



RSM INSIGHT

Accounting for Changes to Lease Contracts

by RSM IFRS Advisory Committee

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Accounting for Changes to Lease Contracts

Accounting for COVID-19 related rent concessions and other modifications to lease contracts, from the lessee's perspective

Implementing IFRS 16 Leases was a substantial task for many preparers, and COVID-19 has brought a new and unexpected source of difficulty and complexity.

The challenges posed by COVID-19 have resulted in a significant increase in the number of leases being re-negotiated or modified, usually where tenants can no longer operate, or have experienced a sudden drop in revenue. As a result, the IASB has issued a limited-scope amendment to IFRS 16 Leases to reduce the administrative burden of accounting for lease adjustments which have arisen as a direct consequence of the COVID-19 pandemic.

In this article, we explain the limited-scope amendment to IFRS 16 for modifications arising directly from COVID-19, and provide illustrative examples of how different types of modifications would be accounted for.

COVID-19 and IFRS 16: the amendment to the standard

The amendment (which does not affect lessors) provides lessees with a practical expedient: lessees have the option not to assess whether COVID-19-related rent concessions are lease modifications. If the practical expedient is applied, the COVID-19-related rent concessions are accounted for as if they were not lease modifications. The expedient applies only to COVID-19-triggered concessions, and only if the following three criteria 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;
- the reduction in lease payments affects only payments originally due on or before 30 June 2021; and
- there is no other substantive change to other terms and conditions of the lease.

The benefit from the practical expedient arises because under normal circumstances, lease modifications can be complex, and not all modifications are treated in the same way.

The practical expedient is limited scope in nature. Entities applying it must disclose that it has been applied, and the amount recognized in profit or loss as a result of its application.

What is a modification?

Under IFRS 16, a lease modification is a change in the scope or in the consideration payable for an existing lease, which was not part of the original terms and conditions. This definition recognises that there are many ways in which a lease agreement could change, but that not all would be lease modifications:

- a deed of variation could be signed, to extend the assets captured by the agreement, for some or for no additional consideration;
- a contract could be cancelled, and a new contract over the same assets but with a different term and new options for extensions could be signed;
- a contract could be terminated early by one of the parties, thereby reducing its term;
- the lease payments in a lease could have been written into the original agreement as being subject to variable increases in rent (for example where they are index-linked in the original lease contract).

The definition of lease modifications under IFRS 16 captures changes which:

- Increase the scope of the contract by adding underlying assets;
- Decrease the scope of the contract by removing underlying assets;
- Shorten the contractual term;
- Increase the contractual lease term; or
- Change the value of lease payments.

However, not all of these are treated in the same way: the standard distinguishes between those which must be treated as a separate lease, and those which must not, and which instead simply require the initial lease liability to be remeasured.

Lease modifications treated as separate leases

Lease modifications are treated as the creation of a new lease if they add the right to use new underlying assets and increase the consideration by a value that represents the stand-alone price of the additional rights of use (including any adjustments to reflect the circumstances of the modified contract).

The modification takes effect on the date when both parties agree to it. When a lease modification is accounted for as a new lease, the lessee accounts for the separate lease in the same way as any new lease, using a new discount rate determined on that date. The original lease is not affected.

Lease modifications not treated as separate leases

Lease modifications which do not meet the above criteria (for example, leases which increase the scope of the lease but not for consideration which represents the stand-alone price of the new scope) are not treated as the creation of new leases, and instead, are treated as remeasurement events. This means that the lease liability is remeasured based on the modified terms, using an updated discount rate applicable on the effective date of the modification, and the value of the right of use asset previously recognized is adjusted by the same amount. For modifications which decrease the scope of the lease, the deduction to the right of use asset cannot create a negative asset balance, so the remainder is taken to the profit and loss.

The discount rate is also updated, to reflect that the modification may have changed the economics of the lease by changing the lease term or the value of underlying assets leased, for example. Therefore, the lease liability is remeasured using updated payments, and an updated discount rate which reflects the interest rate implicit in the lease.

In this instance, the consideration change is allocated to each lease component based on their relative stand-alone prices (and the aggregate stand-alone price of non-lease components, unless these are recognized separately), and then the lease liability is remeasured based on updated payments at an updated discount rate. The other side of the remeasurement of the liability is taken against the right of use asset.

