

Leases — Background Information and Basis for Conclusions

Section 3065

Foreword

In November 2020, the Accounting Standards Board (AcSB) amended LEASES, Section 3065 in Part II of the CPA Canada Handbook – Accounting. The AcSB has approved for publication the contents of this document setting out its rationale for the amendments.

Background Information and Basis for Conclusions documents are sources of generally accepted accounting principles, as described in GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, Section 1100 in Part II of the Handbook. These documents are intended to help readers understand how the AcSB reached its conclusions, but they do not include explanations of requirements or guidance on the application of the relevant Section or Accounting Guideline.

November 2020

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INTRODUCTION

- 1 This document summarizes considerations that were deemed significant by members of the Accounting Standards Board (AcSB) in reaching their conclusions to amend LEASES, Section 3065 in Part II of the CPA Canada Handbook – Accounting. This document sets out the reasons the AcSB undertook the project to develop the amendments, the process of research and deliberation, the key decisions made and the principal reasons for adopting the positions taken and rejecting others. Individual Board members gave greater weight to some factors than to others.
- 2 Nothing in this document is to be taken as overriding the requirements of the Handbook. However, the discussion may help readers understand how the AcSB reached its conclusions in developing the amendments and the Board's intent with respect to its interpretation and application.
- 3 In developing these proposals, the AcSB sought the advice of its Private Enterprise Advisory Committee. This Advisory Committee includes financial statement users, auditors and preparers with a range of backgrounds and experience from across Canada. Members include representatives from organizations of differing sizes and in a variety of industries.

APPLICABILITY TO NOT-FOR-PROFIT ORGANIZATIONS

- 4 Section 3065 in Part II of the Handbook applies to private enterprises as well as not-for-profit organizations (NFPOs) applying the standards in Part III of the Handbook, as relevant. Accordingly, in finalizing the amendments, in light of the feedback received, the AcSB concluded there were no unique considerations for NFPOs applying these proposals.

BACKGROUND AND EFFECTS ANALYSIS

- 5 The economic consequences of the COVID-19 pandemic have given rise to rent concessions in the form of lease payment deferrals or waivers. The current guidance in Section 3065 would require both lessees and lessors to account for COVID-19-related rent concessions as new leases. This could be onerous for enterprises with many leases. The Board received feedback from its Private Enterprise Advisory Committee that while capital leases and sales-type leases or direct financing leases may not be common for buildings, they are common for vehicle and equipment leases.
- 6 Consequently, the AcSB decided to amend Section 3065 to provide relief for both lessees and lessors on accounting for rent concessions received or granted as a result of the COVID-19 pandemic.
- 7 A primary effect of the amendments is to simplify the accounting for COVID-19-related rent concessions by providing optional relief.
- 8 The optional relief in the Exposure Draft allows enterprises to choose whether to account for the COVID-19-related rent concessions as new leases. One respondent was concerned that optional relief would affect comparability. The AcSB understands that providing a choice to apply the relief could affect comparability and, therefore, the Board included disclosure requirements to communicate that an enterprise used the practical expedient. While the Board recognizes that there will be costs relating to the additional disclosure requirements, the simplified accounting for COVID-19-related rent concessions will provide cost savings for preparers.
- 9 Having considered the effects of the changes to Section 3065, the AcSB thinks that the amendments will provide needed relief for both lessees and lessors on accounting for COVID-19-related rent concessions.

DEVELOPMENT OF THE AMENDMENTS

- 10 Throughout the development of the amendments, the AcSB followed its due process. This process included:
- (a) input from its Private Enterprise Advisory Committee (Advisory Committee);
 - (b) issuance in September 2020 of the Exposure Draft, "Leases"; and
 - (c) analysis and consideration of feedback received through written responses to the Exposure Draft.
- 11 The AcSB received six written responses to the Exposure Draft from five public accounting firms and a provincial body. The Board reminds stakeholders that as part of its due process related to Part II of the Handbook, unless confidentiality is requested, it makes available a public file of materials relating to completed projects, which includes response letters received.
- 12 Respondents supported the underlying principles in the Exposure Draft. However, some respondents provided additional comments suggesting changes to some of the proposals.
- 13 Some respondents raised concerns related to guidance in Section 3065 that are outside of the scope of the amendments. The AcSB acknowledges that there may be other areas where changes to Section 3065 may be needed. However, the Board decided to limit the scope of the project to provide relief in a timely manner for COVID-19-related rent concessions.
- 14 The specific issues addressed in this project, including the substantive comments received on the Exposure Draft and any changes made in response to those comments, are as follows.

