IFRS 9 and IFRS 16: Distinguishing Between a Lease Modification and an Extinguishment of a Lease Liability

Extract, IFRS® Accounting Standards Discussion Group Report on the Meeting – September 12, 2024

Background

In July 2024, the IASB issued "Annual Improvements to IFRS Accounting Standards – Volume 11," which amended paragraph 2.1(b)(ii) of IFRS 9 *Financial Instruments*. The amendment clarified how a lessee should account for the derecognition of a lease liability. Specifically, there was uncertainty about whether a lessee was required to recognize any resulting gain or loss in profit or loss. Paragraph BC2.44 in the Basis for Conclusions to the amendment notes that:

> …The amendment clarifies that, when a lessee has determined that a lease liability has been extinguished in accordance with IFRS 9, the lessee is required to apply paragraph 3.3.3 and recognise any resulting gain or loss in profit or loss.

Some interested and affected parties also asked the IASB to clarify the interaction between IFRS 9 and IFRS 16 *Leases* – specifically, how a lessee distinguishes between a lease modification as defined in IFRS 16 and an extinguishment (or partial extinguishment) of a lease liability. The IASB concluded that clarifying that interaction between IFRS 9 and IFRS 16 is beyond the scope of an annual improvement. Therefore, the Group discussed which standard applies (i.e., IFRS 9 or IFRS 16) when the consideration in a lease decreases because the lessor waives its right to a portion of the lease payments. The objective of this discussion is to raise awareness and determine whether there is diversity in the accounting for these transactions.

Fact Pattern 1

- Restaurant A leases restaurant space within a shopping centre from Lessor B.
- Fixed lease payments of $3,000 per month are due in advance on the first day of each month.
- The lease term ends on December 31, 2025.
- There are no extension, termination, or purchase options.
- There are no non-lease components included in the contract.
- On June 30, 2024, there are 18 months remaining in the lease term. The lease liability at that time is $54,000 (discounting is ignored for the purposes of this discussion).
- Due to maintenance issues in the shopping centre, on July 1, 2024, Lessor B irrevocably waives the monthly payment of $3,000 that was otherwise due on that day (i.e., the July 1,

2024, lease payment of $3,000 becomes currently due and then is waived). All other future lease payments remain unchanged.

Issue 1: How should Restaurant A (the lessee) account for a modification that waives a monthly payment only?

Analysis

View 1A – Lease modification under IFRS 16

Proponents of this view think that forgiving a currently due lease payment is a change in the consideration for a lease that was not part of the original terms and conditions of the contract. Therefore, it meets the definition of a lease modification in IFRS 16. IFRS 16 provides guidance on the subsequent measurement of lease liabilities, including lease modifications. Accounting for modifications to lease contracts, including any impact to the related lease liabilities, is therefore within the scope of IFRS 16.

While the derecognition requirements in paragraph 3.3.1 of IFRS 9 may be considered to determine when the liability for the July 1, 2024 lease payment should be derecognized (i.e., when the obligation specified in the contract is discharged, cancelled, or expires), paragraph 3.3.3 (which requires that the de-recognition of a lease liability should be recognized in profit or loss) is not applicable because there is relevant guidance in IFRS 16. In accordance with paragraph 44(b) of IFRS 16, the lease modification is not accounted for as a separate lease because the consideration for the lease did not increase. In addition, the lease modification did not involve a decrease in the scope of the lease. Therefore, in accordance with paragraph 46 of IFRS 16, the lessee should account for the remeasurement of the lease liability by adjusting the carrying amount of the right-of-use asset.

View 1B – Extinguishment of a financial liability under IFRS 9

Proponents of this view think forgiving a currently due lease payment is an extinguishment of a financial liability as described in paragraph 3.3.1 of IFRS 9. Therefore, they think it should be recognized in profit or loss in accordance with paragraph 3.3.3. They note that this accounting treatment was clarified by the IASB in their July 2024 "Annual Improvements to IFRS Accounting Standards – Volume 11." Paragraph BC2.44 in the Basis for Conclusions to those amendments states that:

> …The amendment clarifies that, when a lessee has determined that a lease liability has been extinguished in accordance with IFRS 9, the lessee is required to apply paragraph 3.3.3 and recognise any resulting gain or loss in profit or loss.

