STAFF PAPER

June 2019

IFRS® Interpretations Committee meeting

Project	**Lease term and useful life of leasehold improvements (IFRS 16 and IAS 16)**
Paper topic	Initial Consideration

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Introduction

1. The IFRS Interpretations Committee (Committee) received a submission about applying the lease term requirements in IFRS 16 *Leases* to cancellable or renewable leases. The submitter asks whether:

   (a) a lease contract is enforceable beyond the notice period of a cancellable lease or the initial period of a renewable lease (***Question 1***); and

   (b) the useful life of any non-removable leasehold improvements is limited to the lease term of the related lease (***Question 2***).

2. The objectives of this paper are to:

   (a) provide the Committee with a summary of the matter;

   (b) present our research and analysis; and

   (c) ask the Committee whether it agrees with our recommendation not to add the matter to its standard-setting agenda.

Structure of the paper

3. This paper includes:
   - (a) background information;
   - (b) outreach;
   - (c) staff analysis on Question 1—determination of lease term;
   - (d) staff analysis on Question 2—determination of useful life of non-removable leasehold improvements; and
   - (e) staff recommendation.
4. There are two appendices to this paper:
   - (a) Appendix A—proposed wording of the tentative agenda decision.
   - (b) Appendix B—submission.

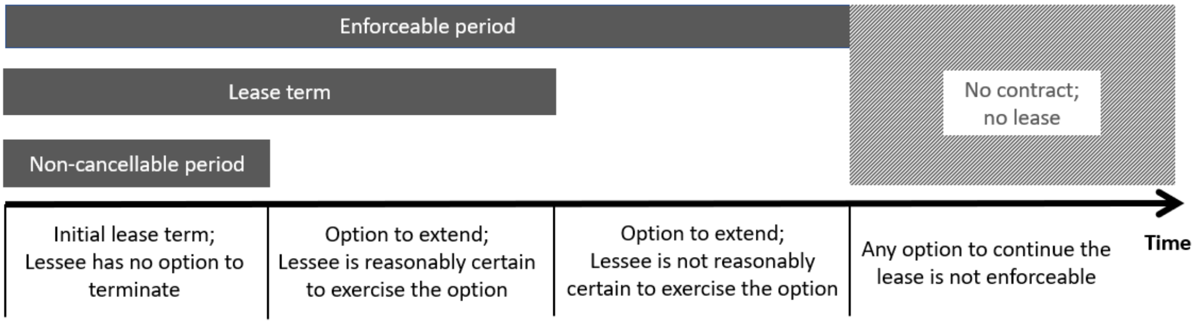
Background information

Components of lease term

5. When considering the fact pattern in the submission, and the analysis in this paper, we think it is helpful to keep in mind the following:
   - (a) the ***non-cancellable period*** of a lease is any period during which the lessee cannot 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 the 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.

6. 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:



7. 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 fact pattern

8. The submission describes two fact patterns:

   (a) **cancellable lease:** an entity enters into a lease contract that does not specify a particular contractual term and continues indefinitely until either party gives notice to terminate. When either the lessee or lessor gives notice, the lease continues for a period of less than 12 months ('notice period') until termination. Neither party is obliged to make a contractual payment on termination.

   (b) **renewable lease:** an entity enters into a lease contract with a specified initial period, which renews indefinitely unless terminated by either the lessee or lessor.

9. The submitter asks two questions:

   (a) ***Question 1:*** how to determine the lease term for these contracts. Specifically, the submitter asks whether an entity considers economic costs other than contractual termination payments when determining the enforceable period of the lease. Such costs might relate, for example, to abandoning or dismantling leasehold improvements.

   (b) ***Question 2:*** whether the useful life of any non-removable leasehold improvements (such as fixtures and fittings) is limited to the notice period of a cancellable lease or the initial period of a renewable lease. The submitter notes that this question is particularly important if the lease contract is not enforceable beyond the notice period of a cancellable lease or the initial period of a renewable lease (Question 1).

10. Appendix B to this paper reproduces the submission, which provides further background information.

11. In the analysis that follows we refer to the notice period of a cancellable lease. However, the analysis applies equally to the initial period of a renewable lease.

