not a strictly legal concept; we therefore disagree with those

respondents who say the concept of strict legal enforceability should be applied when determining lease term. For enforceability to be a strictly legal concept, the lessee would need to have an unconditional right to enforce extension—so an entity would have to ignore the requirements in paragraph B34 that describe enforceability with reference to ‘no more than an insignificant penalty’. If the Board had intended a strictly legal concept, it would have stated in paragraph B34 that a contract is no longer enforceable when the lessee and lessor each has the right to terminate the lease without permission from the other party. The inclusion of ‘with no more than an insignificant penalty’ in paragraph B34 means that, in determining lease term, *irrespective of the reading of the word ‘penalty’* an entity cannot apply enforceability as a strictly legal concept, considering only whether each party has the right to terminate—instead, it must consider whether each party can terminate with no more than an insignificant penalty.

38. We acknowledge the concern raised by respondents and described in paragraphs 34–35 above. That is, a scenario in which the lessor—but *not* the lessee—can terminate the contract without incurring more than an insignificant penalty. We can understand why respondents perceive there to be an inconsistency between the following two sentences (emphasis added):

B34 A lease is no longer enforceable when the lessee and the lessor *each* has the right to terminate the lease without permission from the other party with no more than an insignificant penalty.

BC127 In assessing the enforceability of a contract, an entity should consider *whether the lessor can refuse* to agree to a request from the lessee to extend the lease.

39. However, we note that the Basis for Conclusions accompanies, but is not part of, IFRS 16. The Basis for Conclusions provides context within which IFRS 16 should be read, but neither contains requirements nor overrides requirements in the Standard. Paragraph B34 states that, to no longer be enforceable, *each* party to a lease must have the right to terminate without permission from the other party with no more than an

insignificant penalty. If only one party has such a right, the lease remains enforceable. Paragraph BC127 does not change this requirement of the Standard. For example, consider a lease for which the lessor has the right to refuse to extend but, if it does, it must make a significant cash payment to the lessee on termination. Considering paragraph BC127 in isolation, one could argue that the lessor *can* refuse to extend. However, to say this contract is not enforceable would clearly be inconsistent with paragraph B34 of the Standard.

40. In other words, rather than explaining the concept of enforceability, paragraph BC127 instead explains the Board's rationale. The particular sentence highlighted by respondents was developed by the Board to emphasise—consistent with other areas of IFRS 16—the importance of considering contract economics and not only legal form. For example, consider a lease for which the lessor has the contractual ability to terminate, but is economically incentivised not to do so. The context provided by paragraph BC127 reminds an entity to consider the fact that the lessor is, in reality, unlikely to be able to refuse any request to extend.
41. We think respondents raising the concern in paragraphs 34–35 have focussed on the enforceable rights of individual parties to the contract, whereas paragraph B34 refers to whether the *contract* is enforceable. EY notes in its comment letter paragraph B34's reference to contract enforceability, and not the rights of the individual parties. Finally, we also question the economics of any lease giving rise to the concern raised by respondents and described in paragraphs 34–35. For such a contract to exist, the lessee must agree to a lease that it—but *not* the lessor—is economically incentivised to remain in. We think a lessee is unlikely to agree to such a contract.
42. In the light of the above analysis, we continue to support the Committee's conclusion in its tentative agenda decision.

Practical concerns – assessment from lessor point of view

Respondents' comments

43. Eight respondents (the OIC, the FBF, Telefónica, the KASB, Crédit Agricole Group, Société Générale, PHOENIX Group and ACTEO/AFEP/MEDEF) are concerned that application of a broad definition of 'penalty' in paragraph B34 requires an assessment of economic incentives of the *lessor*. This is because they say an entity would have to determine whether the lessee and lessor *each* would incur more than an insignificant penalty on contract termination.
44. Respondents describe a lessee making such an assessment as 'almost impossible', 'easily challenged' and 'very costly, complex and arbitrary'. Some add that such an assessment would require the lessee to 'guess the intentions' of the lessor.
45. Several of these respondents also note that all lease term requirements in IFRS 16 are written from the *lessee's* point of view. Consequently, these respondents say assessment from the lessor's point of view is difficult, with some adding that, in their view, such an assessment is inconsistent with the requirements of the Standard.

