

IAS 16: Useful Life of Leasehold Improvements

Excerpt, IFRS Discussion Group Report on Meeting – April 19, 2012

IAS 16 *Property, Plant and Equipment* requires the depreciable amount of an asset to be allocated on a systematic basis over its useful life.

In determining a “lease term”, IAS 17 *Leases* requires that a renewal option not be reflected unless it is “reasonably certain” that the option will be exercised. The issue considered by the Group was whether the lease term represents the useful life for leasehold improvements under IAS 16 when the lessee is not reasonably certain it will exercise an option to extend a lease.

Fact Pattern:

- A lessee enters into an operating lease for an office property that has:
 - an initial term of five years; and
 - an option for the lessee to extend the lease for a further five years at market rates.
- Upon commencement of the lease term, the lessee:
 - spends \$2 million on an immovable leasehold improvement specific to the property that has an economic life of seven years; and
 - expects to exercise the extension option, but is not reasonably certain it will do so.

Should the useful life of the leasehold improvements be the shorter of the lease term and the asset’s economic life (i.e., five years) (*View A*) or the asset’s expected economic life (i.e., seven years) (*View B*)?

Proponents of *View A* refer to paragraph 56(d) of IAS 16 and the definition of lease term under IAS 17, arguing that a consistent approach to amortization should be used. Proponents of *View B* give more weight to paragraphs 56(a) and 57 of IAS 16, focussing on the expected use of the asset.

The Group’s Discussion

Group members noted that it is difficult to understand how the lessee in this fact pattern can expect to exercise the extension option but not be reasonably certain it will do so. As a result, Group members questioned how often the fact pattern would occur in practice.

Several Group members observed that there is a relatively unclear distinction between expected and reasonably certain. They expressed the view that expected and reasonably certain do not represent different thresholds.

Group members also noted that, from a practical perspective, management would align the lease term with the economic life of significant leasehold improvements and, in most cases, a financial statement preparer would arrive at compatible approaches.

Group members made several other observations, including that there may be an economic incentive to renew the lease and that only IAS 16 applies to the amortization of the asset (i.e., IAS 17 does not apply).

The Group agreed that this issue should not be brought to the attention of the IFRS Interpretations Committee because the issue is not expected to arise in practice frequently.