COVID-19-related concessions, applying the practical expedient

The benefit of the amendment to IFRS 16 for COVID-19-related lease concessions is therefore a reduction in the burden of

- attempting to determine whether the change to lease terms is a lease modification under the definition in IFRS 16, and
- where it would be a modification:
 - determining whether to account for it as a separate contract or not, and
 - recognizing a remeasurement of the existing lease liability based on a new discount rate.

Applying the expedient, COVID-19-related concessions are accounted for as though they are not lease modifications, and instead, they are treated as variable lease payments, with the modification being recognized directly in the income statement when it occurs.

In practice, the specific treatment will depend on the nature of the concession. Rent abatements will result in a reduction of the lease liability for the foregone rent. This will be treated in accordance with the requirements of IFRS 9 for the derecognition of liabilities, with the corresponding credit being recognized directly in the income statement.

The timing of the recognition of the effect within the income statement will depend on the nature of the concession. If there are no conditions on the concession, then it will be recognized immediately at the point that it is agreed. If it is contingent on future developments (for example, a rent concession which lasts for as long as a government-mandated shutdown remains in force), then the effect would be recognized in the income statement over the period for which the concession applies.

COVID-19 Rent Concessions: illustrative examples

- Scenario 1: a decrease in the value of rental payments over the lease term through rental payment waivers for a number of months (decrease in total consideration due)
- Scenario 2: a deferral in rental payments of a number of months, compensated by higher rent payments at future dates (lease payments substantially the same as original)

Scenario 1: a reduction in rental payments

Retailer Ltd (“Retailer”) entered into a lease contract with lessor Shopping Centre Owner Ltd (“SCO”) for a retail premises within a mall owned by SCO, for a period of 5 years from 1 July 2017. Rental payments are \$100,000 per year, payable quarterly in advance. Retailer adopts IFRS 16 as at 1 July 2019. The incremental borrowing rate at 1 July is 5%, and there are no lease incentives.

Retailer has adopted the practical expedients in IFRS 16 allowing the modified retrospective method of presentation, and allowing the right of use asset to equal the lease liability.

This means that, as at 1 July 2019, Retailer will have recognised the following entries.

Asset	Right of Use Asset	280,783
Liability	Lease Liability	(280,783)

As at 31 March 2020, retailer will have a right-of-use asset of \$210,587, and a lease liability of \$214,392.

As a result of COVID-19, the shopping centre experiences a period of closure and/or very substantially reduced patronage. On 1 April, SCO agrees that rent is to be waived for the period from 1 April to 30 September. There are no other changes to the terms of the lease

Analysis

The closure is a direct result of COVID-19, and the entity is applying the practical expedient. Therefore, the concession is treated as a variable lease payment, not as a lease modification: The remaining lease liability is remeasured at that date, using the same discount rate as on initial adoption, and the difference between the remeasured liability and the value recognised at that date prior to the concession taking effect, is recognised immediately in the income statement.

As at 1 April, Retailer recognises the following entry

Liability	Lease Liability	49,697
Income	Rent concession	(49,697)

This reduces the lease liability by the foregone rent, and recognises the effect as a variable lease payment immediately within the income statement. The remaining lease liability now represents the present value of the future payments, with no change to the discount rate used to calculate the lease liability. There is no change to the value of the right of use asset.

Scenario 2: a deferral in rental payments

Assume the same scenario as in example 1, except that the entity receives a deferral of rent rather than a reduction. This means that

- No rent is payable in April 2020 and July 2020 – a concession of \$50,000
- Quarterly rent is increased from \$25,000 to \$32,143 from October 2020 to April 2022.
- The nominal value of rental payments due over the whole lease term is therefore unchanged.

Analysis

While there is no change to the total cash payable under the lease, there is a change in the timing of payments. Applying the practical expedient, Retailer should remeasure the lease liability based on the revised payments, using the original discount rate. In the above example, this would result in the recognition of the following entry:

Liability	Lease Liability	2,641	
Income	Rent concession		(2,641)

This represents the reduction in the present value of the lease payments as a result of the change in their timing. Again, the updated lease liability represents the present value of the revised future payments, and there is no change to the right of use asset, or to the discount rate used.

The practical expedient illustrated above applies only to changes to leases that are a direct result of COVID-19. All other lease modifications must still be treated in accordance with the requirements of IFRS 16.