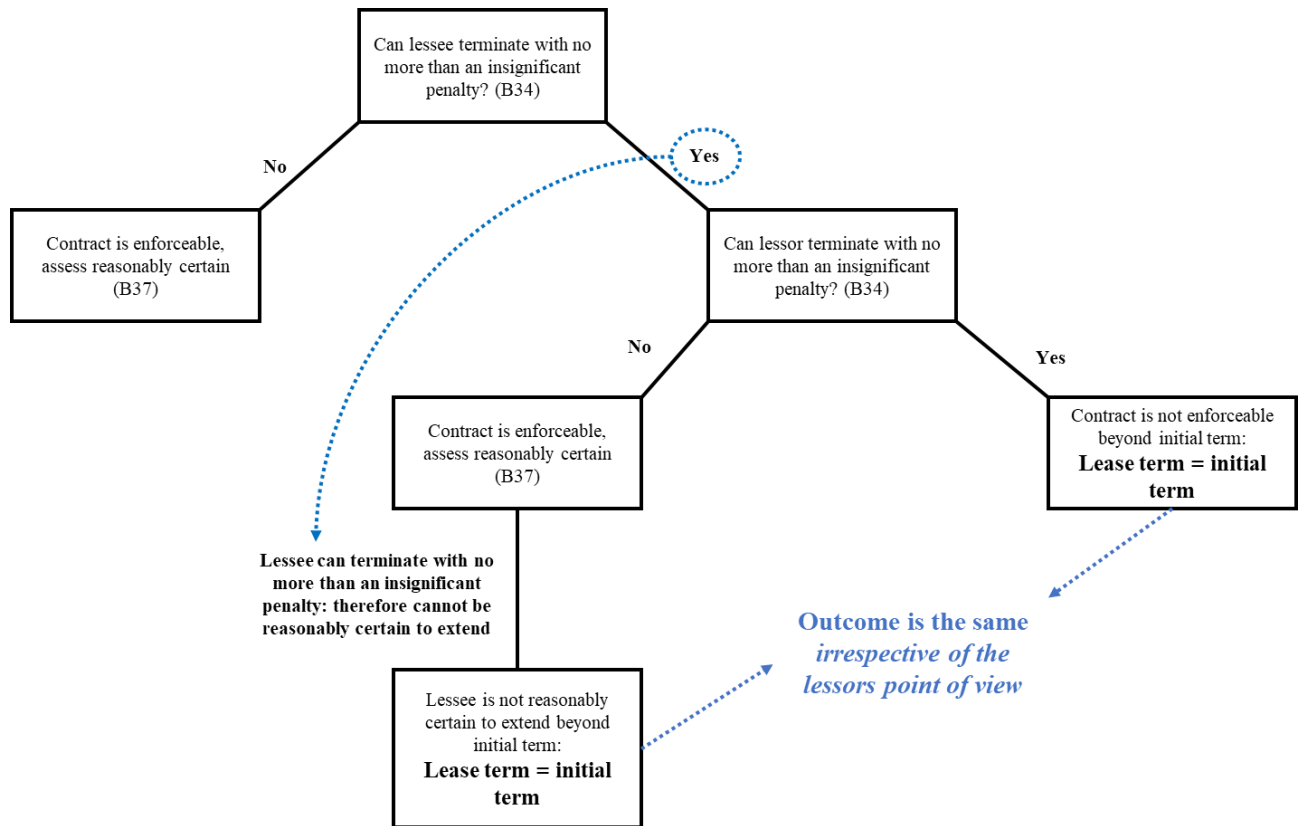
Staff analysis

46. As noted above, paragraph B34 states that a lease is no longer enforceable when the lessee and lessor each has the right to terminate the lease without permission from the other party with no more than an insignificant penalty. We disagree however that paragraph B34 requires a lessee to 'guess the intentions' of the lessor. The existence of a penalty on termination is different from—and more concrete than—an *intention* not to terminate. This is because, as described above, the concept of penalty incorporates economic considerations. For more than an insignificant penalty to exist, there must be an economic disincentive; intention alone is not enough.
47. We acknowledge the point made by respondents that the lease term requirements of IFRS 16 refer to the point of view of the lessee. For example, all of the items listed in paragraph B37 represent economic incentives for a lessee to remain in a lease contract. However, in our view this does not prevent a lessee from identifying the existence of an economic penalty or disincentive for the lessor. For example, the

lessee will know if the underlying asset is highly specialised and, consequently, difficult for the lessor to make alternative use of on termination of the lease.

