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Staff Accounting Bulletin

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August 9, 2020 / Av 19, 5780

SAB 19-3 – Accounting treatment of COVID-related rent concessions attributed to the coronavirus crisis period

Background

1. In recent months the world has been stricken by an event of global proportions and significant macroeconomic implications, stemming from the spread of COVID-19 across many countries including Israel ("The Coronavirus Crisis"). This crisis, and the numerous and diverse actions taken by these countries in response to the crisis and its economic repercussions (including traffic and work restrictions, and economic steps such as grants, loans, and tax relief), pose considerable challenges to the economy.

   The Crisis has adversely affected the business operations of companies in many sectors including rental property and retail sectors. For example, as a result of traffic restrictions imposed due to the Crisis, many shopping centers were closed and occupancy levels were restricted as a result of the need for social distancing. Even when such restrictions were removed, shopping traffic and shopping volume remained limited, leading to a decline in lessees' turnover and other effects. As a result, in several countries, rental property owners ("Lessors") have granted lessees rent concessions or payment holidays for a limited period. These concessions might take various forms such as payment holidays for several months, transition to fixed rent rather than variable rent based on turnover, reduction in the minimum rent payment, and deferral of rent payments ("Coronavirus Rent Concessions"). Furthermore, as a result of the economic crisis, lessees may experience financing issues, as a result of which they will be unable to service their loans or pay the lease payments defined in their lease agreements.

2. The effects of this situation and governmental responses vary across countries. For example, several countries in which lease agreements include an explicit force majeure clause (such as events in respect of which one party is prevented from meeting its contractual obligations in the lease agreement) have explicitly stated that COVID-19 should be considered such an event. In other countries, governments have decided to compensate lessors for the periods of closure, or lessors may have a legal obligation to grant rent concessions.

   In Israel, the state has taken various steps, including the determination of compensation and grant mechanisms, but has not yet intervened in the matter of lease payments owed to lessors under lease agreements, specifically with respect to the period in which the state forced lessors and lessees to close stores. Furthermore, to the best of the Staff's knowledge, at present no uniform case law exists on the legal significance of the Coronavirus Crisis or its effects on signed contracts. A review of companies operating in this sector — lessors and lessees — indicates that since March 2020, as a result of the crisis, various lessors have developed rent concessions programs for their lessees for limited periods, based on the first and second waves of COVID-19 outbreaks in Israel.

3. IFRS 16 ("the Standard") defines the principles for recognizing, measuring, presenting, and disclosing leases, to ensure that lessors and lessees provide relevant information that faithfully reflects their lease transactions. This information offers the readers of financial statements a basis for assessing the effects of leases on an entity's financial position, financial performance, and cash flows.[1]

[1] IFRS 16.1.

The following are key definitions included in IFRS 16 are relevant to this SAB:[2]

- "Lease" – A lease is a contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for a consideration. An operating lease is a lease that does not transfer substantially all the risks and rewards incidental to ownership of the underlying asset.
- "Lease incentives" – Payments made by the lessor to a lessee associated with a lease, or the reimbursement or assumption by a lessor of costs of a lessee.
- "Lease modification" – A change in the scope of a lease, or in the consideration for a lease, that was not part of the original terms and conditions of the lease (for example, adding or terminating the right to use one or more underlying assets, or extending or shortening the contractual lease term).
- "Lease payments" — Payments made by a lessee to a lessor relating to the right to use an underlying asset during the lease term, and comprising fixed payments (including in-substance fixed payments) less any lease incentives, plus variable lease payments that depend on an index or a rate, and other elements as described in the Standard.
- "Variable lease payments" – The portion of payments made by the lessee to a lessor for the right to use an underlying asset during the lease term that varies because of changes in facts or circumstances occurring after the commencement date, other than the passage of time.

The Standard also defines rules for treating changes in leases (including changes in lease payments). These rules define when such changes should be treated as lease modifications, with respect to both lessor and lessee.