Outreach

12. We decided not to perform outreach on this request for a number of reasons:

   (a) We are already aware that the determination of the lease term could have a material effect on the many entities that enter into lease contracts. The Board's effects analysis on IFRS 16 identified the prevalence of leases and the expected widespread effect of recognising all leases (other than short-term leases and leases of low-value assets) on the balance sheet. A lessee is required to apply judgement in determining the lease term when a contract contains optional periods. We are also aware that, for particular leases such as property leases, the potential right-of-use asset and lease liability relating to periods beyond the notice period of a cancellable lease can be material. Consequently, we did not need to perform outreach to conclude that determining the enforceable period and lease term for a cancellable lease could have a material effect on entities affected.

(b) The submission relates to the application of IFRS 16 and, in the light of its effective date (annual reporting periods beginning on or after 1 January 2019), there is likely to be little observable practice at this time. The determination of the lease term in IFRS 16 is similar to that in IAS 17 *Leases* (ie both Standards require an entity to apply judgement in assessing whether a lessee is 'reasonably certain' to exercise an extension option or not to exercise a termination option). We therefore considered whether it would be beneficial to perform outreach on the application of IAS 17's lease term requirements. However, we decided not to do this because we think such outreach may not give a complete and representative picture in the context of IFRS 16. This is for two reasons:

   (i) IAS 17 and IFRS 16 contain different words with respect to the non-cancellable period of a lease—IAS 17 defined the term 'non-cancellable lease', whilst IFRS 16 refers an entity to the definition of a contract and determining the period for which a lease is enforceable. The non-cancellable period of a lease is fundamental to the questions asked by the submitter.

   (ii) We are aware that many entities expect to apply the lease term requirements in IFRS 16 with more rigour than was previously the case applying IAS 17. This is because, applying IAS 17, the majority of lease contracts were classified as operating leases and were not recognised on a lessee's balance sheet. Therefore, for the majority of leases, the length of the lease term did not affect the primary financial statements.

Staff analysis on Question 1: Determination of lease term

Requirements in IFRS 16

13. 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.

14. Paragraph BC156 explains the Board's objective when developing the lease term requirements:

> 'In the IASB's view, 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…'.

Enforceable period

15. Paragraphs B34 and B35 of IFRS 16 contain application guidance about the lease term and non-cancellable period of a lease:

> B34 In determining the lease term and assessing the length of the non-cancellable period of a lease, an entity shall apply the definition of a contract and determine the period for which the contract is enforceable. 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.
>
> B35 If only a lessee has the right to terminate a lease, that right is considered to be an option to terminate the lease available to the lessee that an entity considers when determining the lease term. If only a lessor has the right to terminate a lease, the non-

> cancellable period of the lease includes the period covered by the option to terminate the lease.

16. Appendix A of IFRS 16 notes that the term “contract” is defined in other Standards and used in IFRS 16 with the same meaning. The Appendix goes on to quote the definition of “contract” from Appendix A to IFRS 15 *Revenue from Contracts with Customers*:

> An agreement between two or more parties that creates enforceable rights and obligations

17. Paragraphs BC127-BC129 explain the Board’s rationale for these requirements:

> BC127 For the purposes of defining the scope of IFRS 16, the IASB decided that a contract would be considered to exist only when it creates rights and obligations that are enforceable. Any non-cancellable period or notice period in a lease would meet the definition of a contract and, thus, would be included as part of the lease term. 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; for example the lessee must be able to enforce its right to extend the lease beyond the non-cancellable period. 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. Consequently, by definition, 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.
>
> BC128 Accordingly, if the lessee has the right to extend or terminate the lease, there are enforceable rights and obligations beyond the initial non-cancellable period and the parties to the lease would be required to consider those optional periods in their assessment of the lease term. In contrast, 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.
>
> BC129 The IASB considered whether applying enforceability to leases in this way might encourage entities to add a clause to a lease that does not have economic substance, for example, stating that the lease could be cancelled at any point, knowing that, in practice, it would not be cancelled. However, the IASB is of the view that such clauses are unlikely to be added because there often is an economic disincentive for either the lessor or lessee to agree to their inclusion. For example, if a lessor has priced a contract assuming that the lessee will not cancel the contract, including such a clause would put the lessor at risk of being exposed to higher residual asset risk than had been anticipated when pricing the contract, which would be an economic disincentive for the lessor. Conversely, if the lessor has priced the contract assuming that the lessee will or may cancel the contract, the lessee would be likely to have to pay higher rentals to compensate the lessor for taking on more residual asset risk. Those higher rentals would be an economic disincentive for the lessee, if it does not intend to cancel the contract.

