

**Sue Lloyd
Chair of the IFRS IC
Columbus Building
7 Westferry Circus
Canary Wharf
London E14 4HD
United Kingdom**

Agenda Item Request: Determination of the lease term

Dear Mrs. Lloyd,

The European Securities and Markets Authority (ESMA) is an independent EU Authority that enhances the protection of investors and promotes stable and well-functioning financial markets in the European Union (EU). ESMA achieves this aim by building a single rule book for EU financial markets and ensuring its consistent application across the EU. In the context of its convergence work in the area of financial reporting, I would like to raise the following implementation issue related to IFRS 16 *Leases* with you.

As a result of work carried out by national competent authorities and ESMA's coordination activities regarding the implementation of IFRS 16, we have noted a lack of clarity regarding the requirements related to the determination of the lease term for specific types of cancellable leases. While IFRS 16 is mandatorily applicable in the EU only for the reporting periods starting on or after 1 January 2019, ESMA notes that the lack of explicit guidance in authoritative literature on the determination of the lease term for cancellable leases has already led to a diversity in application of IFRS in the EU. Accordingly, ESMA kindly suggests that the IFRS Interpretations Committee (IFRS IC) considers clarifying the relevant accounting requirements.

A detailed description of the case is set out in the appendix to this letter.

In case you have any questions or comments regarding this letter, I suggest you contact Evert van Walsum, Head of the Investors and Issuers Department (Evert.vanWalsum@esma.europa.eu).

Yours sincerely,



Steven Maijoor

Cc: Hans Hoogervorst, Chair, International Accounting Standards Board (IASB)

APPENDIX – DETAILED DESCRIPTION OF THE ISSUE

1. As part of their monitoring and supervisory activities, ESMA and national enforcers have identified divergent implementation of accounting requirements with regard to the determination of the lease term for 'cancellable leases' in scope of IFRS 16 *Leases*, with a subsequent impact on different determination of the useful life of the right-of-use asset in scope of IAS 16 *Property, Plant and Equipment*.

Issue 1: Determination of lease term

2. A lease contract does not define a specific lease period but allows for the lease to continue until either party of the contract gives notice to terminate the contract (i.e. the contract will continue indefinitely until the lessee or the lessor elects to terminate it) ('cancellable lease'). When a party notifies the termination of the contract, a period of less than 12 months is given till the termination ('notice period'). Neither the lessor nor the lessee will incur any contractual termination payment upon exercising the termination right.
3. ESMA has encountered several variations on this issue, however with a similar underlying accounting issue of application of paragraph B34 of IFRS 16 to be assessed.
4. In many cases, the lessee constructs assets or leasehold improvements, which cannot be moved to another premise and represent amounts more than insignificant (for instance a factory or fixings in a shop). Upon termination of the lease, these assets or leasehold improvements will need to be abandoned, or dismantled upon request of the lessor. Relocation costs will also arise. The question arises how to determine the lease term in these circumstances and, in particular, whether these costs and hence broader economic assessment is to be considered in determination of the lease term (issue 1A).
5. A variation on this issue, encountered in some European jurisdictions, includes a defined initial period (e.g. 12 months or 6 years) which is regularly tacitly¹ renewed for the same period or for short periods (e.g. less than 12 months) unless cancelled by any of the parties (issue 1B)².
6. In this context, ESMA notes that the following views have been observed in practice on the requirements of IFRS 16 for determination of lease term for cancellable leases:

View 1: The lease term is the notice period (Issue 1A) or initial lease term (Issue 1B)

7. Proponents of view 1 are of the opinion that if the lessor and the lessee both have an option to terminate the lease in the lease contract, the lessee cannot consider that the lease term is enforceable beyond the notice period. According to proponents of this view, the

¹ In some cases, the lease contract provides on the expiration date that (i) both parties can without contractual penalties terminate the contract (ii) if both parties decide not to terminate the contract, the contract is tacitly renewed for a further contractually agreed period.

² ESMA has also observed structuring when the initial period of a cancellable lease is set for 11 months in order to benefit the short-term lease exception. Similar considerations for determination of the lease term (i.e. contractual penalty payment versus broader economic outflows connected to the termination clause) apply in this case as well, even though further considerations related to the nature and purpose of such contract need to be considered.

maximum term of the lease would be the non-cancellable period (if any) plus any notice period for leases for which both the lessee and the lessor must agree to extend the lease beyond any non-cancellable period.

