CHANGES TO LEASE PAYMENTS AS A RESULT OF COVID-19: IASB RESPONDS TO QUESTIONS ABOUT IFRS 16 AND FASB ISSUES A STAFF Q&A FOR TOPICS 840 AND 842 (UPDATE AS AT 14 APRIL 2020)

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BACKGROUND

As a result of the COVID-19 pandemic, changes are being made to lease payments, such as lessors providing 'rent holidays' to lessees. On 10 April 2020, in response to questions which have been raised about the application of IFRS 16 to these changes, the IASB issued a document for educational purposes. This document highlights relevant requirements in IFRS 16 and other IFRS Standards when considering how to account for rent concessions that are granted as a result of the COVID-19 pandemic. A key consideration when applying IFRS 16 is whether the change in lease payments represents a lease modification.

Also on 10 April, the FASB issued a Staff Q&A in respect of Topics 840 and 842 (the US GAAP equivalent of IFRS 16): accounting for lease concessions related to the effects of the COVID-19 pandemic. Although the wording in the lease modifications section of IFRS 16 and Topic 842 is identical, the FASB Staff Q&A goes further than the IASB educational document. This is because, for the IASB to provide the same relief as has been provided under US GAAP, amendments would need to be made to IFRS 16. At its Board meeting on 21 April 2020, the IASB will consider a paper covering leases and COVID-19. At the date of publication of this IFRB, the related agenda paper has not yet been published on the IASB's website.

STATUS
Final

EFFECTIVE DATE
Immediate application - IASB educational guidance and FASB Staff Q&A.

Proposed changes to IFRS 16 would be effective by the end of May.

ACCOUNTING IMPACT
IASB educational document: clarifies whether changes to lease payments arising from the COVID-19 pandemic are regarded as lease modifications and provides related accounting guidance.

IASB Board meeting to be held on 17 April to include proposals to amend IFRS 16 to provide relief to lessees similar to the FASB Staff Q&A

FASB Staff Q&A: provides an accounting policy choice as to whether changes in lease payments arising from the COVID-19 pandemic are regarded as a lease modification

SUMMARY OF THE IASB EDUCATIONAL DOCUMENT

ACCOUNTING FOR COVID-19 RELATED RENT CONCESSIONS APPLYING IFRS 16 *LEASES*

IFRS 16 includes requirements which apply when there are changes to lease payments over the term of a lease. The application of those requirements involves judgement and a number of factors, including in particular whether the changes were contemplated as part of the original terms and conditions of the lease. The IASB notes that changes can arise directly from changes to the lease contract itself or indirectly such as from government actions in response to the COVID-19 pandemic.

If changes to lease payments represent a lease modification, then the lease liability is recalculated based on the revised lease payments, discounted using the lessee's incremental borrowing rate at the date of modification. This can give rise to significant changes in recognised liabilities and related right-of-use assets, in particular when there has been a significant change in the lessee's incremental borrowing rate. The accounting requirements mean that the effects of a lease modification are recognised over the remaining term of the lease.

If changes to lease payments do not represent lease modifications, then the changes in lease payments are typically recognised in the period to which they relate.

ASSESSING WHETHER A CHANGE IN PAYMENTS IS A LEASE MODIFICATION

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

A rent holiday or rent reduction by itself is not a change in the scope of a lease. A change in scope would require a change in the asset or assets being leased, or extending or shortening the period of a lease.

The IASB document notes that when assessing whether there has been a change in the consideration for a lease, it is necessary to consider the overall effect of any change in lease payments. As an example, if a lessee is granted a payment holiday of three months, and the lease payments in future periods are increased such that the present value of the total consideration for the lease is unchanged, there is no lease modification.

If either the scope or the consideration for the lease has changed, it is then necessary to consider whether that change was part of the original terms and conditions of the lease. The IASB document notes that IFRS 16.2 requires consideration of the terms and conditions and all relevant facts and circumstances. These may include contractual and/or statutory provisions, as well as other laws and regulations that will or may result in changes to lease payments if particular events occur or circumstances arise. If changes in lease payments result from the application of clauses in the original contract, or from applicable laws and regulation, then even if those clauses, laws and regulations were not expected to apply, there is no lease modification in accordance with the requirements of IFRS 16.

ACCOUNTING FOR CHANGES IN LEASE PAYMENTS

If changes in lease payments do not result from a lease modification, then the change would typically be accounted for by a lessee as a variable lease payment and accounted for in profit or loss. If a lessor has accounted for the arrangement as an operating lease, then the lessor would recognise lower income from the lessee in that particular period.

If changes in lease payments arise from a lease modification, a lessee remeasures the lease liability by discounting the revised lease payments at the discount rate, determined at the date of the lease modification (whether this is the interest rate implicit in the lease, or the lessee's incremental borrowing rate). Assuming there has not been a reduction in the scope of the lease, a corresponding adjustment is made to the right of use asset. If the underlying lease is an operating lease, a lessor will typically account for the modification as a new lease from the date of the modification and the effects are included in the amount of leasing income recognised in future periods.