Optional periods

18. Paragraphs 19 and B37-B40 of IFRS 16 contain requirements about the assessment of optional periods. Paragraph 19 requires an 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'. Paragraph B37 states that factors to consider in this assessment include, but are not limited to:

    (a) contractual terms and conditions for the optional periods compared with market rates;

(b) significant leasehold improvements undertaken (or expected to be undertaken);

(c) costs relating to the termination of the lease;

(d) the importance of the underlying asset to the lessee's operations; and

(e) conditionality associated with exercising the option.

Analysis

Enforceable period

19. Applying IFRS 16, 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 (paragraph BC127). Consequently, the question in the submission is whether any enforceable rights and obligations exist beyond the notice period.

20. We view this ultimately as a question about how to apply the word 'penalty' in paragraph B34, which states (bold added): '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**.'

21. If it is the case that 'penalty' in paragraph B34 captures only a contractual termination payment, then in the scenario described in the submission the contract is not enforceable beyond the notice period of the cancellable lease. This is because neither the lessee nor the lessor will make a contractual termination payment on terminating the lease.

22. In contrast, if 'penalty' is a broader term incorporating other economic penalties that either party might suffer in the event of termination, then it may be that the contract is enforceable beyond the notice period of the cancellable lease. This might be the case if, for example, the leased asset is critical to the lessee's business.

Definition of 'penalty'

23. IFRS 16 does not define the term 'penalty'. Oxford Dictionaries[1] defines the term as follows:

> A punishment imposed for breaking a law, rule or contract.
>
> A disadvantage suffered as the result of an action or a situation.

24. This definition demonstrates that the term 'penalty' is broader than simply a payment. A punishment or a disadvantage can take many forms, and a monetary payment is only one example.

25. Furthermore, we think this is consistent with how the term 'penalty' is used in IFRS 16. Throughout the Standard, when the Board meant 'payments of penalties' (as opposed to a broader notion of penalty), IFRS 16 uses the word 'payment'. For example, paragraph 27(e) of IFRS 16 requires (bold added):

> At the commencement date, the lease payments included in the measurement of the lease liability comprise the following payments for the right to use the underlying asset during the lease term that are not paid at the commencement date:
>
> …
>
> (e) **payments of penalties** for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.

Use of the term 'penalty' in paragraph B34

26. 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 and assessing the length of the non-cancellable period of a lease…'. 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

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[1] Penalty | Definition of penalty in English by Oxford Dictionaries (accessed 10 May 2019)

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'.

27. Furthermore, the Board's explanation in the basis for conclusions about lease term and cancellable leases makes a clear link between an entity's determination of the lease term and the economics of a contract. In particular:

(a) 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';

(b) paragraphs BC127-BC129 refer to the economics of a contract;

(c) paragraphs 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

(d) 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'.

28. Indeed, the inclusion of 'with no more than an insignificant penalty' in paragraph B34 highlights that the assessment of enforceability includes an assessment of the economics of the contract. That requirement means that an entity does not assess enforceability based solely on whether both parties can *contractually* terminate the contract (which would have been one approach that the Board could have adopted regarding enforceability). Instead, an entity must also consider the economics of the contract in assessing whether each party has the right to terminate with no more than an insignificant penalty.

Contract economics

29. We think the definition of the term 'penalty' (paragraphs 23-25 of this paper), and the way the term is used in IFRS 16 (paragraphs 26-28 of this paper), make clear that paragraph B34 uses a broad concept of penalty that captures both termination payments and other types of economic penalty. Consequently, we think it is important to consider the economics of the contract when considering the question in the submission.

30. Consider, for example, a scenario identical to the cancellable lease described in the submission with the added fact that the underlying asset is both:

    (a) specialised, so that lessor would be unable to lease the asset to another lessee on equivalent terms; and

    (b) critical to the lessee's business, so that if the lessee lost control of the use of the underlying asset then the lessee would be unable to operate.