48. Furthermore—and perhaps most importantly—we think there are no practical circumstances in which the lessor’s point of view affects lease term. This is because:
- (a) for a lease to no longer be enforceable, paragraph B34 requires *each* party to be able to terminate the lease with no more than an insignificant penalty. Consequently, if the *lessee* cannot terminate with no more than an insignificant penalty, paragraph B34 says the contract is enforceable irrespective of the lessor’s point of view; and
 - (b) ‘reasonably certain’ is a higher bar than ‘no more than an insignificant penalty’. Applying paragraph B37, a lessee that is reasonably certain to extend a lease must have an economic incentive to remain in that lease. Accordingly, the lessee cannot terminate the contract with no more than an insignificant penalty and, thus, the contract must be enforceable. In other words: irrespective of the lessor’s point of view, there are no circumstances in which a lessee could conclude that it is reasonably certain to extend a lease into a contract period that is unenforceable.

49. This concept is illustrated in the diagram that follows:



50. Accordingly, we think it reasonable to expect a lessee to make the determination described in paragraph B34.

51. In addition, we note that the practical effect of the analysis in this paper for an entity that might have read ‘penalty’ narrowly is that it may be required to assess whether it is reasonably certain to extend (or not terminate) particular leases. That assessment would result in a change to the lease term *only* for leases for which the lessee is reasonably certain to extend (or not terminate).

Requests for standard-setting

Respondents’ comments

52. Seventeen respondents (the OIC, the ANC, BusinessEurope, the FBF, Mazars, the KASB, the ASBJ, Crédit Agricole Group, Société Générale, IFRScommunity.com, the 100 Group, PHOENIX Group, A1 Telecom Group, the ICAI, Deloitte,

ACTEO/AFEP/MEDEF and Petrobras) recommend standard-setting as an alternative to publishing an agenda decision. For the reasons described above, these respondents say it is not possible to reach the conclusion in the tentative agenda decision applying the existing requirements in IFRS 16.

Staff analysis

53. For the reasons described in paragraphs 20–51 above, respondents’ comments on the Committee’s technical analysis do not change our agreement with the Committee’s conclusions reached in its tentative agenda decision. In our view, the principles and requirements in IFRS 16 provide an adequate basis for an entity to determine the lease term of cancellable and renewable leases.
54. However, we acknowledge that reaching that conclusion based on the requirements in the Standard requires analysis and thought—the conclusion is not, for example, explicitly spelt out in one sentence. Although this is consistent with how principles-based Standards are written and should be read (see the discussion in paragraphs 23–32), we also acknowledge that comments and concerns of a similar nature have been made by many respondents and we understand why respondents have those concerns.
55. Consequently, having considered those comments we think the Committee could either:
 - (a) finalise its agenda decision (see Appendix A to this paper); or
 - (b) recommend that the Board address the matter as part of its next Annual Improvements to IFRS Standards.

Finalise agenda decision

56. Applying the criteria in paragraphs 5.16–5.17 of the *Due Process Handbook*, in our view it is not necessary to change IFRS Standards to improve financial reporting. This is because the principles and requirements in IFRS 16 already provide an adequate basis to determine the lease term of cancellable and renewable leases. Therefore, if the Committee agrees with our technical analysis set out in

paragraphs 20–51, the Committee could provide a timely response to stakeholders on this matter by publishing an agenda decision with explanatory material.

57. Appendix A to this paper contains proposed wording for a final agenda decision if the Committee decides to take this approach.

