



In brief

A look at current financial reporting issues

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IFRS IC decision on IFRS 16 lease term

At a glance

The IFRS Interpretations Committee (IC) concluded that the enforceable period of a lease under IFRS 16 Leases reflects broader economics, not just legal rights and termination cash payments. Lessees consider the enforceable period when they are determining the lease term, and therefore which payments to include in the lease liability. Lessees that had previously interpreted the enforceable period more narrowly will need to consider the impact, which may increase recognised lease liabilities.

What is the issue?

IFRS 16 *Leases* requires a lessee to recognise a lease liability for almost all leases. The lease liability is the present value of lease payments during the lease term. A longer lease term will typically create larger lease liabilities.

The lease term cannot exceed the period for which the lease is enforceable. IFRS 16 *Leases* paragraph B34 says 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.”

IFRS 16 does not define the words “penalty” or “enforceable”. The IC observed that, in applying B34, an entity considers the broader economics of the contract, and not only contractual termination payments. If either party will incur a more than insignificant penalty from terminating (including economic penalties), 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 impact and for whom?

Entities which had previously interpreted 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. The IASB expects that an entity would be entitled to sufficient time to determine and implement any change. In this case, 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.

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 IAS 8.

Where do I get more details?

For more information, refer to the agenda decision (<https://www.ifrs.org/news-and-events/updates/ifric-updates/november-2019/>) or please contact Jessica Taurae (jessica.taurae@pwc.com).

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