

COVID-19 related financial reporting issues



Leases

As a result of COVID-19, a lessor and a lessee might renegotiate the terms of a lease or a lessor might grant a lessee a concession of some sort in connection with lease payments. In some cases, a lessor might receive compensation from a local government as an incentive to offer such concessions. **Is it a modification of a lease agreement?** Is this an immediate gain in profit or loss or adjustment to right-of-use asset in lessee's books?

Both lessors and lessees should consider the requirements of IFRS 16 - *Leases* and whether the concession should be accounted for as variable lease payments, lease modification or something else.

Leases

IFRS 16 - *Leases* differentiates lessee's accounting from lessor's accounting.

Lessee's accounting

Lessor's accounting

Lessee should recognise a **right-of-use asset** and a corresponding **lease liability** (unless one of the two recognition and measurement exemptions are applied: short-term leases or leases of low-value assets) for all the leases.

The accounting treatment of a lease from the lessor's perspective is quite different, as lessor shall classify all leases as **finance lease or operating lease**, depending on whether or not the risks and rewards of ownership of a leased asset lie with the lessor. A lease is classified as a finance lease if it transfers substantially all of the risks and rewards incidental to ownership of an underlying asset.

Leases

Concessions that have been granted to lessees as a result of COVID-19 might take a variety of forms, including payment holidays, cash rebates and deferral of lease payments.

Should these concessions be treated:

- as (negative) variable lease payments,
- forgiveness of some of the lease payments,
- deferral of some of the lease payments, or
- a lease modification depending on the facts and circumstances?

In May 2020 the IASB issued amendments to IFRS 16, the *COVID-19-Related Rent Concessions* amendment, which provides lessees with an **optional exemption** from assessing whether a COVID-19-related rent concession is a lease modification. This exemption is provided **only for lessees!**

Lessors and lessees should also consider whether incentives received from a local government are **government grants**.

Leases



The accounting treatment of lease concessions

Lessee's accounting
according to
amendment to IFRS 16

Lessor's accounting
focusing on operating
leases

Leases

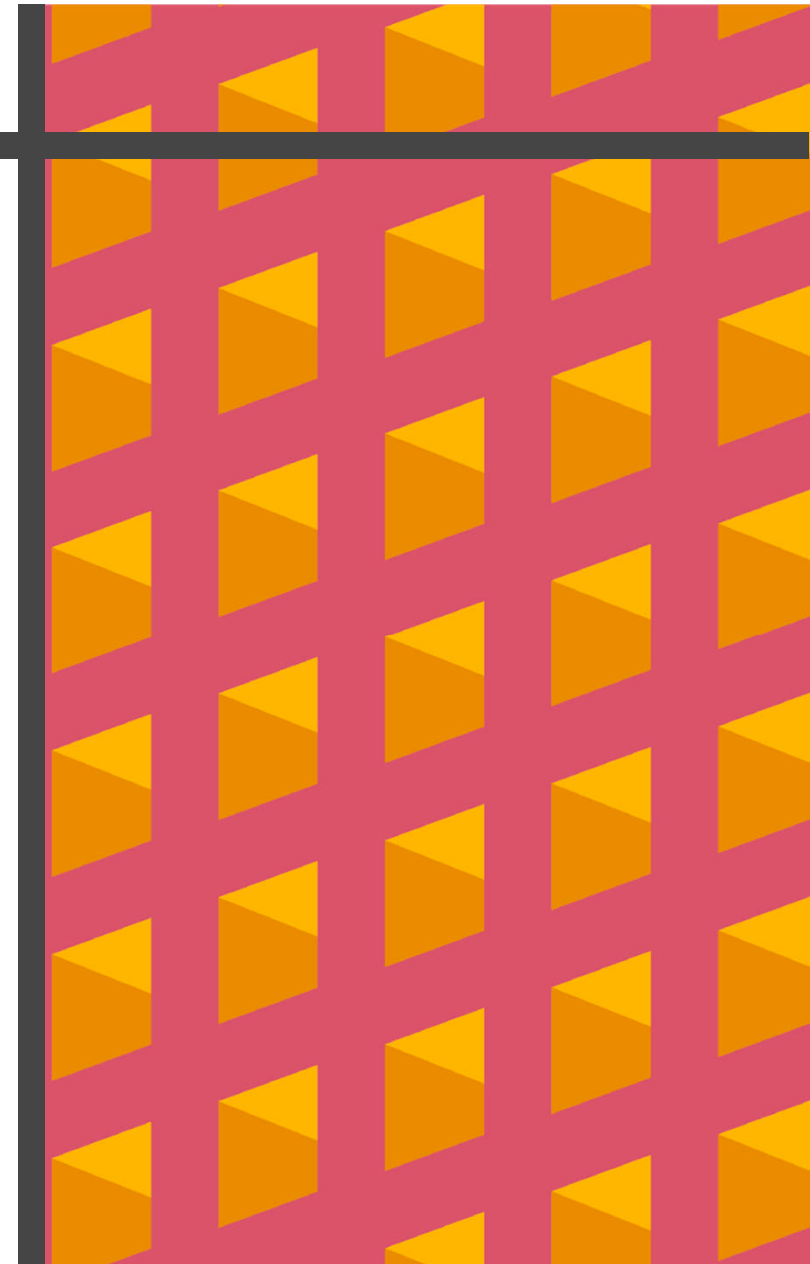
Lessee's accounting according to amendment to IFRS 16