Annual improvement

58. Paragraphs 6.11–6.14 of the [Due Process Handbook](#) include the criteria for annual improvements. To meet these criteria, any proposed amendment would need to be limited to:
- (a) clarifying the wording in a Standard; or
 - (b) correcting relatively minor unintended consequences, oversights or conflicts between existing requirements.
59. Any proposed amendment to paragraph B34 of IFRS 16 to clarify the application of the word ‘penalty’ would meet the first of these criteria. This is because the amendment would represent a minor clarifying change to the Standard—it would add explanation to a concept already specified in IFRS 16. In light of the feedback received, this approach could be helpful to stakeholders in the longer-term in making the Standard more assessable and understandable.
60. Therefore, if the Committee agrees with our technical analysis set out in paragraphs 20–51, the matter raised in the submission could be addressed through an annual improvement.
61. Regarding timeliness, we note that the next annual improvements to IFRS Standards are unlikely to be finalised in the near future. In the meantime, a decision to address the matter through an annual improvement would, in itself, help to communicate the intent of paragraph B34 to stakeholders.

Additions and clarifications to the wording of the agenda decision

Respondents' comments

62. This section reflects only suggestions made assuming retention of the Committee's technical conclusion in the tentative agenda decision. We have not included wording suggestions that would change the technical conclusions because we continue to agree with the technical conclusion reached by the Committee.
63. We received two suggested additions and one suggested clarification to the wording of the tentative agenda decision.

Suggested additions

64. The European Securities and Markets Authority (ESMA) says the Committee could have further explained in the tentative agenda decision what is meant by 'more than an insignificant penalty'. In particular, ESMA recommends that the Committee include in any final agenda decision some of the explanations and considerations that were in the Board's October 2017 educational webinar "[Lease Term Q&A with Board Member Darrel Scott](#)". ESMA is of the view that such additional wording would improve consistent application and enforceability of IFRS 16.
65. International Air Transport Association's Industry Accounting Working Group (IATA IAWG) recommends that the Committee provide additional clarity in any final agenda decision by including examples that illustrate how to apply the conclusion to several specific common practice scenarios.

Suggested clarifications

66. BDO observes that the common understanding of 'penalty' is a monetary payment that is imposed but this is not the case in the context of IFRS 16. BDO suggests clarifying the meaning of 'penalty' in any final agenda decision as follows (suggested new text is underlined):

“...For example, if either party has an economic incentive not to terminate the lease such that it would incur a penalty on termination, which economically compels either party not to terminate the contract, that is more than insignificant...”

Staff analysis

67. If the Committee decides to finalise the agenda decision, we recommend not including the additional material or illustrative examples suggested by ESMA and IATA IAWG. As is the case for all agenda decisions, it is important to focus on explaining how the applicable requirements in the Standard apply to the question asked; the agenda decision should not go beyond explaining those applicable requirements. The additional examples suggested by IATA IAWG relate to other practice scenarios. Including such material in an agenda decision would go beyond responding to the question asked.
68. We also recommend not making the amendment to the tentative agenda decision suggested by BDO in paragraph 66. The suggested amendment is to a sentence that already contains the words (emphasis added) ‘...if either party has an *economic* incentive not to terminate...’. Consequently, in our view it is not necessary to add another reference to economics within that same sentence.

Staff Analysis—Question Two: Useful life of non-removable leasehold improvements

Structure of our analysis

69. The majority of respondents do not comment specifically on Question Two. Of those that did comment:
- (a) two respondents (IDV and ACTEO/AFEP/MEDEF) suggest that the Committee not do anything in response to Question Two at this time. IDV is concerned about disrupting implementation. ACTEO/AFEP/MEDEF suggest that the Committee first address Question One through standard-setting before considering Question Two.
 - (b) four respondents provide comments on the Committee’s technical analysis (paragraphs 70–72 below).

- (c) two respondents make suggestions regarding the wording of the agenda decision (paragraphs 73–75 below).

