Short-term leases

Foreword

IFRS 16 *Leases* became effective for accounting periods beginning on or after 1 January 2019.

The standard includes an important practical expedient for leases with a lease term of twelve months or less: short-term leases. This expedient enables entities to simply expense lease payments over the lease term and avoid the more complex accounting of recognising a right-of-use asset and a corresponding liability on the balance sheet.

On initial application, many entities have taken advantage of this practical expedient; however, it is important both from an accounting system's perspective and for those involved in negotiating and approving leases to understand the potential accounting consequences of subsequent amendments or renewals of these leases.

This publication, in line with previous guidance in this series, provides a step-by-step explanation of the accounting implications of the various subsequent changes that might impact a short-term lease's classification using practical and easy to follow examples.

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Other IFRS 16 *Leases* publications

In reverse chronological order:

Lease modifications – ten comprehensive examples (July 2019)

Lease modifications – extending the lease term (May 2019)

A guide to the incremental borrowing rate (September 2017)

Leases: A guide to IFRS 16 (June 2016)

Contents

Introduction

A recipe for short-term leases – or not?

IFRS 16 *Leases* defines a short-term lease as one that has a lease term of 12 months or less without any purchase options.

IFRS 16 contains a practical expedient that allows a lessee the choice of keeping short-term leases 'off-balance sheet'. Many entities are taking advantage of this practical expedient; however, entities may tend to have a 'once short-term, always short-term' mentality. In other words, once a lease is classified as a short-term lease, it tends to fall off management's radar and subsequent changes thereto *that might result in its failing the short-term lease definition* are often overlooked.

This publication highlights these subsequent changes, which can be broadly categorised as follows:

1) Modification of a short-term lease: see examples 1 to 4 (see also related publications below);
2) Exercising an extension option: see example 5; and
3) Impact of termination options: see examples 6 to 10.

Related publications

We have issued two publications relating to lease modifications.

In the first one *Lease modifications – extending the lease term* issued in May 2019, we discuss (1) what constitutes a lease modification, (2) when a lease modification should be accounted for, and (3) what the impact of a lease modification is on the lease term.

In the second one *Lease modifications – ten comprehensive examples* issued in July 2019, we use numbers and journal entries to illustrate how to account for different types of lease modifications, including a change in consideration, extending or shortening the lease term, as well as adding or removing a leased asset to or from a lease agreement.

We would strongly recommend readers to refer to these publications for a more detailed understanding of the lease modification requirements of IFRS 16, especially when working through examples 1 to 4 of this publication.

Appendix I to this document reproduces the relevant IFRS 16 definitions and guidance on short-term leases together with explanations on some of those concepts.

Appendix II contains links to further Deloitte guidance on short-term leases.

The life of a short-term lease

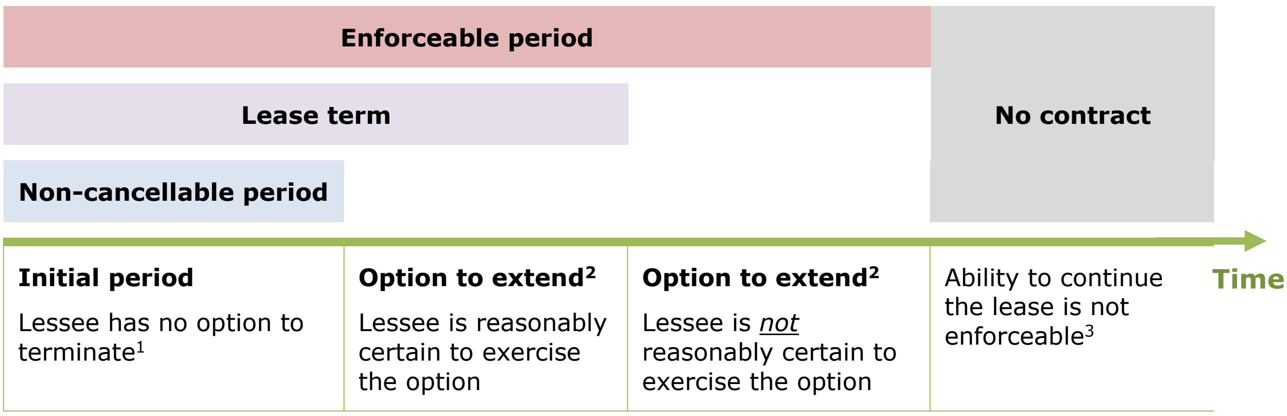
The lease term

It all starts with determining the lease term on the commencement date of the lease.

A short-term lease must have a lease term of 12 months or less determined on the commencement date. Furthermore, it must not contain any purchase options – if it does, it automatically fails the short-term lease definition.

The lease term comprises the non-cancellable period of a lease together with periods covered by an option to extend (terminate) the lease if the lessee is reasonably certain (not) to exercise that option.

The relationship between the non-cancellable period, lease term, and enforceable period of a lease can be illustrated as follows:



Even though a lease may qualify as a short-term lease on the commencement date, it may not remain so forever. This is because IFRS 16.7 requires a short-term lease that is subject to the recognition exemption to be accounted for ***as a new lease*** if there is a lease modification (see modification of a short-term lease section) or a change in the lease term (see exercising an extension option section). (IFRS 16.7)

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[1] See the impact of termination options section for details on how to account for different types of termination options.

[2] The same applies if it is a lessee's option to terminate the lease.

[3] For example, the lessor can refuse a request from the lessee to extend the lease (IFRS 16.BC127). See also examples 8 to 10 for further details on how to determine the enforceable period of a lease.

Some basics

A lessee may apply the short-term lease exemption on a class of underlying asset basis to which the right of use relates. In other words, a lessee can elect to keep short-term leases of e.g. cars off-balance sheet but elect to recognise short-term leases of properties on-balance sheet.

Observation

IFRS 16.8 defines a class of underlying asset as a grouping of underlying assets of a similar nature and use in an entity's operations. This is similar to how IAS 16 *Property, Plant and Equipment* (PPE) defines a class of PPE.

