

MFRS Hot Topics

Lease extensions and renewals

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Welcome to MFRS Hot Topics - a publication from SJ Grant Thornton. This issue will provide guidance on the accounting treatment of lease extensions and renewals.



How to account for lease extensions/renewals in the following situations in accordance to the MFRS 117 Leases:

- exercise of a renewal/extension option where extension period is included in the original lease term
- exercise of a renewal/extension option where extension period is not included in the original lease term
- negotiation of renewal/extension period not covered by a renewal/extension option in the original lease
- re-negotiation of a lease, including a renewal/extension period, that affects the terms and conditions during the original lease term.

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General guidance

At inception of the lease, an entity considers the terms and conditions of the lease, including any renewal/extension options, to determine the appropriate classification of the lease (as an operating or finance lease) (MFRS 117.4, 7-12). The lease term includes any period for which the lessee has the option to continue to lease the asset and, at inception of the lease, it is reasonably certain that it will exercise the option (MFRS 117.4). The impact of exercising a renewal or extension option, or of negotiating a renewal/extension, depends on the circumstances. The requirements are summarised below:

Summary	Reassess original lease classification?	Treatment of renewal/extension period
Exercise of a renewal/extension option where extension period is included in the original lease term	No	No action needed
Exercise of a renewal/extension option where extension period is not included in the original lease term	No	See discussion below
Negotiation of renewal/extension period not covered by a renewal/extension option in the original lease	No	Treat extension period as a new lease
Re-negotiation of a lease, including a renewal/extension, that affects the terms and conditions during the original lease term	Yes	Reassess revised agreement as though revised terms were in place at inception of original lease

Leases are not reclassified for changes in estimates (for example, changes in the estimates of the residual life or the residual value of the leased property), or changes in circumstances (for example, default by the lessee) (MFRS 117.13).

Discussion

Whether a lease is classified as a finance lease or as an operating lease depends on the substance of the transaction rather than the legal form of the contract. MFRS 117.13 requires that lease classification is determined at the inception of the lease. The inception of the lease is the earlier of the date of the lease agreement and the date of commitment by the parties to the principal provisions of the lease. The lease term includes any period for which the lessee has the option to continue to lease the asset and, at inception of the lease, it is reasonably certain that it will exercise the option (MFRS 117.4).

MFRS 117.13 further states:

“If at any time the lessee and the lessor agree to change the provisions of the lease, **other than by renewing the lease**, in a manner that would have resulted in a different classification of the lease...if the changed terms had been in effect at the inception of the lease, the revised agreement is regarded as a new agreement over its term...”
(Emphasis added)

Exercise of a renewal/extension option where extension period is included in the original lease term

If a renewal/extension option was included in the original provisions of the lease and at inception it was considered reasonably certain that the option would be exercised (for example if the option was at a bargain price), then the originally assessed lease term will include the extension period (MFRS 117.4). Consequently, exercise of the option would not cause the classification of the lease to be reassessed. The original lease classification would continue to be applied even if the lessee subsequently determined that it no longer expects to exercise the option.

Exercise of a renewal/extension option where extension period is not included in the original lease term

If a lessee considers at inception of the lease that exercise of the option is less than reasonably certain (which is likely to be the case if the option is at fair value or at a rate that is not a bargain rate) then the lease term will exclude the renewal/extension period. If the lessee determines later that it will probably exercise the option, this would not change the classification of the initial lease. The change in intention is not a change in the provisions of the lease. Changes in estimates (for example, changes in the estimates of the residual life or the residual

value of the leased property), or changes in circumstances (for example, default by the lessee), do not give rise to a new classification of a lease for accounting purposes (MFRS 117.13).

The renewed or extended lease period is effectively treated as a separate agreement. Using this approach, the renewal/extension period is evaluated as a new lease under the classification criteria in MFRS 117.7-12 only with respect to the renewal or extension period. This is consistent with the requirements of Paragraph

10(b) of IC Interpretation 4 Determining whether an Arrangement contains a Lease. The assessment of whether an arrangement contains a lease is done at the inception of the arrangement. A later reassessment is only done if certain conditions are met, eg when a renewal option is exercised, unless the term of the renewal had initially been included in the lease term in accordance with MFRS 117.4. The evaluation of the renewal arrangement shall be evaluated only with respect to the renewal period (IC Interpretation 4.10(b)).

MFRS 117.13 does not explicitly address the issue. Indeed, an alternative interpretation of MFRS 117.13 is that it *prohibits* reassessment of lease classification except when the provisions of the lease are changed. When renewal or extension options are included in the original lease arrangement, their exercise does not amount to a change in the provisions of the lease. It is therefore possible to argue that MFRS 117 requires the original lease classification to be preserved, including for the extension period. Ultimately, this is a point of interpretation. However, when clients adopt this approach we suggest that special care should be taken to ensure that the original lease classification includes a realistic assessment of the likelihood of any extension options being exercised. If an

entity repeatedly asserts that it does not expect to exercise extension options in its leases and then does so, doubt will be cast on its approach to the original assessment.