Reasonably certain vs expected to be available

Respondents' comments

70. Three respondents (Mazars, IDV and Deloitte) observe that the ‘reasonably certain’ threshold in IFRS 16 is not the same as the ‘expected to be available’ threshold in IAS 16. These respondents say an entity can *expect* to renew a lease without being *reasonably certain* to do so. In this case, the useful life of any non-removable leasehold improvements could be longer than the lease term. Similarly, IATA IAWG observes that lease term does not limit the useful life of leasehold improvements.
71. Furthermore, Mazars disagrees with the Committee’s observation that an entity might often reach the conclusion that the lease term is the same as the useful life of non-removable leasehold improvements that the entity will use and benefit from only for as long as it uses the leased asset.

Staff analysis

72. We agree with respondents that ‘reasonably certain’ is not the same as ‘expected to be available’. The Committee considered this in its original analysis and the comment letters have not identified new information. In our view, this point is adequately reflected in the tentative agenda decision. Throughout the tentative agenda decision, the Committee referred to lease term being a *consideration* when assessing the useful life of non-removable leasehold improvements—this reflects the requirements in paragraphs 56–57 of IAS 16. The tentative agenda decision does not state that the useful life of leasehold improvements could *never* be longer than the related lease term.

Additions and clarifications to the agenda decision

Respondents' comments

73. IATA IAWG suggests that the Committee state clearly in any final agenda decision that lease term does not limit the useful life of leasehold improvements. IATA IAWG also suggests that the Committee balance the agenda decision by including examples of scenarios in which the useful life of leasehold improvements will exceed lease term.
74. Shady Fouad Mehelba suggests that the Committee use more specific language in the agenda decision.

Staff analysis

75. If the Committee decides to finalise the agenda decision, we recommend that it does not make any amendments in light of these suggestions. This is because:
- (a) the tentative agenda decision does not state that lease term limits the useful life of any non-removable leasehold improvements. Instead it refers to lease term being a *consideration* when assessing useful life. Consequently, in our view this point needs no clarification. Furthermore, any such clarification could be misinterpreted.
 - (b) it would potentially be confusing to include examples in any agenda decision that do not relate to the question asked.
 - (c) we have not identified an example of 'more specific language' that we think would improve the agenda decision.

Question for the Committee

76. Based on the above analysis, we continue to support the Committee's technical conclusions in the tentative agenda decision on both Question One and Question Two of the submission.

77. In light of the feedback received, we ask the Committee whether:
- (a) the principles and requirements in IFRS 16 (together with those in IAS 16 for Question 2) provide an adequate basis for an entity to determine its accounting for Question One and Question Two. (If the answer is ‘yes’, the Committee will finalise the agenda decision subject to any drafting comments); or
 - (b) whether a minor clarifying narrow-scope amendment to paragraph B34 of IFRS 16 (eg annual improvement) is required?

Questions for the Committee

- 1) Does the Committee agree with the technical analysis in paragraphs 20–51 and paragraphs 70–72?
- 2) If so, to which of the following does the Committee agree:
 - (a) finalise the agenda decision set out in Appendix A to this paper?

or:

 - (b) recommend an amendment to paragraph B34 of IFRS 16 as part of the next Annual Improvements to IFRS Standards?

Appendix A—Possible wording of an agenda decision

A1. We propose the following wording if the Committee decides to finalise the agenda decision (new text is underlined>, and deleted text is struck through).

Lease Term and Useful Life of Leasehold Improvements (IFRS 16 and IAS 16)

The Committee received a request about cancellable or renewable leases.

The cancellable lease described in the request is one that does not specify a particular contractual term but continues indefinitely until either party to the contract gives notice to terminate. The contract includes a notice period of, for example, less than 12 months and the contract does not oblige either party to make a payment on termination. The renewable lease described in the request is one that specifies an initial period, and renews indefinitely at the end of the initial period unless terminated by either of the parties to the contract.

The request asked two questions:

- a. how to determine the lease term of a cancellable lease or a renewable lease. Specifically, the request asked whether, when applying paragraph B34 of IFRS 16 and assessing ‘no more than an insignificant penalty’, an entity considers the broader economics of the contract, and not only contractual termination payments. Such considerations might include, for example, the cost of abandoning or dismantling leasehold improvements.
- b. whether the useful life of any related non-removable leasehold improvements is limited to the lease term determined applying IFRS 16. Non-removable leasehold improvements are, for example, fixtures and fittings acquired by the lessee and constructed on the underlying asset that is the subject of the cancellable or renewable lease. The lessee will use and benefit from the leasehold improvements only for as long as it uses the underlying asset.