SCOPE OF THE RELIEF

- 15 The majority of respondents agreed with the proposal in the Exposure Draft limiting the relief to only rent concessions that occurred as a direct consequence of the COVID-19 pandemic. One respondent suggested broadening the relief to other uncommon situations. The AcSB considered extending the relief to rent concessions beyond those related to COVID-19 (i.e., similar pandemics). This eliminates the need to amend Section 3065 in the future if other pandemics occur and ensures that any relief would be immediately available. However, the AcSB thinks it would be challenging to apply, and difficult to ring-fence, the scope of the relief because it would be open to interpretation regarding what meets the definition of a "similar pandemic". This could result in diversity in practice and unintended consequences.
- 16 The AcSB notes that it would also be difficult to justify limiting the relief to only one type of catastrophic event and not broaden it to other types of events beyond pandemics (e.g., earthquakes). The Board thinks that any future catastrophic events should be assessed on a case-by-case basis and any potential amendments be tailored to the specific circumstance at the time of the event. Therefore, the Board decided that the relief in Section 3065 be limited to rent concessions occurring as a direct result of the COVID-19 pandemic. One respondent noted that since the phrase "occurred as a direct consequence of the COVID-19 pandemic" is not defined, this could lead to different interpretations and audit issues. The Board acknowledges that application of the phrase "direct consequence of the COVID-19 pandemic" will require professional judgment. However, the Board thinks this is appropriate since the purpose of the amendments is to provide guidance for preparers that is simple to apply and flexible enough to capture the majority of COVID-19-related rent concessions.
- 17 Respondents agreed with the proposals in the Exposure Draft to limit the proposed relief to only COVID-19-related rent concessions that occur in a specific timeframe. The AcSB thinks this is important to reduce the risk that the relief is applied to rent concessions other than those that are a direct consequence of the COVID-19 pandemic. Limiting the relief to a specific timeframe also makes it easier for lessees and lessors to apply, and for practitioners to audit, because it reduces the judgment in determining whether the rent concession is related to the pandemic. This judgment could

become more challenging in future periods when it may be more difficult to determine if the rent concessions are COVID-19 related.

- 18 The AcSB recognizes that determining an appropriate timeframe for the relief is challenging because it is uncertain how long the COVID-19 pandemic will last. Respondents agreed with the proposal that the relief be limited to lease payments originally due on or before December 31, 2021. A couple respondents also encouraged the Board to revise the timeframe if the COVID-19 pandemic continues beyond December 31, 2021. The Board thinks that this timeframe chosen will capture the majority of COVID-19-related rent concessions being negotiated or contemplated and provide relief to stakeholders when they need it the most. However, the Board will continuously monitor developments relating to COVID-19.
- 19 Most respondents suggested that the AcSB clarify whether all of the affected lease payments need to be originally due on or before December 31, 2021, to use the relief. In response to this, the Board decided to clarify that:
- (a) any rent concession that results in reduced lease payments must relate to payments that were originally due on or before December 31, 2021; and
 - (b) the condition to use the relief would still be met for deferrals of lease payments originally due before December 31, 2021, but are repaid after December 31, 2021, because the reduced lease payments were originally due prior to December 31, 2021.
- 20 To ensure that the use of the practical expedient is limited to rent concessions that provide relief to lessees, the AcSB proposed that the practical expedient be applicable only to rent concessions that result in the total payments required to be the same or less than the total payments required by the original lease contract. The Board thinks that a rent concession that increases the total payments required for the lease contract would not be a direct consequence of the COVID-19 pandemic, except to the extent the increase reflects only the time value of money. A few respondents suggested that guidance relating to the time value of money be included in Section 3065 to improve comparability. In response to this, the Board decided to add guidance in the standard to clarify that rent concessions that increase the total payments required for a lease contract may still meet the condition if the increase reflects the time value of money.
- 21 The AcSB also proposed that the relief should be available on a lease-by-lease basis. This is meant to provide enterprises flexibility by allowing them to use the relief for those leases where they determine relief is needed most. For example, an enterprise could choose to use the relief for its capital leases and not its operating leases because accounting for capital leases as new leases would be more complex. Respondents agreed with this proposal.