31. In this scenario, both parties might agree to include a termination clause with no contractual payment in the lease contract. This is because each party can be confident that the other has a significant economic incentive *not* to exercise its termination right. We think that such a termination clause would not be substantive. Although there is no termination payment, each party would suffer a more than insignificant economic penalty if it terminated the lease. Consequently, applying paragraph B34 to this fact pattern, an entity would conclude that the contract continues to be enforceable beyond the notice period.

32. We also think the explanation in BC127 is relevant. This paragraph explains the Board's rationale when developing requirements about enforceability and explains that, when applying the concept of enforceability in paragraph B34, an entity should consider whether the lessor can refuse to agree to a request from the lessee to extend the lease. In the fact pattern described in paragraph 30 of this paper, we think it is clear that the lessor would not refuse a request from the lessee to extend (or not to terminate) the lease. If the lessor were to refuse such a request, it would be left with a significant residual asset on which it would be unable to generate a return.

Conclusion – application of paragraph B34

33. Consequently, we think that application of paragraph B34 to the cancellable lease described in the submission leads to a conclusion similar to view 2 in the submission, ie the lease contract *can* be enforceable beyond the end of the notice period. In assessing whether the lease contract *is* in fact enforceable beyond the end of that period, an entity assesses whether the lessor and lessee each has a right to terminate the lease without permission from the other party with no more than an insignificant penalty.

34. In the particular facts described in the submission, we do not have enough information to determine whether the lease is enforceable beyond the end of the notice period. However, the additional facts in paragraph 30 of this paper demonstrate that application of IFRS 16 to the cancellable lease described in the submission can give rise to an enforceable period that is longer than the notice period.

Interaction between B34 and B35

35. The submitter also asked for clarity about the interaction between paragraphs B34 and B35 of IFRS 16.

36. Paragraph B35 states that "if only a lessee has the right to terminate a lease, that right is considered to be an option to terminate the lease available to the lessee that an entity considers when determining the lease term. If only a lessor has the right to terminate a lease, the non-cancellable period of the lease includes the period covered by the option to terminate the lease". Paragraph BC128 explains that "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".

37. The submitter asked what effect paragraph B35 has on the assessment of enforceability in a scenario in which one party has the right to terminate a lease without permission from the other party with no more than an insignificant penalty.

38. Paragraph B34 requires **each** party to have a right to terminate the lease without permission from the other party with no more than an insignificant penalty for the

contract to be enforceable only to the end of the notice period. If only one party has such a right, then the contract is enforceable beyond the notice period.

39. Paragraph B35 is relevant to an entity when considering the non-cancellable period and lease term. Paragraph B35 is *not* relevant to assessing the enforceable period of a lease. This is because an entity would:

(a) first apply paragraph B34 to determine the enforceable period of the lease; and then

(b) if relevant, apply paragraph B35 in determining the non-cancellable period and lease term. Paragraph B35 is relevant if one party, but not the other, has a right to terminate the lease during the enforceable period.

Optional periods

40. If an entity concludes that the enforceable period of a lease is longer than any non-cancellable period, it then goes on to apply paragraphs 19 and B37-B40 to determine the lease term. Specifically, an entity applies these paragraphs to assess whether the lessee is reasonably certain to exercise an option to extend the lease, or not to exercise an option to terminate the lease.

41. The question and analysis in the submission focus on enforceability and not on optional periods. Assessing optional periods requires judgement; however, we think the requirements in IFRS 16 provide an adequate basis for an entity to make the required assessment. We think it is helpful to mention the application of paragraphs 19 and B37-B40 in any tentative agenda decision for completeness. However, we do not propose any further analysis of this element of determining the lease term.

Staff Conclusion

42. In determining the lease term of a cancellable or renewable lease as described in the submission, we conclude that:

(a) an entity first applies paragraph B34 to determine whether the contract is enforceable beyond the notice period of a cancellable lease or the initial period of a renewable lease. In applying this paragraph, the entity considers:

(i) the economics of the contract. For example, if either party has an economic incentive *not* to terminate the lease, and thus 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

(ii) 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. If only one party has such a right, applying paragraph B34 the contract is enforceable beyond the notice period (or initial period).

(b) if an entity concludes that the contract is enforceable beyond the notice period (or initial period), it then applies paragraphs 19 and B37-B40 to assess whether the lessee is reasonably certain not to exercise the option to terminate the lease.

