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Impact of COVID-19 on Financial Reporting in the Real Estate Industry

CRE owners need to consider collectability of rent payments and lease concessions in their financial reporting.

John McCarthy | Oct 15, 2020

As the third quarter comes to a close, the impact of COVID-19 on the U.S. economy continues to be felt. In fact, according to Reuters, the U.S economy suffered its biggest blow since the Great Depression in the second quarter of 2020. In addition, many feel a resurgence of the coronavirus is just ahead of us.

As is often the case with large disruptions to the U.S. economy, the real estate industry, including the hospitality industry, has suffered. Retail and office real estate seem to be the most affected sectors of real estate, while the lack of leisure travel has crippled the business of many hotels. As a result, this has created some hot button financial reporting issues in the real estate industry.

Collectability of lease payments

Whether in times of economic prosperity or economic distress, lessors in lease arrangements must constantly monitor changes in the collectability of lease payments.

Moreover, management of lessors should be comfortable that this collectability analysis is comprehensive, as the analysis is sure to be a focus of auditors. Failure of real estate companies to reserve rent owed to them that may not be collectable could inflate a company's revenue. Briefly, when collectability is less than probable, U.S. Generally Accepted Accounting Principles ("U.S. GAAP") require that lessors reserve these lease receivables on the balance sheet and recognize revenue only when cash is received.

Signs of potential collectability issues are the granting of a deferral of lease payments, as well as a lessee operating in a sector of real estate that has been severely impacted by the ongoing pandemic. In an instance such as the latter, a formal modification does not necessarily need to be reached in order for the accounting of lease payments to be adjusted. Financial statement users may expect additional disclosure of collectability analyses during this time of economic uncertainty.

Rent concessions

A common theme since the start of the pandemic has been the granting of rent concessions by property owners to tenants. These are often in the form of a deferral of rent owed by tenants, but can also be a complete waiver or reduction of certain rent payments. While these are changes to the original lease terms that would typically be accounted for as lease modifications under U.S. GAAP, the Financial Accounting Standards Board ("FASB") acknowledged that its guidance for accounting for lease modifications was not really geared towards modifications resulting from a pandemic. As a result, the FASB ordered relief in the second quarter of 2020 by allowing lessors and lessees, in cases where there is not a substantial change to the lease terms, to either a) apply the lease modification guidance or b) account for the changes as if they were part of the existing contract. Changes that would qualify as substantial, which would preclude applying the FASB relief, would be a change in the rights of the lessee to the leased asset, or the granting of a long-term lease extension.

Impairment

While the type of real estate owned may ultimately determine whether an impairment loss is taken (i.e. retail and hospitality are anticipated to be more affected than industrial real estate), the expectation is that the pandemic will cause companies to perform more robust impairment testing of their real estate assets. Indicators such as a decrease in expected future cash flows due to aforementioned rent concessions and collectability issues, as well as the outright loss of significant tenants, may trigger additional impairment testing. Impaired real estate assets would require the net book value recorded on the balance sheet to be reduced to its fair value, with a loss recognized on the income statement. Complicating matters is the subjectivity involved in estimating fair value, as this often involves external market analyses and complex discounted cash flow models.

What's ahead

As the pandemic continues to rear its ugly head, other financial reporting issues will likely arise. The inability to comply with financial covenants in loan agreements, the restructuring of leases, valuation issues associated with asset acquisitions, along with whether an entity has the proper internal controls to handle changes in the "new normal," are just a few. As always, be sure to consult your real estate tax professional for the latest developments and any appropriate planning adjustments.

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