



Association pour la participation des
entreprises françaises à l'harmonisation
comptable internationale



The Chairman of the
IFRS IC

Columbus Building, 7
Westferry Circus

Canary Wharf

London E14 4HD.

30 July 2019

Dear Ms Lloyd,

Re : Tentative agenda decision “Lease Term and Useful Life of Leasehold Improvements”

We are pleased to provide comments on the tentative agenda decision regarding the determination of lease term and the useful life of leasehold improvements.

We acknowledge that the Committee has observed diversity in interpretation and wishes to solve this matter urgently. Nevertheless, we think that this matter cannot be solved by issuing an agenda decision and should be dealt with through standard-setting activity using a proper due process in view of the fact that:

- The submission highlights substantial differences in interpretation linked to the core principles of IFRS 16;
- These differences in interpretation come from differences within IFRS 16 between the rationale developed in the Basis for Conclusions and certain paragraphs in the standard, adding confusion rather than clarifying the standard. The tentative agenda decision significantly shifts the rationale underlying the assessment of lease terms by introducing economic incentives when determining the enforceable period.

We therefore consider that the Committee goes beyond a mere explanatory analysis of how IFRS 16 should be understood. Indeed, in our view, the tentative agenda decision changes the relevant core principles of IFRS 16 and significantly affects the way preparers understand the principles of IFRS 16 by introducing economic incentives into the determination of the enforceable period. Our purpose is not to discuss whether this path should be followed or not, but we think that this is a major shift from the published standard that should be discussed by the Board within an appropriate due process.

In the Due Process Handbook currently under revision, the IFRS Foundation emphasizes that an agenda decision cannot replace a need for standard setting. We believe that this submission falls into this category.

Please find below further comments on the proposed agenda decision.

If you require any clarification or information, please do not hesitate to contact us.

Yours sincerely,

ACTEO

Patrice MARTEAU
Chairman



AFEP

François SOULMAGNON
Director General



MEDEF

Agnès LEPINAY
Director of economic and financial
affairs



It is our understanding that the Board's initial intentions when drafting IFRS 16 were to reflect enforceable rights and obligations of the parties as part of the lease contract. This notion of enforceability was among the core principles of IFRS 16. Options to terminate or to renew a lease generate rights and obligations to the extent that they are enforceable. The same rationale applies to variable payments (i.e. only variable payments that are fixed in substance are included in the measurement of the lease liability).

As mentioned in the submission, one interpretation of the standard, is that the economics of the contract (or economic incentives) are not to be considered when assessing the enforceability of rights and obligations and determining the enforceable period. It is only in a second step, once the enforceable period is determined, that economic incentives are considered when determining the lease term (within the framework of enforceable rights). Economic incentive and enforceability are therefore two distinct notions that are very different.

The rationale of the Board regarding enforceability is clearly explained in paragraph BC127 of IFRS 16 and we note that this paragraph is not included in the tentative agenda decision. This paragraph is reproduced below (emphasis added in bold type):

Cancellable leases

*BC127 For the purposes of defining the scope of IFRS 16, the IASB decided that a contract would be considered to exist only when it creates rights and obligations that are enforceable. 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 options 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, for example, **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.***

Applying the rationale in paragraph BC127, a contract is not enforceable beyond the non-cancellable period if the lessee cannot enforce the extension without the agreement of the lessor (to the extent that the lessor can refuse to agree a request from the lessee to extend the lease). The fact that the lessee would incur a penalty if the lessor refuses to agree a request to extend the lease does not change that outcome. This rationale would typically apply, in our understanding, to a renewable lease where the lessee can renew the contract only with the agreement of the lessor.

We think that at the very least the IFRS IC should clarify why the tentative agenda decision is not based on paragraph BC127 and explain why the IFRS IC thinks the outcome of the tentative agenda decision is not in contradiction with this paragraph.

We note that the rationale in the tentative agenda decision is mainly based on paragraph B34 of IFRS 16. In our understanding, this paragraph specifically addresses contracts that include termination options (paragraph B34 refers to the "right to terminate the lease") and was introduced as an anti-abuse provision as specified in paragraph BC157:

[... when developing requirements on lease term, the Board was looking to ‘reduce the risk of non-substantive break clauses being inserted within contracts solely to reduce the lease term beyond what is economically reasonable for the lessee]

The staff paper emphasizes in paragraph 26 of the agenda paper that, in developing the lease term requirements in IFRS 16, the Board placed importance on the economics of a contract. The staff paper also refers to paragraph 19, B37 and BC156 of IFRS 16. Those paragraphs notably require an entity to consider “all relevant facts and circumstances that create an economic incentive for the lessee”. However, we note that all those paragraphs deal with the determination of the lease term and the assessment of the probability that options will be exercised (as acknowledged in the staff paper). Those paragraphs do not deal with the determination of the enforceable period.

