Insights

by Capital Markets & Accounting Advisory Services (CMAAS)

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# IFRIC decision on how leasehold improvements affect lease term assessment under MFRS 16

| Applicable MFRS | MFRS 16 *Leases* and MFRS 116 *Property, Plant and Equipment* |
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## Background

Entities with December year-end will be reporting the impact of applying MFRS 16 for the first time in the 31 December 2019 financial statements. The key headline that MFRS 16 brings is that lessees will now recognise a lease liability and a right-of-use asset on the balance sheet. There will undoubtedly be a high level of interest in the magnitude of change to the lessee's balance sheet (and the consequential knock-on effects to the income statement), which is predominantly driven by how much lease liability a lessee recognises in relation to its lease contracts.

Lease liability is measured at the present value of the lease payments over the lease term that are not paid at lease commencement date. Accordingly, determining the length of a lease term is a key pillar to quantifying the lease liability: the longer the lease term is, the larger the amount of lease liability to be recognised by the lessee on the balance sheet.

MFRS 16 paragraph 5(a) also provides lessees with an optional practical expedient to exclude short-term leases from recognition and measurement requirements of the accounting standard. Hence, determining that a lease contract with a duration of 12 months or less will result in nil balance sheet impact for that particular lease contract on lease commencement date should the short-term lease exemption be applied. Clearly, given the importance of a lease term and the various complexities in applying the provisions of MFRS 16, there will be many practical challenges.

## What is the issue?

This article looks at the November 2019 Agenda Decision* by the IFRS Interpretations Committee (the "IC") published in December 2019. Consider the following scenario, adapted from the questions submitted to the IC for consideration:

### Scenario

*Cancellable lease*

Company A (the lessor) enters into a lease contract with Company B (the lessee) with details as follows:

- the lease contract does not specify a particular contractual term and continues indefinitely until either Company A (the lessee) or Company B (the lessor) gives notice to terminate
- if either the lessee or lessor gives notice, the lease continues for a period of < 12 months ('notice period') until termination
- neither party is obliged to make a contractual payment on termination

*Renewable lease*

Company A (the lessor) enters into a lease contract with Company B (the lessee) where the lease contract specifies an initial period that renews indefinitely unless terminated by either the lessee or lessor.

In both leases, assume that Company A (the lessee) has installed non-removable leasehold improvements at the leased asset. The leasehold improvements have an estimated economic life which exceeds 12 months.

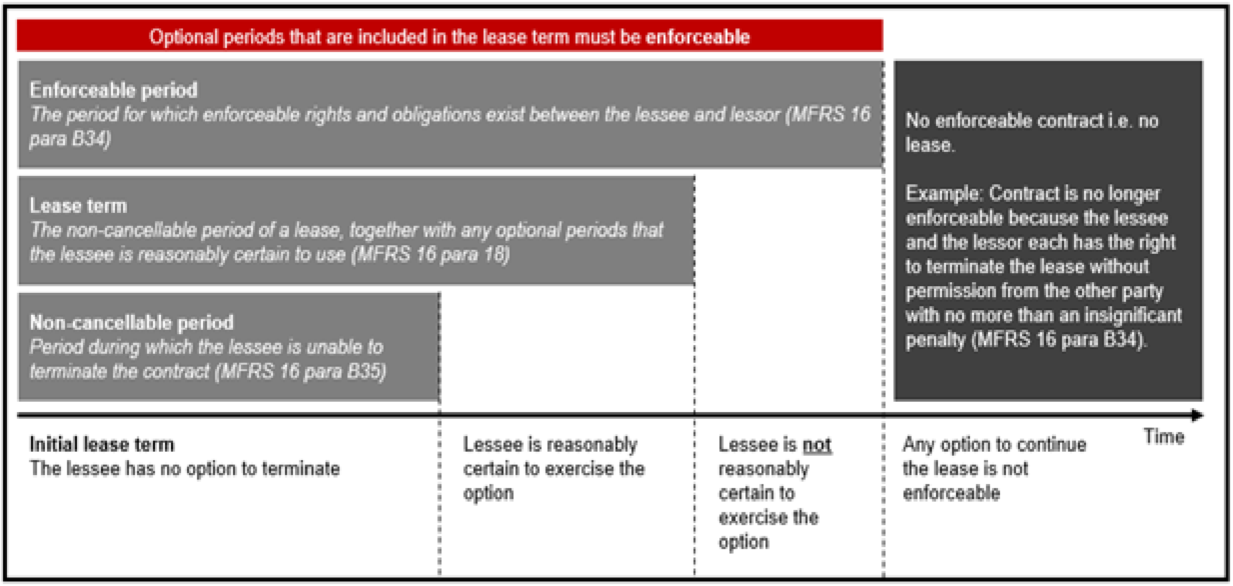
Given the scenario above, the IC was asked the following two questions:

1. How should the lease term of a cancellable lease or a renewable lease be determined?
2. Would the useful life of related non-removable leasehold improvements be limited to the lease term?

** The IC works with the International Accounting Standards Board in supporting consistency in application of IFRS Standards (Malaysian Financial Reporting Standards issued by MASB are equivalent to IFRS Standards). IC agenda decisions often include information to help entities in applying IFRS Standards. They do so by explaining how the applicable principles and requirements in the IFRS Standards apply to the application question described in the agenda decision.*

## What are the principles for determining lease term under MFRS 16?

To work out the lease term, it is useful to return to the basic MFRS 16 principles, summarised in the following table:




*Source: IC Agenda Decision Paper 4 (November 2019)*

The **"non-cancellable period"** effectively sets the minimum period which the lessee *must* recognise as the lease term (where the lease rentals of the period are recognised as part of the lease liability), whilst the **"enforceable period"**, being the period for which enforceable rights and obligations exist between the lessee and the lessor,  can be seen as the maximum period which the lessee *may consider* as the lease term. In particular, MFRS 16 paragraph B34 states that a lease would no longer be 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.

Beyond the enforceable period, there is no contractually binding lease between the lessee and lessor since neither party can enforce their rights and obligations on each other, which would simply mean that from the lessee's perspective there is no lease liability to account for. Essentially, the **"lease term"** will be a period of time that sits somewhere in between the non-cancellable period and the enforceable period. This is because in practice, if there are any options to extend or terminate the lease term, the lease term is clearly an area of judgment.

## What are the principles for determining lease term under MFRS 16? (continued)

The lessee would need to consider all relevant facts and circumstances that create an economic incentive for the lessee to exercise an option to extend the lease, or not to exercise an option to terminate the lease (MFRS 16 paragraph 9). MFRS 16 paragraph B37 provides a list of non-exhaustive examples of such relevant facts and circumstances to be considered (MFRS 16 paragraph B37):

- how do contractual terms and conditions for optional periods compare with market rates;
- whether any significant leasehold improvements have been undertaken;
- are there any costs associated with termination;
- the importance of the underlying asset that is being leased to the lessee’s business; and
- whether there is any further conditionality associated with exercising an option.

Of course, the lease term may very well be identical to the non-cancellable period and the enforceable period, for example in a lease agreement that binds both the lessee and lessor for a duration of 5 years and neither party has any option to extend or terminate.

## What is the IC’s Agenda Decision?

Now that we have recapped the core principles for determining a lease term under MFRS 16, let us revisit the questions submitted to the IC in relation to a cancellable or renewable lease and the IC's deliberation on these issues.

### Determining the lease term of a cancellable or renewable lease

IFRS 16 does not define “penalty” or “enforceable”, both words included in paragraph B34 of IFRS 16. The IC observed that, in applying IFRS 16 paragraph B34, an entity considers the broader economics beyond the contractual termination payments between lessee and lessor. If either party will incur a more than insignificant penalty (including economic penalties) from terminating, the lease is enforceable beyond that date. Once the enforceable period has been determined, the lessee applies the guidance on lessee extension / termination options to determine the lease term i.e. if the lessee is reasonably certain to continue using the asset, the periods are included in the lease term.

