Grant Thornton

Accounting

Advisory

Global

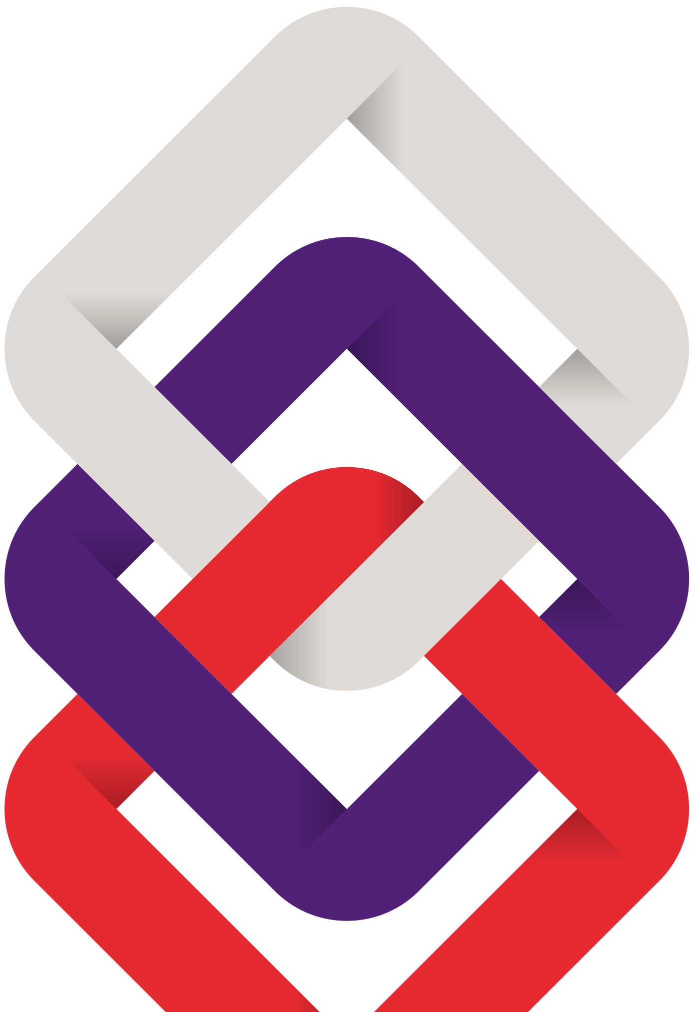
COVID-19 accounting for lease modifications

The COVID-19 pandemic is requiring those responsible for the preparation of financial statements to reconsider whether assumptions and assessments previously made are still valid and appropriate which in turn is creating an additional burden on entities all over the world. In particular, IFRS 16 has become an area of focus for entities and the International Accounting Standards Board (IASB). Lessors are providing lessees with rent concessions. These can be in the form of rent holidays or rent reductions for an agreed timeframe (possibly followed by increased rentals in future periods).

In some jurisdictions, governments are making rent concessions a requirement. In others they are merely encouraging them. The financial effect of these concessions may have a material impact on the financial statements for some lessees, particularly in the retail and hospitality industries which in many cases have been forced to temporarily close their premises.

IFRS 16 contains specific requirements on accounting for lease modifications. Rent concessions that change the overall consideration for the lease are in the scope of these requirements. Lessees are required to assess whether rent concessions are lease modifications and, if they are, apply specific accounting guidance. This can be burdensome, especially for large portfolios of leases which may have different features as well as receiving alternative rent concessions from landlords. Entities already have significant pressures upon them as a result of this pandemic and what is set out in IFRS 16 just adds to the burden.

In response to this, the IASB has therefore added a practical expedient to provide relief for lessees from lease modification accounting for rent concessions related to COVID-19. This article explains the current accounting requirements, the practical expedient and how to apply it.