4. On May 28, 2020, the International Accounting Standards Board (“IASB”) published an amendment to IFRS 16, granting a practical expedient to lessors to treat COVID-related rent concessions, subject to certain conditions[3] (“the Expedient” or “Amendment”). According to the Amendment, a lessee that elects to adopt the Expedient subject to the conditions stated in the Amendment will not be required to assess whether the COVID-related rent concessions constitute a lease modification, as this term is defined in the Standard. Instead, the lessee will treat such rent concessions in the same way as it treats lease changes that do not constitute lease modifications: these are generally treated as variable lease payments, as defined in the Standard.[4] As a result of implementation of the

[2] IFRS 16, Appendix A.

[3] As stated in paragraph 46B of the Amendment to the Standard.

[4] paragraph BC405E of the Amendment to IFRS 16, and paragraph 38 of the Standard.

Expedient, the effects of the rent concessions received by lessees in each period will be typically recognized immediately in profit and loss. The Amendment refers to COVID-related rent concessions, where the lease payment is originally due on or before June 30, 2021.

However, the Amendment **does not** include a corresponding expedient for lessors, for various reasons that are stated in the explanatory note to the Amendment.[5] Therefore, lessors are required to determine the accounting treatment of COVID-related rent concessions that they granted to lessees, pursuant to the provisions of IFRS 16.

5. According to the provisions of the Standard, when implementing the Standard, an entity will consider the conditions of its lease contracts and all the relevant facts and circumstances, including the provisions of law and regulation that apply to lease contracts.[6] As a result, the accounting treatment applied to rent concessions depends on the circumstances and facts of each situation and its commercial substance. The variance across countries in governmental involvement and decisions, as described above, may also affect the accounting treatment under IFRS 16 and the question of whether rent concessions should be treated as a lease modification or not**.** To illustrate, in cases in which a country enacted a law that obligates lessors to grant rent concessions, such concessions may not constitute lease modifications and are deemed part of the original terms of the lease.

6. Because the Amendment does not include a corresponding expedient for lessors to treat COVID-related rent concessions, in Israel lessors may develop different practices for treating such rent concessions, based on various situations and the various programs they determined.

7. **Therefore, this SAB highlights guidelines for determining the accounting treatment of COVID-related rent concessions in operating leases (as described in the Amendment), which lessors and lessees apply pursuant to IFRS 16, as well as guidelines for several situations that ISA Staff has identified as prevalent in the Israeli market. ISA Staff wishes to emphasize that this SAB applies to rent concessions granted by lessors in operating leases exclusively due to the effects of the Coronavirus Crisis, which fall under the scope of the Amendment.[7]**

[5] paragraph BC240A of the Amendment to the Standard.

[6] paragraph 2 of the Standard; document published by IASB on April 10, 2020 "IFRS 16 and COVID-19"

[7] That is, the conditions listed in paragraph 46B of the Amendment to the Standard are satisfied.

8. **ISA Staff wishes to emphasize at the outset of this SAB, that it is extremely important for reporting corporations to provide a complete disclosure of the effects of the Coronavirus Crisis on their business operations and their financial statements in the current period, as emphasized in SAB 99-7 – Effects of the Coronavirus Crisis on Financial Reporting and Disclosures in Financial Statements for Q1/2020.[8] Accordingly, and as described below, lessors and lessees must include a complete disclosure of the material effects of the crisis, including effects related to rent concessions granted by the lessor to the lessee, the amount of the concession, and the accounting treatment implemented by them in their financial statements, as long as the concession is material.**

   Notably, although quarterly financial statements are typically condensed by nature, as a result of the unusual circumstances and very material changes that occurred in the business and economic environments of most lessors on or before the period of Q2/2020, quarterly financial statements must provide a detailed disclosure that allows investors to assess the effects of the COVID-related rent concessions on their financial statements and on the operating indicators used to analyze their business operations, including details of the material judgements that were applied and that constitute the basis for their selected accounting treatment. For more on this issue, see paragraph 16 below.