Accordingly, in applying the short-term lease recognition exemption in IFRS 16.8, a lessee's accounting policy on the identification of classes of assets should be consistent with that adopted by the entity when applying IAS 16.37.

In particular, the class of underlying asset should be determined on the basis of:

- the physical nature and characteristics of the asset. For example, real estate, manufacturing equipment and vehicles would all be reasonable classes of underlying assets given the differences in physical nature; and
- the use of the asset in an entity's operations. For example, it would be appropriate for the lessee to disaggregate real estate assets into separate asset classes by 'type' of real estate to the extent that the different types are used differently in an entity's operations (e.g. retail stores, warehouses and distribution centres).

If a lessee applies the short-term lease recognition exemption, the lease payments associated with the relevant leases are expensed on a straight-line basis over the lease term, unless another systematic basis is more representative of the pattern of the lessee's benefit.

Modification of a short-term lease

Lessees and lessors often enter into negotiations to extend a lease prior to its expiry. Once an agreement is reached, the extension is a lease modification as defined and depending on the length of the extension period, the modification may cause an original short-term lease to no longer meet the short-term lease definition and therefore fail the recognition exemption.

> ***Observation***
>
> A lease modification is defined as a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease. A lease modification includes adding or terminating the right to use one or more underlying assets, or extending or shortening the contractual lease term.
>
> IFRS 16 contains detailed guidance on how to account for lease modifications. For more details, please refer to our earlier publications *Lease modifications – extending the lease term* (May 2019) and *Lease modifications – ten comprehensive examples* (July 2019).

The determination of the lease term upon a lease extension (i.e. renewing the lease of the existing asset without leasing any additional assets) depends on whether the original lease is a short-term lease:

- If the original lease *is* a short-term lease, a lessee applies IFRS 16.7 to the modification. IFRS 16.7 requires any modification of a short-term lease to be considered a new lease on the effective date of the modification. This means that an entity will have to assess the lease term of the new lease to determine if it continues to qualify for the short-term lease exemption. See examples 1, 2 and 4.
- If the original lease is *not* a short-term lease, a lessee applies IFRS 16.44-46 to the modification. In the context of an extension of the lease term, since it does not add the right to use one or more underlying asset, the lease is accounted for as a continuation of the original lease and so the lease term is determined from the commencement date of the original lease to the end of the extended period. See example 3.

This could be summarised as follows:

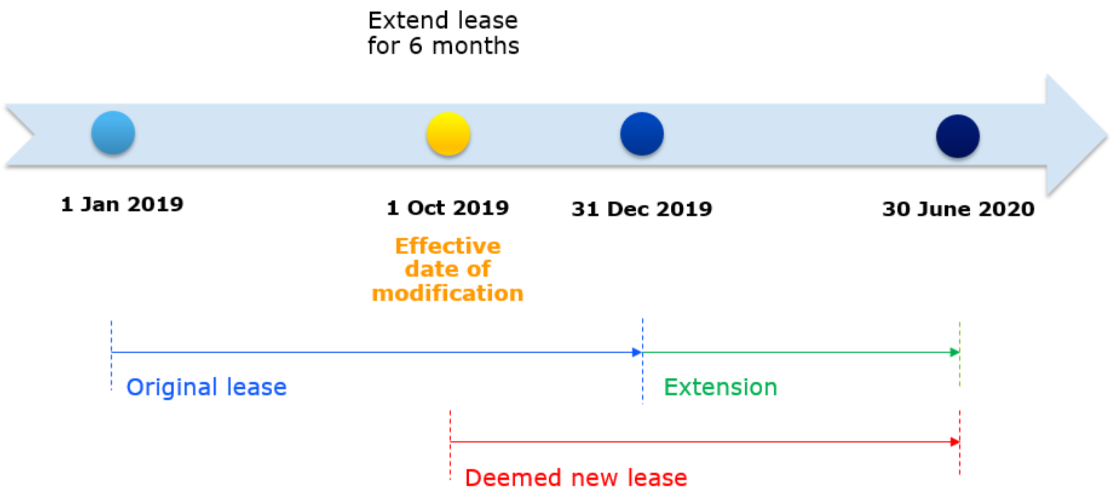
Original lease term	**Extension accounted for as…**	**Revised lease term**
Short-term	A new lease on the effective date of the modification	Determine from effective date of modification to end of extended period
Not short-term	A continuation of the original lease	Determine from commencement date of original lease to end of extended period

Example 1

Original lease is a short-term lease – modification qualifies for the short-term lease recognition exemption

Lessee has a short-term lease that runs from 1 January 2019 to 31 December 2019. There are no extension options. Lessee and Lessor agree on 1 October 2019 to extend the lease for six months from 1 January 2020 to 30 June 2020.[4]

Lessee elects to apply the short-term lease recognition exemption in accordance with IFRS 16.5 to all short-term leases.



Analysis

Since the original lease is a short-term lease to which Lessee has elected to apply the short-term lease exemption, IFRS 16.6-8 apply.

In accordance with IFRS 16.7(a), the lease is considered a new lease if there is a lease modification. There is a modification on 1 October 2019 because the lease has been extended and this extension was not contemplated in the original terms of the lease.

Consequently, the new lease has a commencement date of 1 October 2019 and a lease term of nine months, thus it meets the definition of a short-term lease and qualifies for the short-term lease exemption from 1 October 2019.

The consideration for the modified lease (i.e. existing rentals for October to December 2019 plus new rentals for January to June 2020) will be straight-lined (unless another basis is more appropriate) over the term of the new lease from 1 October 2019 to 30 June 2020.

Conclusion: the lease meets the definition of a short-term lease and remains off-balance sheet for the entire period under review.