Lessor modifications

Finance leases

Lessor accounting for modification of finance leases is detailed in IFRS 16.79 to 80. Similar to lessee accounting, when the scope of a lease increases and the consideration changes commensurately, a separate lease exists. Where this is not the case, the lessor must:

- reassess the accounting for the lease and determine if the lease would have been considered an operating lease if the modification had been known; and, if so:
  - create a new lease from the effective date of the modification; and
  - reclassify the lease receivable balance at the date of modification to property, plant and equipment
- where the lease remains a finance lease, the lease receivable is remeasured by the application of IFRS 9. In such a case, assuming that that the receivable is classified as amortised cost, the change in future cash flows is a remeasurement event resulting in a gain or loss within profit or loss.

Operating leases

IFRS 16 provides only limited guidance on the modification of operating leases from a lessor's perspective. It requires that any modification be considered a new lease, and that any remaining prepayments and accruals are included in the accounting for this new lease. IFRS 16 does not state whether balances arising from the lessor's straight-lining calculation are considered to be accruals or prepayments but our view, consistent with the approach when applying IAS 17, is that they are.

In such an instance, if the new lease continues to be classified as operating, the future cash flows are recognised on a straight line (or other systematic) basis, adjusted for any prepayments or accruals. The expense recognition pattern should ensure the balance is written down to zero at the end of the lease.

Impairment

Due to the change in fair value of future cash flows, impairment indicators may exist such that impairment of the individual assets that are leased should be considered.

Lessee modifications

Reasssessment vs modification

Lease modification and reassessment of the lease liability are two different concepts with potentially different accounting outcomes. Generally, a reassessment takes place when there are changes in lease payments based on contractual clauses included in the original contract – such as changes in CPI, a market price adjustment or a change in any price guarantee arrangement that might appear in the lease contract (IFRS 16.42). In such an instance, the lease liability is remeasured by discounting the future cash flows using the discount rate set in the initial measurement of the lease (IFRS 16.43).

A lease modification (as considered in this document – does not address changes in the leased asset, such as decreases in leased space) arises when the lease contract is altered such that future cash flows and/or the scope of the lease changes. Where an increase in scope occurs, and the payment for this increase in scope is commensurate, a separate lease is accounted for (IFRS 16.44). Otherwise, the original lease is remeasured by:

- identifying a revised discount rate appropriate to the revised lease term, underlying asset and the lessee
- determining the net present value of future cash outflows using that revised discount rate
- adjusting the remaining right-of-use asset for the increase or decrease in the lease liability. If the adjustment exceeds the carrying value of the right-of-use asset this excess is recognised as a gain in profit or loss.

Example 1 – lease abatement

RetailCo closed its stores on 15 March 2020. Economic and regulatory circumstances changed on 30 June 2020 such that RetailCo wished to reopen its stores, however the significant period of time with no cash inflow resulted in insufficient working capital to meet its lease obligations.

On 1 April 2020, RetailCo received a 6-month lease abatement from its landlord, starting 1 April and expiring 30 September 2020. RetailCo's incremental borrowing rate was 4% at lease inception; it is now 6% because its credit rating has fallen. Payments were CU1,000 per month, expiring in 30 June 2021. Renegotiated payments remain consistent. Payments are in arrears.

At 1 April 2020, the balance of the right-of-use asset was CU15,000. The Liability balance was CU14,607.

Month		Original Payment	New Payment
2020	April	1,000	–
	May	1,000	–
	June	1,000	–
	July	1,000	–
	August	1,000	–
	September	1,000	–
	October	1,000	1,000
	November	1,000	1,000
	December	1,000	1,000
2021	January	1,000	1,000
	February	1,000	1,000
	March	1,000	1,000
	April	1,000	1,000
	May	1,000	1,000
	June	1,000	1,000
PV Cash Flows		**CU14,607**	**CU8,779**
Change +/(-)		**(CU5,828)**	

Example 1 – lease abatement (continued)

Journal		CU	CU
Dr	Lease liability	5,828	
Cr	Right-of-use asset		(5,828)

To adjust lease accounting for lease abatement

Decrease in lease liability > right-of-use asset

If the right-of-use asset had been CU5,000 at the date of modification, the decrease of CU5,828 is more than the right-of-use asset. In such a case, a gain is recognised:

Journal		CU	CU
Dr	Lease liability	5,828	
Cr	Right-of-use asset		(5,000)
Cr	Gain (profit or loss)		(828)

To adjust lease accounting for lease abatement

The practical expedient

The practical expedient avoids the need for lessees to carry out an assessment to decide whether a COVID-19-related rent concession received is a lease modification or not. The lessee accounts for the rent concession as if the change was not a lease modification. However, there are no changes for lessors.

