Financial Reporting Considerations of Hybrid-Work Arrangements

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Many companies are currently transitioning to a hybrid-work model to provide their employees with more flexibility to work partly in the office and partly remotely. As a result, they are reconfiguring the use of real estate assets, such as vacating leased spaces, terminating leases early or reconsidering whether to renew leased spaces. The Group discussed some of these scenarios and their associated financial reporting considerations.

Fact Pattern for Issue 1

- Entity A is beginning to execute its hybrid-work model. Given that its employees are only expected to work on-site one to three days per week, Entity A has developed a plan to close three smaller regional offices and move the workforce into its largest building located in the downtown core. Employees will use a hoteling system to reserve a workspace in the office.
- Entity A had originally determined that it was reasonably certain it would renew the lease for one of their smaller regional offices for an additional five-year term after the initial term (Office 1).
- When nine months remain in the initial term of the lease, Entity A revises its budget and decides it will no longer renew the lease for Office 1.
- When six months remain in the initial term of the lease, Entity A gives notice to the landlord that it will not renew the lease beyond the initial term.
- Given employees are still working remotely at this time, Entity A has not begun to vacate the building.

Issue 1: When should Entity A reassess whether it is reasonably certain of exercising the renewal option for Office 1?

Analysis

Paragraph 20 of IFRS 16 *Leases* states that lessees only reassess whether a renewal option is reasonably certain to be exercised if there is a significant event or change in circumstances that is within the entity's control.

In determining whether a significant event has occurred that is within the entity's control, Entity A considers the list of examples in paragraph B41 of IFRS 16. One of these examples is the lessee's business decision that is directly relevant to exercising, or not exercising, an option (e.g., a decision to extend the lease of a complementary asset, to dispose of an alternative asset or to dispose of a business unit within which the right-of-use (ROU) asset is employed). This example suggests the internal business decision made with nine months remaining in the initial lease term should trigger a reassessment.

For Entity A to conclude that it is reasonably certain that it will not exercise the renewal option, the entity will need to demonstrate that it has an economic incentive not to do so. Intention alone does not provide reasonable certainty. Since Entity A may change its decision to renew the lease without any direct economic consequences, it cannot conclude that it is reasonably certain that it will no longer exercise the renewal option when nine months remain in its original lease term.

Entity A should also reassess whether it is reasonably certain that it will exercise the renewal option when management notifies the landlord that it does not intend to renew the lease (i.e., with six months remaining in the lease term). In contrast to the decision made with nine months remaining, this decision cannot be reversed without economic cost. If Entity A decides it wants to retain a physical presence in the area, it will need to find a new space or negotiate with the landlord, both of which will have economic consequences. Therefore, Entity A can conclude that it is reasonably certain that it will no longer exercise the renewal option with six months remaining in the initial lease term.

The Group's Discussion

Most Group members agreed that determining whether it is reasonably certain that an entity will no longer exercise a lease renewal option is not a matter of intention alone. An entity should be able to demonstrate that it has an economic incentive not to renew the lease.

Most Group members agreed that Entity A in the fact pattern has demonstrated that it is reasonably certain that it will no longer exercise the renewal option when management notifies the landlord that it will not renew the lease (i.e., with six months remaining in the lease term). However, several Group members pointed out that there are several facts and circumstances that an entity needs to consider before it can conclude whether it is reasonably certain that it will not renew the lease with nine months remaining in the lease term.

Some Group members indicated that an entity should consider how formal its budgeting process is, and how easily it could change its budget. At many large organizations, budget preparation is a formal process involving careful planning, multiple approvals and communication across the organization. Once the budget is finalized, such organizations are reasonably certain that they will execute business decisions based on the budget. Changing the budget is rare, and involves the same degree of planning, approvals and communication across the organization. In contrast, many smaller organizations have a more flexible budgeting process. For these types of organizations, the internal business decision made with nine months remaining in the lease term might not be sufficient to conclude that the entity is reasonably certain that it will no longer renew the lease.

Some Group members noted that the communication strategy of the business decision not to renew the lease could also impact whether reasonable certainty exists. For example, the entity may have communicated this business decision to the employees who work out of this office. Reversing this decision might lead to employee retention issues as many employees might now prefer to work from home. One Group member pointed out that some companies have publicly communicated their intention to have a work-from-home model for the foreseeable future. Reversing this decision might result in negative economic consequences for the entity as it might create a negative public perception of the company.

One Group member indicated that an entity might consider indirect economic consequences of renewing the lease when assessing whether it is reasonably certain that it will no longer exercise the renewal option. For example, an entity might demonstrate that it experienced significant cost savings as a result of employees working from home during the pandemic. As a result, asking employees to permanently return to the office might not make economic sense for the company.

One Group member highlighted that paragraph B40 in the application guidance of IFRS 16 says that a lessee's past practice regarding the period over which it has typically used certain assets may provide information that is helpful in assessing whether the lessee is reasonably certain to exercise an option. They indicated that this guidance might not apply going forward given that past practices may not reflect the entity's new business model.

Fact Pattern for Issue 2

- Same fact pattern as for Issue 1, except Entity A has another lease of office space that it plans to exit (Office 2), which has four years remaining in the initial lease term.
- Entity A and its landlord negotiate a termination penalty in exchange for allowing Entity A to exit the lease at the end of the year, three years before the original term was set to expire.

Issue 2: How should Entity A account for the termination penalty?

Analysis

Appendix A of IFRS 16 defines a "lease modification" as "a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease." Entity A's arrangement to terminate the lease term early represents a lease modification because:

(a) the reduction of the remaining lease term from four years to one year represents a change in the scope of the lease; and

(b) the termination penalty represents a change in the consideration for the lease.

