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PDC n°29

March 2022 IFRIC Update––Feedback on the Tentative Agenda Decisions on Lessors Forgiveness of Lease Payments (IFRS 9 – *Financial Instruments* and IFRS 16 – *Leases*)

Dear Bruce,

I am writing to you on behalf of the Autorité des Normes Comptables (ANC) to express our views on the above mentioned IFRS Interpretations Committee's (Committee) Tentative Agenda Decision (TAD) published in March 2022.

We recommend the Committee not finalise the proposed TAD. This is because we think the technical analysis set out in this TAD:

- includes developments that only arise from a possible reading of the requirements in IFRS Standards,
- may have significant unintended consequences, and
- raises questions as to whether the resulting conclusion (i) provides information that is useful and (ii) paves the way for structuring opportunities.

Accordingly, we think the matter described in the submission would be best addressed in the context of a standard-setting project which would holistically clarify the requirements applicable to *both* lessors and lessees.

- **How the Committee reads the existing requirements in IFRS Standards**

Our comments below include developments on the Committee's analysis of how to apply the expected credit loss model (ECL model) in IFRS 9 to the operating lease receivable. They also outline two other arguments that, we think, could lead to reach a conclusion that does not align with the Committee's tentative conclusion.

- ***How to apply the ECL model in the fact pattern described in the submission and in other fact patterns***

We agree with the Committee's conclusion that an entity applies the impairment requirements in IFRS 9 and thus, the ECL model, to the operating lease receivable from the date on which the entity recognises that receivable.

That being said, we have reservations on the Committee's conclusion whereby '*…in the period before the rent concession is granted, the lessor measures expected credit losses on the operating lease receivable in a way that reflects an unbiased and probability-weighted amount determined by evaluating a range of possible outcomes (as required by paragraph 5.5.17 of IFRS 9), including considering its expectations of forgiving lease payments recognised as part of that receivable*' (emphasis added). We think the existing requirements in IFRS 9 may enable an entity to reach this conclusion—for the reasons set out in the TAD—but they also may enable to conclude otherwise. In our view, an entity may not consider its expectations of forgiving lease payments recognised as part of the receivable to measure ECLs when the forgiveness of lease payments does not relate to a credit event such as the lessee defaulting or being expected to default on the lease payments. We observe that Appendix A to IFRS 9 includes a definition for ECLs stating those are '*the weighted average of credit losses with the respective risks of a default occurring as the weights*' (emphasis added). We also note that the requirements in IFRS 9 are strongly interrelated to the notion of credit risk (for example the requirements in (i) paragraph 5.5.3 of IFRS 9 to measure the loss allowance for a financial instrument at an amount equal to the lifetime ECL if the *credit risk* on that financial instrument has increased significantly and (ii) paragraph B5.5.36 of IFRS 9 to consider the change in the *risk of default* occurring since initial recognition to determine whether an instrument's credit risk has increased significantly) as defined in Appendix A to IFRS 7 *Financial instruments: Disclosures*[1]. Applying this view, the measurement of ECLs would exclude concessions the lessor expects to grant for reasons other than the lessee's credit risk.

We understand that there has been a long standing debate among stakeholders as to whether to restrict the cash shortfalls used to measure ECLs on financial assets to those arising from the counterparty's credit situation (and thus, ignoring shortfalls arising from the entity's decision to waive cash flows for reasons other than credit risk). The TAD as drafted, inadvertently or not, concludes on that debate. This conclusion would apply to any financial asset to which the requirements in IFRS 9 apply, without having considered the possible unintended consequences—we question whether the TAD is an appropriate way forward to bring such a clarification. The analysis in the TAD might also affect requirements in IFRS 9 other than those related to impairment. In particular, we think this could also affect the reading of the requirements for the derecognition of financial assets in paragraphs 3.2.1–3.2.23 of IFRS 9—in particular those in paragraph 3.2.6 of IFRS 9 with regard to the transfer (or retention) of substantially all the risks and rewards of ownership of a financial asset (for example assessing whether future concessions that an entity expects to grant are part of an instrument's credit risk or dilution risk[2]).

