IFRS 16: Accounting for COVID-19 Related Rent Concessions

Extract, IFRS® Discussion Group Report on the Meeting – May 27, 2020

Many businesses that provide non-essential services have had to temporarily suspend their operations because of COVID-19. As a result, businesses may have received, or seek to receive, rent concessions from their landlords.

In practice, there are generally two types of rent concessions – rent deferrals and rent abatements. Rent deferrals involve the landlord agreeing to defer rent payments to a later period within the lease term. In contrast, rent abatements involve the landlord agreeing to a permanent forgiveness of specified rent payments or portions thereof.

Lessees are required to assess whether a rent concession granted due to COVID-19 is a lease modification under IFRS 16 *Leases*. If the rent concession qualifies as a lease modification, lessees would have to apply the lease modification requirements in IFRS 16, which includes a requirement to remeasure the lease liability using a revised discount rate.

In April 2020, the IASB issued Exposure Draft, "Covid-19-Related Rent Concessions", to provide lessees with relief (hereinafter referred to as "Exposure Draft"). The proposed amendments to IFRS 16 include a practical expedient that permits lessees not to assess whether certain COVID-19 related rent concessions are lease modifications. The IASB has discussed stakeholders' feedback on the proposed amendments at its May 15, 2020 supplementary IASB meeting. The IASB is expected to issue the final amendments by the end of May 2020.[1]

The Group discussed several fact patterns to highlight application considerations relating to the practical expedient based on what is expected from the final amendments to IFRS 16. The fact patterns assume that the amendments will be available for application in financial statements for reporting periods ending June 30, 2020.

At the time of this May 27, 2020 meeting, the Group has not seen the final amendments. As a result, the Group's views are based on the Exposure Draft's proposals and the IASB's discussion at the May supplementary meeting. The Group expects that the practical expedient will apply only to rent concessions occurring as a direct consequence of COVID-19, and only if all the following conditions are met:

(a) the change in lease payments results in revised consideration for the lease that is substantially the same as, or less than, the consideration for the lease immediately preceding the change;

[1] The Group's discussion took place prior to the issuance of the final amendments on May 28, 2020.

(b) any reduction in lease payments affects only payments originally due by a specified date[2]; and

(c) there is no substantive change to other terms and conditions of the lease.

Fact Pattern 1

- A lessee has stopped making payments to its lessor in April and May 2020 because it had to temporarily close its business due to COVID-19. However, no written agreement has been reached by the lessee to obtain a rent concession from the lessor.

Issue 1: Can the lessee apply the practical expedient?

Analysis

In practice, negotiating rent concessions may take some time to accomplish. Although some lessees may not be paying their rent as it comes due, formal agreement with the landlord about alternative payment terms may not yet be reached. If a *force majeure* clause exists in the agreement, the applicability and effects of such a clause in a pandemic situation may not be certain and could take some time to determine.

Without a written agreement, the lessee cannot apply the practical expedient as a rent concession has not been agreed to by the lessee and lessor. The lessee would continue to account for the lease in accordance with the original terms because there is still a contractual obligation to make those payments, including any penalties for non-payment or late payment contemplated in the lease.

The Group's Discussion

Group members generally agreed with the above analysis, noting that there is no change to a lessee's obligation unless there is an agreement between the lessee and lessor.

Group members acknowledged that negotiating rent concessions may take some time to accomplish. Lessees may be in different stages of their negotiations, ranging from early stage to final stage pending formal sign-off. A lessee may have also reached an oral agreement with the lessor regarding rent concessions. One Group member observed there could be a situation in which a lessor provides a rent concession that is subject to the lessor obtaining a government subsidy. Concessions that are conditional on future events are discussed under Issue 5 below. Group members noted that contracts can be written, oral or implied by an entity's customary business practices, as noted in IFRS 15 *Revenue from Contracts with Customers*. Therefore, an entity would need to exercise judgment to assess whether its circumstances constitute having an agreement with the lessor to obtain rent concessions.

Other Group members raised additional points for a lessee to consider in its analysis. For example, if a lessee has not obtained a rent concession from the lessor, the lessee should consider whether a default under the lease agreement may trigger a breach in other agreements that may have cross-default provisions. This situation may give rise to other accounting and disclosure implications, such as potential disclosures under IAS 1 *Presentation of Financial Statements* and IAS 37 *Provisions,*

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[2] In the final amendments to IFRS 16, the second condition states, "any reduction in lease payments affects only payments originally due on or before 30 June 2021 (for example, a rent concession would meet this condition if it results in reduced lease payments on or before 30 June 2021 and increased lease payments that extend beyond 30 June 2021)."