We illustrate four common lease modification or re-estimation scenarios below, which are not a direct result of COVID-19, or where the COVID-19 practical expedient is not applied:

1. Modification which increases the scope of the lease, treated as a separate lease;
2. Modification which increases the scope of the lease, not treated as a separate lease;
3. Modification which decreases the scope of the lease;
4. Remeasurements of lease liabilities for index-linked variable payments

Other lease modifications: illustrative examples

Increase in scope by adding the right to use an underlying asset, with a corresponding increase in consideration

Scenario

Chocolate Cake Ltd (“Choc”) entered into a lease contract with lessor Our Own Properties Ltd (“OOP”) for a specific warehouse (“Sprinkles”) on an industrial estate owned by OOP, for a period of 10 years, for consideration of \$120,000 per year (payable in advance), representing \$80 per square meter *per annum*, with a fixed rental increase of 1.5% per annum. The incremental borrowing rate applicable to this lease is 3.5%.

At the end of year 3, Choc requires additional warehousing space to meet an increase in demand. OOP offers to lease, and Choc accepts to lease, the warehouse on a nearby piece of land, plot “Buttercream”, for \$100,000, representing a rate of \$80 per square meter *per annum* for a period of 6 years. The incremental borrowing rate applicable to this lease is 4%.

Analysis

The new leased premises were not part of the original contract: the transaction is a lease modification.

Moreover:

- the modification increases the scope of the lease by adding the right to use an additional underlying asset (a new warehouse); and
- the additional lease payments are commensurate with market rentals for a warehouse in that area, as adjusted for the circumstances of the contract: it incorporates a discount because of the existing relationship between Choc and OOP.

Choc does not modify the accounting for Sprinkles, and recognises a new lease for the lease of Buttercream.

Numerical illustration

Year 1 - Lease of warehouse *Sprinkles*

Recognise lease liability and right of use asset (assuming no incentives, nor direct costs)

DR	Right of Use Asset	1,100,851	
CR	Lease Liability		(1,100,851)

Recognise lease payments, interest on the lease liability, and depreciation on the ROU asset.

DR	Interest expense	34,330	
CR	Lease Liability		(34,330)
DR	Lease Liability	120,000	
CR	Cash		(120,000)
DR	Depreciation expense	110,085	
CR	Accumulated Depreciation		(110,085)

Year 2 - Lease of warehouse *Sprinkles***Recognise lease payments, interest on the lease liability, and depreciation on the ROU asset.**

DR	Interest expense	31,268	
CR	Lease Liability		(31,268)
DR	Lease Liability	121,800	
CR	Cash		(121,800)
DR	Depreciation expense	110,085	
CR	Accumulated Depreciation		(110,085)

Year 3 - Lease of warehouse *Sprinkles***Recognise lease payments, interest on the lease liability, and depreciation on the ROU asset.**

DR	Interest expense	28,036	
CR	Lease Liability		(28,036)
DR	Lease Liability	123,627	
CR	Cash		(123,627)
DR	Depreciation expense	110,085	
CR	Accumulated Depreciation		(110,085)

Year 4 – Continue lease of warehouse *Sprinkles* + new lease of warehouse *Buttercream****Sprinkles*: Recognise lease payments, interest on the lease liability, and depreciation on the ROU asset.**

DR	Interest expense	24,625	
CR	Lease Liability		(24,625)
DR	Lease Liability	125,481	
CR	Cash		(125,481)
DR	Depreciation expense	110,085	
CR	Accumulated Depreciation		(110,085)

***Buttercream*: Recognise lease liability and right of use asset (assuming no incentives, nor direct costs)**

DR	Right of Use Asset	565,077	
CR	Lease Liability		(565,077)

Increase in scope by adding the right to use an underlying asset, with no corresponding increase in consideration

Assume the same scenario as in example 1, except for the consideration payable for Buttercream: instead of signing a new 6-year lease at a discount per square meter which represents the commercial reality of a new lease to the same tenant, Choc is offered Buttercream at a rate of \$65 per square meter – that is, a discount of almost 19% on the market value. This is offered as an incentive, as the warehouse has stood empty for a few years, and reflects the fact that in combination, Choc will be renting a surface area of 2,250 square meters at an average rate per square meters of \$75.18, which is within the market value of \$75 to \$85 per square meter.

