GAAP advisory

Different impacts to landlords and tenants accounting for rent reductions

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The Covid-19 shock continues to impact the real estate sector with full force, pushing both landlords and tenants to react in different ways.

With pubs, shops and restaurants having been closed for three months, the Financial Times reported the end of June 2020 that “retailers in the UK have paid less than 15 per cent of their rent, according to initial figures from Wednesday’s quarterly payment date…”.

While the UK cautiously comes out of lockdown, many landlords and tenants have been on the forefront, working together to reach a mutually beneficial compromise, such as moving from quarterly to monthly rent collections, from fixed to turnover-based rents or paying half rent due. In other cases, high-street retailers, restaurant chains and hotels are driving hard bargains on lease renewals or forcing rent reductions through company voluntary arrangements (“CVAs”), setting precedence for others to follow.

The International Accounting Standards Board (“IASB”) responded to the impact of the pandemic in record time and published “*Covid-19-Related Rent Concessions (Amendment to IFRS 16)*” at the end of May. The amendment focused on lessee accounting, providing practical expedients and other helpful exemptions but did not provide further guidance for lessors.

Recent events in reconfiguration of leases and rent holidays have given rise to a myriad of scenarios for landlords and other lessors and may catch them by surprise if their accounting impacts are not fully thought through. The first step is to make any initial assessment based on the actual T&Cs in the contracts.

Theta has assessed multiple scenarios that landlords and lessors could be impacted by and discussed the common ones below:

Landlords that operating lease out
The change in scope of, or consideration for, the lease, or both, needs to be carefully considered to assess whether the

change is accounted for as a ‘lease modification’. This will also need to take into consideration whether the change was included in the original terms of the lease (think force majeure type clauses). If a lease modification occurs (i.e. a change in scope or consideration outside of the original terms of the lease), this will give rise to a new operating lease and therefore should be treated as such. Landlords will need to revise their operating lease income recognised in profit or loss going forward, with appropriate adjustments for any prepayments and accruals.

The impact of the economic slowdown on valuation of assets may not be captured with internal valuations, so early engagement with valuers and auditors, using the best data available and proactive communication to the market may be the best way forward to navigate through investor, interim or yearend reporting.

Lessors that finance lease out

In this current economic environment, we would typically expect to see changes to leases to be a reduction in scope or consideration for the lease. To the extent that they meet the definition of a lease modification (see above), lessors will need to consider whether the finance lease classification may change to become an operating lease, or otherwise apply the requirements of IFRS 9 for modifications to the finance lease receivable. Either way, we expect that there would be an impact to the income profile in the future.

Companies should also remember to assess what impact the current environment will have on residual values of the leased assets, be they guaranteed or not. For lessors, original assumptions around unguaranteed residual values may no longer hold true. For lessees especially, changes in residual value could trigger whether payments are now expected to become payable under a residual value guarantee.

In all scenarios, lessors will be expected to perform robust impairment assessments on operating or finance lease receivables, especially changes to the Estimated Credit Losses (“ECLs”) model to reflect increased credit risks of tenants and lessees.

As companies resume trading, it is important to understand what balance sheets and income statements will look like and to get it right at the outset, whether at deal/negotiation stage or for reporting to investors or statutory filings. Theta Financial Reporting has significant experience in navigating through these complexities and can support you in simplifying the solutions for our clients.