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COVID-19 Practical Expedient for Lease Payment Concessions

Background:

The IASB has amended IFRS 16, *Leases* (“IFRS 16”) to provide lessees with practical relief during the Covid-19 pandemic to allow, but not require, lessees to not assess whether a lease payment concession is a lease modification and to account for the lease contract as though it is not a modification on a temporary basis.

IFRS 16 contains requirements for lease modifications to be remeasured. It is not entirely clear as to the type of lease payment concessions (payment deferrals, partial or full lease payment forgiveness, etc.) that would be deemed to be a change in consideration or lease term. It is also not clear how a lease payment concession would be treated if it were deemed not to be a modification. The amendment provides some clarity around these issues and the purpose of this paper is to explain the provisions of the amendment, the clarifications provided and the views of the IAWG where the guidance remains unclear.

Issues:

This paper discusses how the IAWG believes that the COVID-19 practical expedient could be applied.

Analysis of Issues:

Is the amendment mandatory?

The amendment provides an option to apply the relief and is only available in relation to accounting by lessees. There is no relief granted to lessors in head leases or sub-leases.

The relief is to be applied consistently to contracts with similar characteristics and in similar circumstances

What is the scope of relief?

The practical relief provided for by the amendment only applies to “rent concessions” that reduce (defer, partially or fully forgive, etc.) lease payments originally due on or before 30 June 2021.

If, for example, monthly lease payments for a lease were reduce for the period from 1 July 2020 to 1 December 2022, IAWG would be of the view that the practical expedient could not be applied to that lease as the expedient is considered at a contract level and not at a payment level.

The amendment uses the term “rent concession” that for some may suggest a property lease, but the practical relief applies to all leases.

Would deferred lease payments be a modification?

IAWG believes that a deferral of lease payment(s) for substantially the same amount of consideration would not be treated as a modification under the existing IFRS 16. The accounting treatment for this scenario is addressed in BC7(b) of the ED as follows:

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.

IFRS 16.36(b) states that a lessee shall measure the lease liability by reducing the carrying amount to reflect the lease payments made. BC9 of the ED states that a lessee applying the practical expedient would generally recognise the effects of forgiveness of lease payments in profit or loss in the period in which the event or condition that triggers that forgiveness occurs.

We believe a valid approach for lessees in accounting for this scenario is to recognize the interest expense during the deferral period as originally calculated. There would be no impact on the ROU Asset, discount rate or interest calculation. See Scenario 1 of attached illustrative examples.

How would reduced or waived lease payments be treated?

IAWG believes that this fact pattern meets the criteria in paragraph 46B for relief and would otherwise be treated as a modification as the consideration would be substantially modified. The accounting treatment for this scenario is addressed in BC7(a) as follows:

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 BC9 of the ED indicates that a lessee applying the practical expedient would generally recognise the effects of forgiveness of lease payments in profit or loss in the period in which the event or condition that triggers that forgiveness occurs.

We believe a valid approach for lessees in accounting for this scenario is to reduce the lease liability by the amount forgiven and recognize the interest expense as originally calculated. Paragraph BC9 of the ED indicates that the ROU Asset would not be adjusted if the relief was applied. See Scenario 2 of attached illustrative examples.

How would lease payments suspended for a period with the lease extended to match the suspended period be treated?

Paragraph BC5(c) of the ED states the following:

This condition reflects the Board's view that lessees should not apply the practical expedient to lease modifications that are unrelated to the covid-19 pandemic but are negotiated at the same time as a covid-19-related rent

concession (although, for example, a three-month rent holiday in 2020 followed by three additional months of substantially equivalent payments at the end of the lease would not prevent a rent concession from being within the scope of the practical expedient).

The language in this subparagraph clarifies that changes in terms and conditions are permissible if they are pandemic related and meet the other criteria in paragraph 46B.

We believe a valid approach for lessees is to continue to recognize the interest expense during the deferral period as originally calculated without regard to the deferred interest element. There would be no impact on the ROU Asset, discount rate or interest calculation. The ROU Asset would be discounted over the original lease term. See Scenario 3 of attached illustrative examples.