The practical expedient is only applicable to rent concessions provided as a direct result of the COVID-19 pandemic. In addition, the relief is only for lessees that are granted these rent concessions. All of the following conditions in relation to permitting a lessee to apply the practical expedient need to be met:

- the rent concession provides relief to payments that overall results in the consideration for the lease contract being substantially the same or less than the original consideration for the lease immediately before the concession was provided
- the rent concession is for relief for payments that were originally due on or before 30 June 2021. So payments included are those that are reduced or deferred on or before 30 June 2021, but any subsequent rental increases can go beyond 30 June 2021
- there are no other substantive changes to the other terms and conditions of the lease.

Lessees are not required to apply the practical expedient it is optional. They are also not required to apply the practical expedient to all leases that are eligible for application. They are however, required to apply it to leases with similar characteristics and in similar circumstances. When identifying such lease contracts, different approaches may be acceptable. For example, the entity may apply the practical expedient based on the class of underlying asset. This could involve applying the practical expedient to leased property, but not leased equipment. Another approach could be to apply the practical expedient based on the type of rent concession received. For example, the entity may choose to apply the practical expedient to rent concessions that relate to rent forgiveness but apply lease modification accounting to any other type of lease concession. If the entity chooses to apply the practical expedient to some but not all lease contracts then additional disclosure will be required, see below.

Disclosure

If applying the practical expedient, the amendments require the entity to disclose:

- that it has applied the practical expedient to all its rent concessions, or if only some of them, a description of the nature of the contract it has applied the practical expedient to, and
- the amount in profit or loss for the reporting period that reflects the change in lease payments arising from rent concessions (as a result of applying the practical expedient).

Effective date

The amendment is applicable for reporting periods beginning on or after 1 June 2020. Earlier application will be permitted, including for financial statements not yet authorised for issue at 28 May 2020 (the date the amendment was issued).

IFRS as endorsed by the EU

However, the amendment cannot be adopted by entities applying EU-adopted IFRS until it has been endorsed for use in Europe. At the time of writing, EU endorsement is expected to be in September 2020. In some instances this may be too late for entities wishing to take advantage of the amendment in the preparation of interim financial statements in accordance with IAS 34 that will be approved for issue prior to the date of EU endorsement. If interim financial statements are being audited or reviewed we strongly encourage reporting entities to understand well before the financial statements are approved how this situation will be reported on by their assurance provider.

Types of concessions applying the practical expedient

Some practical examples of where the practical expedient might be used:

Type of concession	Description
Deferral of lease payments	Lessors allow lessees to defer making their lease payments until a later date, lowering the payments in one period and then increasing them in future periods. A concession that simply defers rentals payments to a later date is not necessarily a modification based on the IASB's recent education guidance. The changes in the practical expedient are however still useful as they avoid the lessee having to assess whether or not modification accounting applies.
Forgiven lease payments	Lessors providing rent free periods or rent holidays with no other changes to the lease and no requirement to repay these amounts at a later date.
Partial deferral and forgiveness of lease payments	Lessors allow lessees to defer some lease payments as well as giving them a rent-free period.

"The practical expedient avoids the need for lessees to carry out an assessment to decide whether a COVID-19-related rent concession received is a lease modification or not."