Contingent Liabilities and Contingent Assets. An entity should also consider the need for non-adjusting subsequent event disclosures under IAS 10 *Events after the Reporting Period* if it has obtained agreement with the lessor after the reporting date.

Fact Pattern 2

- Same as fact pattern 1, except the lessee and lessor have agreed on a rent concession.

Issue 2: How does the lessee assess whether the revised consideration under the lease is "substantially the same as or less than" the original consideration for the lease before the rent concession?

Analysis

Once a rent concession is agreed to by the lessor and lessee, the lessee should determine whether the rent concession qualifies for the practical expedient. In the Exposure Draft, paragraph BC5(a) of the Basis for Conclusions states, in part, the following:

> The Board is of the view that a change that results in more than an insubstantial increase in total payments for the lease could not result solely from a covid-19-related rent concession (as described in this Exposure Draft), except to the extent the increase reflects the time value of money.

The Exposure Draft does not specify whether the lessee should use discounted or undiscounted lease payments to assess whether the rent concession qualifies for the practical expedient. Furthermore, the practical expedient is also silent on whether the assessment should be made over the remaining lease term or the entire lease term. Therefore, lessees will have to apply judgment.

The Group's Discussion

Some Group members thought that it should be apparent if a lease amendment pertains only to rent concessions occurring as a direct consequence of COVID-19, or if the lease amendment includes other changes to the terms and conditions of the arrangement. Some Group members discussed a situation when there is an increase to the revised lease consideration. In that situation, an entity would need to assess whether the increase is within the scope of the practical expedient by considering if the increase approximates a market interest rate to reflect the time value of money. A lease agreement may also change from fixed to variable rent payments. In this case, a lessee would need to determine whether the lease amendment is within the scope of the practical expedient.

Regarding whether the assessment should be made over the remaining or the entire lease term, some Group members thought that it should be based on the remaining lease term. The practical expedient is meant to cover scenarios where leases are modified as a result of COVID-19. Therefore, it seems reasonable to consider the change in payments relative to the future consideration under the leasing arrangement rather than relative to the entire leasing arrangement.

Some Group members noted that the standard is silent on whether discounted or undiscounted lease payments should be used in the assessment. Therefore, entities will need to apply judgment and that judgment should be applied consistently from transaction to transaction.

Fact Pattern 3

- A lessee and lessor have agreed to a rent deferral that results in total lease payments that are substantially the same when compared to the original lease.
- The lessee is not required to pay fixed lease payments of $100 per month in May, June and July 2020 until a later period in the lease term. For example, the lessee might be required to pay rent of $100 per month for each of October, November and December 2021, in addition to the rent normally due in those months.
- Assume that the lessee has elected to take the practical expedient in the Exposure Draft.

Issue 3: What are the implications of a rent deferral under the proposals in the Exposure Draft?

Analysis

In the Exposure Draft, paragraph BC7(b) in the Basis for Conclusions states:

> A change in lease payments that reduces payments in one period but proportionally increases payments in another does not extinguish the lessee's lease liability or change the consideration for the lease— instead, it changes only the timing of individual payments. In this case, a lessee would continue to reduce the lease liability for payments made to the lessor applying paragraph 36(b) of IFRS 16.

However, paragraph 36(a) of IFRS 16 also indicates that after the commencement date, a lessee shall measure the lease liability by increasing the carrying amount to reflect interest on the lease liability. If the lessee follows its original lease payment schedule, interest will then accrete over the months in which no lease payments are made. This creates a potential gain on settlement of the lease obligation because the interest credited to the lease liability will not be paid given the lessee would only need to make the original deferred lease payments. The accounting in such circumstances may require the exercise of judgment.

The Group's Discussion

Group members discussed the analysis above and provided several comments for consideration.

One approach is to remeasure the lease liability to reflect the revised lease payment schedule using the original discount rate and recognize the remeasurement gain in profit or loss. A few Group members discussed another approach of recording the remeasurement gain as an adjustment to the right-of use asset. This approach is similar to the remeasurement guidance in IFRS 16 for modifications, except that the adjustment is calculated using the original discount rate instead of a revised discount rate. Some Group members thought this approach seemed logical but acknowledged it could be difficult to support based on the expected wording of the amendments to IFRS 16.

Other approaches may be possible. For example, one approach may involve setting up a deferred credit that is taken into income over the term of the lease. Group members acknowledged that this is a potential application issue and discussions will likely continue after the IASB issues the final amendments. The final amendments should be assessed to see if there is wording that may help address this matter.

Fact Pattern 4

- A retailer was required to close its store in early April 2020 due to government-imposed restrictions. The retailer was supposed to pay $100 per month in rent for May, June and July 2020.
- On April 30, 2020, the landlord agreed in writing to forgive those months' rents. The forgiveness is enforceable even if the government restrictions are lifted before the end of the three-month period.
- Assume that the lessee has elected to take the practical expedient in the Exposure Draft.