In order to support consistent and robust application of IFRS 16, the IASB published the COVID-19-Related Rent Concessions amendment to IFRS 16 in May 2020. The amendment provides **lessees** with an **optional exemption** from assessing whether a **COVID-19-related rent concession** that meets certain conditions, is a lease modification and **require lessees to account for those rent concessions as if they were not lease modifications**.

To provide the relief when needed most, the IASB enabled immediate application of the amendment in any financial statements - interim or annual - not authorised for issue at the date the amendment was issued (28 May 2020, subject to endorsement process).

The exemption shall be applied retrospectively, recognising the cumulative effect of initially applying the amendment as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the beginning of the reporting period in which a lessee first applies the amendment.

This **optional exemption** is provided only for lessees. If a lessee does not apply the optional exemption of the amendment, the accounting treatment lease modifications should be followed.



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The practical expedient of the amendment applies only to rent concessions occurring as a **direct consequence of the COVID-19** pandemic and only if **all** of the following conditions are met:

- 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;
- any **reduction** in lease payments affects only payments originally **due on or before 30 June 2021 (This has been extended recently to 30 June 2022)**; and
- there is **no substantive change to other terms** and conditions of the lease, considering both qualitative and quantitative factors.

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A lessee that chooses to apply the practical expedient shall apply it consistently to all lease contracts with similar characteristics and in similar circumstances.