Example 2 – accounting for unconditional forgiven lease payments

Scenario

A lessee enters into a five-year lease agreement on 1 January 2019, the monthly payments are CU1,000. The business of the lessee is significantly impacted by COVID-19 and so the lessor agrees to provide a rent concession. On 1 May 2020, the lessor agrees to forgive six months of payments unconditionally in 2020 with no adjustment to future rentals. Assume interest accrues using an incremental borrowing rate of 5% (calculated on a daily basis). Monthly depreciation is CU885.

Analysis

The lessee determines the practical expedient can be applied. As the concession is unconditional, it is accounted for on 1 May 2020 as this is the date that triggers the event. The lessee accounts for this concession as a negative variable lease payment.

Original schedule of lease payments

Month	Opening balance	Interest	Payment	Closing balance
January 2019	53,135.00	213.72	(1,000.00)	52,348.72
February 2019	52,348.72	196.49	(1,000.00)	51,545.21
March 2019	51,545.21	214.24	(1,000.00)	50,759.45
April 2019	50,759.45	204.16	(1,000.00)	49,963.61
May 2019	49,963.61	207.68	(1,000.00)	49,171.29
June 2019	49,171.29	197.77	(1,000.00)	48,369.06
July 2019	48,369.06	201.05	(1,000.00)	47,570.11
August 2019	47,570.11	197.72	(1,000.00)	46,767.83
September 2019	46,767.83	188.11	(1,000.00)	45,955.94
October 2019	45,955.94	191.01	(1,000.00)	45,146.95
November 2019	45,146.95	181.59	(1,000.00)	44,328.54
December 2019	44,328.54	184.25	(1,000.00)	43,512.79
January 2020	43,512.79	180.86	(1,000.00)	42,693.65
February 2020	42,693.65	165.99	(1,000.00)	41,859.64
March 2020	41,859.64	173.99	(1,000.00)	41,033.63
April 2020	41,033.63	165.04	(1,000.00)	40,198.67
May 2020	40,198.67	167.08	(1,000.00)	39,365.75
June 2020	39,365.75	158.34	(1,000.00)	38,524.09
July 2020	38,524.09	160.12	(1,000.00)	37,684.21
August 2020	37,684.21	156.64	(1,000.00)	36,840.85
September 2020	36,840.85	148.18	(1,000.00)	35,989.03
October 2020	35,989.03	149.58	(1,000.00)	35,138.61
November 2020	35,138.61	141.34	(1,000.00)	34,279.95
December 2020	34,279.95	142.48	(1,000.00)	33,422.43

Example 2 – accounting for unconditional forgiven lease payments (continued)

The journal entries before the concession are as follows:

Journal:	CU	CU
Dr Interest in the profit or loss	213.72	
Cr Lease liability		213.72

Representing the interest charged for the period (monthly journal)

Journal:	CU	CU
Dr Depreciation of right-of-use asset	885	
Cr Right-of-use asset – depreciation charge for the year		885

Representing depreciation for the period (monthly journal)

Amended schedule of lease payments

Month	Opening balance	Interest	Payment	P&L variable gain	Closing balance
January 2019	53,135.00	213.72	(1,000.00)	–	52,348.72
February 2019	52,348.72	196.49	(1,000.00)	–	51,545.21
March 2019	51,545.21	214.24	(1,000.00)	–	50,759.45
April 2019	50,759.45	204.16	(1,000.00)	–	49,963.61
May 2019	49,963.61	207.68	(1,000.00)	–	49,171.29
June 2019	49,171.29	197.77	(1,000.00)	–	48,369.06
July 2019	48,369.06	201.05	(1,000.00)	–	47,570.11
August 2019	47,570.11	197.72	(1,000.00)	–	46,767.83
September 2019	46,767.83	188.11	(1,000.00)	–	45,955.94
October 2019	45,955.94	191.01	(1,000.00)	–	45,146.95
November 2019	45,146.95	181.59	(1,000.00)	–	44,328.54
December 2019	44,328.54	184.25	(1,000.00)	–	43,512.79
January 2020	43,512.79	180.86	(1,000.00)	–	42,693.65
February 2020	42,693.65	165.99	(1,000.00)	–	41,859.64
March 2020	41,859.64	173.99	(1,000.00)	–	41,033.63
April 2020	41,033.63	165.04	(1,000.00)	–	40,198.67
May 2020	40,198.67	138.03	–	(6,000)	34,336.70
June 2020	34,336.70	129.32	–	–	34,466.02
July 2020	34,466.02	143.75	–	–	34,609.77
August 2020	34,609.77	139.68	–	–	34,749.45
September 2020	34,749.45	144.92	–	–	34,894.37
October 2020	34,894.37	140.83	–	–	35,035.20
November 2020	35,035.20	146.12	(1,000.00)	–	34,181.32
December 2020	34,181.32	142.56	(1,000.00)	–	33,323.88

