

HKFRS / IFRS UPDATE 2020/04

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PROPOSED PRACTICAL EXPEDIENT FOR LESSEES TO ACCOUNT FOR COVID-19-RELATED RENT CONCESSION



COVID-19 related measures implemented by the governments over the world have tremendous impacts on global economy. Because of these measures and the economic downturn, "rent holidays" or "rent concessions" to lessees is occurring. Under HKFRS/IFRS 16, lessees should assess and determine whether a rent concession is a lease modification which is defined in HKFRS/IFRS 16. If lease modification accounting is applicable, the lessee is required to discount the revised lease payments using a revised discount rate. The assessment of whether a rent concession is a lease modification could be difficult and judgemental in certain situations. To some lessees this exercise may be challenging. An example is a retailer with a large volume of lease contracts and the contract terms are different.

With this background, the International Accounting Standards Board (IASB) met on 17 April 2020 to propose narrow-scope amendments to IFRS 16 to allow lessees to elect accounting for COVID-19 related rent concessions as if they were not lease modifications. Appended to this *Update* is a newsletter published by BDO Global which contains a good summary of the proposed amendments and insights of the practical effects of the proposed amendments.

Subject to approval of the proposed amendments under the standard setting protocol, the IASB aims at releasing the amendments in May 2020 with the amendments become effective immediately upon issuance. This means that for an entity with 31 March 2020 year-end reporting, if the amendments are issued before its financial statements are finalised, the entity could apply the practical expedient to its financial statements.

HKFRS is fully converged with IFRS. It is therefore reasonable to expect the same proposed amendments made by the IASB, if approved, will be incorporated into HKFRS 16. Due to the necessary due process of approving amendments to HKFRSs, it is possible that HKFRS 16 amendments are available for adoption after IFRS 16 amendments effective date.

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APPENDIX

AMENDMENTS TO IFRS 16 PROPOSED BY IASB FOR LESSEES

INTERNATIONAL FINANCIAL REPORTING BULLETIN

2020/06

BACKGROUND

As a result of the COVID-19 pandemic, changes are being made to leases, 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, but did not propose amendments to IFRS 16. Instead, the document set out guidance on judgements to be made when accounting for changes to lease payments including whether they give rise to lease modifications.

Also on 10 April 2020, 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.

Subsequently, the IASB held a meeting on 17 April 2020 to propose narrow-scope amendments to IFRS 16 to offer relief to lessees in accounting for lease modifications that arise as a direct result of COVID-19.

The description of the proposed practical expedients below are based on the staff paper discussed on 17 April 2020 and IASB discussions. The IASB voted unanimously to approve the proposals outlined in the staff paper, subject to minor modifications. The eventual exposure draft and if approved, final amendments, may differ from the summary below.

THE ISSUE FOR LESSEES

The IASB has received feedback that lessees are experiencing significant operational difficulty in applying the existing requirements of IFRS 16 for lease concessions. Many types of lease concessions provided to lessees as a result of COVID-19 would meet the definition of a lease modification, which require lessees to remeasure the lease liability based on the revised cash flows using a revised discount rate.

The IASB noted while this requirement is not typically onerous, it becomes challenging to apply for lessees with potentially hundreds or thousands of leases, especially when entities are experiencing significant other operational disruptions due to the effects of COVID-19. Entities are also required to assess whether each change to a lease contract meets the definition of a lease modification, which adds another layer of complexity.

THE PROPOSED AMENDMENTS

The IASB Staff recommendation is for IFRS 16 to be amended to:

- (a) provide lessees with an exemption from the requirement to determine whether a COVID-19-related rent concession is a lease modification;
- (b) require lessees that apply the exemption to account for COVID-19-related rent concessions as if they were not lease modifications;

STATUS

Exposure draft forthcoming; 14 day comment period is expected.

EFFECTIVE DATE

Proposed to have immediate effect with retroactive application.

ACCOUNTING IMPACT

Significant operational relief for lessees in accounting for modifications to lease contracts as a consequence of COVID-19.

- (c) require lessees that apply the exemption to disclose that fact; and
- (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.