ACCOUNTING FOR COVID-19-RELATED RENT CONCESSIONS

Deferrals of lease payments

- 22 In the case of deferrals of lease payments, this type of rent concession is a timing difference as it is payable at a later date. Therefore, during the deferral period, instead of recording cash payments and receipts, a lessee will record a lease payable and a lessor will record a lease receivable.
- 23 Using the practical expedient in paragraph 3065.11A, and in accordance with paragraph 3065.11B, the following provides an example of the journal entries for an operating lease with a three-month lease payment deferral of \$1,000 per month in January-March 2021 that needs to be repaid in October-December 2021. This example is for illustrative purposes only and for simplicity assumes that the \$1,000 monthly lease payments have been the same throughout the lease term which equals the straight-line expense amount, and all amounts have been presented on a gross basis.

In each of January-March 2021 (the deferral period):

Lessee records:

DR Lease expense	1,000
CR Lease payable (deferral)	1,000

Lessor records:

DR Lease receivable (deferral)	1,000
CR Lease revenue	1,000

In each of April-September 2021:

Lessee records:

DR Lease expense	1,000
CR Cash	1,000

Lessor records:

DR Cash	1,000
CR Lease revenue	1,000

In each of October-December 2021:

Lessee records:

DR Lease expense	1,000
DR Lease payable (deferral)	1,000

Lessor records:

DR Cash	2,000
CR Lease receivable (deferral)	1,000

CR Cash	2,000	CR Lease revenue	1,000
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- 24 Using the practical expedient in paragraph 3065.11A, and in accordance with paragraph 3065.11B, the following provides an example of the journal entries for a capital and sales-type lease with a three-month lease payment deferral of \$1,000 per month in January-March 2021 that needs to be repaid in October-December 2021. This example is for illustrative purposes only and for simplicity assumes that the interest expense amount is the same each month, and all amounts have been presented on a gross basis. This example also assumes that no interest is included in the lease receivable or lease payable.

In each of January-March 2021:

Lessee records:

DR Interest expense	250
DR Obligation for capital lease	750
CR Lease payable (deferral)	1,000

Lessor records:

DR Lease receivable (deferral)	1,000
DR Unearned income	250
CR Finance income	250
CR Lease payments receivable	1,000

In each of April-September 2021:

Lessee records:

DR Interest expense	250
DR Obligation for capital lease	750
CR Cash	1,000

Lessor records:

DR Cash	1,000
DR Unearned income	250
CR Finance income	250
CR Lease payments receivable	1,000

In each of October-December 2021

Lessee records:

DR Interest expense	250
DR Obligation for capital lease	750
DR Lease payable (deferral)	1,000
CR Cash	2,000

Lessor records:

DR Cash	2,000
DR Unearned income	250
CR Finance income	250
CR Lease payments receivable	1,000
CR Lease receivable (deferral)	1,000

Reduction or waiver of lease payments

- 25 In the case of reductions or waivers of lease payments, the total payments required are less than the total payments required by the original lease contract. A lessee and a lessor continue to record the lease payments in accordance with the original lease contract. In addition, during the period that the lease payments are reduced or waived, a lessee and a lessor will recognize the reduction in total lease payments in net income in the period to which the lease payments relate.
- 26 Using the practical expedient in paragraph 3065.11A, and in accordance with paragraph 3065.11C, the following provides an example of the journal entries for an operating lease with a three-month lease payment waiver of \$1,000 per month in January-March 2021 that does not need to be repaid. This example is for illustrative purposes only and for simplicity assumes that the \$1,000 monthly lease payments have been the same throughout the lease term which equals the straight-line expense amount, and all amounts have been presented on a gross basis.

