

20 August 2019

Sue Lloyd  
Chair  
IFRS Interpretations Committee  
Columbus Building  
7 Westferry Circus  
Canary Wharf  
London  
United Kingdom  
E14 4HD

Dear Ms Lloyd

## **Tentative agenda decision – Lease Term and Useful Life of Leasehold Improvements (IFRS 16 and IAS 16)**

Deloitte Touche Tohmatsu Limited is pleased to respond to the IFRS Interpretations Committee's publication in the June 2019 IFRIC Update of the tentative decision not to take onto the Committee's agenda the request for clarification on the determination of the lease term and useful life of leasehold improvements.

### Determination of the lease term of a cancellable lease or a non-renewable lease

We disagree with the Committee decision not to take the issue of how to determine the lease term of a cancellable lease or a renewable lease onto its standard-setting agenda. This issue highlights a key difficulty that entities and their auditors face in the application of IFRS 16 which is the assessment of whether a contract continues to be enforceable if both parties have termination rights but at least one of the parties would suffer a more than insignificant penalty if they were to exercise their right (i.e., whether economic disincentive to the exercise of a termination right is relevant to the assessment of whether a lease contract continues to be enforceable).

It is clear (and we agree) that economic incentives are considered in assessing whether an option to extend (or terminate) will be exercised (or not exercised). This is explained in paragraphs BC152 to BC159 as being the consequences of the decisions made in developing IFRS 16 that enforceable options should be recognised and measured using a probability threshold.

We do not believe that the same clarity exists with respect to determining the period for which a lease is enforceable. This lack of clarity is attributable to the fact that paragraph B34 may be read as indicating that a termination right is enforceable only if there is no more than an insignificant penalty attached to its exercise. This may be further interpreted as introducing a concept of "economic compulsion" in establishing the existence of enforceable rights and obligations. The application of paragraph B34 causes confusion because it appears at odds with some of the discussion in the BC, but paragraph B34 is not presented as a clear exception to the general principles in IFRS Standards (and in IFRS 16, more specifically).

In explaining the decisions made by the Board with respect to the enforceable period of a lease, paragraph BC127 refers to the need to assess the existence of a contract. In particular, paragraph BC127 indicates 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

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included as part of the lease term” and “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 lease and the lessor beyond that term”. Hence, BC127 appears to indicate that the intent in establishing the existence of a lease contract (and its enforceable period) was to link it to the existence of enforceable rights and obligations.

As explained in the tentative decision, the lease term is at least as long as the non-cancellable period and may extend into the “enforceable” period. In a lease contract that contains termination rights for both the lessee and lessor and neither party would incur more than an insignificant penalty in exercising its right, paragraph B34 notes that the lease term would not extend beyond the non-cancellable period because there is no period beyond that which is enforceable. This is so even if it is reasonably certain that the lessee would not exercise its cancellation right. This is because, as explained in BC127, there is no contract beyond the non-cancellable period as either party can cancel. However, it is not clear why the existence of a “more than insignificant penalty” is a relevant factor in assessing the enforceability of the rights and obligations of the parties. This appears at odds with the general principle in IFRS Standards. In particular, paragraph 4.60 of the Conceptual Framework that indicates that “all terms in a contract – whether explicit or implicit – are considered unless they have not substance”

The tentative decision goes on to state that when the circumstances in paragraph B34 are not present, i.e., when only one party has the right to terminate the lease without permission from the other party with no more than an insignificant penalty, the contract is enforceable beyond the date on which the contract can be terminated by that party. It follows that paragraphs 19 and B37-40 are then applied to assess whether the lessee is reasonably certain not to exercise its termination option (assuming the lessee holds such an option). This is the case, regardless whether the lessor or the lessee would incur a more than insignificant penalty upon exercise of their right to terminate the contract.

In particular, in the situation where both parties have the right to terminate the contract without permission from the other party after an initial non-cancellable period but the lessee would incur a more than insignificant penalty if it were to exercise its right to terminate the lease, the tentative decision indicates that the enforceable period extends beyond the non-cancellable period. An assessment would need to be made regarding whether it is reasonably certain that the lessee would not exercise its right to cancel in determining the lease term. Again, even though both parties can cancel the lease (and the lessor could cancel without penalty in this situation), the extended period is deemed an enforceable period.