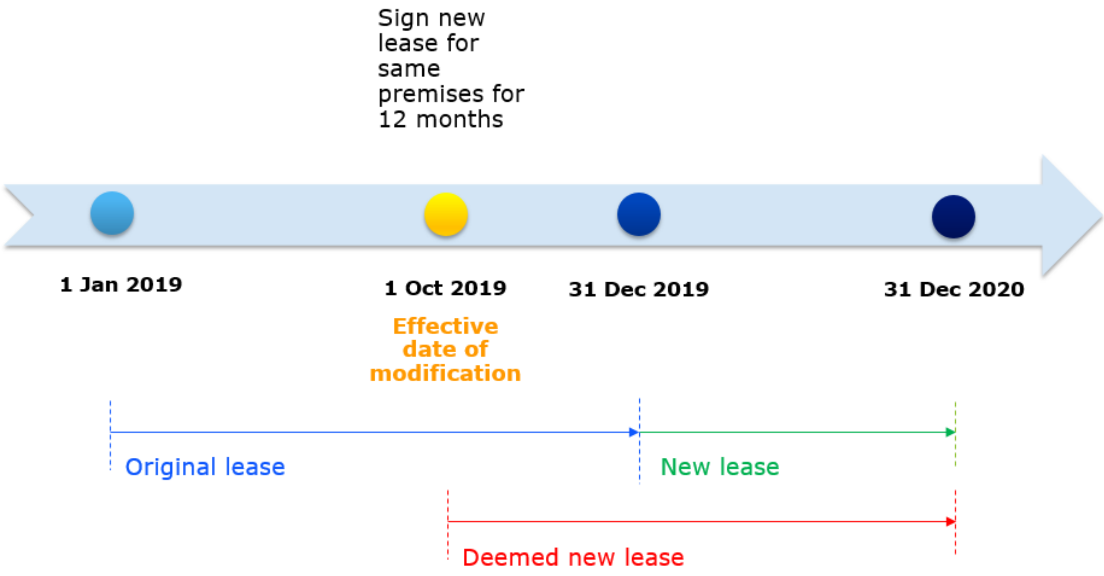
[4] All entities in this publication have a December year-end.

Example 2

Original lease is a short-term lease – modification does <u>not</u> qualify for the short-term lease recognition exemption

Lessee has a short-term property lease that runs from 1 January 2019 to 31 December 2019. There are no extension options. Lessee and Lessor agree on 1 October 2019 to enter into a new lease to rent the same premises for 12 months from 1 January 2020 to 31 December 2020.

Lessee elects to apply the short-term lease recognition exemption in accordance with IFRS 16.5 to all short-term leases.



Analysis

Since the original lease is a short-term lease to which Lessee has elected to apply the short-term lease exemption, IFRS 16.6-8 apply.

In accordance with IFRS 16.7(a), the lease is considered a new lease if there is a lease modification. As discussed in the *Lease modifications – extending the lease term* publication, entering into a new lease on the same underlying asset is tantamount to extending the lease term of the existing lease, which is a modification as defined.

Consequently, the new lease for the purposes of IFRS 16.7(a) has a commencement date of 1 October 2019 and a lease term of 15 months, thus it does not meet the definition of a short-term lease. As such, Lessee should recognise a right-of-use (RoU) asset and lease lability for the new 15-month lease on 1 October 2019. The RoU asset and lease liability will appear in the 2019 annual financial statements.

Conclusion: the lease is a short-term lease and stays off-balance sheet from 1 January 2019 to 30 September 2019; it fails the short-term lease definition from 1 October 2019 and is recognised on-balance sheet from that date.

Observation

How did you set up your system and processes to identify whether something is a short-term lease? In example 2, the new legal contract signed on 1 October 2019 is for a term of 12 months so it would have met the definition of a short-term lease had it not been for the application of the modification requirements. If your system and processes merely ask whether the new lease has a lease term of 12 months or less, the answer to which is yes, you would have accounted for the modification incorrectly.

How do your processes identify new contracts that should be accounted for as a modification? Specifically, how do those processes identify new contracts or renewals that should be brought on balance sheet?

Observation

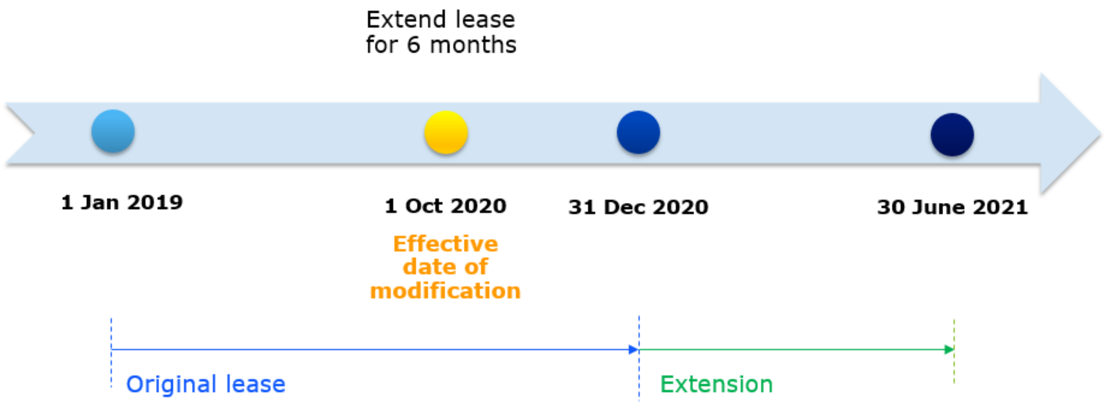
Example 2 is a very common example of rolling 12-month leases. The continued 12-month extensions every year before expiry of the original lease would cause the contract to fail the short-term lease definition. The lease will have to be brought on balance sheet upon the first extension as seen in example 2.

Are your personnel involved in negotiating lease contracts aware of these accounting consequences? Do they know how their negotiations will affect the balance sheet ratios and other key performance indicators?

Example 3

Original lease is *not* a short-term lease

Lessee has a lease of a machine for two years that runs from 1 January 2019 to 31 December 2020. There are no extension options. Lessee and Lessor agree on 1 October 2020 to extend the lease for six months from 1 January 2021 to 30 June 2021.



Analysis

The agreement to extend the lease is a modification because it was not contemplated in the original terms of the lease. Since the modification does not add the right to use one or more underlying assets, it does not meet the criteria in IFRS 16.44(a) to be accounted for as a separate lease. The commencement date of the modified lease remains 1 January 2019, i.e. the date when the machine was first made available for use by Lessee.