Question 1 for the Committee
Does the Committee agree with our analysis, set out in paragraphs 19-42 of this paper, of the application of IFRS 16 to cancellable and renewable leases as described in the submission?

Staff Analysis on Question 2: Determination of useful life of non-removable leasehold improvements

43. The submitter asks about the determination of the useful life of leasehold improvements (for example, fixtures and fittings):

    (a) acquired by an entity that meet the definition of property, plant and equipment in IAS 16 *Property, Plant and Equipment*;

    (b) constructed on an underlying asset that is the subject of a lease; and

    (c) that are non-removable, ie the entity will use and benefit from the leasehold improvements only for as long as it uses the underlying asset.

44. The question asked is whether the useful life of the non-removable leasehold improvements could ever be longer than the term, or enforceable period, of the lease.

45. Throughout this section, we have used the following terms consistently with their meaning in IAS 16:

    (a) ***economic life***: the period of use that would consume all of the future economic benefits embodied in leasehold improvements. Economic life is in effect the maximum period over which leasehold improvements could be used; and

    (b) ***useful life***: the period over which leasehold improvements are depreciated applying IAS 16. This may be equal to, or shorter than, the economic life.

Requirements in the Standards

IAS 16

46. Paragraph 6 of IAS 16 defines the useful life of an asset as (bold 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". Paragraph 50 requires an asset to be depreciated over its useful life.

47. Paragraphs 56-57 contain further requirements about determining the useful life of an asset. In particular, paragraph 56(d) requires an entity to consider 'legal or similar limits on the use of the asset, such as the expiry dates of related leases'.

48. Furthermore, paragraph 57 states that:

> The useful life of an asset is defined in terms of the asset's expected utility to the entity… the useful life of an asset may be shorter than its economic life. The estimation of the useful life of the asset is a matter of judgement based on the experience of the entity with similar assets.

IFRS 16

49. As described in paragraph 18 of this paper, paragraph B37 of IFRS 16 describes examples of factors an entity considers when determining whether a lessee is reasonably certain to exercise an extension option or not to exercise a termination option. Those factors include:

> (b) 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 the option to extend or terminate the lease, or to purchase the underlying asset, becomes exercisable[.]

Analysis

50. We have first considered the useful life of non-removable leasehold improvements in the context of optional periods in a lease (see paragraphs 51-59 below), and then in the context of the enforceable period of a lease (see paragraphs 60-67 below).

Optional periods

51. Consider a fact pattern in which a lessee has material non-removable leasehold improvements with an economic life that is:

(a) substantively longer than the non-cancellable period of the lease; and

(b) not longer than the period covered by options to extend or terminate the lease.

52. In determining the lease term, the lessee applies paragraphs B37-B40 of IFRS 16 to assess whether it is reasonably certain to extend, or not to terminate, the lease. Paragraph B37(a)–(e) contains several factors that an entity must consider in making this assessment. Paragraph B37(b) requires an entity to consider “significant leasehold improvements undertaken (or expected to be undertaken) over the term of the contract…”.

53. Applying this requirement to the fact pattern described in paragraph 51 of this paper, we think the lessee has a significant economic incentive not to terminate the lease until the end of the economic life of the leasehold improvements. Consequently, in the great majority of cases, we would expect a lessee with such leasehold improvements to conclude that it is reasonably certain to extend, or not to terminate, the lease. For this reason, in the great majority of such cases we would expect the lease term of any related lease applying IFRS 16 to be at least as long as the economic life of non-removable leasehold improvements. In these cases, the question identified by the submitter does not arise.

54. We acknowledge that a lessee *could* conclude that it is not reasonably certain to extend (or not to terminate) the lease beyond the non-cancellable period. This is because an entity is required to *consider* the factors in paragraph B37 when determining the lease term. Individual considerations in paragraph B37 do not form bright lines, but instead must be considered overall.

55. Consequently, even if a lessee has a significant economic incentive not to terminate the lease until the end of the economic life of the leasehold improvements, it is possible that the existence of other factors could, on balance, lead the lessee to conclude that it is not reasonably certain to extend (or not to terminate) the lease. However, we think this could be the case only if:

(a) the lessee has a significant economic incentive *not to* extend the contract (for example, access to an equivalent asset on more favourable terms); and

(b) the incentive described in (a) is equally, or more, compelling than the economic incentive *to* extend arising from the existence of material non-removable leasehold improvements.