Example 2 – accounting for unconditional forgiven lease payments (continued)

The journal entries accounting for the concession are:

Journal:	CU	CU
Dr Lease liability	6,000	
Cr Profit or loss		6,000

Representing the forgiven payments (one-off journal at 1 May 2020 – see note 1)

Journal:	CU	CU
Dr Interest in the profit or loss	213.72	
Dr Lease liability		213.72

Representing the interest charged for the period (monthly journal – see note 2)

Journal:	CU	CU
Dr Depreciation of right-of-use asset	885	
Cr Right-of-use asset – depreciation charge for the year		885

Representing depreciation for the period (monthly journal)

Note 1 – In our view, the presentation of the credit within profit or loss aligns more closely with how variable lease payments should be accounted for. However, we recognise there is an argument to present the credit as a financial item, as 'debt forgiveness'. So long as it is appropriately disclosed in the financial statements either treatment would be acceptable.

Note 2 – The incremental borrowing rate used to measure the interest on the lease liability should remain unchanged. After accounting for the rent concession, the lessee's lease liability represents all future payments owing to the lessor discounted at the lessee's incremental borrowing rate.

Example 3 – accounting for conditional forgiven lease payments

Scenario
The scenario for this example is the same as example above except the concession is conditional on whether the country is still in lockdown at the beginning of the month when the rent is due.

Analysis
In which case the journal representing the forgiveness of the lease payments is amended to a monthly journal as follows:

Journal:	CU	CU
Dr Lease liability	1,000	
Cr Profit or loss		1,000

Representing the forgiven payments (monthly journal)

This is because the date that triggers the accounting is the first of every month the concession is offered. The interest charged for those months of the concession would be impacted and should be re-calculated accordingly.

Example 4 – accounting for deferral of lease payments

Scenario

A lessee enters into a two-year lease agreement on 1 January 2020, the monthly payments are CU1,000. The business of the lessee is significantly impacted by COVID-19 and so the lessor agrees to provide an unconditional rent concession. On 1 July 2020, the lessor agrees to defer three months of payments in 2020. In this example we have assumed interest accrues using an incremental borrowing rate of 5% (calculated on a daily basis).

Original schedule of lease payments

Month	Opening balance	Interest	Payment	Closing balance
January 2020	22,820.00	92.01	(1,000.00)	21,912.01
February 2020	21,912.01	82.44	(1,000.00)	20,994.45
March 2020	20,994.45	87.48	(1,000.00)	20,081.93
April 2020	20,081.93	80.97	(1,000.00)	19,162.90
May 2020	19,162.90	79.84	(1,000.00)	18,242.74
June 2020	18,242.74	73.56	(1,000.00)	17,316.30
July 2020	17,316.30	72.15	(1,000.00)	16,388.45
August 2020	16,388.45	68.28	(1,000.00)	15,456.73
September 2020	15,456.73	62.32	(1,000.00)	14,519.05
October 2020	14,519.05	60.49	(1,000.00)	13,579.54
November 2020	13,579.54	54.76	(1,000.00)	12,634.30
December 2020	12,634.30	52.64	(1,000.00)	11,686.94
January 2021	11,686.94	48.69	(1,000.00)	10,735.63
February 2021	10,735.63	41.84	(1,000.00)	9,777.47
March 2021	9,777.47	40.74	(1,000.00)	8,818.21
April 2021	8,818.21	35.55	(1,000.00)	7,853.76
May 2021	7,853.76	32.73	(1,000.00)	6,886.49
June 2021	6,886.49	27.76	(1,000.00)	5,914.25
July 2021	5,914.25	24.65	(1,000.00)	4,938.90
August 2021	4,938.90	20.57	(1,000.00)	3,959.47
September 2021	3,959.47	15.97	(1,000.00)	2,975.44
October 2021	2,975.44	12.40	(1,000.00)	1,987.84
November 2021	1,987.84	8.01	(1,000.00)	995.85
December 2021	995.85	4.15	(1,000.00)	–