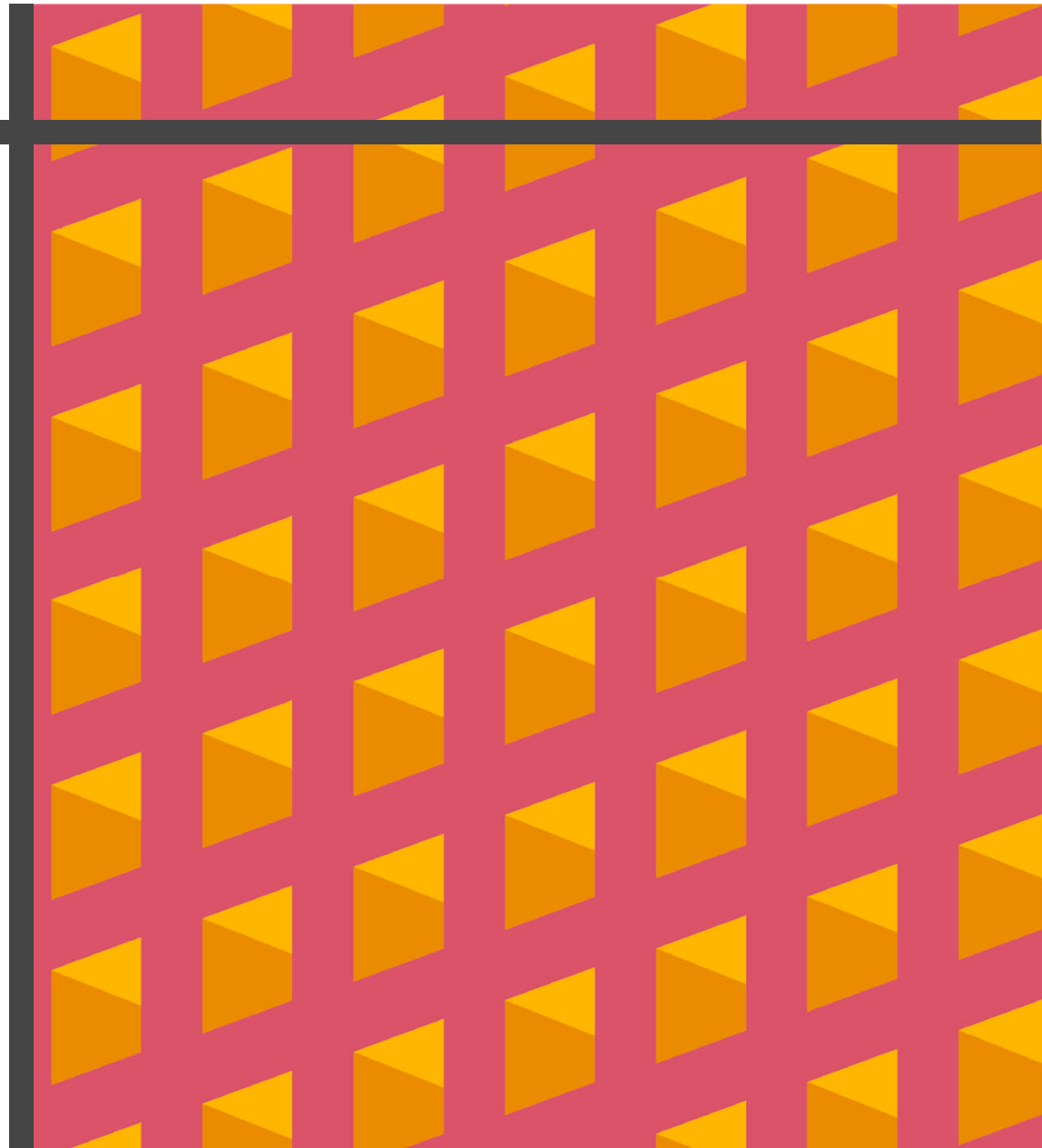
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Lessee's accounting according to amendment to IFRS 16

Let's discuss how a lessee applying the practical expedient would account for the two basic types of change in lease payments.

Reduction in lease payments

Deferral of lease payments



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Reduction in lease payments

Where the concession takes the form of a reduction in the payments required by the lease, with no change in the scope of the lease and without substantive change to other terms and conditions of the lease, a lessee would account for a reduction in lease payments as **variable lease payments** that are not dependent on an index or a rate and would also make a corresponding **adjustment to the lease liability** to derecognise the part of the lease liability that has been forgiven.

Lessee: The effect is recognised in profit or loss in the period in which the event or condition that triggers the reduced payments occurs with a corresponding adjustment to the lease liability.

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Reduction in lease payments

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Reduction in lease payments

Where the concession takes the form of a reduction in the payments required by the lease contract, with no change in the scope of the lease and without substantive change to other terms and conditions of the lease, a lessee would account for a reduction in lease payments as **variable lease payments** that are not

Variable lease payments

Lease liability is the present value of the future lease payments during the lease term.

A lease contract may contain variable lease payments, which are contingent payments depending on the underlying variable:

- payments based on an index or a rate (for example payments linked to a consumer price index);
- payments not based on an index or a rate (for example payments based on the revenue resulting from a retail store); and
- in-substance fixed payments.

According to IFRS 16 variable lease payments based on an index or a rate are part of the lease liability, while **variable lease payments that are not based on an index or a rate** are not part of the lease liability, but they **are recognised in the income statement** when the event or condition that triggers those payments occurs.

