Unit of Account for Lease Modification Accounting

Extract, IFRS® Discussion Group Report on the Meeting – September 19, 2023

The Group then discussed whether lease modifications should be assessed at the contract level or at the separate lease component level.

Background

With remote and hybrid work arrangements becoming more common, many entities are reducing their leased office space. Some entities are reducing office space by, for example, reducing the amount of square footage leased on one floor of an office building, or by terminating the lease of an entire floor in an office lease that relates to multiple floors in the same building. If an entity reduces the scope of their lease and the reduction in scope was not part of the original terms and conditions of the lease, this would meet the definition of a lease modification in IFRS 16 *Leases*.

Lease modifications

An entity applies the guidance in paragraphs 44-46B of IFRS 16 to account for lease modifications. Paragraph 44 states that:

> A lessee shall account for a lease modification as a separate lease if both:
>
> (a) the modification increases the scope of the lease by adding the right to use one or more underlying assets; and
>
> (b) the consideration for the lease increases by an amount commensurate with the stand-alone price for the increase in scope and any appropriate adjustments to that stand-alone price to reflect the circumstances of the particular contract.

Since neither of the above conditions would be met when an entity reduces their leased office space, the lessee would not account for the lease modification as a separate lease. For a lease modification that is not accounted for as a separate lease, paragraph 45 of IFRS 16 requires a lessee to:

(a) allocate the consideration in the modified contract applying paragraphs 13-16;
(b) determine the lease term of the modified lease applying paragraphs 18-19; and
(c) remeasure the lease liability by discounting the revised lease payments using a revised discount rate. The revised discount rate is determined as the interest rate implicit in the lease for the remainder of the lease term, if that rate can be readily determined, or the lessee's incremental borrowing rate at the effective date of the modification, if the interest rate implicit in the lease cannot be readily determined.

For a lease modification that fully or partially decreases the scope of the lease, paragraph 46 of IFRS 16 requires the lessee to decrease the carrying amount of the right-of-use asset to reflect partial or full termination of the lease. Paragraph 46 also requires the lessee to recognize in profit or loss any gain or loss relating to the partial or full termination of the lease.

Separating components of a contract

For a contract that is, or contains, a lease, paragraph B32 of IFRS 16 requires that an entity account for each lease component within the contract as a separate lease component if both of the following criteria are met:

(a) the lessee can benefit from use of the underlying asset either on its own or together with other resources that are readily available to the lessee. Readily available resources are goods or services that are sold or leased separately (by the lessor or other suppliers) or resources that the lessee has already obtained (from the lessor or from other transactions or events); and

(b) the underlying asset is neither highly dependent on, nor highly interrelated with, the other underlying assets in the contract. For example, the fact that a lessee could decide not to lease the underlying asset without significantly affecting its rights to use other underlying assets in the contract might indicate that the underlying asset is not highly dependent on, or highly interrelated with, those other underlying assets.

The Group discussed whether an entity applies the requirements for lease modifications in paragraphs 44-46B of IFRS 16 to the contract as a whole or to each separate lease component.

Fact Pattern 1

- Company X has entered into a lease contract for one floor of a multi-floor office building for a term of 10 years.
- There was no early termination right within the original lease contract.
- In Year 3 Company X determined that they will no longer need a portion of the overall leased space (20 per cent of the floor being leased) beyond Year 5.
- Company X enters into an amendment to the lease agreement with the lessor to terminate the lease on that portion of the floor at the end of Year 5.
- The rental payment for the remaining office space in Years 6 to 10 is reduced proportionately to the reduction in leased space.
- Company X has determined that the lease of one floor of office space represents one lease component.
- The incremental borrowing rate (IBR) was 4 per cent at the inception of the lease and 6 per cent at the date of modification.

Issue 1: How should Company X account for the partial termination of one leased floor?

Analysis

The change in leased floor space is a reduction in the scope of the lease. Since this reduction in scope was not part of the original terms and conditions of the lease, this meets the definition of a lease modification. Since this lease modification reduces the scope of the lease, Company X would

not account for the modification as a separate lease; that is, paragraph 44 of IFRS 16 does not apply.

In accordance with the requirements in paragraphs 45-46 of IFRS 16 and following Illustrative Example 17, “Modification that decreases the scope of the lease,” Company X would first reduce the right-of-use asset and lease liability to reflect partial termination of the lease and recognize any difference in profit or loss. Then it would adjust the lease liability to its modified carrying amount based on the revised discount rate of 6 per cent at the effective date of the modification, with a corresponding adjustment to the right-of-use asset.

The Group’s Discussion

The Group agreed with the analysis. Some Group members indicated it would be unlikely for a lessor to reduce the lease payments proportionately to the reduction in leased space and accept no termination penalty because the fair value per square foot of leased space normally fluctuates throughout the lease term. A lessee would also normally consider their ability to re-lease the space to another lessee in their negotiation of the modified lease payments and any termination penalty assessed. Therefore, although the Group agreed that the analysis is technically accurate, it thought that this fact pattern (or a similar fact pattern) might be unlikely to occur.