Additionally, we think the Committee's analysis in this respect raises questions as to how to account for financial assets that an entity recognises applying other IFRS Standards but to which IFRS 9, in particular the impairment requirements in this Standard, apply. The TAD applies to an asset recognised applying the requirements in IFRS 16 but also subject to the derecognition and impairment requirements in IFRS 9. We specifically seek clarifications as to *whether*, and if so, *how* the proposed analysis would apply to receivables and contract assets that an entity recognises applying IFRS 15 *Revenue from Contracts with Customers* and to which IFRS 9 applies.

To illustrate our questions, assume that an entity in the context of an ongoing and established business relationship (i) has transferred the control of goods or services to a customer and has recognised a

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[1] IFRS 7 defines credit risk as '*the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation*'.

[2] Also called dispute risk. This risk is generally excluded from the risks and rewards analysis.

receivable accordingly and (ii) expects subsequently to grant a price concession to the customer (for a reason other than the customer's credit risk). In those circumstances, entities currently apply the requirements in paragraphs 50–59 of IFRS 15 on variable consideration and adjust the transaction price to reflect this price concession and thus, reduce the amount of revenue recognised in profit or loss––as explained in paragraph BC194 of IFRS 15[3], IFRS 15 distinguishes price concessions (which adjust the transaction price) and impairment losses (which do not adjust the transaction price) that are recognised to reflect the customers' credit risk. Entities do not apply the ECL model in IFRS 9 in the example above because the concession is granted for reasons other than the customer's credit risk. However, if the analysis set out in the TAD were to apply, entities would first apply the ECL requirements to the receivable, and then recognise an impairment loss (ECL loss allowance) ie an expense to reflect the price concession––this is because the analysis in the TAD, unlike IFRS 15, does not distinguish a price concession and impairment losses. Some could arguably ask why a different approach should prevail when applying the requirements to IFRS 16 in similar circumstances. Without further clarification in this respect, concerns exist that the analysis in the TAD could be applied to situations other than those described in the submission and thus, could have unintended consequences.

Accordingly, we recommend the Committee not finalise the TAD, or at least, not in its current form. If the Committee were to proceed with the TAD, we suggest the description of the fact pattern be amended to restrict the fact pattern to a situation in which the rent concession is granted because of the lessees' credit situation––all stakeholders would at minimum agree on the Committee's conclusion on such a fact pattern.

As a final note, we remind that the IASB (Board) decided to begin the *Post Implementation Review of IFRS 9––Impairment* (PIR) in the second half of 2022. This PIR may shed light on how the interaction between IFRS 9 and other IFRS Standards works in practice. Consequently, it may be helpful to defer this matter to the PIR or to await the end of the PIR to conclude.

- ***Viewing the forgiveness of lease payments as a lease incentive***

The Committee did not investigate in the TAD whether the forgiveness of lease payments would qualify as a lease incentive. If so, an entity would recognise the effect of the rent concession over of the lease term. We observe that paragraphs 44–45 of Agenda Paper 4 for the March 2022 Committee meeting (March 2022 paper) reject this view contending that the forgiveness does not meet the definition of lease incentives in Appendix A to IFRS 16[4].

We think the definition of lease incentives in IFRS 16 should not be interpreted narrowly to only capture payments in cash. In our view, lease incentives may include 'notional payments' made by the lessor to the lessee that are settled *net* in the lease payments––such payments reduce the amounts owed by the lessee but involve no formal cash outflow from the lessor. We would question the relevance of the requirements in IFRS 16 if that Standard were to distinguish––and thus, to specify differing accounting requirements for––incentives settled in cash from those that are settled net. This would also not align with how a lessor would account, at the lease commencement date, for rent-free periods which, in substance, are lease incentives.

Absent any reference in the definition of lease incentives as to how the payment should be settled, we think the Committee cannot reject the view whereby an entity may account for the rent concession as

[3] Paragraph BC194 of IFRS 15 states that '*the boards observed that in some cases it may be difficult to determine whether the entity has implicitly offered a price concession or whether the entity has chosen to accept the risk of default by the customer of the contractually agreed-upon consideration (ie customer credit risk). The boards noted that an entity should use judgement and consider all relevant facts and circumstances in making that determination. The boards observed that this judgement was being applied under previous revenue recognition requirements. Consequently, the boards decided not to develop detailed requirements for differentiating between a price concession and impairment losses*'.