Accordingly, the total lease term of the modified lease is 2.5 years. It would be incorrect to treat the lease as a short-term lease from 1 October 2020, being the effective date of the modification, on grounds that the remaining term of the lease is nine months from that date.

Lessee should remeasure the lease liability on 1 October 2020 to reflect the present value of the modified lease payments from 1 October 2020 to 30 June 2021 discounted using a revised discount rate on that date (IFRS 16.45). A corresponding adjustment is made to the RoU asset (IFRS 16.46(b)).

Conclusion: At no point in time is this lease a short-term lease.

Example 4

Modification of a lease that existed on the date of initial application

On 1 January 2019, the date of initial application (DIA) of IFRS 16, Lessee has a lease of a residential unit that ends on 30 April 2019 with no extension or termination options. Prior to expiry of the lease, Lessee enters into negotiation with Lessor to extend the lease.

Negotiations on the terms of the new lease are ongoing at 30 April 2019 and both parties agree to continue leasing the same unit on the same terms as the original lease until an agreement could be reached. They agree to provide the other party with one month's notice to terminate the arrangement without penalty if either party wants to end the arrangement.

On 14 July 2019, Lessee and Lessor sign an agreement to lease the same unit for another 12 months starting from 1 August 2019 to 31 July 2020 at a revised rent. There are no renewal or termination options under the new agreement. They also agree that Lessee can occupy the same unit for the remainder of July 2019 at the original rent.

Lessee elects to apply the short-term lease recognition exemption in accordance with IFRS 16.5 to all short-term leases. It also elects to apply the paragraph C10(c) transition practical expedient to account for all leases with a lease term of less than 12 months at the DIA as short-term leases.

Analysis

Since the lease has a remaining lease term of four months at the DIA, it qualifies for the paragraph C10(c) transition practical expedient to be accounted for as a short-term lease. As such, IFRS 16.6-7 apply and the lease is off-balance sheet from the DIA to 30 April 2019.

For the period between 1 May 2019 and 13 July 2019, the lease is a month-to-month lease because both Lessee and Lessor could terminate the lease unilaterally with no penalty[5] by serving only one month's notice to the other party (IFRS 16.B34). Each extra day stayed during this period is effectively a modification of the existing lease to extend it for one more day. In terms of IFRS 16.7(a), the lease is accounted for as a 'new' one-month lease every day during this period.

Similarly, when Lessee and Lessor agree on 14 July 2019 to extend the lease to 31 July 2020, the original one-month lease is modified and is accounted for as a new lease in terms of IFRS 16.7(a). The 'new' lease has a commencement date of 14 July 2019 and a lease term of 12 months and 18 days, therefore it is *not* a short-term lease as defined from 14 July 2019.

As such, Lessee should recognise a RoU asset and lease lability for the new 12-month 18-day lease on 14 July 2019. The RoU asset and lease liability will appear in the 2019 annual financial statements.

Conclusion: the lease is a short-term lease and stays off-balance sheet from the DIA to 13 July 2019; it is recognised on-balance sheet from 14 July 2019.

Observation

When dealing with short-term leases, it is important to go through each change to the lease chronologically to identify any potential modifications and the effective date of the modification.

As can be seen from example 4, it is easy to mistake the lease for a short-term lease for the entire period under review by saying that it is a month-to-month lease from 1 May 2019 to 13 July 2019 and that the new lease is only for 12 months.

The key is to realise that 14 July 2019 is the effective date of modification of the newly signed lease, which is the date when both parties agree to the terms of a lease modification. As Lessee already has the right to use the premises, the commencement date of the new lease for the purposes of IFRS 16.7(a) is 14 July 2019 and not 1 August 2019, which causes the lease term to be longer than 12 months.

This is the same principle as in example 2.

[5] See example 8 for a discussion of what constitutes a penalty in terms of IFRS 16.B34.

Exercising an extension option

When a lease contains an extension option that is exercisable by the lessee, the lease term can change if there are changes to the reasonable certainty of exercise of the option (IFRS 16.20) or upon actual exercise of the option if it was not previously included in the determination of the lease term (IFRS 16.21(a)).

Observation

A lessee first assesses whether it is reasonably certain to exercise an extension option or a termination option on the commencement date of the lease. A lessee revisits the 'reasonably certain' assessment *only* upon the occurrence of a significant event or a significant change in circumstances that:

a) is within the control of the lessee; and
b) affects its previous assessment of the lease term.

'Reasonable certainty' is a high hurdle and its assessment may require significant judgement in some cases. Entities are encouraged to consult their auditors and accounting advisors in such cases.

When there is a change in the lease term of a short-term lease, the lease is accounted for as a new lease on the date of the change (IFRS 16.7(b)). This means the lessee must assess the lease term of the new lease on the date of change. See example 5.

Example 5

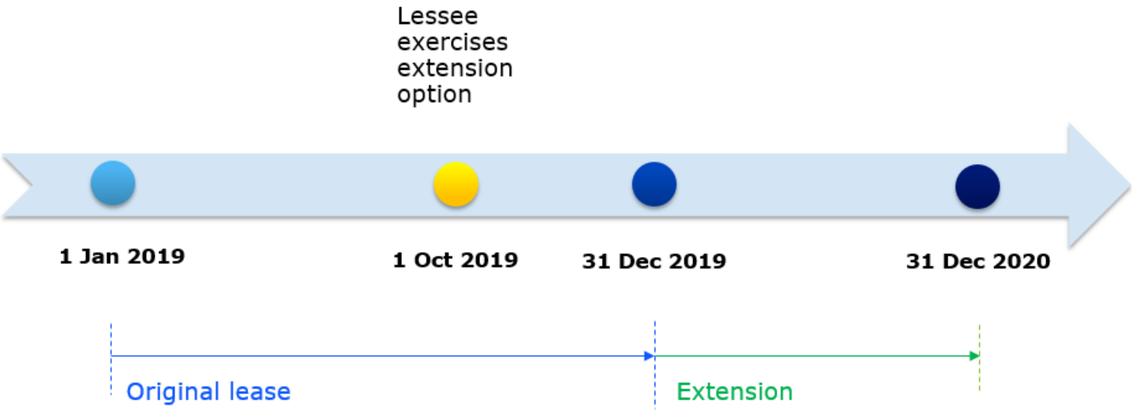
Exercising an extension option

Lessee has a short-term lease that runs from 1 January 2019 to 31 December 2019 with an option to extend the lease for one year to 31 December 2020.

