

Impact of Covid-19 on accounting for leases (3/38/20)

The Covid-19 pandemic has brought significant changes to the business environment, including temporary rent concessions. As a result, amendments to International Financial Reporting Standard 16 Leases ("IFRS 16"), which were adopted on 28 May 2020 and could be applied to financial statements for 2020, are awaiting EU approval.

The amendments

A lessee can apply practical relief to any rent concessions occurring as a direct consequence of Covid-19 if three conditions are all met:

1. The change in lease payments results in revised consideration for the lease that is substantially the same as, or less than, the consideration for the lease immediately preceding the change;
2. Any reduction in lease payments affects only payments originally due on or before 30 June 2021;
3. There is no substantive change to other terms and conditions of the lease.

The term "substantive change" is not explained in detail, so the lessee needs to assess any changes in terms of quality and quantity. To better understand the concept of substantivity, let us look at a few examples.

If a lease agreement has three years left to run and the lessor grants a two-month rent concession without changing the total period, area and consideration for the lease, the change is unlikely to significantly affect the lease liability. As a result, the lessee can apply the practical relief and account for the change as a variable lease payment, without recalculating the entire lease liability.

However, if in addition to this change, the lease period is extended for two years, this is likely to mean a substantive change to other terms and conditions of the lease because the total future lease payments go up significantly, so the practical relief is not available. Likewise, a significant increase or reduction in the leased area is likely to represent a substantive change to other terms and conditions of the lease.

It is important to note that applying the practical relief is an option – the lessee can also choose to account for any Covid-19 related rent concession as a lease modification and make the full recalculation according to IFRS 16.

When applying the practical relief, the rent concession is accounted for as a variable lease payment, i.e. recognised in profit or loss for the relevant period with an appropriate reduction in the lease liability but with no effect on accounting for the right-of-use asset. The relevant period under IFRS 16 is when the parties agree to change the terms and conditions of the lease, not when payment is actually made.

The lessee should remember that accounting policies must be applied consistently. So if there are two or more leases with a similar rent concession, all of them must be accounted for under the same principles. And the lessee's financial statements must indicate that the practical relief under IFRS 16 has been applied.

Any relief for lessors?

No practical relief related to Covid-19 is available to lessors under IFRS 16. Accordingly, when it comes to rent concessions, the lessor needs to assess whether this is a substantive change to other terms and conditions of the lease that requires accounting for a lease modification.