Accounting for Lease Modifications

Points of reference for preparers of financial reports

Introduction

The recent COVID-19 outbreak has caused extensive disruptions to the global economy. In Australia, the Commercial Tenancies Code was agreed with all states and territories, resulting in similar legislation being established in each jurisdiction providing relief to commercial and retail tenants who qualify (generally those with a turnover of $50m or less that have experienced a 30% or greater loss in revenue, and where the tenant is participating or will participate in the JobKeeper program).

This document seeks to provide guidance on the key accounting implications of lease modifications for both lessors and lessees, including available practical expedients contained within AASB 2020-4 *Covid-19-related Rent Concessions*.

Background

AASB 16 contains specific requirements on accounting for lease modifications which differ depending on whether the entity is a lessor or lessee in an arrangement. Rent concessions that change the overall consideration for the lease are in the scope of these requirements – whether the entity is lessee or lessor.

Lessees are currently 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 with different features and different types of concessions. The AASB has therefore added a practical expedient to provide relief for lessees from lease modification accounting for rent concessions related to COVID-19 by issuing the aforementioned AASB 2020-4.

Lessee vs lessor: a matter of perspective - and timing

The accounting defined by AASB 16 *Leases* are driven by each parties 'rights' and 'obligations'. While this simplifies the application in most instances, difficulty arises where contractual modifications are expected but not yet agreed – for instance, as a result of a 'right' defined by legislation that is described as a minimum. That this right is a default does not prevent the lessor and lessee negotiating an arrangement that is very different to that defined in legislation.

As a result, the lessor and lessee must make multiple judgements, particularly:

- Does the lessee have a right to reduced rental? If so, is that reduction measurable?
- Does the lessor have an obligation to reduce the rental payment?
- Are these rights and obligations contractually enforceable at reporting date?

Legislated benefits – SME lessees

The absence of a legislated right or obligation removes the ability of a lessee to determine that a contractual modification has occurred. It is therefore able to be assumed that, in the majority of circumstances, there has been no relief granted to the lessee by default. As a result, lessee modification accounting does not apply – due to the absence of a contract granting rights.

For the lessor, a reading of AASB 16 may give rise to the same conclusion, but the lessor must consider:

- Whether full revenue recognition is appropriate given an expectation of modifications being given or if partial may be appropriate (Scenario 1, right); or
- Whether the revenue recognition model in AASB 16 is so stringent as to require full revenue recognition, and, if so, how the value of the receivable should be adjusted (Scenario 2, right).

Absence of legislation – Non-SME lessees

The absence of a legislated right or obligation removes the ability of a lessee to determine that a contractual modification has occurred. It is therefore able to be assumed that, in the majority of circumstances, there has been no relief granted to the lessee by default. As a result, lessee modification accounting does not apply – due to the absence of a contract granting rights.

For the lessor, a reading of AASB 16 may give rise to the same conclusion, but the lessor must consider:

- Whether full revenue recognition is appropriate given an expectation of modifications being given or if partial may be appropriate (Example 2 Scenario 1, below); or
- Whether the revenue recognition model in AASB 16 is so stringent as to require full revenue recognition, and, if so, how the value of the receivable should be adjusted (Example 2 Scenario 2, below).

Because the standard follows a rights and obligations model, it may be reasonable for each party to arrive at different responses to the facts and circumstances described, as in the below examples.

Ultimately, the method of presentation will be a management judgement and policy – neither perfectly conforms with Australian Accounting Standards.

Example 1: Legislated benefit determinations

Lessee
No lease modification exists – there is uncertainty as to the nature and form of any reduction.
The lease is modified – the lessee has a legal right a reduction in rentals.

Lessor
No lease modification exists – there is significant uncertainty regarding any modification and the form it may take.
The lease is modified – the lessor has a legal obligation to reduce rentals or provide a minimum of benefit to the lessee.

Example 2: Gross vs net revenue

Scenario 1

Revenue	180)
Forgiveness expense	(30)
Net profit impact	150

Scenario 2

Revenue (gross)	180
Adjustment: expected forgiveness	(30)
Revenue disclosed	150

Accounting for lessors – modification accounting

Lessors categorise their leases as either operating or financing. AASB 16 contains specific requirements for each class of lease which can result in a lease transitioning from one category to another, depending on the facts and circumstances.

In certain circumstances, the lessor may incur a loss as a result of the modification – but in all circumstances, the lessor should consider whether impairment of the underlying asset is indicated in the context of AASB 136 *Impairment of Assets.*

Operating leases

AASB 16 provides only limited guidance on 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. AASB 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 AASB 117, 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. Another systematic basis could be that, for example, the pattern of recognition of the lease income reflects variability in the sold right of use – for example, seasonal access to a ski resort. For a period of closure with no right of access granted, no income would be recognised.

Example 3 demonstrates an example where income is straight lined.

Finance leases

Lessor accounting for modification of finance leases is detailed in AASB 16.79 to 80. 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.