Issue 4: When should the lessee recognize the forgiveness of lease payments?

Analysis

In the Exposure Draft, paragraph BC7(a) of the Basis for Conclusions states:

> A lessee applying the practical expedient would generally account for a forgiveness or waiver of lease payments as a variable lease payment applying paragraph 38 of IFRS 16. The lessee would also make a corresponding adjustment to the lease liability—in effect, derecognising the part of the lease liability that has been extinguished by the forgiveness or waiver of lease payments.

Paragraph 38(b) of IFRS 16 indicates that a lessee recognizes in profit or loss variable lease payments not included in the measurement of the lease liability in the period in which the event or condition that triggers those payments occurs.

The event or condition that triggered the negative variable lease payment is the agreement to forgive three months' rent on an unconditional basis. Therefore, the benefit resulting from the forgiveness of lease payments should be recognized when the agreement is reached (i.e., on April 30, 2020). This is also consistent with derecognition guidance in paragraph 3.3.1 of IFRS 9 Financial Instruments, which applies to lease liabilities.

The Group's Discussion

Group members agreed with the above analysis.

Fact Pattern 5

- Same as Fact Pattern 4, except the forgiveness of rent is conditional on a future event (i.e., the forgiveness of rent expires when the government allows the lessee's business to reopen).

Issue 5: If the forgiveness of rent is conditional on a future event, when should the lessee recognize the forgiveness of lease payments?

Analysis

It would seem appropriate to recognize the benefit resulting from the forgiveness of lease payments with each passing month that the government restriction remains in effect.

The Group's Discussion

Group members agreed with the above analysis. One Group member noted that the forgiveness period could go beyond the period covered by the practical expedient. Therefore, entities would need to assess whether such rent forgiveness would be within the scope of the practical expedient.

Fact Pattern 6

- A retailer leases a store. Due to the government-imposed restrictions, the store has been closed to the public starting early April 2020. Since that time, no online or phone orders are being fulfilled from the store. There has been no change to the lease agreement between the lessee and lessor.
- The retailer's accounting policy is to depreciate the right-of-use asset relating to the leased store on a straight-line basis over the lease term.

Issue 6: Should the lessee suspend depreciation of the right-of-use asset during the period that the lessee is prevented from using the store?

Analysis

Paragraph 31 of IFRS 16 states:

> A lessee shall apply the depreciation requirements in IAS 16 *Property, Plant and Equipment* in depreciating the right-of-use asset, subject to the requirements in paragraph 32.

Paragraph 32 of IFRS 16 indicates that a lessee depreciates the right-of-use asset from the commencement date to the earlier of the end of the useful life of the right-of-use asset or the end of the lease term, unless the lease transfers ownership of the underlying asset to the lessee.

Paragraphs 31 and 32 of IFRS 16 reinforce the concept that the right to use a property under a lease is a time-based right that diminishes over time. In addition, paragraph 55 of IAS 16 indicates that depreciation does not cease when the asset becomes idle or is retired from active use unless the asset is fully depreciated. Therefore, the lessee should continue to depreciate the right-of-use asset on a straight-line basis during the period it is unable to use the store.

The lessee should also consider whether the inability to use the leased asset is an impairment indicator. If so, it should be tested for impairment in accordance with IAS 36 Impairment of Assets.

The Group's Discussion

Group members agreed with the above analysis.

Group members noted that depreciation should not cease because the lessee has not been evicted from the premises. In a way, the lessee is still using the premises to store its goods. In addition, as the right to use the asset is time based, consumption of the benefit inherent in the asset occurs over time and therefore depreciation of the right-of-use asset is related to the passing of time.

The Group also briefly discussed an alternative view in which an entity may want to reconsider its depreciation method in light of COVID-19 to reflect a new consumption pattern (e.g., unit of production). However, several Group members cautioned that if an entity decides to change its depreciation method, the method needs to represent a better estimate of the consumption of benefits for the remainder of the asset's useful life. As a result, it would generally represent a permanent change in depreciation method rather than a temporary change. These Group members thought it would be rare for an entity to change its depreciation method solely because of COVID-19 because the depreciation method should reflect the consumption of benefits and not the realization of benefits. They emphasized that IAS 16 has specific guidance that addresses idle assets, as noted in the analysis above.

Overall, Group members discussed these six fact patterns to raise awareness of the practical expedient in the forthcoming amendments to IFRS 16. No further action was recommended to the AcSB.

(For a full understanding of the discussions and views expressed, listen to the audio clip).