

**PHILIPPINE INTERPRETATIONS COMMITTEE (PIC)
QUESTIONS AND ANSWERS**

Q&A No. 2019-12

Determining the lease term under PFRS 16, *Leases*

This Q&A aims to provide guidance in determining the lease term under the new leases standard. Such exercise may require significant judgment especially when the lease agreement contains an option to either extend or terminate the lease.

Issue

How should an entity determine the lease term under PFRS 16, *Leases*?

Discussion

PFRS 16, *Leases*, defines “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.

The *Basis for Conclusions* of PFRS 16 indicates that a contract would be considered to exist only when it creates rights and obligations that are enforceable. Therefore, any non-cancellable period or notice period in a lease would meet the definition of a contract and, thus, would be included as part of the lease term. To be part of a contract, **any option to extend or terminate the lease that are included in the lease term must also be enforceable**. For example, the lessee must be able to enforce its right to extend the lease beyond the non-cancellable period.

If optional periods are not enforceable (e.g., if the lessee cannot enforce the extension of the lease without the agreement of the lessor), the lessee does not have the right to use the asset beyond the non-cancellable period. Consequently, by definition, there is no contract beyond the non-cancellable period (plus any notice period) if there are no enforceable rights and obligations existing between the lessee and lessor beyond that term. **In assessing the enforceability of a contract, an entity should consider whether the lessor can refuse to agree to a request from the lessee to extend the lease.** 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 thus, 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.**

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 (i.e., including those that are not indicated in the lease contract) 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.

Practical examples in determining lease term

1. ***Lease for twelve months without renewal option but lessee has historically renewed the lease.*** Even though it is usually expected of the lessee to renew the lease based on customary business practices and/or past experience of the lessee, the lease term is still 12 months and will qualify as a short-term lease since absent any option, the lessee has no enforceable right to renew the lease beyond 12 months. Under PFRS 16.7, every time there is a modification to the lease term of a short-term lease, it shall be treated as a new lease.
2. ***Zero penalty leases - lessee.*** Assume a 14-year lease that can be terminated by the lessee every two years without incurring any penalty. Because it is only the lessee that can terminate the lease, only the lessee has the absolute right to enforce the entire duration of the lease. It is not impacted by the preference of the lessor. In assessing the period over which the lessee will enforce the lease, it should be assessed as to what the lessee can do and what the lessee is reasonably certain to do. Among those that can be considered are the leasehold improvements that the lessee has built on the leased properties, the interaction of this lease contract with the other arrangements that the lessee has entered into, and the experience of the lessee in leases of similar assets in the past.
3. ***Zero penalty leases - both parties.*** A similar example in No. 2, but this time, either party can terminate the lease for zero penalty. This is an example where PFRS 16 B34 will come in. B34 states 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*”. However, while the contract states that either party on termination will not pay any penalty to the other, PFRS 16 requires an entity to consider all relevant facts and circumstances that create an economic incentive for either party to exercise or not to exercise the option. For example, if either party will suffer more than an insignificant amount of resource outflows or losses on termination (e.g., significant cost of leasehold improvements built and cost of relocating for the lessee, or significant cost of finding a new tenant for the lessor), then this becomes an economic penalty for the concerned party not to exercise the termination clause. In this example, the lessee has already built significant leasehold improvements on the leased property, hence there is significant economic disincentive or penalty for the lessee to exercise its termination option. In effect, only the lessor has the option to terminate the lease at zero penalty. Under PFRS 16 B35, “if only the 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”. In this example, the lessee actually has the right to terminate the lease but because of the significant economic penalty involved, similar to No. 2 above, the lessee has to assess the period over which the lessee is reasonably certain to continue leasing the asset. Depending on the lessee’s

assessment, the lease term could be 14 years. In conclusion, this example illustrates that having a zero penalty on either party to terminate the lease will not automatically make the contract unenforceable as discussed in B34 because of the presence of other economic penalties that render such zero penalties without substance.

4. ***Lease continues to be renewed until either party terminates.*** In this example, a lease has an initial term of 12 months and gets automatically renewed for an indefinite period unless cancelled by either the lessee or lessor. The issue in this example is whether the lease is enforceable beyond the 12-month period, and if yes, what is the lease term absent any specific date up to when the lease can be renewed. Similar to the discussions in Examples 2 and 3 above, if the economic penalty for either party to terminate is no more than insignificant, then the renewal period beyond the initial 12 months is considered unenforceable; hence the term cannot be more than 12 months. On the other hand, if either party can cancel but will sustain an economic penalty that is more than insignificant (i.e., renewal period is considered enforceable), then it will be assessed as to whether the lessee is reasonably certain to continue with the lease and for how long, keeping in mind the entity's reasonable expectation of the period over which the asset will be used. Judgement will need to be exercised in this assessment considering the available facts and circumstances including the significant economic incentives and penalties to the lessee and the length of time the lessee typically uses this kind of asset.
5. ***Rolling 12-month extension options.*** In this example, a lease has an initial period of 10 years and the lessee can extend the contract on a rolling basis for 12 months thereafter. Also, there are no termination payments if the extensions are not taken. Assuming that after 10 years, the lessee concludes that the remaining lease term at that time is only 12 months, can the PFRS 16 recognition exemption for short-term leases be applied? The answer is No because the basis of the IASB in coming up with the off-balance sheet reprieve available to short-term leases is a purely cost saving measure and hence applicable only to clearly simple and straight-forward short term leases. This example is a case of a revised lease term (following the exercise by the lessee of an extension option) that requires remeasurement of a lease asset and liability that are already on the balance sheet.

Effective date

The effective date of the consensus in this Q&A follow that of Appendix C of PFRS 16, upon approval by the FRSC.

Date approved by PIC: December 17, 2019

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