Example 3: Lessor operating lease modification

A lessor has entered into an operating lease for office space with a lessee. The pattern of payments, made annually, are:

Year	Cash	S/L Balance
1	100	30
2	120	40
3	140	30
4	160	0

Total	520
S/ Rental income	130

At the end of Year 2, with Year 2 rental not paid, the lessor negotiates with the lessee to adjust rental payments as follows:

Year 2	100
Year 3	120
Year 4	140

The rental straight line balance is an asset of 30. This is included to recalculate the straight line rental income for future periods:

Year	Cash	S/L Balance
		30
2	100	40
3	120	30
4	140	0

Total	360
S/L Asset	(30)
Remaining rental income	330
S/L income	110

Where the lease remains a finance lease, the lease receivable is remeasured by the application of AASB 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 applying the catch-up guidance (ie discounting the revised contractual cash flows using the original discount rate).

Accounting for lessees – modification accounting

Modification accounting as applicable for lessees is defined by AASB 16. AASB 16 defines both "modification" and "reassessment" accounting.

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, a change in any price guarantee arrangement that might appear in the lease contract (AASB 16.42). In such an instance, future cash flows are reforecast and present-valued utilising the discount rate set in the initial measurement of the lease (AASB 16.43).

A lease modification (as considered in this document, which does not address changes in 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 change. Where an increase in scope occurs, and the payment for this increase in scope is commensurate, a separate lease is accounted for (AASB 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; and
- 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 4: Lessee lease abatement (modification accounting)

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 CU 15,000. The Liability balance was CU 14,607.

	Payment	
Timing	**Original**	**New**
April '20	1,000	0
May '20	1,000	0
June '20	1,000	0
July '20	1,000	0
August '20	1,000	0
September '20	1,000	0
October '20	1,000	1,000
November '20	1,000	1,000
December '20	1,000	1,000
January '21	1,000	1,000
February '21	1,000	1,000
March '21	1,000	1,000
April '21	1,000	1,000
May '21	1,000	1,000
June '21	1,000	1,000
PV Cash Flows	CU 14,607	CU 8,779
Change +/(-)	(CU 5,828)	

Journal

Dr. Lease Liability	CU 5,828	
Cr. Right-of-use asset		CU 5,828

To adjust lease accounting for lease abatement

Accounting for lessees – the practical expedient

The practical expedient bypasses the need for lessees to carry out an assessment to determine 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 of amounts deferred can go beyond 30 June 2021; and
- there are no other substantive changes to the other terms and conditions of the lease.

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

- are deferred for a period of time, and then increased at a future date;
- are forgiven completely for a period of time; or
- are partly deferred and partly forgiven, and then partly increased at a future date.

A concession that simply defers rentals payments to a later date is not necessarily a modification based on the guidance issued. The guidance in the standard is still useful as they avoid the lessee having to assess whether or not modification accounting applies.

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).

Example 5: Forgiven lease payments

A lessee is paying monthly payments of CU 1,000. The lessor has agreed to forgive 6 months of payments in 2020 with no adjustment to future rentals. Assume interest accrues at CU80 per month. Monthly depreciation is CU 100.

During the period of forgiven payments (monthly journals):

Journals		
Dr. Lease Liability	CU 1,000	
Cr. Profit or loss		CU 1,000
Representing the forgiven payments		
Dr. Interest expense	CU 80	
Cr. Lease liability		CU 80
Representing the interest charged for the period		
Dr. Amortisation expense	CU 100	
Cr. Right-of-use asset		CU 100
Representing the amortisation charge for the period		

In our view, the preferred presentation of the credit within profit or loss is to follow the accounting policy for variable lease payments, however we do believe there is an argument to present the credit as a financial item as ‘debt forgiveness’. As long as it is appropriately disclosed, in our view either treatment would be applicable.

Disclosure

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

- that the practical expedient has applied it to all rent concessions, or otherwise, a description of the nature of the contract(s) it has been applied to; and
- the reporting period’s profit or loss impact arising from the application of the practical expedient.

Example 6: Payments deferred and then increased at a future date

A lessee is paying monthly lease payments of CU 1,000. The lessor has agreed to defer 6 months of lease payments from 2020 to 2021 as a result of COVID-19. Assume interest accrues at CU 80 per month and the 6 months increased lease payments of CU 2,000 commence on 1 April 2021 and continue until 30 September 2021.

During the period of deferral of payments (monthly journals):

Journals		
Dr. Lease Liability	CU 0	
Cr. Right-of-use asset		CU 0
Representing the deferred payments		
Dr. Interest expense	CU 80	
Cr. Lease liability		CU 80
Representing the interest charged for the period		

During the period of increased payments (monthly journals):

Dr. Lease liability	CU 2,000	
Cr. Cash		CU 2,000
Representing the cash payments made		
Dr. Interest expense	CU 80	
Cr. Lease liability		CU 80
Representing the interest charged for the period		

The lease liability at the end of the period where payments were increased would be the same as if the payments had not been altered at all.

During both periods, in our view, amortisation should be charged on the right-of-use asset as normal.

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