The increase in consideration does not represent market value for the additional warehousing space; and therefore, this modification is not accounted for as a separate lease.

Illustration

The first 3 years are accounted for as in example 1. At the start of year 4, which is the effective date of the lease modification through the start of the Buttercream lease, Choc must remeasure the lease liability, by discounting the revised lease payments using a revised discount rate. The other side of the journal is posted as an increase to the carrying value of the right of use asset.

So, at the end of year 3, the closing position on balance sheet is:

Asset	Right of Use Asset	770,596
Liability	Lease Liability	(829,058)

The lease liability is remeasured, based on:

- revised payments of \$206,731 for years 4 and subsequent (representing \$125,481 per the original lease terms of Sprinkles, plus an additional \$81,250 for the added Buttercream), increasing by 1.5% per annum;
- an improved discount rate of 3.25% representing the improved security of a larger facility.

The remeasured lease liability is: \$1,375,581 meaning a difference of \$546,523.

The journal to reflect this is:

DR	Right of Use Asset	546,523
CR	Lease Liability	(546,523)

For illustration, the journals posted in year 4 are then:

DR	Interest expense	37,988
CR	Lease Liability	(37,988)
DR	Lease Liability	206,731
CR	Cash	(206,731)
DR	Depreciation expense	188,160
CR	Accumulated Depreciation	(188,160)

Decrease in scope and consideration

Scenario

Downsize Pty Ltd (“Downsize”) is 3 years into an office lease from Properties ‘R Us Pty Ltd (“PRU”). The terms of the original lease are as follows:

- 5-year fixed term, with a 1-year option to renew which, at inception seemed reasonably certain to be exercised, based on the cost of \$425 per square meter for property just outside Melbourne CBD;
- Rental payments made quarterly in advance;
- Fixed-rate increases of 1.8%;
- Incremental borrowing rate at commencement of 5%
- The rent gives Downsize the right to use the entire 4th floor (being 600 sq.m) of one of PRU’s iconic buildings, Ironbuild.

On inception, Downsize recognised, in relation to this lease:

DR	Right of Use Asset	1,392,479
CR	Lease Liability	(1,392,479)

By the end of year 3, Downsize has determined its business needs are such that it must, in fact, down-size. It identifies the north-eastern wing of the floor, 100 sq.m as surplus to its requirements, and agrees with PRU to change the terms of the lease, effective on the first day of year 4:

- The leased space will now be 500 sqm;
- Payments will decrease by 15%, broadly in proportion to the decreased rental space;
- The optional 6th year is not going to be exercised, and is removed from the contract

Because these terms were not in the original agreement, these changes represent a lease modification.

At the date the modification is agreed, the incremental borrowing rate is reassessed and measured at 7%. So, at the end of year 3, the closing position on balance sheet is:

Asset	Right of Use Asset	696,239
Liability	Lease Liability	(768,593)

The question is how to account for the removal of the right to use an underlying asset (a defined floorspace), the lower lease payments and the shortened contractual lease term.

Explanation

First: removal of right of use of an underlying asset

Downsize determines the proportionate decrease in the carrying amount of the right-of-use asset on the basis of the remaining right-of-use asset: having gone from 600 to 500 square metres, this is an 16.67% decrease in the ROU asset.

- 83.33% of the pre-modification right-of-use asset (\$696,239) is \$580,199; a reduction of \$116,040.
- 83.33% of the pre-modification lease liability (\$768,593) is \$640,494; a reduction of \$128,099.

Consequently, Downsize reduces the carrying amount of the right-of-use asset by \$116,040 and the carrying amount of the lease liability by \$128,099, and recognises the difference between the decrease in the lease liability and the decrease in the right-of-use asset (\$12,059) as a gain in the profit or loss at the effective date of the modification.

The journals are as follows:

DR	Lease Liability	\$128,099
CR	Right of Use Asset	(\$116,040)
CR	Gain on disposal of ROU asset (P&L)	(\$12,059)

Then: remeasure the lease liability

At the effective date of the modification (at the beginning of Year 4), Downsize remeasures the lease liability based on:

- a 2-year remaining lease term,
- annual payments of \$53,125 with a 1.8% fixed increase in year 2; and
- an incremental borrowing rate of 7% per annum.