Whilst this may be a reasonable interpretation, the application of paragraph B34 is likely to continue to be a source of confusion. This is because it is not clear why a lessee’s termination right that is ignored in the application of paragraph B34 (because the lessee would suffer a more than an insignificant penalty if it exercised that right) would then be subject to a “more than reasonably certain” test in paragraph 19. In other words, it is not clear why a lessee’s termination option that is genuine should be ignored under paragraph B34 because of the economic consequences of its exercise on the lessee. This seems to introduce confusion between the purpose of paragraph B34 (that appears aimed at establishing enforceability, which is generally thought to reflect the existence of contractual rights and obligations) vs paragraph 19 (that appears aimed at assessing the economic incentives of a lessee to exercise or not exercise an option).

We do not believe that it would be appropriate to conclude on how the requirements of B34 should be applied via an agenda decision because of the apparent inconsistencies noted above that raise questions on the intent of the Board.

We suggest that there are two potential manners in which the issue could be addressed depending on the principle the Board intended to set forth (both of which requiring a standard-setting action)

1. If, consistent with the explanations in BC127-BC129, the Board meant that a lease should be considered no longer enforceable (such that the lease contract ends) when the lessee and lessor each has the right to terminate the lease without permission from the other, ignoring termination options that have no substance, then we would suggest that the words “with no more than an

insignificant penalty” be deleted from paragraph B34. This is because, as explained above, assessing whether a termination option has substance is not the same as assessing whether its exercise exposes the party to a more than insignificant penalty. We do not believe that it would be necessary to replace these words because the principle that only contractual terms that have substance are considered is well established.

2. If the Board meant to introduce a limited exception as part of the assessment of the enforceability of a termination right (and of the lease contract), then we believe that this should be the subject of an interpretation. This is because this appears to deviate from the principles set out in the conceptual framework and used elsewhere in IFRS Standards. Under this alternative, we believe that it would also be necessary to provide guidance on the assessment of what is a more than insignificant penalty (including whether the magnitude of the penalty is assessed considering both the upside and downside resulting from its exercise and the benchmark against which the significance of a penalty is assessed).

We do not believe that the proposed agenda decision would help in bringing clarity to this fundamental ambiguity in what IFRS 16 requires. We believe that, as a result, diversity will continue to exist in the absence of appropriate standard setting.

Whether useful life of any related non-removable leasehold improvements is limited to the lease term determined applying IFRS 16

Putting aside the concerns expressed above with respect to the conclusion reached by the Committee on the first issue, we agree with the IFRS Interpretations Committee’s decision not to add this second issue onto its agenda. However, we disagree with the analysis provided because it fails to acknowledge an important element which is the fact that the level of certainty threshold for establishing the lease term in IFRS 16.18 is that of “reasonably certain” whereas the useful life of an asset under IAS 16, for depreciation purposes, “is expected to be available” which conveys a lower level of certainty that the renewal option will be exercised.

The decision also overlooks the fact that the useful life of the leasehold improvements should, in accordance with IAS 16.51, be reviewed on an ongoing basis whereas the lease term is determined at commencement of the lease and is not subsequently reassessed, except in limited circumstances. Hence, if at the commencement date a lessee had not deemed it reasonably certain to renew the lease and had originally determined the useful life of the leasehold improvements to be limited to the lease term, a change in lessee’s expectation of renewal may result in an increase in the useful life of the leasehold improvements without a similar adjustment to the lease term.

Finally, we also note that for the purposes of IFRS 16, a contract is considered to exist only when it creates rights and obligations that are enforceable. Any options to extend or terminate the lease that are included in the lease term must also be enforceable. Accordingly, in the absence of enforceable options to renew, the lease term is limited to the initial non-cancellable period (assuming there is no early termination option). This is the case regardless of the likelihood that the lessee will ask for a renewal of an existing contract and that a lessor would accept a lessee’s proposal to renew the lease. The likelihood that the parties would agree to enter into a renewed lease may also justify in specific situations the conclusion that the useful life of the leasehold improvements extends beyond the lease term.

If you have any questions concerning our comments, please contact Veronica Poole in London at +44 (0) 20 7007 0884.

Yours sincerely

A handwritten signature in blue ink, appearing to read 'V. Poole', with a stylized, flowing script.

**Veronica Poole**  
Global IFRS Leader