

Accounting for Lessee's COVID-19 Rent Concessions

Many organisations have had to embrace virtual working thereby reducing access or completely shutting down their offices due to the enforced COVID-19 lockdowns. As a result, many lessees have gone back to their landlords to request modifications to their lease payments or rent concessions.

Considering that governments and other economic participants have provided similar relief to alleviate the economic hardship experienced during these difficult times, some lessors have deemed it fit to grant request for lease modification or rent concessions to lessees as a cushion to the direct impact of COVID-19. Most lease modifications or payment holidays received by lessees take the form of either a decrease in rental payments or a deferral of rentals (payment holiday). For every accountant, the question becomes, how should the lessees report these different lease modifications or rent concessions?

What is Lease Modification?

This is essentially a change in the lease agreement; therefore, we start by looking at the lease modification guidance in IFRS 16 on Leases (IFRS 16). According to IFRS 16, a lease modification is defined as a change in the scope of a lease or the consideration for a lease, that was not part of the original lease terms and conditions. Further, it includes adding or terminating the right to use one or more underlying assets or extending or shortening the contractual lease term.

The International Accounting Standards Board (IASB) issued amendments to IFRS 16 in May 2020 to address the impact of rent concessions received as a direct result of COVID-19. The IASB noted that applying lease modification guidance could become complex and cumbersome for lessees, especially where large volumes of leases are affected.

This amendment applies only to lessees and not to lessors. It allows lessees to account for COVID-19 related rent concessions as variable lease payments instead of as a lease modification affecting the asset. The variable lease payment is to be recognised through the income statement in the period in which the event or condition that triggers those payments occurs.

Reduction in Lease Payment vs Deferral of Lease Payment

As mentioned, lessees can receive rent concessions that take the form of a reduction of lease payments or a lease payment deferral. It is important to understand what these entails and what the accounting implications are:

❖ Reduction of Lease Payments

Reduction of lease payments by way of a reduction in the rental amounts, rent free periods or payment holidays are payments where the lessor provides a rent free or reduced rental period to the lessee without expecting the lessee to repay those lease payments.

A lessee who has applied the practical expedient will account for a reduction in lease payments as a variable lease payment reducing the lease expense in income statement with the corresponding adjustment against the lease liability (applying paragraph 38 of IFRS 16). The lessee no longer has the full obligation as originally agreed on with the lessor and thus must reflect the 'revised' contractual obligation after taking the rent concession into account.

❖ Deferral of Lease Payments

A deferral of lease payments occurs when the lessor has decreased the lease payment for a certain period and the lessee then pays an increased lease payment at a later stage to catch up the payments. These type of rent concessions are not accounted for as variable lease payments as they are not forgiven and do not extinguish a portion of the lessee's liability.

These rent concessions are accounted for as a remeasurement to the lease liability. The lessee will continue to recognise interest as well as an adjustment for the time value of money. This is in line with the principle that the lessee always reflects the present value of future lease payments.

The lessee will present the revised lease payment schedule using its original discount rate when the concession becomes effective as the lessee is not applying lease modification accounting by using the practical expedient. The impact of the remeasurement is recognised in the income statement when the rent concession becomes effective.

With regards to the right-of-use asset, the lessee will continue to depreciate its right-of-use asset over the lease term (and possibly the extended lease term if applicable). The lessee will also consider any impairment on the right-of-use asset in accordance with IAS 36 on Impairment of Assets.

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Applying the IFRS 16 COVID-19 Rent Concessions

This amendment is practical expedient and voluntary. However, there are three conditions that must be met before a lessee can apply this, namely:

- ❖ the amendment to the lease payments results in a revised consideration being less than or equal to the consideration before the lease revision.
- ❖ the reduction in lease payments is only for periods up to 30 June 2021; and
- ❖ there is no substantive change to any other term and conditions of the lease. [IFRS 16.46B]

Rent concessions that substantially increase the lease consideration would not meet the requirements of the first condition of the practical expedient above. If the increase reflects time value of money, the consideration is deemed to be substantially the same and the rent concession could potentially meet the first condition of the practical expedient. Where, for example, the rental space is reduced, together with the concession, the third condition is not met.

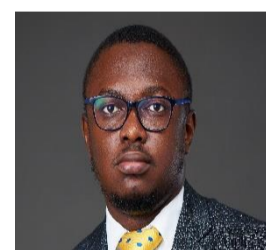
Other considerations

Lessees should always consider whether there are any indicators that the right-of-use asset could be impaired in terms of IAS 36, especially in these uncertain times and with COVID-19 being considered an indicator by most regulators. The uncertainty in recoverable amounts and fair value is greatly increased as a buyer would most likely not pay the same price for an asset at the start of the pandemic versus a date further down in the pandemic. It is important to keep monitoring for any impairment triggers.

In terms of disclosure around the application of the practical expedient, lessees are required to disclose the fact that they have applied the practical expedient. This is in addition to stating whether the practical expedient was applied to all rent concessions that met the requirements of paragraph 46B of IFRS 16. If the practical expedient was not applied to all rent concessions, the lessee must disclose information about the nature of the contracts to which the lessee has applied the practical expedient. The amount recognised in income statement for the reporting period to reflect changes in lease payments must also be included in the related COVID-19 rent concession disclosures.

Lessees should also consider the tax impacts of applying the practical expedient and how it can impact current and deferred tax.

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