PARTIAL LEASE LIABILITY EXTINGUISHMENT

Part of a lessee's obligation might be extinguished by a change in lease payments, such as a release from the obligation to make certain specified payments. In those cases, the lessee would determine whether part of the lease liability should be derecognised by applying the derecognition requirements in IFRS 9.3.3.1. This is because the derecognition requirements of IFRS 9 apply to lease liabilities recognised in accordance with IFRS 16.

IMPAIRMENT OF ASSETS

The IASB's document also notes that right-of-use assets recognised by lessees and items of property, plant and equipment recognised by lessors which are subject to operating leases are within the scope of IAS 36 *Impairment of Assets*. The circumstances that give rise to lease concessions as a result of COVID-19 are considered likely to be an indicator that the assets are impaired. For lessees, this includes the short term effect of loss of earnings during the lease payment concession period, together with potential longer term effects on the economic performance of right-of-use assets. Lessor will need to consider the requirements of IFRS 9 when accounting for the impairment of lease receivables.

DISCLOSURE

The IASB notes that lessees and lessors will need to make appropriate disclosures about the effect that leases have on their financial position, financial performance and cash flows, referencing the requirements of IFRS 16, and IAS 1 *Presentation of Financial Statements*. In addition, significant disclosures may be required in accordance with IAS 36.

SUMMARY OF THE FASB Q&A – TOPICS 840 AND 842: ACCOUNTING FOR LEASE CONCESSIONS RELATED TO THE EFFECTS OF THE COVID-19 PANDEMIC

PURPOSE

The COVID-19 pandemic has severely affected the global economy and significantly disrupted business operations. As a result, many lessors are, or will be, providing lease concessions to lessees. While these concessions vary, payment forgiveness and deferral are expected to be the most common types. Because of the widespread effects of the pandemic, lease concessions are expected to be for substantial numbers of lease contracts for both lessor and lessees.

In order to provide interpretative guidance, the FASB staff developed a Q&A to answer some frequently asked questions. The Q&A apply to entities that have leases affected by the economic disruption caused by the COVID-19 pandemic.

BACKGROUND TO THE ISSUE

Changes to lease payments that are not included in the original lease contract are generally accounted for as lease modifications. As with IFRS 16, for lessees this would result in the lease liability being recalculated at the date of modification, with the revised lease payments being discounted at an updated discount rate determined at that date. Lessors would also account for a lease modification.

The key point addressed in the Q&A is whether concessions granted by lessors as a result of the COVID-19 pandemic could be required to be accounted for by lessors and lessees as lease modifications. If so, then lessors and lessees would have to carry out a detailed analysis of the requirements of each lease contract to determine whether the original contractual terms included a provision for revised lease payments on the occurrence of an event such as the COVID-19 pandemic. If not (and, generally speaking, lease contracts do not contemplate these changes) the lease modification guidance would have to be applied to each individual lease. This could be complex and costly.

QUESTION 1: ARE LEASE MODIFICATIONS RELATED TO THE EFFECTS OF THE COVID-19 PANDEMIC REQUIRED TO BE ACCOUNTED FOR IN ACCORDANCE WITH THE LEASE MODIFICATION GUIDANCE IN TOPIC 842 AND TOPIC 840?

The FASB staff note that, due to the unprecedented and global nature of the COVID-19 pandemic, it may be very difficult for entities to determine whether existing lease contracts contain enforceable rights and obligations for lease concessions and, if they do, whether the concessions actually granted as a result of the COVID-19 pandemic would be consistent with the contractual terms or would instead be lease modifications. The analysis may become even more complex as a result of government programmes which could encourage or require lessors to grant payment holidays or defer payments to later dates. Consequently, without interpretative guidance, the application of the lease modification requirements in Topic 842 and Topic 840 could be both complex and costly.

Although the guidance in those standards deals with lease concessions made in the ordinary course of business, the FASB staff believes that this guidance did not contemplate the wide ranging and significant concessions that are being made as a result of the COVID-19 pandemic. It is also acknowledged that the recognition of the effects of those lease concessions over the remaining term of the lease (as would be required by modification accounting) may not reflect the economics of the concessions.

The FASB staff consider that it is appropriate to make an accounting policy choice available to entities. This policy choice would enable entities to account for lease concessions made as a result of the COVID-19 pandemic 'as though enforceable rights and obligations for those concessions existed (regardless of whether those enforceable rights and obligations for the concessions explicitly exist in the contract).' This means that if an entity chooses to apply the relief made available by the accounting policy choice, the entity will not need to carry out a lease-by-lease analysis.