Entity A then applies paragraphs 44-46 of IFRS 16 to account for the lease modification. Given the term of the lease is reduced, the criteria in paragraph 44 of IFRS 16 are not met. As such, the lease modification should not be accounted for as a separate lease.

Entity A first recognizes the proportionate decrease in the ROU asset and the lease liability to reflect the reduction in the lease term. The difference between the amounts is recognized in profit or loss at the effective date of the modification.

Entity A then recognizes the difference between the remaining carrying amount of the lease liability and the modified lease liability as an adjustment to the ROU asset. This reflects the change in the consideration due to the termination penalty and the revised discount rate.

The Group's Discussion

Group members agreed with the analysis.

One Group member pointed out that the analysis provided in the paper only applies when the termination penalty is not part of the original lease agreement. Some lease agreements can be quite lengthy, and it is important for entities to read through these agreements in detail to determine whether a termination penalty was prenegotiated. If the termination penalty is part of the original lease agreement, an entity would need to apply the reassessment guidance discussed in Issue 1 instead of accounting for it as a lease modification.

Some Group members indicated that the entity should also consider whether the asset is impaired as a result of the decision to terminate the lease.

Issue 3: Assume the same fact pattern as for Issue 2, but consider the accounting for the lease termination penalty from the perspective of the lessor that accounts for the lease as an operating lease.

Analysis

As required by paragraph 87 of IFRS 16, the lessor will account for this lease modification as a new lease at the date of modification.

The lease termination penalty will be included in the consideration for the lease that the lessor recognizes as rental income on a straight-line basis over the remaining term of the lease.

The Group's Discussion

The Group agreed with the analysis.

One Group member observed that there is diversity in practice in terms of recognizing early termination penalties on operating leases when the new lease has a short duration. Some entities recognize the termination penalty as soon as the termination is negotiated, some recognize it when the lessee vacates the premises, and some recognize it on a straight-line basis until the lessee vacates the premises. However, this diversity in practice might be due to materiality considerations rather than technical arguments under the literature.

One Group member indicated that entities should consider the collectability of the termination penalty when accounting for modifications to operating leases. If the termination penalty is not collectible, an entity should consider whether it should recognize a credit loss.

Another Group member pointed out that some lessors may have lease incentives on their balance sheet for which amortization may need to be accelerated in the event of an early termination.

Some Group members observed that the fact pattern assumes the new lease is an operating lease. In practice, an entity would need to assess whether the new lease is a finance lease.

Fact Pattern for Issue 4

- Same as Fact Pattern for Issue 2, except that Entity A also decides to vacate a single floor of the building located in the downtown core and will use a hoteling system that will reduce the need for office space. Entity A will continue occupying eight floors of the building.
- The common area maintenance (CAM) expense is a significant (25-30 per cent) proportion of the expense for the downtown office space. Entity A must continue to pay for all CAM expenses under the terms of the lease contract.
- Entity A has not elected to combine lease and non-lease components using the practical expedient permitted in paragraph 15 of IFRS 16. It will consider whether its ROU asset related to the one floor they intend to vacate is impaired under IAS 36 *Impairment of Assets*.

Issue 4: Should Entity A also consider whether there may be an onerous contract for the portion of the CAM expenses related to the one soon-to-be vacated floor?

Paragraph 10 of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* defines an onerous contract as "a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it." The question is whether an onerous contract assessment can be performed at a level lower than the contract level.

View 4A – No, the unit of account under IAS 37 for the non-lease component is the contract as a whole

Proponents of this view think that the lease contract has two distinct units of account: the lease component and the non-lease component.

Typically, when assessing whether customer contracts are onerous under IAS 37, an entity looks at the whole contract rather than each component. The onerous contract assessment is therefore performed for the non-lease component as a whole.

View 4B – Yes, the unit of account under IAS 37 is each lease component

Proponents of this view think that the unit of account for the lease contract (including the non-lease component) is each floor. The entity assesses the lease component for impairment under IAS 36, and the non-lease component against the onerous contract guidance in IAS 37.

The unit of account for the impairment assessment and onerous contract assessment should be consistent.

View 4C – Accounting policy choice

Views 4A and 4B have merit, such that an accounting policy choice is available, to be applied consistently.

The Group's Discussion

Most Group members agreed with View 4A. They indicated that IAS 37 does not provide any guidance on breaking the contract down into components when performing the onerous contract assessment. They also thought that had the IASB intended for onerous contracts to be assessed at the component level, this would have been stated explicitly in the standard. Some Group members considered previous discussions on assessing onerous contracts under IFRS 15 *Revenue from Contracts with Customers*, and that the onerous contract assessment should be performed at the contract level, not at the performance obligation level. If the same logic is applied to IAS 37, this would support View 4A. One Group member also thought that it can be difficult to determine the CAM expenses for a particular floor, making it impractical to perform the onerous contract assessment at this level.

One Group member agreed with View 4B, indicating that it would be more consistent for the onerous contract assessment under IAS 37 to be done at the same level as the impairment assessment under IAS 36. Another Group member has seen arrangements in practice where an entity has a separate contract for each floor of the leased building. In such cases, this Group member thought that it would be appropriate to perform the onerous contract assessment for each floor.

Some Group members noted that entities should assess the specific facts and circumstances when determining the level at which to perform the onerous contract assessment. Although View 4A might be appropriate in some situations, entities should consider whether performing the assessment at a lower level is more appropriate in their specific scenario.

Overall, the Group's discussion raised awareness of the financial reporting considerations of hybrid-work arrangements. No further action was recommended to the AcSB.