Emphasis Regarding the Accounting Treatment Implemented by Lessees

9. As noted in paragraph 4 above, the Amendment defines an optional practical expedient for treating COVID-related rent concessions, subject to various conditions. A lessee that elects to adopt the expedient is not required to assess whether the COVID-related rent concessions constitute lease modifications, as this term is defined in the Standard. Instead, the lessee will treat these concessions in the same manner as lease changes that do not constitute lease modifications, and which are typically treated as variable lease payments; As a result, the effects of the concessions are immediately recognized in profit and loss. A lessor that does not elect to adopt the practical expedient will assess whether the rent concessions constitute lease modifications and will treat them according to the provisions of the Standard.

[8] For SAB 99-7, see LINK: [SAB 99-7]

10. According to the provisions of the Amendment,[9] a lessee that adopts the expedient must include a qualitative and quantitative disclosure of the COVID-related rent concessions it received and in respect of which the expedient was applied. To the extent that the expedient was applied only to a portion of these rent concessions, the disclosure must include information about the features of the concessions to which the expedient was applied. Furthermore, the lessee must include a disclosure of the amount recognized in the accounting period in profit or loss in respect of the changes in lease payments to which the expedient was applied.

    A lessee that elects not to adopt the expedient must include a disclosure of this fact, and a qualitative and quantitative disclosure of the rent concessions granted to it and the accounting treatment applied thereto. According to the provisions of the explanatory note to the Amendment and the disclosure rules of IFRS 16, a disclosure must include the effects of the concessions on the lessee's cash flows – the reduction in the lessee's cash outflows as a result of the concessions, and the amount of the adjustment applied to lease liabilities. For additional information on this matter, see the explanatory notes to the Amendment.[10]

11. ISA Staff stresses the importance of providing a full disclosure by the lessee of the amount of the COVID-related rent concessions granted to the lessee, whether the expedient was applied or not, so that the concessions' effects on the results of the lessee's business operations may be understood. Furthermore, a full disclosure is important to enable a comparison of the lessee's results across different periods, and to compare its results to other companies operating in the same sector, even if they apply a different accounting treatment to such concessions.[11]

Emphasis Regarding the Accounting Treatment Implemented by Lessors

12. In response to the waves of COVID-19 outbreak in Israel and various restrictions imposed by the government, beginning in March 2020 several rental property companies developed various rent programs for their tenants, specifying payments for specific months. For example, in March 2020, several rent relief programs were instituted for a limited period of several months (from the second half of March 2020 to a portion of Q2/2020), which covered the months in which shopping centers were closed due to closures and traffic restrictions imposed across the board by the

[9] paragraph 60A of the Amendment to the Standard.

[10] See paragraph BC205G of the explanatory note to the Amendment to the Standard; IFRS 16.51, IFRS 16.59.

[11] See 3.20 to the conceptual framework on the importance of the comparative principle with respect to useful financial information.

state, and also covered subsequent months of re-organization and preparations for the return to routine under new restrictions.

13. The effects of these COVID-related rent concessions and relief on the business results of rental property companies (as well as the general effect of the crisis on this sector) are reflected in a decline in rental income and a consequent decline in profitability, in the operating indicators used to analyze rental property companies (e.g., NOI, FFO, etc.), and in the value of the real estate properties they own.

