HLB MANN JUDD
ADVISORY AND ACCOUNTING

THE NEW LEASES STANDARD: PART 2

Lease term

The lease term is a key input in calculating the amount of the lease liability (and consequently the right-of-use asset). Assessing the lease term will often require judgement, especially when the lease contains features like rent renewal and termination options.

AASB 16 Leases defines the lease term as the non-cancellable period for which a lessee has the right to use an underlying asset, together with both:

- periods covered by a lessee's extension option if extension is reasonably certain; and
- periods covered by a lessee's termination option if the lessee is reasonably certain not to terminate.

The concept of 'reasonably certain' has been carried over from the superseded AASB 117 *Leases* and remains unchanged. In applying this concept, entities are required to consider all relevant facts and circumstances that create an economic incentive for the lessee to exercise, or not to exercise, the option. This is discussed on the next page.

Consideration of enforceability

A contract is an agreement between two or more parties that creates enforceable rights and obligations. In assessing the lease term, entities need to determine the period for which the lease agreement is enforceable.

A lease is not enforceable when both the lessee and the lessor each have the right to terminate the lease without permission from the other party with no more than an insignificant penalty.

The term 'penalty' is open to interpretation, but it would be appropriate to include all aspects of termination penalties, not only those that are contractual and financial. In other words, the meaning of 'penalty' in this context extends to the existence of any significant economic disincentives of exercising the termination option, taking into account all facts and circumstances.

Options to extend or terminate a lease are only taken into consideration when assessing the lease term when they are enforceable. Consequently, if a lessor has the right to decline a lessee's request to extend or terminate the lease, then the lessee's option is not enforceable and is ignored in assessing the lease term.

If only the lessor has a right to terminate the contract, the non-cancellable lease period includes the period covered by the option to terminate the lease. This is because 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.

When assessing the lease term, entities also need to consider whether local laws and regulations create enforceable rights and obligations that need to be included in the evaluation of the lease term.

Assessing the lease term

The lease term begins on the commencement date – the date on which the lessor makes the underlying asset available for use by the lessee – and includes any rent-free periods provided by the lessor to the lessee. It is from the commencement date that assets, liabilities, income and expenses resulting from a lease are recognised. The timing of when the lease payments begin under the contract does not affect the commencement date of the lease. It's all about when the lessee takes possession of, or is given control over, the use of the underlying asset.

In contrast to lessor termination options discussed above, 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 are required to consider those optional periods in assessing the lease term. In making this assessment, the lessee considers all facts and circumstances (see examples of such facts and circumstances below) that create an economic incentive for the lessee to exercise, or not to exercise, the option. It should include any expected changes in facts and circumstances from the commencement date until the exercise date of the option.

EXAMPLES OF RELEVANT FACTS AND CIRCUMSTANCES

Contractual terms and conditions compared with market rates	For example: • amount of payments for the lease in any optional period; • amount of any variable payments for the lease or other contingent payments such as termination penalties and residual value guarantees; • the terms and conditions of any options that are exercisable after initial optional periods e.g. a purchase option that is exercisable at the end of an extension period at a rate that is currently below market rates.
Significant leasehold improvements	Significant leasehold improvements undertaken (or expected to be undertaken) over the term of the contract that are expected to have significant economic benefit to the lessee when the option becomes exercisable.
Termination costs	These would include negotiation costs, relocation costs, costs of identifying another suitable underlying asset suited to the lessee's needs, integration costs, or termination penalties and similar costs, including costs associated with returning the underlying asset in a required condition and/or location.
Importance of the asset to the lessee	The importance of the leased asset to the lessee's operations, considering, for example, whether the underlying asset is specialised, its location, and the availability of suitable alternatives.
Conditions attached to exercising options	Whether certain conditions have to be met before an option can be exercised, and the likelihood that those conditions will exist.
Options and other contractual features	Where an option is combined with one or more other contractual features (e.g. residual value guarantee) such that the lessee guarantees the lessor a minimum or fixed cash return that is substantially the same regardless of whether the option is exercised, an entity should assume that the lessee is reasonably certain to exercise the option to extend the lease, or not to exercise the option to terminate the lease.
Length of non-cancellable period	The shorter the non-cancellable period of a lease, the more likely a lessee is to exercise an option to extend the lease or not to exercise an option to terminate the lease. This is because the costs associated with obtaining a replacement asset are likely to be proportionately higher the shorter the non-cancellable period.
Lessee's past practice	A lessee's past practice regarding the period over which it has typically used particular types of assets (whether leased or owned), and its economic reasons for doing so, may provide information that is helpful in assessing whether the lessee is reasonably certain to exercise, or not to exercise, an option.