8. Paragraph 18 and Appendix A of IFRS 16 define the lease term as *'the non-cancellable period for which a lessee has the right to use an underlying asset, 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.'*
9. Paragraph B34 of IFRS 16 provides further guidance on determination of the lease term with regards to the enforceability of the contract. In particular, paragraph B34 clarifies that in determining the lease term and assessing the length of the non-cancellable period of a lease, the issuer *'shall apply the definition of a contract and determine the period for which the contract is enforceable'*.
10. Proponents of view 1 point to the rationale for this guidance included in paragraph BC 127 to IFRS 16, which seems to limit enforceability to contractual conditions. It states that in order to be *'part of a contract, any options to extend or terminate the lease that are included in the lease term must also be enforceable [...]'. 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.'*
11. Paragraph BC 127 of IFRS 16 concludes that there is no contract beyond the non-cancellable period (plus any notice period) if there are no enforceable rights and obligations existing between the lessee and lessor beyond that term. 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. Some proponents of view 1 believe that this conclusion is also valid for tacit renewal contracts.
12. Furthermore, Appendix A of IFRS 16 clarifies that *'contract'* is defined in other standards and used in IFRS 16 with the same meaning, i.e. *'an agreement between two or more parties that creates enforceable rights and obligations'*. Proponents of view 1 refer for example to the definition of contract in IFRS 15 *Revenue from Contracts with Customers* that limits it to the legally enforceable consideration. In particular, they refer to paragraph 10 of IFRS 15 that refers to enforceability of the rights and obligations in a contract as a matter of law and paragraph 11 of IFRS 15 that limits application of accounting requirements to the duration of the contract (i.e. the contractual period) in which the parties to the contract have present enforceable rights and obligations taking into account the applicable legal framework.
13. Proponents of View 1 consider that the guidance in paragraph B34 of IFRS 16 which states 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'* emphasizes that if both parties can breach the contract at no cost, there is in substance no contract and that even if a lessee incurs more than an insignificant cost upon termination of a cancellable lease by the lessor this does not create an *enforceable* right for the lessee to extend the contract.

14. Consequently, proponents of view 1 are of the view that the assessment of enforceability, including the reference to the insignificant penalty related to cancellation, should be limited to contractual conditions (taking into account the applicable legal framework) and should not consider all other non-contractual conditions (such as economic assessment of incentives or compulsion not to cancel or to prolong a lease contract).

View 2: The lease term can go beyond the end of the notice period (issue 1A) and the initial lease term (issue 1B). The lessee has to assess if the lessor and the lessee have both a right to terminate the lease with no more than an insignificant penalty.

15. While proponents of view 2 agree with the definition of the lease term, they highlight the guidance in paragraph B34 of IFRS 16 implying that the existence of more than an insignificant penalty creates enforceability of a lease contract even with a termination clause held by both parties.
16. While no further guidance or basis for conclusions is given in IFRS 16 regarding the assessment of what is an insignificant penalty, proponents of view 2 refer to other educational material and discussions provided by the IASB on this matter.
17. In particular, in October 2017, a webcast was released on the IASB website named 'Lease term Q&A by Darell Scott (Board member)'³. This webcast highlights the following:
 - a. The contract is considered to be no longer enforceable only when both parties have a right to terminate the lease.
 - b. In assessing the notion of *no more than an insignificant penalty*, the analysis should not only capture the termination penalty payment specified in the contract, but use a broader economic consideration of penalty and thus include all kinds of possible economic outflows related to termination. These outflows are for instance for the lessee economic cost of relocation, cost of abandoned leasehold improvement, etc. and for the lessor cost of finding a new tenant, lease incentives to new tenants, etc.
 - c. The assessment of significance of the termination penalty needs to assess the economic substance of the contract, not just explicit contractual termination clauses. Such assessment should, where relevant for the assessment of the lessee, take into account past practice in using the termination (or extension) options.
18. Notwithstanding the practical difficulties of the assessment of significance of the penalty from the lessor perspective by the lessee, it seems to remain unclear whether the notion of insignificant penalty should be assessed from both the lessor and the lessee perspective or if either the lessor or lessee encountering an insignificant penalty is sufficient.
19. Proponents of view 2 are of the opinion that based on paragraph B34 and the clarification provided by the IASB webcast, both, or either, the lessee and the lessor should assess

³ <https://www.ifrs.org/webcast/?webcastid=1163617>

whether there is more than an insignificant penalty to determine the lease term that can go beyond the notice period. To assess the notion of significant penalty, a broad economic definition of penalty should be used and considered for both the lessor and the lessee. In this context, proponents of view 2 make also reference to paragraph 19 of IFRS 16, which requires the entity to ‘consider all relevant facts and circumstances that create an economic incentive for the lessee to exercise the option to extend the lease, or not to exercise the option to terminate the lease’.

20. In the view of the proponents of view 2, the same assessment of economic incentives should apply for paragraph B34 as well. Subsequently, if the penalty is more than insignificant for both of the parties, the lease term would be assessed based on the criteria in paragraph B37 of IFRS 16.
21. In addition, some proponents of view 2 also highlight the rationale for paragraph B35 of IFRS 16 when only the lessee has the right to terminate the lease. The IASB has clarified in paragraph BC 128 of IFRS 16 that in that case ‘a lessor’s right to terminate a lease is ignored when determining the lease term because, in that case, 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’. Consequently some proponents of view 2 are of the view that the interaction of paragraphs B34 and B35 of IFRS 16 and their underlying rationales should be further clarified.