Lease term

Paragraph 18 of IFRS 16 requires an entity to determine the lease term as the non-cancellable period of a lease, together with both (a) periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option; and (b) periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option.

In determining the lease term and assessing the length of the non-cancellable period of a lease, paragraph B34 of IFRS 16 requires an entity to determine the period for which the contract is enforceable. Paragraph B34 specifies that ‘a lease is no longer enforceable when the lessee and the lessor each has the right to terminate the lease without permission from the other party with no more than an insignificant penalty’.

Paragraph BC156 sets out the Board’s view that ‘the lease term should reflect an entity’s reasonable expectation of the period during which the underlying asset will be used because that approach provides the most useful information’. ~~Paragraph BC129 explains that, in the Board’s view, an entity is unlikely to add a clause to a lease contract that does not have economic substance.~~

The Committee observed that, in applying paragraph B34 and determining the enforceable period of the lease described in the request, an entity considers:

- (a) the broader economics of the contract, and not only contractual termination payments. For example, if either party has an economic incentive not to terminate the lease such that it would incur a penalty on termination that is more than insignificant, the contract is enforceable beyond the date on which the contract can be terminated; and
- (b) whether each of the parties has the right to terminate the lease without permission from the other party with no more than an insignificant penalty. Applying paragraph B34, a lease is no longer enforceable only when both parties have such a right. Consequently, if only one party has the right to terminate the lease without permission from the other party with no more than an insignificant penalty, the contract is enforceable beyond the date on which the contract can be terminated by that party.

If an entity concludes that the contract is enforceable beyond the notice period of a cancellable lease (or the initial period of a renewable lease), it then applies paragraphs 19 and B37–B40 of IFRS 16 to assess whether the lessee is reasonably certain not to exercise the option to terminate the lease.

Useful life of non-removable leasehold improvements

Paragraph 50 of IAS 16 requires an item of property, plant and equipment (asset) to be depreciated over its useful life.

IAS 16 defines the useful life of an asset as (emphasis added) ‘*the period over which an asset is expected to be available for use by an entity; or the number of production or similar units expected to be obtained from the asset by an entity*’.

Paragraphs 56 and 57 of IAS 16 provide further requirements on the useful life of an asset. In particular, paragraph 56(d) specifies that in determining the useful life of an asset, an entity considers any legal or similar limits on the use of the asset, such as the expiry dates of related leases. Paragraph 57 specifies that the useful life of an asset (a) is defined in terms of the asset’s expected utility to the entity, and (b) may be shorter than its economic life.

An entity applies paragraphs 56–57 of IAS 16 in determining the useful life of non-removable leasehold improvements. If the lease term of the related lease is shorter than the economic life of those leasehold improvements, the entity considers whether it expects to use the leasehold improvements beyond that lease term. If the entity does not expect to use the leasehold improvements beyond the lease term of the related lease then, applying paragraph 57 of IAS 16, it concludes that the useful life of the non-removable leasehold improvements is the same as the lease term. The Committee observed that, applying paragraphs 56–57 of IAS 16, an entity might often reach this conclusion for leasehold improvements that the entity will use and benefit from only for as long as it uses the underlying asset in the lease.

Interaction between the determination of the useful life of non-removable leasehold improvements and the enforceable period of the lease and lease term

In assessing whether a lessee is reasonably certain to extend (or not to terminate) a lease, paragraph B37 of IFRS 16 requires an entity to consider all relevant facts and circumstances that create an economic incentive for the lessee. This includes significant leasehold improvements undertaken (or expected to be undertaken) over the term of the contract that are expected to have significant economic benefit for the lessee when an option to extend or terminate the lease becomes exercisable (paragraph B37(b)).