On the commencement date of the lease (1 January 2019), Lessee is not reasonably certain to exercise the extension option. The lease term is therefore only 12 months and the lease meets the definition of a short-term lease.

On 1 October 2019, Lessee exercises the option to extend the lease.

Lessee elects to apply the short-term lease recognition exemption in accordance with IFRS 16.5 to all short-term leases.



Analysis

Since the original lease is a short-term lease to which Lessee has elected to apply the short-term lease exemption, IFRS 16.6-8 applies.

In accordance with IFRS 16.7(b), the lease is considered a new lease if there is a change in the lease term. There is a change in the lease term on 1 October 2019 because Lessee exercises an extension option that was not previously included in the determination of the lease term.

Consequently, the new lease for the purposes of IFRS 16.7(b) has a commencement date of 1 October 2019 and a lease term of 15 months, thus it does not meet the definition of a short-term lease. As such, Lessee should recognise a RoU asset and a lease lability for the new 15-month lease on 1 October 2019. The RoU asset and the lease liability will appear in the 2019 annual financial statements.

Conclusion: the lease is a short-term lease and stays off-balance sheet from 1 January 2019 to 30 September 2019; it fails the short-term lease definition from 1 October 2019 and is recognised on-balance sheet from that date.

Observation

Example 5 is a very common scenario as almost all lease agreements require extension options to be exercised prior to the expiry of the original lease.

It is important to note that for the purposes of IFRS 16, the new lease commences on the date of the change in lease term (1 October 2019) and not on the start of the extension period (1 January 2020). This means that if the renewal period is for at least one year and notice to renew must be served prior to the expiry of the original lease, the new lease will not qualify for a short-term lease.

Observation

Modification versus exercising an option

Even though example 5 has the same outcome as example 2, they result from different events.

In example 5, the original lease contains an extension option. When the lessee exercises an option that was previously assessed as not reasonably certain to be exercised, there is a change in lease term (IFRS 16.21). This is not a modification of the lease because the original terms of the lease already provide the lessee with a right to extend.

In contrast, in example 2, the original lease does not contain an extension option. The subsequent negotiation with the lessor to extend the lease is a change in the scope of the lease not contemplated in the original lease agreement. As such, it is a lease modification as defined.

You cannot see an accounting difference between a change in lease term and a modification in the context of a short-term lease because IFRS 16.7 requires both events to be accounted for as a new lease from the date of change. Nevertheless, this is something to bear in mind for non-short-term leases because a change in lease term is accounted for differently from a lease modification.

Observation

Interaction with the paragraph C10(c) transition practical expedient

IFRS 16.C10(c) is a transition provision that allows a lessee to account for leases as a short-term lease if it has a remaining lease term of 12 months or less at the DIA.

If an entity applies the paragraph C10(c) transition practical expedient, the lease is regarded as a short-term lease for all intent and purposes and it is subject to the requirements of IFRS 16.6-7. Accordingly, the principles illustrated in examples 1, 2, 4 and 5 apply to any subsequent modification or change in lease term of such a lease.

Impact of termination options

Lease contracts often contain termination options. The determination of the lease term is affected by which party has the right to exercise the termination option.

- **Lessor-only** termination options – these are ignored when determining the lease term because the lessee has an unconditional obligation to pay for the full period of the lease, unless and until the lessor decides to terminate the lease (IFRS 16.B35 and BC128). See example 6.
- **Lessee-only** termination options – the lease term is determined by assessing whether the lessee is reasonably certain to exercise the termination option (IFRS 16.18(b)). See example 7.
- **Both parties** have the option to terminate the lease – this affects the enforceable period of the lease. If both the lessee and the lessor can terminate the lease unilaterally on a particular date(s) with no more than an insignificant penalty, the lease is no longer enforceable beyond that date (IFRS 16.B34). See examples 8, 9 and 10.

See also the diagram under the lease term section for the relationship between the non-cancellable period, lease term and enforceable period of a lease.

Example 6

Lessor-only termination option

Lessee has a two-year lease that runs from 1 January 2019 to 31 December 2020. Lessor can terminate the lease at any time without penalty[6] by giving Lessee three months' notice.

Analysis

The lease term is two years.

IFRS 16.35 states that 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. This is because the lessee has an unconditional obligation to pay for the full period of the lease until and unless the lessor decides to terminate the lease (IFRS 16.BC128).

The non-cancellable period of the lease is therefore two years, which is the same as the lease term because there are no other extension or termination options.

The lease is therefore ***not*** a short-term lease.

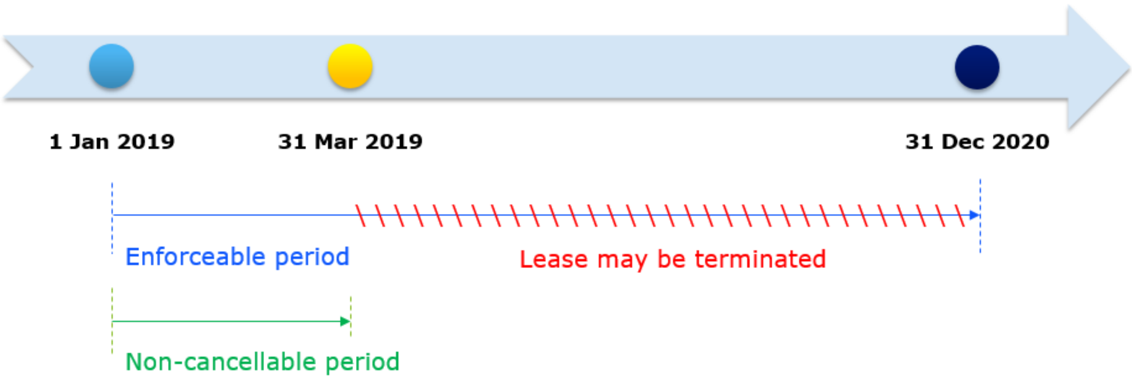
[6] See example 8 for a discussion of what constitutes a penalty in terms of IFRS 16.B34.