Fact Pattern 2

- Company X has entered into a lease contract for five floors of a multi-floor office building for a term of 10 years.
- The stand-alone selling price on a per-square-foot basis is the same for each floor throughout the 10-year lease.
- There was no early termination right within the original lease contract.
- In Year 3, Company X determined that they will no longer need a portion of the overall leased space (one floor) beyond Year 5.
- Company X enters into an amendment to the lease agreement with the lessor to terminate the lease of one floor at the end of Year 5.
- As part of the amended agreement, Company X does not need to pay a termination penalty.
- The rental payment for the remaining office space in Years 6 to 10 is reduced proportionately to the reduction in leased space.
- Company X has determined that each floor in the office building represents a separate lease component.
- There are no non-lease components in the contract.
- The IBR was 4 per cent at the inception of the lease and 6 per cent at the date of modification.

Issue 2: How should Company X account for the termination of an entire floor in a multi-floor lease?

Analysis

View 2A – The unit of account for lease modifications is at the contract level and Company X should remeasure the entire contract (i.e., all floors)

Proponents of this view think that the definitions of a lease and a lease modification in Appendix A of IFRS 16 indicate that lease modifications should be applied at the contract level and not at the separate lease component level because they refer to the contract as a whole, and not the component that has been modified. Appendix A defines a "lease" as, "A contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration."

Appendix A 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 (for example, adding or terminating the right to use one or more underlying assets, or extending or shortening the contractual lease term)."

They note that the guidance in the standard on separating components of a lease refers only to the separation of lease components and the allocation of consideration between the various components. It does not indicate that each component constitutes a separate lease. Furthermore, paragraph 45(a) of IFRS 16 requires the lessee to allocate the consideration in the modified contract applying paragraphs 13-16. Proponents of this view think that these paragraphs require an allocation of consideration to non-lease components and lease components, which supports the view that lease modifications should be accounted for at the contract level.

If Company X accounts for the lease modification at the contract level, they would first reduce the carrying amount of the right-of-use asset and lease liability to reflect partial termination of the lease, recognizing any difference in profit or loss. Then they would adjust the lease liability to its modified carrying amount based on the revised discount rate (i.e., the IBR of 6 per cent) at the effective date of the modification, with a corresponding adjustment to the right-of-use asset.

Proponents of this view note that the accounting outcome under this approach would be consistent with the accounting outcome under Issue 1. They think that the accounting outcomes under Issue 1 and Issue 2 should be similar because the lease modifications under both fact patterns are economically similar.

View 2B – The unit of account is at the separate lease component level and Company X should remeasure only the amended lease component of the contract (i.e., the amended floor)

Entities often account for a lease of assets constituting separate lease components as one lease because the inputs used (e.g., lease term, lease payments, discount rates) are the same for each of the lease components. However, the requirements in paragraphs 12, B12 and B32 of IFRS 16 imply

that the accounting for leases should be performed at the separate component level. Therefore, proponents of this view think that entities would not be precluded from applying lease modification accounting at the separate lease component level, even when the entity accounts for the separate lease components as one lease, and especially when the unmodified lease components are not impacted by the lease modification.

In this fact pattern, the lease payments are reduced proportionately to the reduction in overall leased space and the allocation of lease payments to the space that will continue to be leased will remain unchanged. Since the individual floors in the office space are assessed and accounted for separately, terminating the right to use one floor is a reduction in the scope of one lease component. There is, however, no change in consideration related to the remaining four floors. Since these lease components have not been modified, an entity would not apply the requirements in paragraph 45 of IFRS 16 to them.

If Company X accounts for the lease modification at the separate lease component level, they would first reduce the carrying amount of the right-of-use asset and lease liability attributable to the modified lease component to reflect the early termination of that component, recognizing any difference in profit or loss. Then they would adjust the lease liability attributable to the modified lease component to its modified carrying amount based on the revised discount rate (i.e., the IBR of 6 per cent) at the effective date of the modification, with a corresponding adjustment to the right-of-use asset.

Proponents of this view note that Company X would not be required to remeasure the lease liability for the unmodified lease components using the revised discount rate. Since the revised discount rate would need to be applied to the contract as a whole under Issue 1 and Issue 2 – View 2A, this approach would result in a different accounting outcome.

View 2C – There is an accounting policy choice to be made as to whether lease modification accounting is at the "contract" level or "separate lease component" level

Proponents of this view think that Views 2A and 2B both have merit. In the absence of specific guidance on this matter, they think it is reasonable for entities to apply the requirements in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* and establish an accounting policy choice. The Group was also asked if their views on Issue 2 would change if, as a result of the lease amendment, there was a termination payment that was payable up front or over time.