## What is the IC's Agenda Decision? (continued)

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### Determining the useful life of non-removable leasehold improvements

The IC was also asked whether the useful life of the non-removable leasehold improvement would be limited to the lease term. That is, if the lease term is determined to be the notice period of 12 months or less, then the useful life of the leasehold improvements would follow that period.

The IC noted that IAS 16 *Property, Plant and Equipment* (MFRS 116 is equivalent)  explains that  "useful life" is the period over which an asset is expected to be available for use by the entity and IAS 16 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' and useful life of an asset may be shorter than its economic life.

In responding to the question posed, the IC indicated that if the lease term of the related lease is shorter than the economic life of those non-removable leasehold improvements, the lessee should consider whether it expects to use the leasehold improvements beyond that lease term. If the lessee does not expect to use the leasehold improvements beyond the lease term of the related lease then, applying IAS 16, the lessee should conclude that the useful life of the non-removable leasehold improvements is the same as the lease term. The IC observed that, , 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.

## What is the IC's Agenda Decision? (continued)

### Interaction between lease term and useful life of non-removable leasehold improvements

Based on the IC's observation, the existence of any non-removable leasehold improvement is critical and linked to assessing the enforceable period of the cancellable or renewable lease. The broader economics of the contract should be considered when determining the enforceable period of the lease. If a lessee 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 lessee might incur a more than insignificant penalty if it terminates the lease. Even though the lessee need not make any termination payments to the lessor, the lessee would suffer a penalty of giving up its ability to fully utilise the leasehold improvements, such as costs of abandoning or dismantling non-removable leasehold improvements. Consequently, applying MFRS 16 paragraph B34, a lessee should consider whether the contract is enforceable for at least the period of expected utility of the leasehold improvements.

## What is the impact and for whom?

Entities which had previously interpreted MFRS 16 paragraph B34 differently, for example only considering contractual termination payments as penalties, will need to re-assess the lease term for their leases. Using a broader interpretation of penalty, some leases will have a longer enforceable period. If there are longer enforceable periods and the lessee is reasonably certain to continue using the asset, it will result in a longer lease term and therefore larger lease liabilities for the lessee.

## When does it apply?

The agenda decision has no formal effective date. The IC has noted that agenda decisions might often result in explanatory material that was not previously available, which might cause an entity to change an accounting policy. Entities are therefore encouraged to apply the Agenda Decision as part of the implementation of MFRS 16 where possible.

In situations where entities might not have sufficient time to implement the changes by 31 December 2019, particularly if they have a large volume of leases with different terms and conditions, entities may apply the Agenda Decision at a future point in time by way of a change in accounting policy. When the change in policy is implemented, it should be applied retrospectively, and comparative amounts should be restated. When management has concluded that a change in an accounting policy is required as a result of an agenda decision but that change has not been made yet, they should consider providing disclosures similar to those provided about forthcoming standards in accordance with paragraphs 30 and 31 of MFRS 108 *Accounting Policies, Changes in Accounting Estimates and Errors*.

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| **Do you need further information on this topic?** | Refer to the IC's Agenda Decision here; or<br>Contact: Foo Wee Liam \| Assurance Director from PwC Malaysia CMAAS<br>Email: foo.weeliam@pwc.com \| Tel: +60 (3) 2173 0620 |
| **Stay up to date with the latest developments in financial reporting and capital markets** | CMAAS's monthly newsletter "Accounting & Capital Markets Round-Up" features 3 hot topics written in a way that you can easily access.<br>Click on this link to subscribe and receive the newsletter in your inbox as soon as it is released each month. The newsletter is accessible via mobile phone as well. |