Effective date and transitional provisions

A lessee would apply the amendment:

- (a) for annual reporting periods beginning on or after 1 June 2020. Earlier application is permitted, including in financial statements not yet authorised for issue at the date the amendment is issued; and
- (b) retrospectively, recognising the cumulative effect of initially applying the amendment as an adjustment to the opening balance of retained earnings in the year of adoption.

The purpose of the effective date is to permit those with reporting periods ending near that issuance date of the amendment from being barred from adopting the relief at a later time if the amendment was made effective immediately.

The effective date would allow for the reporting entity to not apply the practical expedient in an interim period(s) or current financial year and then adopt it in 2021 after they have applied IFRS 16 without the benefit of the expedient.

APPENDIX: ILLUSTRATED EXAMPLES (Note that this is one valid approach and not the only approach to accounting for these concessions.)

Background: Lessee enters into a 24-month lease of commercial real estate for two years starting on January 1, 2020. Payments of \$100.00 are due the first of each quarter. The implicit interest rate is not determinable and the incremental borrowing rate on January 1, 2020 is 5%. The present value of the payments discounted at 5% is \$678.64. The ROU Asset is valued at the same amount and depreciated over 8 periods of three months on a straight-line basis. As a result of the Covid-19 crisis lease payment concessions are negotiated with the lessor on April 27, 2020. The incremental borrowing rate at this time increases to 6%.

*Scenario 1: **Deferral of payments:*** payments in Jul and Oct are deferred to Jul and Oct 21

*Scenario 2: **Forgiveness of payments:*** payments on July 1, 2020 and October 1, 2020

*Scenario 3: **Extension of payments:*** payments on July 1, 2020 and October 1, 2020 are deferred to January 1, 2022 and April 1, 2022 with the lease extended by six months on the same terms

Accounting entries determined at inception of the lease

		1JAN20	1APR20	1JUL20	1OCT20	1JAN21	1APR21	1JUL21	1OCT21	1JAN22	1APR22
Lease Payment	Cr Cash	\$100.00	\$100.00	\$100.00	\$100.00	\$100.00	\$100.00	\$100.00	\$100.00		
Interest element	Dr Interest Expense	\$28.93	\$25.38	\$21.65	\$17.73	\$13.62	\$9.30	\$4.76	\$0.00		
Principal element	Dr Lease Liability	\$71.07	\$74.62	\$78.35	\$82.27	\$86.38	\$90.70	\$95.24	\$100.00		
ROU Asset element	Dr Depreciation Cr Accumulated Depreciation	\$84.83	\$84.83	\$84.83	\$84.83	\$84.83	\$84.83	\$84.83	\$84.83		

*Scenario 1: **Deferral of payments***

Adjusting entries

Dr Cash (Note 1)	\$100.00	\$100.00	Cr Cash	\$100.00	\$100.00			
Cr Lease Liability	\$100.00	\$100.00	Dr Lease Liability	\$100.00	\$100.00			
Adjusted Lease Liability	\$607.57	\$532.95	\$554.60	\$572.33	\$485.95	\$395.25	\$200.00	\$0.00

*Scenario 2: **Forgiveness of payments***

Dr Cash (Note 1)	\$100.00	\$100.00						
Cr Gain	\$100.00	\$100.00						
Adjusted Lease Liability	\$607.57	\$532.95	\$454.60	\$372.33	\$285.95	\$195.25	\$100.00	\$0.00

*Scenario 3: **Extension of payments***

Dr Cash (Note 1)	\$100.00	\$100.00				Cr Cash	\$100.00	\$100.00		
Cr Lease Liability	\$100.00	\$100.00				Dr Lease Liability	\$100.00	\$100.00		
Adjusted Lease Liability	\$607.57	\$532.95	\$554.60	\$572.33	\$485.95	\$395.25	\$300.00	\$200.00	\$100.00	\$0.00

Note 1: This entry does not reflect an inflow of cash, but rather a reversal of the entry to show an outflow of cash in the example. No cash flow takes place.