As such, a lessee applying paragraph 3.3.1 of IFRS 9 should also apply paragraph 3.3.3.

Group members were also asked to consider whether their views on Issues 1, 2, and 3 would change if on July 1, 2024, Lessor B had waived past due amounts rather than currently due amounts (e.g., consider if Restaurant A had not made lease payments for the six months from January to June 2024, and Lessor B decided to waive these past due amounts).

The Group's Discussion

Most Group members agreed that, depending on the facts and circumstances, it can be unclear whether an entity should apply IFRS 9 or IFRS 16 when a lessor waives its right to a portion of the lease payments in a contract. This is because the amendment made to IFRS 9 does not appear to resolve the tension between the scope of IFRS 9 versus IFRS 16. In this example, from the lessee's perspective, the irrevocable waiver of a lease payment currently due could fall within the scope of IFRS 16 as it meets the definition of a lease modification which includes a change in the consideration for a lease, and could also fall within the scope of IFRS 9, paragraph 3.3.1 which applies to partial extinguishments of financial liabilities (including lease liabilities). They emphasized that an entity should consider all applicable facts and circumstances when determining which standard to apply. However, in this fact pattern, most Group members said they could not preclude either View.

One Group member favoured applying IFRS 9 in this fact pattern because the irrevocable waiver of a lease payment could qualify as a partial extinguishment of the lease liability in the scope of paragraph 3.3.1 of IFRS 9. However, since the definition of a lease modification in IFRS 16 includes changes in the consideration for a lease, it may be difficult to preclude Restaurant A from applying IFRS 16. Another Group member thought, depending on the fact pattern, an entity might apply the derecognition requirements in IFRS 9 when a lessor forgives past due amounts, and the lease modification requirements in IFRS 16 when a lessor agrees to reduce future lease payments. They noted that a lessor forgiving a currently due lease payment falls in between the past and the future, making it challenging to determine which standard to apply in this case.

Some Group members thought that determining which standard to apply is dependent on whether the whole lease contract or the individual lease payments is determined to be the unit of account for the transaction. If the whole lease contract is the unit of account, they thought the forgiveness of lease payments should be accounted for as a lease modification under IFRS 16. However, if the individual lease payments are the unit of account, they thought the forgiveness of past and currently due payments should be accounted for as an extinguishment of a lease liability under IFRS 9.

Several Group members noted that the amendments to IFRS 9 clarified that the gain or loss should be recognized in profit or loss if the lessee concludes that the forgiveness of the currently due lease payment is an extinguishment of the lease liability. One Group member raised that the lessee should consider whether the right of use asset is impaired if the forgiveness of the lease payment is recognized in profit or loss. Another Group member raised that if the forgiveness of the lease payment is material to the entity, it might need to disclose its accounting policy as a significant judgment.

Fact Pattern 2

- Assume the same fact pattern as Fact Pattern 1, except Lessor B also agreed to extend the lease term by six months to June 30, 2026.

Issue 2: How should Restaurant A (the lessee) account for a modification that waives a monthly payment and extends the lease term?

Analysis

View 2A – Lease modification under IFRS 16

Like View 1A, proponents of this view think forgiving a currently due lease payment is a change in the consideration for a lease that was not part of the original terms and conditions of the contract. Therefore, it meets the definition of a lease modification in IFRS 16. They noted that extending the lease term also qualifies as a lease modification in IFRS 16 as it changes the scope of the lease. As such, the multiple changes to the lease contract are within the scope of the lease modification guidance in IFRS 16. The guidance in paragraph 3.3.3 of IFRS 9 on where the impact of derecognizing a financial liability should be recognized (i.e., in profit or loss) is not applicable because there is relevant guidance in IFRS 16.