This relief would be available only to rent concessions occurring as a direct consequence of the COVID-19 pandemic and only if all of the following conditions are met:

- (a) the change in lease payments results in revised consideration for the lease that is the *substantially the same as, or less than, the consideration for the lease immediately preceding the change;
- (b) any reduction in lease payments affects only payments originally due in 2020 (a rent concession would meet this condition if it results in reduced lease payments only in 2020 and increased lease payments in 2020 or periods thereafter); and
- (c) there is no substantive change to other terms and conditions of the lease.

*In proposed criterion (a), the use of 'substantially the same' was proposed based on discussions at the IASB meeting on 17 April, and was not included in the original staff paper. It was included to ensure that concessions where the effect of the time value of money nominally increases total consideration would not be prevented from applying the practical expedient.

Proposed criterion (b) would mean that any reduction in payments that would occur subsequent to 2020 would result in the concession not qualifying for the proposed practical expedient. For example, if a rent concession provided a lessee with a 10% reduction in monthly lease payments from 1 July 2020 - 1 June 2021, criterion (b) would not be satisfied, and the proposed practical expedient could not be utilised, since the reduction in payments is not contained solely to 2020.

Proposed criterion (c) would make the practical expedient unavailable to concessions that substantially altered other aspects of a lease. Therefore, it would not be possible for lessees and lessors to introduce other substantive modifications to lease contracts and still apply the proposed practical expedient.

The proposed practical expedient would be subject to the requirements of IFRS 16.2, and therefore entities would apply it consistently to contracts with similar characteristics in similar circumstances. Said another way, this practical expedient would not be available on a lease-by-lease basis.

THE PRACTICAL EFFECTS OF THE PROPOSED AMENDMENTS

If lease concessions in the form of payment holidays, or reduced payments for a period of time, are not be accounted for as modifications based on applying the proposed practical expedient, it is likely that they would be accounted for as variable lease payments.

For example, if a lessor provided a lessee with a 50% reduction in lease payments for a period of 3 months, and it satisfied the criteria to utilise the proposed practical expedient, instead of adjusting the lease liability with the corresponding effect adjusting the right-of-use asset, the adjustment to the lease liability would be accounted for as a variable lease payment. This variable lease payment not based on an index or rate would be recorded in profit or loss as required by IFRS 16.38(b), and therefore, the forgiveness would be recorded in profit or loss, rather than adjusting the right-of-use asset, since the practical expedient would permit the lessee to not apply the requirements for lease modifications.

Lease concessions might also be in the form of a deferral, such as where the next three months of payments are deferred to be paid later in the lease term. Under the proposed amendments, it would appear that the recognition of those payments might similarly be deferred.

The proposed amendments would be effective immediately upon issuance, meaning that, for example, if an entity had a reporting period end of 31 March 2020, but had not yet finalised its financial statements by the time the amendments are issued, it could apply the practical expedient to its 31 March 2020 financial statements.

DISCLOSURE OF THE EFFECTS OF THE PROPOSED AMENDMENTS

The IASB did not propose additional disclosure requirements, other than entities that utilise the proposed amendments would disclose that fact. IFRS 16 already contains requirements for lessees to disclose variable lease payments included in profit or loss (IFRS 16.53(e)), therefore, at least some of the effects of applying the proposed practical expedient would already be addressed by existing disclosure requirements.

LESSOR ACCOUNTING

The IASB did not propose to amend the accounting requirements for lessors. Despite every concession provided to a lessee having a corresponding lessor effect, the IASB noted that the circumstances differ for lessors. Lessor accounting did not change substantially as a consequence of the adoption of IFRS 16, and many concessions offered to lessees relate to leases that are accounted for as operating leases by lessors, which have less complex requirements than lessee accounting.

The Staff Q&A issued by the FASB extended the relief in US GAAP to lessees and lessors, therefore, the IASB's approach differs from FASB's in this regard.

NEXT STEPS

The IASB is required to obtain approval from the IFRS Foundation Trustees to issue an exposure draft with a 14 day comment period, which is shorter than the minimum period normally permitted by the Due Process Handbook. If received, the IASB is aiming for the release of an exposure draft very quickly, with the final amendments, if approved, to be issued in May 2020. Those amendments would be effective immediately on issue.



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