We think that in the tentative agenda decision, the IFRS IC encompasses in a single analysis the determination of the enforceable period (based on rights and obligations of the parties) and the assessment of the lease term (taking into account economic incentives). In particular, the fact that a lessee has an economic incentive to exercise an option to extend a lease (for example because the lessee made a significant investment in leasehold improvements) does not give him an enforceable right to exercise that option if the lessor can refuse to agree to that request, as specified in paragraph BC127.

Moreover, we note that the whole standard is currently drafted from a lessee’s perspective in assessing the enforceable period and the probability of exercising options. Paragraphs 18 and 19 of IFRS 16 specifically mention an analysis of relevant facts and circumstances that create an economic incentive for the lessee. Paragraph 20 explains that the lessee should reassess the probability only upon the occurrence of circumstances that are within its control; there is no mention of reassessment in case of change in circumstances within the control of the lessor. We therefore believe that IFRS 16 was not initially drafted to deal with cases of reassessment of the lease term in the event of economic change on the lessor’s side due to a purely legal assessment of these options, which does not change over time contrary to an economic assessment.

Notion of penalty in paragraph B34

We note that the tentative agenda decision clarifies that a broad economic definition of penalty should be used in the context of applying paragraph B34. We think that the tentative agenda decision should clarify that economic incentives to terminate a lease should also be considered when assessing whether a significant penalty is incurred. For example, a lessor that incurs a penalty on termination in the form of a monetary payment made to the lessee may have an economic incentive to terminate the lease if the lease payments it can expect from renting the asset as part of a new lease are higher than the lease payments under the current lease (and this rise at least compensates the monetary payment made to the lessee). In other words, the notion of penalty should be understood as a net notion that should include any economic benefits to terminate a lease.

Useful Life of Leasehold Improvements

Regarding the second part of the request, the useful Life of Leasehold Improvements, we suggest that the Committee should not conclude until the problem of the lease term has been appropriately addressed (via standard-setting activity).

Indeed, we believe that the conclusions on the depreciation period are very largely dependent on the assumptions made and conclusions reached about the way the lease term should be determined:

- Should the enforceable period be assessed based on economic incentives, we acknowledge that lease term and useful life are quasi-systematically aligned.
- On the other hand, if the enforceable period is based solely on the analysis of the rights and obligations of the parties, then there may be more frequent cases of disconnection between lease-term and useful life of leaseholds because they are not determined according to the same standards nor the same principles.

In any event, we agree that an entity must be consistent in determining the assumptions used in the assessment of both periods within the enforceable period.

Please find below an analysis of the interaction between lease term and useful life for non-removable leasehold improvements in two different scenarios.

Example Case 1: Lease renewable every three years, with the decision entirely in the hands of the lessee without the lessor being able to oppose it. After 9 years, there is no legal right to extend the contract.

- Within the 9-year period, when the lessee has control over the renewals, one can expect an alignment between the lease term and the useful life of leasehold improvements. It is worth noting however, that the “alignment” is not systematic given the different thresholds used in IAS 16 (expected) and IFRS 16 (reasonably certain). The fact that the lessee has made significant leasehold improvements is one of the indicators used in the assessment of the lease term within the enforceable period but could be refuted by other facts and circumstances.

- In accordance with IFRS 16, the lessee does not have the right to recognise a ROU in excess of 9 years. However, past practice and its current economic position may suggest that the lessee will be able to re-sign a lease for the same asset. In this case, it would not be inconsistent to have depreciation periods for leasehold improvements longer than 9 years.

Case 2: One-year lease with tacit renewal each year - the lessor can oppose renewal each year

According to the contractual analysis of enforceable rights and obligations which seems to us to prevail today under IFRS 16 (see our comments on part I), one may consider that the enforceable period is one year. The fact that the lessee has made significant leasehold improvements certainly puts him at economic risk but does not change the enforceable period of the contract and gives him no rights over the lessor to impose a longer period as explained in paragraph BC127 of IFRS 16. In this case, there will be a systematic disconnection between the lease-term (corresponding to the enforceable period of one year) and the expected useful life of leasehold improvements.