14. As described in paragraph 4 above, the Amendment to IFRS 16 does not include an expedient for lessors that corresponds to the expedient granted to lessees (as a result of which they are not required to assess whether the COVID-related rental concessions constitute lease modifications as defined in the Standard, or not). **Therefore, lessors must determine the accounting treatment of COVID-related rental concessions that they granted to lessees, pursuant to IFRS 16**. Pursuant to IFRS 16, if the rent concessions are treated as modifications to operating leases, a lessor must account for the modification as a new lease from the effective date of the modification, considering any prepaid or accrued lease payments relating to the original lease as part of the lease payments for the new lease.[12] The Standard further determines that the lessor will use the straight line method to recognize lease payments from operating leases as income, or use any other systematic method, if that systematic method is more representative of the pattern in which benefit from the use of the underlying asset is diminished.[13]

    According to IFRS 16, when a lessor grants a lease incentive to a lessee, the incentive will typically be recognized using the straight line method (or using any other systematic method as described above) over the remainder of the lease term. The underlying rationale is the economic approach that views lessors and lessees as parties that enter a general lease transaction and who take into account all the terms of the transaction. That is, an incentive granted by a lessor to a lessee is typically based on economic negotiations between the parties who have a comprehensive perspective of the lease agreement (including the contractual lease payments, the lease term, etc.) and of the lessor's intention to incentivize the lessee to enter into the lease agreement. However, the rent concession programs that rental property companies in Israel developed were designed to assist tenants in coping with the current situation, and in several cases these programs were

[12] IFRS 16.87.
[13] IFRS 16.81.

not based on a consideration of the specific circumstances of each lessee. This was the result of the government's lack of involvement in the rental contracts between lessors and lessees even with respect to the months in which shopping centers were closed. An accounting treatment of these concessions, which reflects their effects on the companies' results of operations over the lessees' remaining lease term, implies that the effects of both the Coronavirus crisis and the actions taken by rental property companies on their financial statements and on the operating measures that constitute a basis for the analyses of their business operations, will be spread across the lease term and will not be reflected in the period in which they occurred.

15. Based on ISA Staff discussions with various stakeholders in this market, it appears that a variety of accounting treatments are being used to treat different types of COVID-related concessions and relief granted by lessors. These approaches are based on the professional literature of international accounting firms on the accounting treatment of COVID-related lease payments. In paragraphs 18-20 below, ISA Staff addresses various alternatives available to companies, based on the Amendment and on professional literature, that are applicable in situations that ISA Staff found to be prevalent in the Israeli market.

16. ISA Staff stresses at the outset that ISA Staff recognizes that under the circumstances, there may be numerous approaches for handling COVID-related rent concessions granted by lessors, and it is not possible to define a single measurement model because accounting treatment is a function of the circumstances of each case and may involve significant judgments.

    The issue of the proper accounting treatment for COVID-related rent concessions requires significant judgments, both with respect to the whether these concessions constitute a lease modification or not, and with respect to the accounting treatment required as function of the conditions related to the concessions. Therefore, ISA Staff stresses that a full disclosure is required of these judgments and their assumptions, and the accounting treatment applied by lessors to COVID-related rent concessions pursuant to International Accounting Standard 1 -Presentation of Financial Statements ("IAS 1") and the disclosure requirements pursuant to IFRS 16.[14] Furthermore, also required is a full disclosure of the quantitative and qualitative effects of the concessions, their amounts, and their effects on the operating

[14] IAS 1.122.

measures used to analyze the results of the companies' business results (e.g., NOI, FFO).

17. ISA Staff further stresses that this SAB is not a substitute for lessors' obligations to examine the nature of the concessions granted to lessees based on the circumstances, facts, and factors relevant for such analysis. Furthermore, and as stated in paragraph 7 above, concessions that fail to meet the conditions stated in the Amendment for the practical expedient granted to lessees (e.g., if the concession is conditional upon an extension of the lessee's lease term, if the changes lead to a higher consideration than the consideration determined in the original lease contract, or if the concessions apply to rent for periods that are longer than the period stated in the Amendment, etc.) do not fall within the scope of this SAB.