56. When the circumstance described in paragraph 55 of this paper does arise, paragraphs 56-57 of IAS 16 help a lessee to determine the useful life of the leasehold improvements. Applying these paragraphs, the lessee would consider:

(a) limits on the use of the leasehold improvements, such as the expiry dates of the related lease (paragraph 56(d) of IAS 16); and

(b) the period of the leasehold improvements' expected utility to the entity - which may be shorter than their economic life (paragraph 57 of IAS 16).

57. Applying these considerations to the fact pattern described in paragraph 55 of this paper, we think a lessee would conclude that the useful life of the non-removable leasehold improvements is the same as the lease term of the related lease. This would be the period over which the leasehold improvements are expected to have utility to the entity as described in paragraph 57 of IAS 16.

Reasonably certain vs expected to be available

58. The submission describes an alternative view whereby there is no link between (a) the determination of the useful life of non-removable leasehold improvements, and (b) the assessment of optional periods of any related lease. This view notes that the level of certainty in assessing optional periods ('reasonably certain' applying IFRS 16) and in determining the useful life ('expected to be available' applying IAS 16) are different, ie IAS 16 requires a lower level of certainty than IFRS 16. Consequently, applying this view a lessee might conclude that the useful life (and depreciation period) of the leasehold improvements is longer than the lease term of the related lease.

59. Although this is theoretically possible, we think it would be a rare outcome of applying the requirements for lease term in IFRS 16 and useful life in IAS 16. This is for the reasons described above in paragraphs 51-57 of this paper. In summary, paragraph 57 of IAS 16 explains that the useful life of an asset is defined in terms of

the asset's expected utility to the entity. We are unable to identify a realistic fact pattern in which a lessee would be both:

(a) **expecting** to utilise leasehold improvements during an optional period; and yet

(b) **not** reasonably certain to utilise that optional period having considered the factors set out in paragraphs B37-B40 of IFRS 16.

Enforceable periods

60. Consider a fact pattern in which a lessee has material non-removable leasehold improvements with an economic life that is longer than the period for which the contract is initially considered to be enforceable. In other words, before the leasehold improvements have reached the end of their economic life, the lessee considers that it and the lessor each has the right to terminate the lease without permission from the other party with no more than an insignificant penalty.

61. We think it is extremely unlikely that a lessee would install material non-removable leasehold improvements whose utility is dependent on what it considers to be an unenforceable lease contract. This is because it would not be economically sensible to do so.

62. Nonetheless, if a lessee did construct such material leasehold improvements, we think the very existence of those leasehold improvements would provide an indicator that the lease is, in fact, enforceable (as described in paragraph B34 of IFRS 16) beyond the date on which the contract can be terminated.

63. In considering this scenario, we think it is helpful to add numbers to the fact pattern described in the submission:

Example

Cancellable lease as described in the submission

Lease payments: CU2,000 per annum

Contractual termination payment: £Nil

Notice period: 1 year

Non-removable leasehold improvements cost: CU10,000

Economic life of leasehold improvements: 10 years

Analysis

At lease commencement, the lessee has invested CU10,000 in leasehold improvements. If the lessee does not consider the contract to be enforceable beyond the one-year notice period, it has invested CU10,000 in an asset from which it will recover only CU1,000 of that investment (ie one year of use of the 10-year economic life of the asset).

In other words, a decision to terminate the lease after one year would give rise to an economic penalty of CU9,000 for the lessee.

64. Applying paragraph B34 of IFRS 16 to this example, we think the lease contract continues to be enforceable after the one-year notice period. This is because the lessee does *not* have the right to terminate the lease without permission from the lessor with no more than an insignificant penalty. If the lessee did choose to terminate, it would incur a significant penalty of CU9,000.

65. We think the lessee *could* conclude that the lease is not enforceable beyond the notice period if it genuinely expected to use the leasehold improvements only during that one-year notice period. In this case, we think the lessee would appropriately:

(a) apply paragraph B34 of IFRS 16 and conclude that the lease is not enforceable beyond the one-year notice period (all other factors permitting). The lease term in that case would be one year; and

(b) apply paragraphs 56-57 of IAS 16 and depreciate the leasehold improvements over the period during which the entity expects to use them. This would be the same as the one-year lease term. Applying paragraphs 56-57 of IAS 16 we think a lessee would not conclude that it expects non-removable leasehold improvements to be available for its use beyond the enforceable period of the related lease.