[4] IFRS 16 defines lease incentives as '*payments made by a lessor to a lessee associated with a lease, or the reimbursement or assumption by a lessor of costs of a lessee*'.

a lease incentive––this is paving the way for an accounting that does not align with the conclusion in the TAD.

Our above-described view also aligns with the requirements in SIC Interpretation 15 *Operating Leases––Incentives*[5]. Forgiving lease payments is, in substance, equivalent to a rent free (or reduced rent) period. SIC Interpretation 15 considered rent fee periods as incentives. We acknowledge that IFRS 16 superseded this Interpretation. However, we think the reading of that Interpretation can usefully inform the understanding of lease incentives in IFRS 16 because paragraph BC65 of IFRS 16 includes the Board's observation that '*…IFRS 16 substantially carries forward the lessor accounting requirements in IAS 17, with the exception of the definition of a lease…, initial direct costs… and lessor disclosures…*'. Absent any statement indicating otherwise, we presume that IFRS 16 substantially carried forward the requirements in IAS 17 (and its related SIC Interpretations) with regard to the definition of incentives.

- ***The lack of definition for 'accrued lease payments' in IFRS 16***

The TAD explains that paragraph 87 of IFRS 16 requires a lessor to consider any prepaid or accrued lease payments relating to the original lease as part of the lease payments for the new lease. The TAD goes on and says that the Committee observed that lease payments due from the lessee that the lessor has recognised as an operating lease receivable (to which the derecognition and impairment requirements in IFRS 9 apply) are *not* accrued lease payments.

We observe that (i) paragraph 87 of IFRS 16 does not distinguish 'lease receivables' and 'accrued lease payments' (it solely refers to 'prepaid or accrued lease payments') and (ii) IFRS 16 does not define 'accrued lease payments'. Accordingly, an alternative view exists whereby, in the fact pattern described in the submission, all unpaid amounts relating to revenue recognised before the contract's modification date, and thus the operating lease receivable, can be part of 'accrued lease payments'––those unpaid amounts accrued as part of the lease, noting they are often part of the negotiations between to the lessor and the lessee to determine the revised terms and conditions of the lease. Absent any clear requirements in this respect, we think the Committee's analysis is only one possible reading of the requirements in IFRS 16.

- **The relevance of the requirements in IFRS 9 and IFRS 16 in the TAD and the risk of structuring opportunities**

  - ***Applying the analysis in the TAD to more prevalent situations than the fact pattern described in the submission***

The TAD discusses a fact pattern in which the rent concession is one for which the only change to the lease contract is the lessor's forgiveness of lease payments due from the lessee under that contract. In other words, the lessor waives some lease payments without negotiating other changes to the lease. In our view, this fact pattern is less common than the circumstances in which the forgiveness of lease payments is made alongside other changes to the lease (for example, lease term's extension, modifications to the future lease payments, etc.). We seek clarifications as to whether the analysis set out in the TAD would also be applicable to those fact patterns––it would be helpful if this could be further clarified given the prevalence of those other fact patterns.

Applying the analysis set out in the TAD, the lessor would (i) first apply the ECL requirements in IFRS 9 to any operating receivable recognised as part of the lease until the modification is agreed, (ii) then apply the derecognition requirements in IFRS 9 to the receivable on the date the rent concession is granted and (iii) the lease modification requirements in IFRS 16 to future lease payments.

[5] SIC 15 Interpretation 15 was an interpretation of IAS 17 *Leases*.

We question whether the analysis, if transferable to the fact patterns described above, would provide useful information in all those circumstances. Let's assume that (i) a lessor waives the payment of rent that became receivable until the lease modification is agreed and (ii) the lessor and the lessee agree to increase the future lease payment by the same amount than the one of the waived receivables (ignoring the effect of passage of time). In this case, the lessor would recognise an ECL impairment loss on the amount receivable before the modification date ––this receivable having been recognised together with income––and would recognise exactly the same amount as income over the new lease term as part of the rents dues afterwards. Over time, the lessor would have recognised that amount twice as income. We are unsure of this resulting in useful information. Applying the lease modification requirements in paragraph 87 of IFRS 16 may provide more useful information.