Example 7

Lessee-only termination option

Lessee has a two-year lease that runs from 1 January 2019 to 31 December 2020. Lessee can terminate the lease at any time without penalty[7] by giving Lessor three months’ notice.

- 2-year lease
- Lessee option to terminate at any time by giving 3 months’ notice



Analysis

The lease consists of:

- a non-cancellable period of three months (because Lessee must give at least three months’ notice before terminating the lease), and
- an option to terminate the lease covering a period of 21 months.

IFRS 16 defines 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.

Accordingly, on the commencement date of the lease, Lessee should assess whether it is reasonably certain to continue leasing the asset beyond the non-cancellable period of three months by considering all relevant facts and circumstances that create an economic incentive for it not to exercise the termination option, as described in IFRS 16.B37–B40.

In this case, the non-cancellable period is three months and the enforceable period is the full two years. Depending on whether and when Lessee is reasonably certain to terminate the lease, the lease term could range from three months to two years which impacts whether the lease qualifies for a short-term lease.

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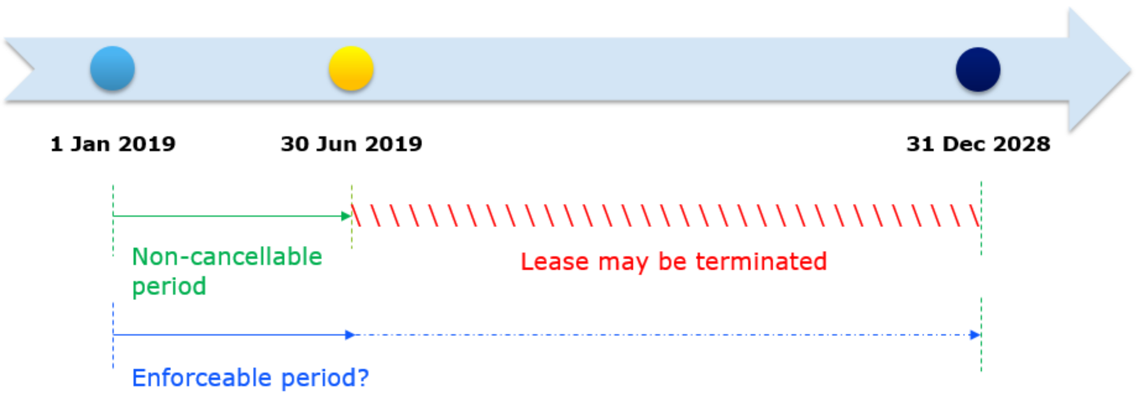
[7] See example 8 for a discussion of what constitutes a penalty in terms of IFRS 16.B34.

Example 8

Both parties have an option to terminate the lease – how to interpret 'penalty'

Lessee has a ten-year lease that runs from 1 January 2019 to 31 December 2028. Both Lessee and Lessor can terminate the lease from 1 July 2019 onwards without any contractual penalty. The non-cancellable period is therefore six months only.

- 10-year lease
- Both parties have an option to terminate at any time from 1 July 2019



Analysis

In order to determine the lease term in cases where both parties have an option to terminate the lease, the lessee should first establish what the enforceable period of the lease is.

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.B34).

In this case, the first part of paragraph B34's requirement is met, i.e. either party can terminate the lease unilaterally from 1 July 2019 onwards; however, more information is needed to assess whether the second part of B34's requirement is met, i.e. whether there is more than an insignificant penalty upon early termination.

Penalty is not defined in IFRS 16. The IFRS Interpretations Committee (IFRS IC) discussed its interpretation as part of a larger issue in the June 2019 meeting and tentatively decided that *penalty should be interpreted broadly to capture both termination payments and other types of economic penalty, including the costs of abandoning or dismantling non-removable leasehold improvements.* In other words, if either party has an economic incentive *not* to terminate the lease (because if it did, it 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. (IFRS IC June 2019 tentative agenda decision) (IFRS IC's TAD).

Based on the IFRS IC's TAD, Lessee cannot automatically conclude that the enforceable period and thus the lease term is only six months in this example. The IFRS IC's TAD indicates that it is ***not sufficient*** to say that there is no contractual penalty upon termination to argue that paragraph B34 is met and so the lease is not enforceable beyond 30 June 2019.

In terms of the IFRS IC's TAD, if facts and circumstances indicate that Lessee will incur more than an insignificant penalty to terminate the lease after just six months, e.g. the lease is for office premises and Lessee will have to abandon valuable leasehold improvements or it will have to incur significant relocation costs or costs to restore the leased premises to its original condition, then the lease is enforceable beyond 30 June 2019. This in turn means that the lease term may be longer than just six months (comprising a non-cancellable period of six months plus the period covered by Lessee's termination option during which Lessee is reasonably certain not to exercise).

In light of the IFRS IC's TAD, Lessee should consider the broader economics of the contract to consider whether, and at which point in time, terminating the lease will give rise to no more than an insignificant penalty for either party in order to determine the enforceable period of the lease. Once the enforceable period of the lease is determined, Lessee can determine the lease term by assessing whether, and at which point in time within the enforceable period, it is reasonably certain to terminate the lease, similar to the assessment in example 7.

Observation

The IFRS IC received 31 comment letters in response to the tentative agenda decision mentioned in example 8 – an unusually high response rate. A large number of respondents asked the IFRS IC to clarify, *inter alia*, why an assessment of economic incentives is relevant in determining the enforceable period of a lease, and sought further clarification on how to interpret 'penalty' in the context of IFRS 16.B34.

The IFRS IC will consider these comment letters at a future public meeting. At the time of writing, the IFRS IC has yet to finalise the tentative agenda decision.

Observation

Significant judgement may be required in some cases to assess whether either party would incur 'more than an insignificant penalty' to terminate a lease (IFRS 16.B34).

In light of the ongoing debates, views may continue to evolve and we recommend entities to consult their auditors and accounting advisors in such cases.