Case A – Rent waivers attributed to the Coronavirus Crisis in respect of operating lease receivables

18. If the lessor waives rent to which it is entitled, and which was recognized in its financial statements as operating lease receivables, the professional literature offers two alternative accounting treatments. ISA Staff will not intervene in the election of either of these alternatives as the accounting policy for treating COVID-related rent waivers, in respect of which a receivable balance exists, provided that this policy is applied consistently to all the cases in which similar waivers were given, and that a detailed disclosure is given of the accounting policy adopted by the lessor with respect to these cases:

    A. **Accounting treatment as a leasing modification, according to IFRS 16**, based on the change in the total consideration for the lease as a result of the waiver. The implication of this accounting policy is that the waiver in respect of operating lease receivables is spread over the remaining lease term;

       If this policy is implemented, the lessor must include a complete disclosure of the amount of the waiver and its qualitative and quantitative effects, including its effects on the operating indicators used to analyze the results of the lessor's operations (see paragraph 16 above).

    B. **Accounting treatment according to IFRS 9 Financial Instruments** ("IFRS 9"), because the derecognition provisions and the impairment provisions in this standard also apply to operating lease receivables recognized by the lessor.[15]

[15] IFRS 16.89-97.

According to the provisions of IFRS 9, an entity must derecognize a financial asset when and only when the contractual rights to cash flows from the financial asset expire.[16] As a result, beginning from the date an unconditional rent waiver was granted,[17] the condition for derecognizing operating lease receivables is satisfied.

In the matter of measuring operating lease receivables, ISA Staff stresses that, as stated above, the impairment provisions of IFRS 9 apply to this asset. Therefore, impairment must be tested regularly after the recognition of operating lease receivables, and a provision in respect of expected credit losses must be created as required by IFRS 9. In the matter of measurement upon derecognition, according to IFRS 9, on this date the profit or loss of the difference between the carrying amount of the operating lease receivables (measured upon derecognition, including a test of impairment in respect to its related expected credit losses[18]) and the consideration received in respect thereof, is recognized. [19]

19. In the event that the lessor adopts the accounting policy described in paragraph 18.B above with respect to a waiver of rent in respect of operating lease receivables, that is to say — derecognition of the operating lease receivables pursuant to IFRS 9, ISA Staff stresses that:

A. **Presentation in profit and loss statement** – Pursuant to IAS 1, the waivers that were presented as derecognition of operating lease receivables must be presented on a separate line in the profit and loss statement, such that the net effect of the lessor's rent waiver on income will be clear (notably, pursuant to IAS 1, any impairments in respect of this asset must also be presented on a separate line).[20]

<u>The following example is an illustration of presentation</u>:

Rental income	xxx
Less – derecognition of operating lease receivables due to COVID-related waivers	(xxx)
Net rental income	xxx

[16] IFRS 9.2.1(b)(ii).

[17] IFRS 9.3.2.3(a).

[18] Alternatively, in a conditional concession, from the date the conditions are satisfied.

[19] IFRS 9.5.5.1.

[20] IFRS 9.3.2.12

B. **Weighting the waiver's effect on operating indicators (e.g., NOI, FFO)** – When calculating the operating indicators used to analyze the results of the lessor's operations, deduct the amounts recognized in respect of an impairment in operating lease receivables, and also deduct the profit or loss recognized in respect of the derecognition of operating lease receivables due to COVID-related waivers.

<u>Case B – Reducing the minimum fixed component of the contractual lease payments that are based on the higher of the fixed rent component and the percentage of sales</u>

20. One of the common concessions lessors granted to lessees is a reduction of the fixed rent component, based on the mechanism of the higher of the fixed component and the variable component (such as percentage of turnover; "Higher of the Two Approach"). In many cases, in anticipation of the re-opening of the economy in early May 2020, and as part of the COVID-related rent concessions and relief programs, lessors modified the terms of the lease agreements, retaining the Higher of the Two Approach and reducing the fixed component to a lower amount for a predefined period, while variable lease payments remained unchanged.