This equals \$404,356.

Downsize recognises the difference between the remaining lease liability of \$640,494 and the modified lease liability of \$404,356 (which equals 236,137) as an adjustment to the right-of-use asset, reflecting the change in the consideration paid for the lease and the revised discount rate.

DR	Lease Liability	236,137
CR	Right of Use asset	(236,137)

To summarise, the position is as follows:

	Pre-modification	Remove relinquished ROU	Remeasure Lease Liability for new terms	Post-modification
Right of Use Asset	696,239	(116,040)	(236,137)	344,062
Lease Liability	(768,593)	128,099	236,137	(404,357)
(Gain)/Loss in P&L		(12,059)		

Change to lease estimates: illustrative example

Leases with variable payments linked to an index

Scenario

Lessee Homework Ltd has a 5-year lease on a property. The lease payments are paid upfront, and are set at \$100,000 per year for the first year, increasing each year in line with CPI (measured at Capital City, All Groups). CPI at inception was 125. At the end of year 1, the CPI has increased by 2.5%.

Analysis

CPI-linked increments in lease payments are a form of variable lease payment which is to be included within the calculation of the lease liability under paragraph 27 (b) of IFRS 16: “[Lease] payments included in the measurement of the lease liability [include] *variable lease payments* that depend on an index or a rate, initially measured using the index or rate as at the commencement date.” This means that no estimate is made on inception of any future index or rate, and instead, a static payment is modelled into the lease liability calculation on inception.

Accounting

The accounting is as follows:

- On inception, measure the lease liability at the present value of \$100,000 per year over 5 years.
- Identify the rate of change at the end of year 1.
- Determine the new yearly lease payments for years 2 onwards.
- At the commencement of year 2, remeasure the lease liability at the present value of these new yearly payments over the remaining term.

Illustration

The interest rate implicit in the lease was not easily determinable, so the Homework’s incremental borrowing rate was used. This was determined as being 5%.

Assume for illustrative purposes no lease incentives, nor material initial direct costs associated with this lease.

On inception:

The entity measures the lease liability assuming no inflation, and payments made in advance.

Year	Payment	Discount factor	Present value of payments
1	100,000	1.00	100,000
2	100,000	0.95	95,238
3	100,000	0.91	90,702
4	100,000	0.86	86,383
5	100,000	0.82	82,270
TOTAL			454,593

To record the initial liability and right of use asset, the following journal is posted:

DR	Right of use asset	454,593	
CR	Lease liability		(454,593)

By the end of year 1:

Journal entries have been posted as follows:

DR	Lease Liability	100,000	
CR	Cash		(100,000)
<i>To recognise the payment of the lease as due</i>			
DR	Interest expense	17,730	
CR	Lease Liability		(17,730)
<i>To recognise the interest on the liability</i>			
DR	ROU amortisation expense	90,919	
CR	Accumulated ROU amortisation		(90,919)
<i>To recognise the amortisation of the ROU asset</i>			

At the end of year 1, in relation to this lease, Homework's balance sheet shows:

Right of use asset	363,676
Lease liability	(372,325)

The entity then accesses the CPI and identifies that the yearly payment due for year 2 is \$102,500. The entity remeasures the liability at the start of year 2.

On day 1 of year 2

The entity remeasures the lease liability, using the same discount rate as on inception:

Remaining Years	Payment	Discount factor	Present value of payments
1	102,500	1.00	102,500
2	102,500	0.95	97,619
3	102,500	0.91	92,971
4	102,500	0.86	88,543
TOTAL			381,633

The following journal is then posted to record the uplift in the value of the liability, from 372,325 to 381,633:

DR	Right of use asset	9,308	
CR	Lease liability		(9,308)

The remeasured Right of Use asset is depreciated over the remaining useful life of the asset.

By the end of year 2, the following journal entries have been made:

DR	Lease Liability	102,500	
CR	Cash		(102,500)
<i>To recognise the payment of the lease as due</i>			
DR	Interest expense	13,957	
CR	Lease Liability		(13,957)
<i>To recognise the interest on the liability</i>			
DR	ROU amortisation expense	95,408	
CR	Accumulated ROU amortisation		(95,408)
<i>To recognise the amortisation of the ROU asset</i>			

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