66. As described in paragraph 61 above, we think this scenario is extremely unlikely to occur because it is not economically sensible. Nonetheless, the scenario is helpful in demonstrating that:

(a) an entity's determination of the useful life of leasehold improvements requires consideration of the term of the related lease; and

(b) an entity's determination of the enforceable period and lease term of a lease requires consideration of the useful life of non-removable leasehold improvements.

67. Accordingly, applying paragraphs B34 of IFRS 16 and paragraphs 56-57 of IAS 16, we would expect an entity to conclude that the useful life of non-removable leasehold improvements is not longer than the enforceable period of the related lease.

Staff Conclusion

68. In the fact pattern described in the submission, we conclude that:

(a) in determining the useful life of non-removable leasehold improvements:

(i) an entity applies paragraph 56(d) of IAS 16 and considers any legal or similar limits on the use of the asset, such as the expiry dates of related leases.

(ii) an entity also applies paragraph 57 of IAS 16 and considers the leasehold improvements' expected utility to the entity.

(iii) if an 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 leasehold improvements is the same as the lease term. This may be shorter than the economic life of the leasehold improvements.

(b) in determining lease term (including enforceable period) of the lease on which non-removable leasehold improvements are constructed:

(i) an entity applies paragraph B37 of IFRS 16 and considers 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 the option to extend or terminate the lease becomes exercisable.

(ii) an entity also considers the economics of the contract when determining the enforceable period of a lease (see staff conclusion on Question 1 of the submission in paragraph 42 of this paper). This includes, for example, the costs of abandoning or dismantling non-removable leasehold improvements.

(iii) 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.

Question 2 for the Committee
Does the Committee agree with our analysis, set out in paragraphs 50-68 of this paper, of the application of IAS 16 and IFRS 16 in determining the useful life of non-removable leasehold improvements as described in the submission?

Should the Committee add this matter to its standard setting agenda?

Is it necessary to add to or change IFRS Standards to improve financial reporting?[2]

69. Based on our analysis, we think the requirements in IFRS 16 provide an adequate basis for an entity to determine the enforceable period and lease term of cancellable and renewable leases. Furthermore, we think the requirements in IAS 16 and IFRS 16

[2] Paragraph 5.16(b) of the *Due Process Handbook.*

provide an adequate basis for an entity to determine the useful life of any non-removable leasehold improvements relating to such a lease.

Staff recommendation

70. On the basis of our assessment of the Committee's agenda criteria in paragraphs 5.16–5.17 of the *Due Process Handbook* (discussed in paragraph 69 of this paper), we recommend that the Committee does not add this matter to its standard-setting agenda. Instead, we recommend that the Committee publish a tentative agenda decision that explains how an entity applies the requirements in IAS 16 and IFRS 16 to the fact pattern described in the submission.

71. Appendix A to this paper outlines the proposed wording of the tentative agenda decision.

Questions 3 and 4 for the Committee
3 Does the Committee agree with our recommendation not to add this matter to its standard-setting agenda? 4 Does the Committee have any comments on the proposed wording of the tentative agenda decision set out in Appendix A to this paper?

Appendix A—Proposed wording of the tentative agenda decision

Lease term and useful life of leasehold improvements (IFRS 16 *Leases* and IAS 16 *Property, Plant and Equipment*)

The Committee received a request about cancellable or renewable leases.

A cancellable lease 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. A renewable lease 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 an entity considers the economics of the contract when determining the enforceable period of the lease, and not only any contractual termination payment. Such consideration 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 reasonable 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 regarding lease term, which is 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 Boards 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 economics of the contract. For example, if either party has an economic incentive not to terminate the lease and thus 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. If only one party has such a right, 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.

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

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 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 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—Submission

B1. We have reproduced the submission below. We have not anonymised this submission because it is available of the public website of the European Securities and Markets Authority (ESMA).

<u>Submission</u>

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 tacitly[3] renewed for the same period or for short periods (e.g. less than 12 months) unless cancelled by any of the parties (issue 1B)[4].

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[3] 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.

[4] 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.

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
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)'[5]. 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.

[5] https://www.ifrs.org/webcast/?webcastid=1163617

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 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 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.