Accounting for Covid-19 - related rent concessions applying IFRS 16 Leases

Tony Castagnetti
Maggio 2020

Abstract

The effects of the pandemic, Covid-19, has led most countries to implement a lockdown period and as a result, many businesses have turned to their landlords to provide rent holidays on their commercial leases.

The International Accounting Standards Board has issued guidance on the application of IFRS 16 for Covid-19-related rent concessions. IFRS 16 Leases contemplates that changes may occur in lease payments over the term of a lease. The required accounting for such changes (if material) involves the application of judgement and depends on several factors, including importantly whether those changes were part of the original terms and conditions of the lease. Changes could arise either directly from amendments to the lease contract itself or indirectly—for example, from actions of government in response to the covid-19 pandemic.

The application of IFRS 16 requires changes in lease payments to be treated in the same way, regardless of how they derived.

Some changes are specifically mentioned within the IFRS and guidance is given as to how they should be accounted for. An example would be changes arising from movements in an index or rate used to determine lease payments. As stated in the IFRS, if variable lease payments are based on an index or rate and this changes, the lessee remeasures the lease liability and the right-of-use asset, based on the new payments required at the existing discount rate. But if the variable lease payments are not based on an index or rate (for example they vary with sales or market prices) the changes in payments are recognised in the period in which they occur.

Otherwise the accounting treatment depends on whether there has been a modification to the lease itself. This would imply that the modification was not part of the original terms or conditions of the lease.

The first step therefore in dealing with material rent holidays or concessions is to determine whether they were part of the original lease contract. Although such amendments might appear to be due to Covid-19 concessions they might arise from changes in indices, base rates or performance measures which were embedded in the contract from the outset. Contracts should therefore be checked thoroughly as the accounting treatment differs depending on the result.

IFRS 16 defines a lease modification 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. If there is no change in either the scope of the lease or the consideration for the lease, then there is no lease modification. Examples of a change in the scope of a lease include adding or terminating the right to use one or more underlying assets or extending or shortening the contractual lease term. A rent holiday or rent reduction alone is not necessarily a change in the scope of a lease.

Consideration needs to be given to the terms and conditions of the contract and all the relevant facts and circumstances. Relevant facts and circumstances may include contract, statutory or other laws or regulations applicable to lease contracts. For example, lease contracts or applicable laws or regulations may contain clauses that result in changes to payments if particular events occur or circumstances arise. Government action (for example, such as the requirement to close retail stores under a lockdown for a period of time in order to contain covid-19) might be relevant to the legal interpretation of clauses, such as force majeure, that were in the original contract or in applicable laws or regulations.

Changes in lease payments that result from clauses in the original contract or in applicable laws or regulations are part of the original terms and conditions of the lease, even if the effect of those clauses (arising from an event such as the covid-19 pandemic) was not previously contemplated. In such a case there is no lease modification for the purposes of IFRS 16 as they were included in the original contract. That change would therefore be accounted for as a variable lease payment.

If, on the other hand, the change in lease payments results from a modification of the contract, lessees will need to:

- Remeasure the lease liability by discounting the revised lease payments using a revised discount rate (either the implicit rate or the incremental borrowing rate at the date of the modification).
- Decrease the carrying amount of the right-of-use asset to reflect the partial or full termination of the lease due to the modification, recognising any gain or loss in profit or loss.

If a change in lease payments results in the extinguishment of a part of a lessee's obligation specified in the contract (for example, a lessee is legally released from its obligation to make specifically identified payments), the lessee would need to consider whether the requirements for derecognition of a part of the lease liability are met applying paragraph 3.3.1 of IFRS 9 Financial Instruments. Lease terms are often judgemental as they involve decisions about whether break clauses or extension options will be exercised. The effect of the Covid-19 situation may change previous judgements and therefore require remeasurements of lease liabilities and right-of-use assets.

There is also the question of impairment. The circumstances that give rise to rent concessions as a result of the covid-19 pandemic are likely to indicate that assets may be impaired. The loss of earnings during the period covered by a rent concession may be an indicator of impairment of the related asset. Similarly, longer-term effects of the covid-19 pandemic could affect the expected ongoing economic performance of right-of-use assets. IAS 36 Impairment of Assets applies in determining whether right-of-use assets (for lessees) and items of property, plant and equipment subject to an operating lease (for lessors) are impaired.

Lessors will also need to consider the applicable requirements of IFRS 9, for example when accounting for any impairment of lease receivables.

Finally, we come to the question of disclosures. Both lessees and lessors should ensure disclosures are sufficient to allow users to understand the impact of any Covid-19 related changes in lease payments and/or receipts on the entity's financial position and performance.