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Coronavirus and implications on accounting

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Considerations regarding lessor accounting for COVID-19-rent concessions

The Covid-19 pandemic has resulted in a number of lessors granting rent concessions to lessees. In May 2020 the Swiss Parliament voted in favor of a motion to subsequently waive rents for certain rents (mainly related to retail space) and the IASB issued "Covid-19-Related Rent Concessions - Amendment to IFRS 16" which allows a lessee, as a practical expedient, to not assess whether a Covid-19 related rent concession is a lease modification. No relief has been granted to lessors to account for a lease modification. Therefore, applying IFRS 16 Leases in the current environment raises a number of practical issues particularly for lessors.

1. Overview

In the context of the ongoing Covid-19 pandemic lessees affected by the lock-down (e.g. retailers) have obtained, or are expecting to obtain, some form of rent concession from lessors.

Rent concession granted by a lessor can take many forms, including current or subsequent waiver, reductions and deferral of lease payments. A concession might also include a change to the lease term.

IFRS 16 *Leases* contains certain guidance on accounting for changes in lease payments for both lessees and lessors. Lessor accounting for lease modifications[i] depends on the classification of the lease as operating or finance lease. This paper focuses on the treatment of operating leases as the majority of the leases affected is expected to qualify as operating leases. Given that an operating lease results in straight-line revenue recognition, a lessor accounts for a modification to an operating lease as a new lease from the effective date of the modification, considering any prepaid or accrued lease payments relating to the original lease as part of the lease payments for the new lease.[ii] Where an operating lease is not modified, but some of the payments are no longer due under the lease agreement (for example, because of force majeure or similar clauses in the contract or applicable laws or regulation), it would be appropriate for the lessor to treat the change to the payments as a negative variable lease payment and to reduce the recognition of revenue for the periods affected by the amount that is no longer to be paid under the contract by the lessee.

Assessing whether the rent concessions are lease modifications, and applying the required accounting in practice, could be difficult in the current environment. Therefore, in May 2020, the IASB issued *Covid-19-Related Rent Concessions - Amendment to IFRS 16 (the amendment)* which, effective in substance immediately, grants an optional relief to lessees from assessing whether a Covid-19 related rent concession is a lease modification or not. The May 2020 amendments to IFRS 16 do not apply to lessors, therefore lessor accounting for rent concessions is based on the existing guidance.

2. Collectability

As a result of Covid-19, collectability of rentals on some operating leases has become increasingly uncertain. The question is then whether the lessor should continue to recognise the corresponding lease income.

Unlike other standards such as IFRS 15 *Revenues from Contracts with Customers*, IFRS 16 does not refer to collectability to determine whether (and when) lease income should be recognised. Therefore, different approaches will be seen in practice. The lessor may continue to recognise operating lease income even when it may not be collectable, and apply IFRS 9's guidance on credit losses to recognized lease receivables.

However, alternatively the lessor could only recognize lease payment to the extent collectable to take into account the high uncertainty related to the collectability of the full lease payments. Entities should choose the policy consistent with the accounting treatment applied to similar cases of non-recoverability in the past.

3. Waiver for or reduction of past lease receivables in an operating lease

As stated above, rent concession granted by a lessor can take many forms, including current or subsequent waiver, reductions and deferral of lease payments. The following considerations only deal with the accounting of a waiver for or a reduction of past lease receivables in an operating lease from the angle of the lessor. In such a case the lessor may have recognized rent income during the lockdown period (e.g. lease payments due for the period April to June 2020), which subsequently may be waived or reduced in August or September 2020 following the enactment of a law based on the May 2020 motion of the Swiss parliament to lower the rents below CHF 20'000 per month for restaurants and other companies closed down by the Federal Council in March by 60% or through a voluntary waiver / reduction from the lessor.

Expecting the future enactment of the governmental law later in the year or a voluntary waiver by the lessor, the lessee may have suspended the lease payments for the period April to June. In the interim reporting as of 30 June 2020, the lessor should have performed an assessment of the recoverability of the lease receivable and may have written off (part of) the lease receivable expecting not to recover the outstanding amount (in full).

IFRS 16 does not include clear guidance on how to account for the subsequent waiver/reduction granted in August or September 2020 and there are mixed views on what the appropriate accounting may be. Due to this lack of specific guidance different accounting approaches might be applied in practice in the interim reporting as of 30 September 2020. Entities should choose their treatment as an accounting policy choice and apply it consistently to amendments to contracts with similar characteristics and in similar circumstances.

One possible approach would be to treat the rent concession as a lease modification. The lessor would account for the modification as a new lease from the effective date of the modification (August or September 2020), considering the waiver granted as an incentive to be (prospectively) straight lined over the new lease term. Therefore, a lessor could follow the guidance in paragraph 87 of IFRS 16 which states that an operating lease modification should be treated as a new lease, and that any ‘accrued lease payments’ (after any write offs recognised as of 30 June 2020) must be treated as part of the lease payments for the new lease. Consequently, the lessor would not change the amount previously recognised on the balance sheet for contractually due past rentals immediately on the modification, but it would recognise lower lease income over the remaining term of the lease.

Another possible approach might be the following: The lessor did not waive its contractual entitlement to the April to June lease payments at that time, and accordingly recorded a lease receivable for the outstanding payments. The subsequent waiver of those lease payments by the lessor means that the lessor’s contractual entitlement expires at that point, resulting in the derecognition of the lease receivable (or related part of the lease receivable) when the lessor subsequently waives its contractual entitlement to those lease payments. [iii] Under this accounting, the forgiveness (to the extent that the receivable has not been written down on 30 June 2020) would be recognised as a loss in the income statement, with a corresponding reduction to the lease receivable in the period in which the reduction is contractually agreed.

In case the lessee has paid all or part of the outstanding rent after 30 June 2020 but before the law enactment the question arises how the payment should be accounted for by the lessor. A reasonable approach might be to recognise the cash received as a liability to the extent of the expected refund according to the new law.

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[i] Defined as a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease.

[ii] IFRS 16.87

[iii] This lease receivable falls within the scope of IFRS 9 for the purposes of derecognition and impairment (IFRS 9.2.1(b)), and accordingly is derecognized when contractual rights to the cash flows expire (IFRS 9.3.2.3(a).