Example 4 – accounting for deferral of lease payments (continued)

The lessee determines that as the rent concession is a direct consequence of COVID-19, the practical expedient can be applied. Because the rent payable has been deferred and not forgiven a negative variable lease payment is not accounted for. Instead, the lessee remeasures the present value of the lease liability using the original discount rate of 5% (which remains unchanged). The lessee then recognises the impact of the change in the present value of the lease liability in profit or loss when the rent concession becomes effective. After the deferral period, the payments increase to CU1,200 for the remaining lease term.

Amended schedule of lease payments

Month	Opening balance	Re-measurement	Interest	Payment	Closing balance
January 2020	22,820.00	–	92.01	(1,000.00)	21,912.01
February 2020	21,912.01	–	82.44	(1,000.00)	20,994.45
March 2020	20,994.45	–	87.48	(1,000.00)	20,081.93
April 2020	20,081.93	–	80.97	(1,000.00)	19,162.90
May 2020	19,162.90	–	79.84	(1,000.00)	18,242.74
June 2020	18,242.74	–	73.56	(1,000.00)	17,316.30
July 2020	17,316.30	(107.60)	72.17	–	17,280.87
August 2020	17,280.87	–	72.00	–	17,352.87
September 2020	17,352.87	–	69.97	–	17,422.84
October 2020	17,422.84	–	72.60	(1,200.00)	16,295.44
November 2020	16,295.44	–	65.70	(1,200.00)	15,161.14
December 2020	15,161.14	–	63.17	(1,200.00)	14,024.31
January 2021	14,024.31	–	58.44	(1,200.00)	12,882.75
February 2021	12,882.75	–	50.21	(1,200.00)	11,732.96
March 2021	11,732.96	–	48.88	(1,200.00)	10,581.84
April 2021	10,581.84	–	42.67	(1,200.00)	9,424.51
May 2021	9,424.51	–	39.27	(1,200.00)	8,263.78
June 2021	8,263.78	–	33.32	(1,200.00)	7,097.10
July 2021	7,097.10	–	29.57	(1,200.00)	5,926.67
August 2021	5,926.67	–	24.70	(1,200.00)	4,751.37
September 2021	4,751.37	–	19.16	(1,200.00)	3,570.53
October 2021	3,570.53	–	14.87	(1,200.00)	2,385.40
November 2021	2,385.40	–	9.62	(1,200.00)	1,195.02
December 2021	1,195.02	–	4.98	(1,200.00)	0

Journal:	CU	CU
Dr Lease liability	107.60	
Cr Profit or loss		107.60

Representing the impact of remeasuring the lease liability. At 1 July 2020 the lease liability is remeasured to CU17,208.70, which is the present value of the remaining 15 lease payments, discounted at 5% (which is the lessees unchanged discount rate).

How Grant Thornton can help

Preparers of financial statements will need to be agile and responsive as the situation unfolds. Having access to experts, insights and accurate information as quickly as possible is critical – but your resources may be stretched at this time. We can support you as you navigate through accounting for the impacts of COVID-19 on your business.

Now more than ever the need for businesses, their auditors and any other accounting advisors to work closely together is essential. If you would like to discuss any of the points raised, please speak to your usual Grant Thornton contact or visit **www.grantthornton.global/locations** to find your local member firm.

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