View 2B – Partly an IFRS 9 extinguishment and partly an IFRS 16 lease modification

Like View 1B, proponents of this view think forgiving a currently due lease payment is an extinguishment of a financial liability as described in paragraph 3.3.1 of IFRS 9, even when the modification is part of a broader contract modification. Therefore, they think the forgiveness should be recognized in profit or loss in accordance with paragraph 3.3.3 of IFRS 9. However, the extension to the lease term is a lease modification that should be accounted for in accordance with the lease modification guidance in IFRS 16.

The Group's Discussion

Most Group members agreed with View 2A. They thought the forgiveness of the currently due lease payment combined with the extension of the lease term should be accounted for as a lease modification under IFRS 16. They noted these two amendments were likely negotiated together, making it challenging to account for them separately. For example, one Group member noted that the lessor might not have agreed to waive the currently due lease payment if the lessee did not agree to the six-month term extension. Another Group member noted that the market rate for leased space often fluctuates over time, and that the six-month term extension might not be at the current market rate and may be influenced by other factors, such as the forgiveness of currently due lease payments. If the rent for the extended term is above the market rate, even though the lessee benefits from the waiver, it will incur a higher cost for rent during the extension period. This raises the question as to whether this cost is part of the forgiveness under IFRS 9, is part of the future lease payments under IFRS 16, or both. Therefore, depending on the facts and circumstances, it might be challenging to allocate the revised consideration between the extinguishment of the lease liability under IFRS 9 and the lease modification under IFRS 16. One Group member also mentioned a recent discussion by the Group on the unit of account for lease modification accounting. They noted that this discussion highlighted some of the practical challenges associated with allocating revised lease consideration when there is a contract modification.

Some Group members noted their view on this issue depends on whether the whole lease contract or the individual lease payments are the unit of account. If the whole lease contract is the unit of account, they supported View 2A. If the individual lease payments are the unit of account, they would consider splitting the amendment to the contract between IFRS 9 and IFRS 16. However, they acknowledged the practical challenges associated with doing so.

Fact Pattern 3

- Assume the same fact pattern as Fact Pattern 1, except Lessor B also agrees to reduce the monthly payment that will be due on August 1, 2024, to $2500. All other future lease payments remain unchanged.

Issue 3: How should Restaurant A (the lessee) account for a contract modification that waives a monthly payment and reduces a future monthly payment?

Analysis

View 3A – Lease modification under IFRS 16

Proponents of this view think forgiving a currently due lease payment and reducing a future lease payment are both changes in the consideration for a lease that was not part of the original terms and conditions of the contract. Therefore, they both meet the definition of a lease modification in IFRS 16. Since both modifications are decreases in the consideration for the lease, the change is not accounted for as a separate lease. The modifications also do not decrease the scope of the lease. Per paragraph 46 of IFRS 16, the modification is accounted for as an adjustment to the lease liability and the right-of-use asset.

View 3B – Partly an IFRS 9 extinguishment and partly an IFRS 16 lease modification

Like View 1B, proponents of this view think forgiving a currently due lease payment is an extinguishment of a financial liability as described in paragraph 3.3.1 of IFRS 9, even when the modification is part of a broader contract modification. However, the reduction of the future lease payment is a lease modification that should be accounted for in accordance with the lease modification guidance under IFRS 16.

The Group's Discussion

Most Group members agreed with View 3A. They thought the reduction of a future lease payment was within the scope of the lease modification guidance in IFRS 16. They also noted that the agreement to waive the currently due lease payment and reduce the future payment were likely negotiated together. Therefore, it could be challenging to account for them separately for the reasons highlighted in the Group's discussion on Issue 2.

Some Group members raised that there might be an additional view which is applying the derecognition guidance in IFRS 9 to both the waiver of the currently due lease payment and the reduction of the future payment. They thought this additional view might also be supportable as the reduction in cash outflows is a partial derecognition of the lease liability within the scope of IFRS 9. As noted in the discussion on Issue 1, some might find this more supportable if the entity determines that the unit of account is the individual lease payments rather than the whole contract.

The Group noted that the IASB is conducting its post-implementation review of IFRS 16 and expects to issue its Request for Information in the first half of 2025. Therefore, the Group recommended that the AcSB consider highlighting observations from this discussion in its response to the IASB's Request for Information.