Negotiation of renewal/extension period not covered by a renewal/extension option in the original lease

If there was no renewal/extension option in the original lease but the lessee negotiates a renewal/extension with the lessor, the renegotiated provisions of the lease need to be considered carefully to evaluate whether or not a reassessment of the lease classification is needed.

A renewal or extension of the arrangement that does not include modification of any of the provisions of the original lease should be evaluated only with respect to the renewal or extension period. There is no change to the provisions of the original lease and the renewal/extension agreement is treated as a separate agreement. The contractual provisions of this agreement should be evaluated to determine the appropriate classification using the criteria in MFRS 117.7-12 with respect to the renewal or extension period.

Re-negotiation of a lease, including a renewal/extension that affects the terms and conditions during the original lease term

Where the renegotiation involves modifying the terms of the initial lease for the remaining period prior to the renewal/extension period, then the initial lease classification needs to be reassessed in accordance with MFRS 117.13. The assessment is made as if the changed terms had been in effect at the inception of the lease. The revised agreement is regarded as a new agreement over its remaining term, which includes both the remaining term of the original lease plus the renewal/extension period. Any reclassification is dealt with prospectively from the date of modification and no retrospective restatement should apply.

Examples

Example 1

Entity A has a non-cancellable lease of a machine for a 4-year period. At the inception of the lease, the lease was assessed as an operating lease. The economic life of the machine is 8 years. The lease did not contain an option to extend the term of the lease.

After 3 years, the entity applied to the leasing company to extend the lease for a further 4 years after the initial 4-year period is complete. The leasing company granted the extension on an arm's length basis, to take effect immediately after the end of the existing lease period, without modification of the terms and conditions for the original 4-year lease period.

Solution 1

There is no modification of the provisions of the original lease so there is no need to re-assess the lease classification during the existing 4-year lease period. The accounting for the remaining term of the original lease term should continue without modification.

The four-year extension is assessed as a new lease agreement. Its classification is determined using the MFRS 117 criteria, based on the asset at the start of the extension period and the terms of the lease as they apply to that period.

Example 2

Entity C leases a new building from Entity D. The original term of the lease was 25 years and the estimated economic life of the building is 45 years. The lease contained clauses requiring Entity C to carry out and pay for scheduled maintenance of the building. At inception the lease was classified as an operating lease. Now, after 20 years, Entity C renegotiates the lease. The maintenance clauses are removed, the rental amount lowered, and other clauses are modified, all with immediate effect. The new remaining lease term is 25 years, which is equal to the remaining estimated remaining economic life of the building.

Solution 2

In this case, the original terms of the initial lease are modified and so the lease classification needs to be reassessed in accordance with MFRS 117.13. The reassessment is made as if the revised terms had been in effect at the inception of the original lease (ie as if the building had been leased for 45 years in the original agreement, scheduled maintenance was paid for by Entity C for the first 20 years and not thereafter, and the rental amount was at the higher amount for the first 20 years but the lower amount thereafter). The lease, as modified, would have been for 100% of the estimated economic life of the building, so the classification of the lease at inception would have been different. Therefore, the revised agreement is considered to be a new lease over its remaining term. If this new lease is determined to be a finance lease, this new classification is applied prospectively from the date of the modification; there is no prior year restatement. Entity C records the asset on its statement of financial position at the lower of its present fair value and the present value of the remaining minimum lease payments (calculated using the current interest rate, residual value, etc at the date of modification). It records a finance lease liability for the same amount.

Example 3

Entity E leases an asset from Entity F for 10 years. The lease includes an extension option under which Entity E may continue to lease the asset from Entity F for a further 5 years at a fair value rental. The asset has an economic life of 15 years. At inception, Entity E was not reasonably certain that it would exercise the option, (which is not a bargain rental option). Consequently, Entity E classifies the lease as an operating lease on the basis of a 10-year minimum lease period.

Near the end of the ninth year of the lease, Entity E serves notice to Entity F that it will exercise the option to extend the lease term for the further 5 years.

Solution3

The exercise of the extension option does not change the provisions of the lease. A change in intention reflects a change in circumstances or estimates that do not trigger a reassessment of the lease classification during the original 10-year lease period. The accounting for the remaining term of the original lease term should continue without modification.

The 5-year extension can be assessed as a new lease agreement. Its classification is then determined using the normal MFRS 117 criteria, based on the asset at the start of the extension period and the terms of the lease as they apply to that period.





KUALA LUMPUR

Level 11, Sheraton Imperial Court
Jalan Sultan Ismail
50774 Kuala Lumpur

T +603 2692 4022
F +603 2721 5229
E info@my.gt.com

PENANG

51-8-A,
Menara BHL Bank
Jalan Sultan Ahmad Shah
10500 Penang

T +604 228 7828
F +604 227 9828
E info.pg@my.gt.com

KUANTAN

A-105A, 1st Floor
Sri Dagangan, Jalan Tun Ismail
25000 Kuantan
Pahang

T +609 515 6124
F +609 515 6126
E info.ktn@my.gt.com

JOHOR BAHRU

Unit 29-08, Level 29
Menara Landmark
12 Jalan Ngee Heng
80000 Johor Bahru, Johor

T +607 223 1848
F +607 224 9848
E info.jb@my.gt.com

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