Issue 2: Determination of useful life

22. ESMA notes that a further question arises about the interaction of IAS 16 and IFRS 16 about the impact in the determination of the enforceable period and lease term has on the useful life determined for the purposes of depreciation charges. This becomes an issue especially in case view 1 for issue 1 is selected for assets or non-removable leasehold improvements (such as fixtures and fittings).
23. According to paragraph 31 of IFRS 16, the right-of-use asset is measured at cost less any accumulated depreciation determined in accordance with the depreciation requirements of IAS 16, subject to specific requirements of paragraph 32 of IFRS 16. According to paragraph 32 of IFRS 16 *‘If the lease transfers ownership of the underlying asset to the lessee by the end of the lease term, or if the cost of the right-of-use asset reflects that the lessee will exercise a purchase option, the lessee shall depreciate the right-of-use asset from the commencement date to the end of the useful life of the underlying asset. Otherwise, the lessee shall depreciate the right-of-use asset from the commencement date to the earlier of the end of the useful life of the right-of-use asset or the end of the lease term.’*
24. Appendix A to IFRS 16 clarifies that ‘*useful life*’ is defined in other standards and used in IFRS 16 with the same meaning. Appendix A to IFRS 16 and paragraph 6 of IAS 16 define useful life of an asset as *‘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’*. Paragraph 56(d) of IAS 16 clarifies that legal or similar limits on the use

of the asset, such as the expiry dates of related leases, are considered in determining the useful life of an asset.

25. In this context, ESMA notes that the following views have been observed in practice on interaction of the requirements of IAS 16 and IFRS 16 for cancellable leases:

View 1: Useful life is limited to the lease term of the cancellable lease (i.e. both terms are aligned)

26. Proponents of view 1 are of the opinion that in accordance with paragraph 56(d) of IAS 16, the useful life needs to take into consideration the limits on the use of the asset, and the example given by this paragraph is the expiry dates of related leases. Hence, the useful life of the asset or non-removable leasehold improvement cannot be longer than the lease term, which in case of a non-cancellable lease will be only the non-cancellable notice period or non-cancellable initial period (i.e. the period determined in issue 1).
27. This reflects the assessment that the enforceable lease contract is limited to the non-cancellable period, and when view 1 in issue 1 is applied, the economic value of the leasehold improvements will not be considered as a termination penalty (to the extent it is not included in the contract).

View 2: There is no specific link between determination of lease term and useful life

28. While proponents of view 2 acknowledge the guidance in paragraph 32 of IFRS 16 and paragraph 56(d) of IAS 16, they also note that the definition of useful life (period over which asset is expected to be available for use by an entity) can differ from the definition of the lease term which refers to non-cancellable periods and options reasonably certain to exercise.
29. For proponents of view 2, the level of certainty for establishing the lease term (reasonably certain according to paragraph 18 of IFRS 16) and the useful life for depreciation purpose (expected to be available in accordance with paragraph 6 of IAS 16) are different and the IAS 16 conveys a lower level of certainty required. Hence, in some circumstances, the options to extend a lease will not be taken in the lease term whereas the leasehold improvements would be depreciated over their economic life as the entity expects to extend the lease but is not reasonably certain to do so (for example, but not limited to the case of a cancellable lease).
30. For proponents of this view, paragraph 32 of IFRS 16 that requires the lessee to depreciate the right-of-use asset until the earlier of the end of the useful life of the right-of-use asset or the end of the lease is not applicable to leasehold improvements, which are in the scope of IAS 16 only.

Request

31. ESMA seeks clarification on how to determine the lease term for cancellable leases and contracts with tacit renewal clause and in particular how to assess enforceability of the lease term with the reference to the existence of a no more than insignificant penalty.
32. ESMA observes that different views have been expressed on (i) the limitation of the lease term to the contractual or enforceable period based on the interaction of specific paragraphs of the application guidance as well as (ii) the limitation of penalties to contractual payments or wider economic consideration of penalties. While ESMA acknowledges the wider assessment of penalties from the economic perspective by analogy with paragraph 19 of IFRS 16 and as discussed in the abovementioned IASB webcast, doubts have been expressed whether without further guidance provided by the IASB or IFRS IC (in form of an amendment or interpretation of IFRS 16) such view can be effectively enforced by auditors or regulators in a consistent way.
33. ESMA also notes that paragraph BC 109 of ED/2013/6 that provided some guidance on the matter stating *'for leases for which both the lessee and the lessor must agree to extend the lease beyond the non-cancellable period, the maximum term of the lease would be the non-cancellable period plus any notice period'* has been removed when finalising IFRS 16, leading to divergent assessment of the intentions of the Board.
34. ESMA is of the view that the lack of clarity of the text of IFRS 16 leads to divergent practices in various jurisdictions amongst others the European jurisdictions. ESMA has already observed different views expressed and applied in the market. Consequently, ESMA suggests that the IFRS IC and/or the IASB clarify these issues.
35. Furthermore, ESMA also suggests that the IFRS IC clarifies the intended interaction between the lease term and the useful life. While ESMA understands that the intent has been to align these two terms as demonstrated by paragraphs 32 of IFRS 16 and 56(d) of IAS 16, ESMA also notes a difference in the threshold of assessment within the respective definitions. Consequently, ESMA is of the view that further explanatory text might help address the issue and thereby prevent additional divergence from emerging in practice.