In each of January-March 2021 (the waiver period):

Lessee records:

DR Lease expense	1,000
CR Gain due to waiver	1,000

Lessor records:

DR Loss due to waiver	1,000
CR Lease revenue	1,000

In each of April-December 2021

Lessee records:

DR Lease expense	1,000
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Lessor records:

DR Cash	1,000
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CR Cash	1,000	CR Lease revenue	1,000
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- 27 Using the practical expedient in paragraph 3065.11A, and in accordance with paragraph 3065.11C, the following provides an example of the journal entries for a capital and sales-type lease with a three-month lease payment waiver of \$1,000 per month in January-March 2021 that does not need to be repaid. This example is for illustrative purposes only and for simplicity assumes that the interest expense amount is the same each month, and all amounts have been presented on a gross basis. This example also assumes that no interest is included in the lease receivable or lease payable.

In each of January-March 2021:

Lessee records:

DR Interest expense	250
DR Obligation for capital lease	750
CR Gain due to waiver	1,000

Lessor records:

DR Loss due to waiver	1,000
DR Unearned income	250
CR Finance income	250
CR Lease payments receivable	1,000

In each of April-December 2021

Lessee records:

DR Interest expense	250
DR Obligation for capital lease	750
CR Cash	1,000

Lessor records:

DR Cash	1,000
DR Unearned income	250
CR Finance income	250
CR Lease payments receivable	1,000

DISCLOSURE

- 28 The AcSB understands that providing a choice to apply the relief for COVID-19-related rent concessions could affect comparability between those enterprises that use the practical expedient and those enterprises that do not. Therefore, the Exposure Draft proposed that those enterprises that choose to use the expedient disclose that fact. For rent concessions that result in deferrals of lease payments, the Exposure Draft proposed that they also disclose the carrying amounts of lease payables and lease receivables relating to the deferrals. For rent concessions that result in a reduction in total lease payments, the Exposure Draft proposed that enterprises also disclose the amount recognized in net income for the period relating to the reduction.
- 29 Two respondents suggested additional disclosures, such as disclosing when an enterprise has used the practical expedient for only some, but not all, leases that met the conditions to apply the expedient. The respondents thought this is important information for financial statement users. The AcSB agreed and added a requirement for enterprises to disclose the fact and the reasons for not applying the practical expedient to leases that otherwise could have used the expedient because they met the conditions in paragraph 3065.11A.

EFFECTIVE DATE AND TRANSITION

- 30 Considering the importance of the relief and the urgency of receiving it, the AcSB proposed that the amendments should be effective for fiscal years ending on or after December 31, 2020. Respondents did not raise any concerns related to the effective date. Accordingly, the amendments are applicable for annual financial statements relating to fiscal years ending on or after December 31, 2020. The Board thinks that this effective date will give enterprises the opportunity to apply the relief to most COVID-19-related rent concessions received or granted in 2020, which the Board thinks is when enterprises need the relief the most. The Board also decided to permit earlier application, which includes financial statements not yet authorized for issue. Early adopting the amendments provides enterprises an opportunity to apply the practical expedient as the rent concessions occur. For example, if the financial statements of an enterprise with an October 31, 2020, year-end are not authorized for issue until November 30, 2020, the enterprise could apply the relief in those financial statements.
- 31 All respondents agreed with the Exposure Draft proposal that the amendments be applied retrospectively in accordance with ACCOUNTING CHANGES, paragraph 1506.05(d). Retrospective application allows for similar COVID-19-related rent concessions to be accounted for consistently, including those that may already have been accounted for as new leases in accordance with Section 3065 before the proposed relief was available.

CONSEQUENTIAL AMENDMENTS

- 32 As part of the amendments to Section 3065 discussed above, there were no significant consequential amendments to other Sections in Part II of the Handbook.

EXPOSURE FOR COMMENT

- 33 After resolving the issues arising from the exposure draft process, the AcSB considered, as part of its due process, whether the revisions to the proposals should be exposed for comment.

- 34 The revisions have been highlighted in the relevant sections throughout the Basis for Conclusions. These revisions consist of changes and clarifications to reduce complexity, based on feedback received from stakeholders. Other than the changes and clarifications already highlighted in the Basis for Conclusions, only minor drafting changes were made. Therefore, the AcSB decided that there was no need for re-exposure.

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