The Group's Discussion

Several Group members indicated that Fact Pattern 2 depicts facts and circumstances that they do not normally observe. They noted that in this fact pattern, Company X negotiated the termination of one floor in isolation. The Group members indicated that contract modifications normally involve renegotiations of the entire contract. The modified lease payments in the renegotiated contract and any termination penalty charged might depend on several factors, including current market conditions, the floors included in the modified lease and the lessor's ability to lease the vacated floor(s) to other tenants at a more or less favourable rate. They also noted that in many offices the

fair value per square foot of leased space is different on each floor, and the relative value of each floor often fluctuates throughout the lease term. These factors would all need to be considered as part of the renegotiation of the lease.

Most Group members agreed with View 2A because they thought this approach better reflects the economics of a transaction when the entire lease is renegotiated upon the termination of one floor. Other Group members agreed with View 2A because they thought the wording of the lease modification guidance implies that the lessee should allocate the consideration in the modified contract to the modified lease components (in accordance with paragraphs 13-16 of IFRS 16) after the entity determines that a contract modification has occurred (i.e., the standard does not say to allocate consideration to lease components first, and then assess whether a lease component has been modified). They noted that IFRS 16 does not provide specific guidance on whether a lessee should allocate the modified consideration at the contract level or separate lease component level when a contract is modified. However, they thought this view is consistent with the application of paragraph 13 of IFRS 16. They noted that they supported this view whether or not the lessor charged a termination penalty. Some Group members thought that Company X should apply the lease modification guidance to the contract as a whole regardless of whether all the lease components are identical. They thought that this would result in a more consistent application of the standards to different facts and circumstances. One Group member noted that paragraph 44 of IFRS 16 indicates that an entity shall treat a lease modification as a separate lease only when the modification represents an increase in the scope of the lease and the consideration for the lease increases by an amount commensurate with the stand-alone price for the increase in scope. Since Company X decreased the scope of their lease, this transaction is not in scope of paragraph 44. Therefore, they thought that Company X should remeasure the lease liability for the entire contract. They also thought that, in most situations, remeasuring the entire lease liability based on the revised discount rate would not be onerous, as following View 2B, there is already a requirement to determine an updated incremental borrowing rate for the modified component. One Group member thought that the accounting outcome for Fact Patterns 1 and 2 should be the same because these fact patterns are economically similar.

Some Group members supported View 2B. They thought that lease modifications should be accounted for at the separate lease component level because this is the level at which the contract is accounted for. One Group member noted that the standard does not require an adjustment to the incremental borrowing rate on the existing lease components when the modification increases the scope of a lease and the consideration for the lease increases by an amount commensurate with the stand-alone price for the increase in scope. Therefore, they thought that it would be more consistent if entities did not adjust the discount rate on unmodified lease components when the scope of the lease decreases. However, other Group members noted that the guidance in paragraph 45 and Illustrative Example 17 of IFRS 16 demonstrate that an entity is required to adjust the discount rate when the scope of the lease decreases. One meeting participant raised an alternative fact pattern when Company X enters into five separate but identical leases at the same time and then subsequently terminates only one of those leases. They thought that in this alternative fact pattern the lessee would apply the lease modification guidance to the terminated

lease only. They thought the accounting outcome should be the same when a lessee terminates one lease or one lease component. One Group member noted that paragraph B2 of IFRS 16 provides application guidance on the combination of contracts that are entered into at or near the same time with the same counterparty. They indicated that the five contracts in this alternative fact pattern would be accounted for as a single contract if one of the criteria in paragraph B2 is met.

Some Group members thought that Views 2A and 2B both have merit, depending on the facts and circumstances, and that an entity should apply judgment to determine which method best reflects the economics of the transaction (i.e., this is not an accounting policy choice as indicated in View 2C). They noted that an entity would be required to disclose this accounting policy if it is material to the entity, and that this disclosure should specify that the lease and non-lease components are identified at the inception of the lease, and not at the point of lease modification. Some Group members thought that accounting for the lease modification at the separate lease component level would only be appropriate if each of the lease components is identical, which is unlikely to be the case. One Group member who agreed with View 2B indicated that they would agree with View 2A if the lessor charged a termination penalty to Company X. However, they noted that the lessor may not charge a termination penalty if the lease payments on the remaining floors are at a favourable rate. One Group member noted that paragraphs 4.48-.55 of the *Conceptual Framework for Financial Reporting* provides guidance on how to identify the unit of account for a transaction. They thought that entities should refer to this guidance when determining the unit of account for a lease modification. However, one Group member noted that paragraphs SP1.1-1.3 specify that the Conceptual Framework is not a Standard, and that nothing in the Conceptual Framework overrides any requirement in a Standard.

Overall, the Group's discussion raised awareness of views on the unit of account for lease modification accounting. The Group acknowledged that there are diverse views on this matter. However, some Group members noted that, in many cases, the impact of applying the lease modification requirements to the modified component or to the contract as a whole may be immaterial because the difference is an offset to the right of use asset. Therefore, no immediate actions were recommended to the AcSB as a result of this discussion. The Group recommended that the Board consider highlighting observations from this discussion in its response to the IASB's Request for Information, "Post-implementation Review of IFRS 16," when it is issued.