Reassessing the lease term

After lease commencement, AASB 16 requires lessees to monitor leases for significant changes that could trigger a change in the lease term. A lessee reassesses whether it is reasonably certain to exercise an extension option, or not to exercise a termination option, upon the occurrence of a significant event or a significant change in circumstances that:

- is within the control of the lessee; and
- affects whether the exercise, or non-exercise, of the option is reasonably certain.

Examples of significant events or changes in circumstances that could trigger a reassessment include:

- substantial leasehold improvements not anticipated at lease commencement that are expected to have significant economic benefit for the lessee when the option becomes exercisable;
- significant modifications to, or customisation of, the leased asset that were not anticipated at commencement date;
- the inception of a sublease of the underlying asset for a period beyond the end of the previously determined lease term; and
- a business decision of the lessee that is directly relevant to exercising, or not exercising, the option. For example, deciding to extend the lease of a complementary asset, to dispose of an alternative asset, or to dispose of a business unit in which the right-of-use asset is employed.

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

- the lessee exercises an option not previously included in the determination of the lease term;
- the lessee does not exercise an option previously included in the lease term;
- an event occurs that contractually obliges the lessee to exercise an option not previously included in the lease term;
- an event occurs that contractually prohibits the lessee from exercising an option not previously included in the lease term.

If the reassessment of the lease term results in a change, lessees would remeasure the lease liability using revised inputs (such as the discount rate) at the reassessment date. A corresponding adjustment would be made to the right-of-use asset.

The examples below demonstrate some of the principles discussed relating to the lease term:

Scenario 1:

Lessee A enters into a contract with Lessor B to lease an office for a period of six years. The contract includes an option to extend the lease for a further two years if both the lessee and lessor agree to the two-year extension. There is no penalty for either party if they do not agree to extend. Company A is certain it will exercise its option to extend the lease.

Under the contract, the lease term is six years. Both the lessee and the lessor could unilaterally elect not to extend the arrangement without more than an insignificant penalty meaning neither party has enforceable rights beyond the initial non-cancellable lease period of six years.

Scenario 2:

Lessee X enters into a contract to lease a warehouse for eight years. The lessor has the option to terminate the lease after five years.

A lessor's right to terminate a lease is ignored in determining the lease term. Lessee X is obliged to pay rent under the contract for eight years unless the lessor chooses to terminate early. In other words, the lessor can enforce the contract for the full eight-year period. Accordingly, the lease term is eight years.

Scenario 3:

Lessee P enters into a non-cancellable lease agreement with Lessor Q to lease a commercial building. The lease is for five years initially, and P has the option to extend the lease by another five years at the same rental.

To determine the lease term, P considers the following factors:

- *It is P's intention to stay in business in the same area for at least ten years.*
- *The location of the building is ideal for relationships with customers and suppliers.*
- *Market rentals for a similar building in the same area are expected to increase by 12% over the ten-year period of the lease. At inception of the lease, rentals are in accordance with current market rates.*

P concludes that it has a significant economic incentive to extend the lease. Therefore, for lease accounting purposes, P uses a lease term of ten years.

Scenario 4:

A retailer enters into a lease for a specific retail space in a shopping centre for three months a year, being October, November and December, for a non-cancellable term of seven years. The contract states that the same space will be provided to the retailer every year over the seven-year period.

Under the contract, the retailer has the right to use the space for three months every year for seven years, thus the lease term is 21 months. The emphasis is on the period the lessee has the right to use the underlying asset, rather than the contractual term.

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