- ***The relevance of the requirements in IFRS Standards to the fact pattern described in the submission***

On the basis of its analysis of the requirements in IFRS 9 and IFRS 16, TAD results in outlining differing accounting requirements for:

- amounts contractually due but not paid (which the lessor had recognised as an operating lease receivable). An entity applies the ECL requirements and derecognition requirements in IFRS 9 to those amounts. It recognises them as *expense* in profit or loss when it grants the rent concession.
- amounts that are not yet contractually due (or future lease payments under the lease). The lease modification requirements in paragraph 87 of IFRS 16 apply to those payments, thus resulting in those amounts being recognised as *reduction of income* over the new lease term.

We question whether having differing recognition and presentation outcomes for those two types of amounts provides useful information. In substance, the lessor grants a rent concession to the lessee and allocates part of that concession on amounts contractually due. We think this allocation does not, itself, fundamentally change the nature of the underlying transaction.

Let's assume a lessee makes quarterly prepayments for rents due under a lease. The lessee stops making the payments for one quarter. The lessor has a receivable for the amounts outstanding. The lessor and lessee enter into negotiations. Further to the negotiations, the lessor releases the lessee from its obligation to pay an amount equivalent of three month-rents. The parties have here some leeway with regard to the allocation of the corresponding forgiveness––ie whether it settles the existing receivable or reduces future lease payments––and by doing so, to achieve differing accounting outcomes (whereas the substance of the agreement is not so different, if different at all). The lessee resumes payments. There are differing ways of allocating that forgiveness of lease payments which, each, result in differing accounting outcomes––ie allocating the forgiveness to (i) the receivable (and then impairing that receivable), or (ii) the future lease payments (and then recognising the forgiven amount as a reduction of future income over the new lease term), or (iii) the receivable and future lease payments together.

Accordingly, we think that treating a rent concession on a lease receivable differently from a rent concession on future lease payments inevitably risks paving the way for structuring opportunities to recognise and present differently rent concessions that have the same economic substance. As illustrated in the example above, this is detrimental to comparability and risks creating opportunities for earnings management.

In practice, negotiations between a lessor and a lessee to amend a lease contract may also take time. In the example above, the negotiations may continue between the parties to such an extent than several quarters in a row may be unpaid, thus making the allocation of the forgiveness even more crucial.

The length of the negotiations between the lessor and the lessee to agree on a lease modification (including a rent concession), the allocation of that concession, the existence and amounts of lease payments already made at the modification date are possible inputs to create, wittingly or unwittingly, variations in accounting outcomes for similar transactions.

We have even more doubts about the relevance of the existing requirements when having in mind the proposed standard-setting approach in paragraph 77 of the March 2022 agenda paper––which, the staff thinks, best aligns with the Board's intentions when developing IFRS 16 and thus, would justify *Annual Improvements to IFRS*––which would result in the lessee recognising *both* types of amounts as income when the rent concession is granted. We acknowledge that lessors and lessee's accounting are (wittingly) not symmetrical in IFRS 16 but think any discrepancy for the accounting of the forgiveness is difficult to understand.

- **Our overall recommendation**

Overall, we are not convinced by the technical robustness of the TAD and its helpfulness. We think the Committee should recommend standard-setting to the Board to address a lessor's accounting for a rent concession in which the only change to the lease contract is the lessor's forgiveness of lease payments due from the lessee. This recommendation also would align with the Committee's recommendation in relation to the lessee's accounting[6]––a recommendation we do support. In particular, we think:

- more adequate to consider the matter holistically, ie considering both the lessor's and lessee's sides and, by doing so, to retain coherent and information-useful principles to account for the rent concession on both of those sides[7].
- recommending standard-setting for a lessee and finalising an agenda decision for a lessor's accounting may also predetermine the Board's decisions on specifying the accounting for a lessee.

Should you need any further clarification, please do not hesitate to contact me.

Yours sincerely,

Patrick de Cambourg

[6] March 2022 *IFRIC Update*, Other matters.

[7] We do not recommend any specific way forward in this respect––in particular we do not opine that the lessor's and the lessee's accounting should be symmetrical.