IFRS 16: Future Lease Payments

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IFRS 16 *Leases* defines lease term as follows:

> "The non-cancellable period for which a lessee has the right to use an underlying asset, 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."

Paragraph 19 of IFRS 16 states that "[i]n 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."

Fact Pattern 1

An entity requires its Board of Directors' (Board) approval before any renewal options in a lease agreement can be exercised. Usually, this approval is not obtained until three months before the lease renewal date.

Issue 1: How should the entity incorporate factors outside of management's control in determining whether it is reasonably certain to exercise the lease renewal option?

View 1A – The lease term should exclude the renewal option until Board approval is obtained.

An entity exercises judgment in determining the weight assigned to each factor considered. If the Board's approval is seen as a key determinant in the lease renewal decision, this may prohibit the inclusion of any renewal options in the lease term at the lease commencement date. This view is further supported if the Board has a history of rejecting lease renewals or makes lease renewal decisions using information that is unavailable to the entity at the lease commencement date.

Under this view, the lease term on initial recognition would exclude renewal options. When renewal options are subsequently approved by the Board, a reassessment of the lease term would be performed, and the lease liability would be remeasured to reflect this change.

View 1B – The lease term should include the renewal option when other factors support that the entity is reasonably certain of exercising such option.

Proponents of this view note that there is no single factor that is determinative in assessing the lease term. The entity should consider all available relevant factors in making the decision.

Board approval can be viewed as a final step in the lease-renewal process, and one that is controlled by the entity. In order to balance timeliness of financial reporting with reliability of the information presented, it would be appropriate for the entity to review all relevant and available information that the Board would ultimately consider. This information should be used to support an assessment for accounting purposes, independent of Board approval.

The entity should consider factors described in paragraph B37 of IFRS 16 in making its assessment of whether it is reasonably certain to exercise the renewal option. A subsequent rejection of a renewal option initially included in the lease term would require remeasurement of the lease liability at the time the decision is made.

The Group's Discussion

One Group member noted that the entity's requirement to have Board approval is a factor to be considered. Another Group member suggested that the Board's approval to renew the lease would be a final step after considering all economic factors that any member of the entity would have taken into consideration. As such, whether it is management or the Board that has the decision-making authority is not relevant because both would be expected to act in the entity's best economic interests.

Group members agreed that the lease term should include the renewal option when other factors support that the entity is reasonably certain of exercising such option (View 1B).

Fact Pattern 2

An entity is reasonably certain to exercise the renewal option in a lease. The renewal option does not specify the payment amounts but requires them to be at market rates.

Issue 2: How should the entity measure the lease liability when future lease payments upon renewal are not known until a later date?

View 2A – The renewal option should not be included on initial recognition of the lease.

Proponents of this view note that estimating the future lease payments in a renewal term is subject to significant measurement uncertainty. In certain industries with rapidly changing market conditions, it may be difficult to use historical rates as a basis for estimating future lease payments. Including such an estimate would reduce the quality of reported financial information.

The future lease payments contain an element of variability and may be contingent on factors unknown to the entity at the lease commencement date. Paragraph 27 of IFRS 16 requires the inclusion of variable lease payments in the measurement of a lease liability only when such payments are based on an index or rate.

Proponents of this view also considered paragraph 4.16 of the existing *Conceptual Framework for Financial Reporting* issued by the IASB in September 2010. This paragraph indicates the decision to acquire future assets does not give rise to a present obligation, unless there is an irrevocable agreement in place. The paragraph seems to suggest that when the renewal term has not yet been exercised or communicated, no legal or constructive obligation has been created. As such, there is no obligating event that would result in a liability.

View 2B – The renewal option should be included in the lease term at the same rate as the immediately preceding lease term.

Proponents of this view note that the determination of being reasonably certain to exercise a renewal option can be viewed as an acknowledgement of a present obligation. A key principle of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* is that uncertainty is inherent in business decisions. Therefore, the standard allows for the use of estimates and management's judgment in many financial statement areas.

When a renewal option is included in the lease term, it is likely that the renewal rate will be at or above the rate in the preceding term in an inflationary environment. Absent contrary information, an entity should estimate the lease payments in a renewal term based on the current rate paid as this is a reliable estimate of the minimum future outflow. If the actual rate differs upon renewal, the lease liability would be remeasured to reflect this change.

View 2C – The renewal option should be included in the lease term with an adjustment to reflect an increase in future lease payments.

Proponents of this view note that an entity may be able to achieve an increased level of precision by making reasonable adjustments to the base lease rate in order to estimate future lease payments. When there is a history of rent escalation for a particular site, or a site with similar characteristics, it is unrealistic to assume that there will be no change to the current lease rate. A comparison of the lease rate to current market rates, real estate market trends, and other information available to the entity may also lead to the conclusion that the current rate is not the best estimate of the future outflow.

As noted in paragraph 33 of IAS 8, the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability. Therefore, an entity should consider all reliable information available, subject to the cost constraint, to determine the adjustment to future lease payments.

The Group's Discussion

The Group discussed economic considerations that could affect the likelihood of an entity renewing the lease. Economic factors to consider include costs of relocation, loss of customers and loss of existing infrastructure. When a decision to renew is reasonably certain after considering economic factors as in the fact pattern, the Group's view is that the renewal option should be included in the lease term (not View 2A).

Group members supported including the renewal term in the lease term at the same renewal rate as the immediately preceding lease term when measuring the future lease payments (View 2B). Including an adjustment to reflect an increase in future lease payments would be inconsistent with the guidance (View 2C).

One Group member emphasized that measuring the lease liability could be challenging and requires extensive effort, especially for entities with a large volume of leases.

The Group's discussion raises awareness about the consideration of renewal options when determining future lease payments. No further action was recommended to the AcSB.

(For a full understanding of the discussions and views expressed, listen to the audio clip).