In addition, as noted above, an entity considers the broader economics of the contract when determining the enforceable period of a lease. This includes, for example, the costs of abandoning or dismantling non-removable leasehold improvements. If an entity expects to use non-removable leasehold improvements beyond the date on which the contract can be terminated, the existence of those leasehold improvements indicates that the entity might incur

a more than insignificant penalty if it terminates the lease. Consequently, applying paragraph B34 of IFRS 16, an entity considers whether the contract is enforceable for at least the period of expected utility of the leasehold improvements.

The Committee concluded that the principles and requirements in IFRS 16 provide an adequate basis for an entity to determine the lease term of cancellable and renewable leases.

The Committee also concluded that the principles and requirements in IAS 16 and IFRS 16 provide an adequate basis for an entity to determine the useful life of any non-removable leasehold improvements relating to such a lease. Consequently, the Committee {decided} not to add the matter to its standard-setting agenda.

Appendix B: Analysis of other comments relating to Question One

B1. The table below outlines other comments relating to Question One, together with our analysis and conclusions.

Respondents' comments	Staff analysis and conclusions
<p>1. <i>Educational material</i></p> <p>EY and BDO suggest that the Committee develop educational material discussing the concept of enforceable rights and obligations in IFRS 16.</p>	<p><i>We recommend no action in response to this matter.</i></p> <p>The Board has previously developed educational material⁴ about lease term that is available on the IFRS Foundation public website.</p>
<p>2. <i>Modification of the lease term</i></p> <p>The FBF and Crédit Agricole Group say a change in assessment of the lessor's economic incentives (and disincentives) is not considered a modification event applying paragraphs 20–21 of IFRS 16. These respondents are concerned about how, applying the tentative agenda decision, an entity would account for a change in economic incentives during the lease term.</p>	<p><i>We recommend no change to the agenda decision in this respect.</i></p> <p>The Committee was asked about the determination of the lease term at the commencement date. Accordingly, this question is beyond the scope of the submission.</p> <p>Nonetheless, we note that paragraphs 20 and B41 of IFRS 16 specify the circumstances in which an entity would reassess the lease term.</p>
<p>3. <i>Renewable leases</i></p> <p>The KASB and Korea Listed Companies Association disagree that</p>	<p><i>We recommend no change to the agenda decision in this respect.</i></p>

⁴ [Educational material on lessee measurement \(including lease term\)](#); [Educational material on lease term](#)

Respondents' comments	Staff analysis and conclusions
<p>renewable leases are equivalent to cancellable leases.</p> <p>Furthermore, these respondents disagree that an option to extend a lease should be considered in determining the lease term at the commencement date. The KASB suggests that this option be treated as a lease modification only if and when it is exercised.</p>	<p>The agenda decision explains what is meant by renewable and cancellable leases (as set out in the submission). In our view, the explanation in the agenda decision is adequate and illustrates that such leases are interchangeable for the purpose of the question asked.</p> <p>Applying paragraph 18 of IFRS 16, an entity determines the lease term to include 'periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option'. Accordingly, IFRS 16 includes an explicit requirement to consider options to extend a lease at the commencement date. We therefore disagree with the respondent's technical analysis.</p>
<p>4. <i>Other matters</i></p> <p>David Hardidge summaries his own technical analysis applying the lease term requirements in IFRS 16 to a range of topics including:</p> <p>(a) interaction between paragraphs B34 and B35 (and the associated explanation in paragraph BC128).</p> <p>(b) distinguishing between an option for the lessor to terminate early as opposed to a requirement to obtain the</p>	<p><i>We recommend no change to the agenda decision in this respect.</i></p> <p>Paragraphs 35–39 of Agenda Paper 3 presented at the Committee's June meeting explained the interaction between paragraphs B34 and B35. The Committee agreed with the staff analysis, which in our view addresses the respondent's question in this respect.</p> <p>All additional matters raised are beyond the scope of the question asked. Accordingly, no further analysis is performed.</p>

Respondents' comments	Staff analysis and conclusions
<p>lessor's approval for extension in paragraph BC127.</p> <p>(c) examples of contracts (eg office accommodation, month-to-month leases and contracts in the telecoms industry) for which he asks the Committee to investigate and answer particular fact patterns.</p>	