Example 9

Both parties have an option to terminate the lease – no penalty; termination option can be exercised on one date only

Lessee leases a property from Lessor for two years from 1 January 2019 to 31 December 2020. Both Lessee and Lessor can terminate the lease at 31 December 2019 by giving three months' notice. If neither party exercises its termination option on 30 September 2019, the lease will run until 31 December 2020.

There is no penalty associated with the termination option for either Lessee or Lessor.

Neither party exercises its termination option on 30 September 2019.

Analysis

In order to determine the lease term in cases where both parties have an option to terminate the lease, the lessee should first establish what the enforceable period of the lease is.

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.B34).

As at 1 January 2019, because Lessee and Lessor both have a right to terminate the lease at the end of one year without penalty, the maximum enforceable period of the lease is only one year.

As regards the lease term, it is not necessary to consider the likelihood that either party will exercise its right to terminate – the fact that the lease is not enforceable beyond 12 months is sufficient to conclude that the lease term is only one year as at the commencement date of the lease.

The lease therefore has an enforceable period, a non-cancellable period and a lease term of one year as at 1 January 2019, i.e. it is a short-term lease as defined.

On 30 September 2019, as neither party exercises its termination option, there is a change in the non-cancellable period of the lease and thus the lease term on that date. As the original lease is a short-term lease, the change in lease term results in a new lease for the purposes of IFRS 16.7. Consequently, the new lease has a commencement date of 1 October 2019 and a lease term of 15 months because the lease now runs until 31 December 2020. As a result, the lease does not meet the definition of a short-term lease from 1 October 2019.

Lessee should recognise a RoU asset and lease lability for the new 15-month lease on 1 October 2019. The RoU asset and lease liability will appear in the 2019 annual financial statements.

Conclusion: the lease is a short-term lease and stays off-balance sheet from 1 January 2019 to 30 September 2019; it fails the short-term lease definition from 1 October 2019 and is recognised on-balance sheet from that date.

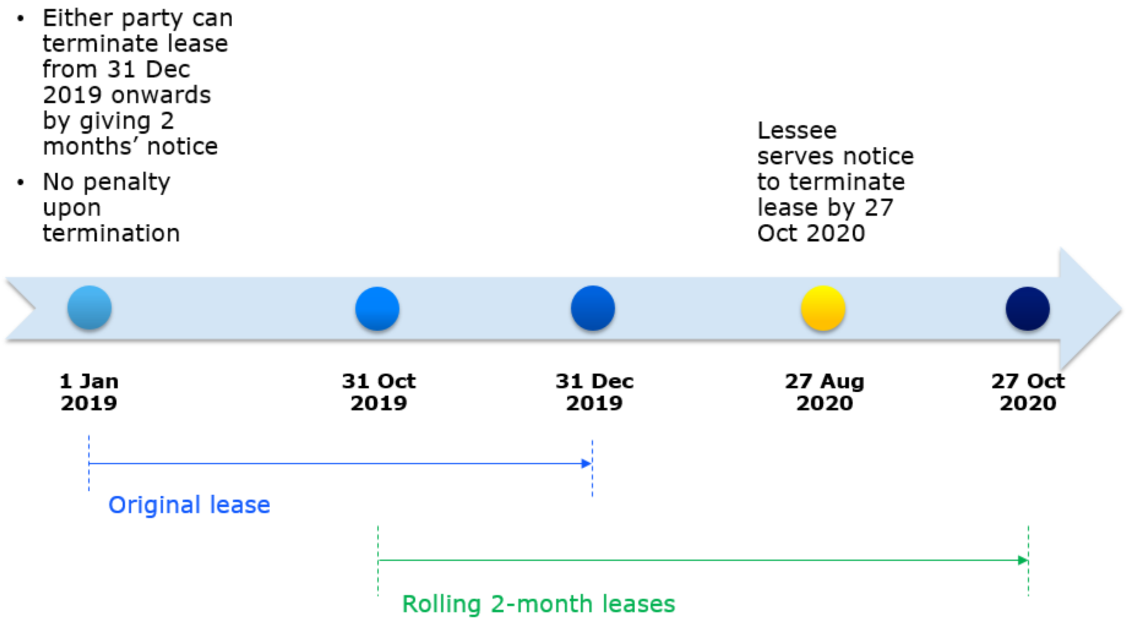
Example 10

Both parties have an option to terminate the lease – no penalty; termination option can be exercised at any time after one year

Lessee leases a property from Lessor for two years from 1 January 2019 to 31 December 2020. The lease may be terminated by either party by giving two months' notice. The earliest date on which notice to terminate the lease may be served is 31 October 2019 (to end the lease by 31 December 2019). Unless either party exercises its termination option before 31 October 2020, the lease will run until 31 December 2020.

There is no penalty associated with the termination option for either Lessee or Lessor.

Lessee serves notice to terminate the lease on 27 August 2020 (i.e. the lease will run until 27 October 2020).



Analysis

In order to determine the lease term in cases where both parties have an option to terminate the lease, the lessee should first establish what the enforceable period of the lease is.

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.B34).

As at 1 January 2019, because Lessee and Lessor both have a right to terminate the lease at the end of one year without penalty, the maximum enforceable period of the lease is only one year.

As regards the lease term, it is not necessary to consider the likelihood that either party will exercise its right to terminate – the fact that the lease is not enforceable beyond 12 months is sufficient to conclude that the lease term is only one year as at the commencement date of the lease.

The lease therefore has an enforceable period, a non-cancellable period and a lease term of one year as at 1 January 2019, i.e. it is a short-term lease as defined.

From 1 November 2019 onwards, as either party may terminate the lease without penalty by giving two months' notice, the enforceable period and non-cancellable period of the lease during this time is two months. Each day that passes without the lease being terminated creates a new two-month lease. Again, the likelihood of either party exercising its right to terminate is irrelevant because the lease term by definition covers at least the non-cancellable period and cannot exceed the enforceable period of the lease, both of which is two months from 1 November 2019 onwards.

Similarly, when Lessee exercises the termination option on 27 August 2020, a new lease with a lease term of two months commences on this date.

Conclusion: the lease is a short-term lease and stays off-balance sheet throughout the entire period under review.