21. This change — reduction of the fixed lease component — may lead to a decline in the total lease-related consideration, and therefore this appears to be an operating lease modification as defined in IFRS 16, which should be treated by the lessor as a new lease beginning from the effective date of the modification[21] (that is, the date on which both parties agreed to the change). Pursuant to the Amendment,[22] the lessor in an operating lease will recognize rental income using the straight line method, or use any other systematic basis, if that systematic basis is more representative of the pattern in which benefit from the use of the underlying asset is diminished.

    It is ISA Staff's opinion that in the event that all of the following conditions obtain:

    A. The lease agreement defines a rental payment mechanism based on the higher of the fixed and variable components;
    B. The lessor reduces the minimum amount of the fixed component, and all other terms remain unchanged;
    C. The variable component is effective and significant (that is, this is <u>not</u> an ineffective or insignificant variable component as a result of which the total effective payment substantially equals the fixed payment, pursuant to IFRS 16)

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[21] IFRS 1.82.
[22] paragraph 87 of the Standard

ISA Staff will not intervene in the accounting treatment that uses the revised minimum amount of the fixed component as the systematic method that best represents the pattern in which the benefit from the use of the underlying asset is diminished, in lieu of spreading the deduction in the fixed amount over the remaining lease term using the straight line method.[23]
According to this possible accounting policy, in each period, the lessor will recognize rental income according to the lease payments effectively received for that period, that is — the higher of the two amounts: the minimum fixed lease payments after the lease modification and the percentage of sales in each period.

22. **The rational to this position**:
    A. In this case, the fixed component was reduced in view of a significant macroeconomic crisis and is attributed directly to its effects, which include state decisions to remove or impose restrictions that affect shopping traffic, and a return to routine under restrictions. Therefore this amount may better represent the diminishing benefit from the use of the underlying asset than the straight-line method.
    B. Furthermore, as a result of this approach, COVID-related rent reductions will be recognized (both in the lessor's financial statements and in its operating measures such as NOI and FFO) in the period in which they were granted. This will eliminate the potential distortion that would otherwise be caused by deducting the fixed component over the remaining lease term using the straight-line method (although profit and loss should reflect lower income in the period in which the minimum amount of the fixed component, the distortion would lead to higher recognized income).

<u>Case C – COVID-related rent concessions subject to material conditions</u>

23. As noted in paragraph 3 above, pursuant to IFRS 16, variable lease payments are the portion of payments made by the lessee to a lessor for the right to use an underlying asset during the lease term that varies because of changes in facts or circumstances occurring after the commencement date, other than the passage of time.

24. One of the most common relief measures granted by lessors in during the first COVID-19 wave, and specifically when the state imposed a quarantine and shopping centers were closed, was rent concession for a limited period. In some cases, this relief was subject to certain material conditions. For

[23] paragraph 81 of the Standard.

example,[24] the lessee is entitled to a discount only on the period that the shopping center's closure was ordered by the state.

25. **In such cases, <u>in which the rent concessions were subject to material conditions</u>, ISA Staff will not intervene if such concessions are treated as negative variable lease payments beginning from the date on which both parties agree, and will be immediately recognized on the date that these conditions obtain. Obviously, if the conditions do not obtain, the lessee will not be entitled to concessions, and in such case the lessor will recognize income in the full amount of the original lease payments.**

26. **ISA Staff stresses that lessors must use their own judgment in determining if a condition for COVID-related rent concession to a lessee constitutes a material condition, in which case the concession amount may be considered as negative variable lease payments, as stated above. The lessor must provide a full disclosure of this significant judgment, including the conditions that were considered to be material conditions, and why, and how it will apply the accounting treatment to the rent concessions due to the effects of the Coronavirus Crisis.**

[24] Notably, this measurement alternative, based on a method that is not the straight-line method, does not apply in situations in which the rental mechanism includes only fixed lease payments, and these payments are reduced. This is because that immediate recognition in profit or loss of the amount of the reduction does not necessarily better represent the pattern in which the benefit from use of the underlying asset diminishes.