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Reduction in lease payments

Deferral of lease payments

Deferral of lease payments

Where the concession takes the form of a change in lease payments that reduces payments in one period but proportionally increases payments in another period, it does not extinguish the lessee's lease liability or change the consideration for the lease. It changes only the timing of individual payments. In this case, a lessee would **continue to** both **recognise interest** on the lease liability and **reduce that liability** to reflect lease payments made to the lessor.

As a result of the change in the timing of lease payments, lessees shall calculate the present value of future lease payments using the original discount rate. The difference between the carrying value of the lease liability and the new present value shall be treated as a cumulative catch up adjustment.

Lessee: After accounting for the cumulative catch up adjustment, the lessee would continue to increase the carrying amount of the lease liability to reflect interest and reduce the carrying amount of the lease liability to reflect lease payments made.

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Lessor's accounting - Operating Leases

Let's discuss the proper accounting treatment for different lease concessions made as a result of COVID-19 from the lessor's perspective. IFRS 16 requires an entity to consider both the terms and conditions of contracts and all relevant facts and circumstances.

Please note, that as concessions are more prevalent in operating leases, we will discuss the issues for operating leases.

Pre-existing clauses in lease contracts



Actions of government



Forgiveness of lease payments



Deferral of lease payments



Other concessions



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Pre-existing clauses in lease contracts

Some lease contracts contain pre-existing force majeure or similar clauses.

Where a clause applies to COVID-19 and results in reduced payments, the lessor is required by contract to reduce payments (it might not be considered to result from a lease modification, since they are provided in accordance with existing contractual terms). As a result, in line with paragraph 38(b) of IFRS 16, the benefit of a reduction in payments is recognised in the period in which the event or condition that triggers the reduced payments occurs.

On the other hand, where it is determined that the **clause only allows the party suffering** from the force majeure to **enter into a negotiation** with the other party, any changes to the lease payments that are made after such a negotiation might, for example, be appropriately accounted for as the forgiveness of some of the lease payments or as a lease modification.

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A change in lease payments is treated in the same way, regardless of whether the change results from the contract itself or from applicable law and regulation. Accordingly, the impact of a **lease concession imposed only by law, regulation or government actions** might be similar to the impact of a concession required by a pre-existing clause in the lease contract.

This might also be appropriately accounted for as **negative variable lease payments** that are **not dependent on an index or a rate**. The effect is recognised in the period in which the event or condition that triggers the reduced payments occurs.

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Forgiveness of payments contractually due for past rent:

Lessors might agree to forgive some amount of payments contractually **due for past rent**, without changing the scope of the lease or other terms.

Where such reductions are not required by the contract or by laws or regulation, lessor can have an **accounting policy choice** between applying requirements of IFRS 9 or IFRS 16.

IFRS 9 extinguishment: The forgiveness would be recognised as a loss in the income statement, with a corresponding reduction to the lease receivable in the period in which the reduction is contractually agreed.

IFRS 16 modification - Alternatively, the lessor could consider that the definition of a lease modification is met, because there is a change in the consideration for the lease (that is, the reduction was not part of the original terms of the lease). Therefore the guidance for **operating lease modification** should be followed, ie the modification is treated as a new lease, and any 'accrued lease payments' must be

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Some concessions might be in the form of the **lease payments being rescheduled** rather than reduced – such that, in nominal terms, the **consideration for the lease has not changed**.

Where such a deferral is proportionate, an entity might judge that it is not a lease modification, since there is no change in either the scope of the lease or the consideration for the lease.

Since the deferral does not change the total consideration, the amount of revenue to be recognised in each period throughout the lease will not change. However, to the extent that the deferrals result in a build-up of an accrued rent receivable or debtor relating to straight-line rent recognition, the lessor should apply the relevant impairment requirements under IFRS 9.

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If management concludes that the substance of the concession is not appropriately accounted for using the other methods set out above, it should consider whether the **substance is a lease modification**.

An example might be a concession that is **negotiated** between the lessor and the lessee and that results in a **change to the terms of the lease contract**.

The lessor accounts for a modification as a new lease from the effective date of the modification, considering any prepaid or accrued lease payments relating to the original lease as part of the lease payments for the new lease.

Thank you