Appendix I – relevant IFRS 16 guidance

Definitions

Commencement date of the lease	The date on which a lessor makes an underlying asset available for use by a lessee.
Effective date of the modification	The date when both parties agree to a lease modification.
Inception date of the lease	The earlier of the date of a lease agreement and the date of commitment by the parties to the principal terms and conditions of the lease.
Lease modification	A change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease (for example, adding or terminating the right to use one or more underlying assets, or extending or shortening the contractual lease term).
Short-term lease	A lease that, at the commencement date, has a lease term of 12 months or less. A lease that contains a purchase option is not a short-term lease.

Inception date v. commencement date – example

A lessee and a lessor agree to the principal terms of a lease on 1 January 20x1. The principal terms include but are not limited to the leased item (a residential unit), lease term, lease payments, payment profile, termination and extension rights etc. The agreement is non-cancellable from this date.

The lease agreement is signed on 1 March 20x1 and the key to the residential unit is handed over to the lessee on 1 June 20x1.

In this case, the inception date of the lease is 1 January 20x1, being the earlier of the date of the lease agreement (1 March 20x1) and the date of commitment by the parties to the principal terms and conditions of the lease (1 January 20x1).

The commencement date is 1 June 20x1 being the date on which the residential unit is made available for use by the lessee.

Correctly identifying the inception date and the commencement date is important because parties to an agreement need to assess whether an agreement is, or contains, a lease at the inception date and a lessee is required to disclose information about committed but not yet commenced leases in certain cases (IFRS 16.59(b)(iv)).

As for the commencement date, its significance in the context of a short-term lease stems from the fact that the lease term *starts* on the commencement date. This directly affects the length of the lease term which in turn dictates whether a lease qualifies as a short-term lease.

Effective date of the modification

It is straightforward to identify the effective date of the modification in most cases.

In situations where this is not clear, it is worth bearing in mind that 'the date when both parties agree to a lease modification' is essentially the date when both parties have a shared understanding of, and are committed to, the modified principal terms and conditions of the lease. It could be viewed as equivalent to the inception date of a lease but on modified terms.

In the context of short-term leases to which the recognition exemption applies, the lease is accounted for as a new lease on the effective date of the modification. The lease term for the new lease starts on this date so it is important to identify the effective date of the modification correctly because it affects the length of the lease term, which in turn affects whether the new lease meets the definition of a short-term lease.

Recognition exemptions

5 A lessee may elect not to apply the [general recognition, measurement and presentation requirements of IFRS 16 for lessees] to:

(a) short-term leases; and

(b) ….

6 If a lessee elects not to apply the [general recognition, measurement and presentation requirements of IFRS 16 for lessees] to either short-term leases or …, the lessee shall recognise the lease payments associated with those leases as an expense on either a straight-line basis over the lease term or another systematic basis. The lessee shall apply another systematic basis if that basis is more representative of the pattern of the lessee's benefit.

7 If a lessee accounts for short-term leases applying paragraph 6, the lessee shall consider the lease to be a new lease for the purposes of this Standard if:

(a) there is a lease modification; or

(b) there is any change in the lease term (for example, the lessee exercises an option not previously included in its determination of the lease term).

8 The election for short-term leases shall be made by class of underlying asset to which the right of use relates. A class of underlying asset is a grouping of underlying assets of a similar nature and use in an entity's operations. …

Lease term

18 An entity shall 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.

19 In assessing whether a lessee is reasonably certain to exercise an option to extend a lease, or not to exercise an option to terminate a lease, an entity shall 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, as described in paragraphs B37–B40.

20 A lessee shall reassess whether it is reasonably certain to exercise an extension option, or not to exercise a termination option, upon the occurrence of either a significant event or a significant change in circumstances that:

(a) is within the control of the lessee; and

(b) affects whether the lessee is reasonably certain to exercise an option not previously included in its determination of the lease term, or not to exercise an option previously included in its determination of the lease term.

21 An entity shall revise the lease term if there is a change in the non-cancellable period of a lease. For example, the non-cancellable period of a lease will change if:

(a) the lessee exercises an option not previously included in the entity's determination of the lease term;

(b) the lessee does not exercise an option previously included in the entity's determination of the lease term;

(c) to (d) …

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.

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

Transition practical expedients

C10 A lessee may use one or more of the following practical expedients when applying [IFRS 16] retrospectively in accordance with paragraph C5(b) to leases previously classified as operating leases applying IAS 17. A lessee is permitted to apply these practical expedients on a lease-by-lease basis:

(a) to (b)…

(c) a lessee may elect not to [recognise a RoU asset and a lease liability for] leases for which the lease term ends within 12 months of the date of initial application. In this case, a lessee shall:

  (i) account for those leases in the same way as short-term leases as described in paragraph 6; and

  (ii) include the cost associated with those leases within the disclosure of short-term lease expense in the annual reporting period that includes the date of initial application.

(d) to (e)….

Appendix II – relevant Deloitte guidance

The following links are accessible by DART (Deloitte Accounting Research Tool) subscribers only.

Sign up for a subscription to DART or a 30-day free trial.

IFRS 16:5(a)>2.4-1 Short-term leases – impact of interdependent contracts

IFRS 16:6>8.2.4.3-1 Period over which lease incentives should be recognised for short-term leases and leases of low-value assets – example

IFRS 16:7>8.2.2.3-1 Short term leases – lessee right to terminate within 12 months – example

IFRS 16:7>8.2.2.3-2 Short term leases – both lessee and lessor have a right to terminate within 12 months – example

IFRS 16:7>8.2.2.3-3 Short term leases – modification that qualifies as a short-term lease – example

IFRS 16:7>8.2.2.3-4 Short term leases – modification that does not qualify as a short-term lease – example

IFRS 16:8>8.2.2.2-1B Short-term leases – application of recognition exemption to a class of assets

IFRS 16:18>6.1.1-1 Lease term when the lease consists of non-consecutive periods of use

IFRS 16:C10(c)>14.6.3.2-1 Comparison of the practical expedient in IFRS 16:C10(c) with the short-term lease recognition exemption

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