The accounting policy choice is available for only those concessions that relate to the effects of the COVID-19 pandemic that do not result in a substantial increase in the rights of the lessee or the obligations of the lessor. As an example, it would be available for concessions that result in the total payments required by the modified contract being substantially the same or less than total payments required by the original contract. 'Substantially the same' is not defined, with entities being expected to apply reasonable judgement in making the determinations.

It is noted that some lease concessions will result in the deferral of payments, meaning that the total amount of lease payments remains the same but the timing of payment is different. The FASB staff note that there are multiple ways of accounting for those deferrals, and that in their view none are more preferable than the others. Two are identified in the Q&A, being:

- Account for the concession as if no change to the lease contract were made, with lease income (lessor) and lease expenses (lessee) continuing to be recognised during the deferral period; or
- Account for the deferred payments as variable lease payments.

QUESTION 2: IS AN ENTITY PRECLUDED FROM ACCOUNTING FOR LEASE CONCESSIONS RELATED TO THE EFFECTS OF THE COVID-19 PANDEMIC BY APPLYING THE LEASE MODIFICATION GUIDANCE IN TOPIC 842 AND TOPIC 840?

Because the application of the approach set out in the Q&A is an accounting policy choice, an entity is still permitted to apply the lease modification accounting guidance.

QUESTION 3: DOES AN ENTITY HAVE TO ACCOUNT FOR ALL LEASE CONCESSIONS RELATED TO THE EFFECTS OF THE COVID-19 PANDEMIC EITHER (a) AS IF THE ENFORCEABLE RIGHTS AND OBLIGATIONS TO THOSE CONCESSIONS EXISTED IN THE ORIGINAL CONTRACT OR (b) IN ACCORDANCE WITH THE LEASE MODIFICATION GUIDANCE IN TOPIC 840 AND TOPIC 842?

Entities are not required to apply a single approach to all leases. However, it is noted that, consistent with the requirements of paragraph 842-10-10-1, Topic 842 should be applied consistently to leases with similar characteristics and in similar circumstances.

QUESTION 4: SHOULD AN ENTITY PROVIDE DISCLOSURES ABOUT LEASE CONCESSIONS RELATED TO THE EFFECTS OF THE COVID-19 PANDEMIC?

Disclosures are required about material concessions given (lessors) or received (lessees) and the accounting effect. These need to be sufficient to enable users of financial statements to understand the nature and financial effect of those lease concessions.

BDO COMMENT

The clarifications in the IASB document are not the same as the interpretative guidance in the FASB Staff Q&A, with the US GAAP guidance going significantly further. However, as noted above, the IASB does not have a 'Staff Q&A' available to it, and in order to make similar changes to IFRS it would be necessary to amend IFRS 16 (see below).

For US GAAP reporters, we understand that the SEC Staff would not object if an entity treats lease concessions (forgiveness or deferrals) either as lease modifications, or as set out in the FASB Staff Q&A. However, in the same way as the FASB, the SEC would limit the application of the FASB Staff Q&A approach to concessions that are directly linked to the COVID-19 pandemic.

UPDATE AS AT 14 APRIL 2020

The IASB has announced that it will hold an additional Board meeting on Friday 17 April. One of the items on the agenda for that meeting is 'IFRS 16 and COVID-19: Accounting for COVID-19 related lease concessions'. In the agenda paper it is proposed that amendments are made to IFRS 16 for lessee accounting that would be similar to those set out in the FASB Staff Q&A. However, no changes to lessor accounting in accordance with IFRS 16 have been proposed. The IASB Staff recommendation is for IFRS 16 to be amended to:

> (a) provide lessees with an exemption from assessing whether a COVID-19-related rent concession is a lease modification;
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> (b) require lessees that apply the exemption to account for COVID-19-related rent concessions as if they were not lease modifications;
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> (c) require lessees that apply the exemption to disclose that fact; and
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> (d) require lessees to apply the exemption retrospectively in accordance with IAS 8, but not require them to restate prior period figures. Instead, a lessee would recognise any difference arising on initial application of the amendment in opening retained earnings (or other component of equity, as appropriate) in the annual reporting period that includes the date of initial application.

In addition, the IASB Staff recommend that the amendments would be effective immediately on issue of the final amendment. In order that any amendments can be finalised as quickly as possible, the Trustees would be asked to approve a shortened comment period of 14 days. Although the shortest comment period available under the IASB's normal due process is 30 days, if 75% of the Trustees agree, then it is possible for the comment period to be shortened, although a comment period cannot be dispensed with.

Under the proposed approach, the amendments could be finalised and effective by the end of May 2020, which would allow entities with 31 March period/year ends to utilise them. Although the amendments might not be available to entities with annual reporting periods ended 31 January or 29 February 2020, the Staff expect that, given the timing of developments in relation to the COVID-19 pandemic, there are likely to have been relatively few related amendments to lease payments before March 2020.