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Illustrative examples on covid-19-related rent concessions

In January 2020, the FRSC of the HKICPA published examples on rent concessions (January illustrative examples)¹ to illustrate the application of HKFRS 16 *Leases* to some common rent concession fact patterns observed in Hong Kong due to the market conditions experienced at that time following months of political unrest.

As a result of the covid-19 pandemic, many lessors are providing rent concessions to lessees. HKFRS/IFRS 16 *Leases* specifies how lessees account for changes in lease payments, including rent concessions. However, the International Accounting Standards Board (IASB) was informed that applying those requirements to a potentially large volume of covid-19-related rent concessions could be challenging in practice, particularly for lessees that are currently preparing their financial statements applying the new lessee accounting model in IFRS 16 for the first time. The IASB responded by issuing the following:

- educational material in April 2020 to highlight requirements within IFRS 16 and other IFRS Standards that are relevant for companies considering how to account for rent concessions granted as a result of the covid-19 pandemic²; and

¹ https://www.hkicpa.org.hk/-/media/HKICPA-Website/New-HKICPA/Standards-and-regulation/SSD/06_New-and-major-stds/ie161.pdf

² <https://cdn.ifrs.org/-/media/feature/supporting-implementation/ifrs-16/ifrs-16-rent-concession-educational-material.pdf>



- *Covid-19-Related Rent Concessions* (Amendment to IFRS 16) in May 2020, which provides lessees with a practical expedient for covid-19-related rent concessions. No change has been made to lessor accounting. The Institute issued an equivalent amendment to HKFRS 16 in June 2020.

Covid-19-Related Rent Concessions (Amendment to HKFRS 16)

Paragraph 46A of the Amendment to HKFRS 16 provides a practical expedient that a lessee may elect not to assess whether a rent concession that meets the conditions in paragraph 46B is a lease modification. A lessee that makes this election shall account for any change in lease payments resulting from such a rent concession in the same way as if the change were not a lease modification.

Paragraph 46B of the Amendment to HKFRS 16 states that the practical expedient in paragraph 46A applies only to rent concessions occurring as a direct consequence of the covid-19 pandemic and only if all of the following conditions are met:

- a) 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;
- b) any reduction in lease payments affects only payments originally due on or before 30 June 2021; and
- c) there is no substantive change to other terms and conditions of the lease.

A lessee that chooses to apply the practical expedient shall apply it consistently to all lease contracts with similar characteristics and in similar circumstances, as required by paragraph 2 of HKFRS 16 [paragraph BC205C of the Amendment to HKFRS 16].

Paragraphs BC205E(a)-(c) of the Amendment to HKFRS 16 provide examples of accounting for changes in lease payments if they are eligible for applying the practical expedient:

- a) forgiveness or waiver of lease payments would generally be accounted for as a variable lease payment applying paragraph 38 of HKFRS 16 with a corresponding adjustment to the lease liability.
- b) a change in lease payments that reduces payments in one period but proportionally increases payments in another does not extinguish the lessee's lease liability or change the consideration for the lease – instead, it changes only the timing of individual payments. In this case, applying paragraph 36 of HKFRS 16, a lessee would continue to both recognise interest on the lease liability and reduce that liability to reflect lease payments made to the lessor.



- c) a reduction in lease payments, incorporating both a forgiveness of payments and a change in the timing of payments.

Note: Even in the absence of the practical expedient, a change in lease payments described in (b) does not meet the definition of a lease modification as there is no change in the scope of a lease, or the consideration for a lease (i.e. the accounting would be the same regardless of whether the practical expedient is elected). However, applying the practical expedient would mean that the assessment of whether the change in lease payments described in (b) meets the definition of a lease modification would not be required.

Paragraph 60A of the Amendment to HKFRS 16 requires a lessee that applies the practical expedient in paragraph 46A to disclose:

- a) that it has applied the practical expedient to all rent concessions that meet the conditions in paragraph 46B or, if not applied to all such rent concessions, information about the nature of the contracts to which it has applied the practical expedient; and
- b) the amount recognised in profit or loss for the reporting period to reflect changes in lease payments that arise from rent concessions to which the lessee has applied the practical expedient in paragraph 46A.

The Amendment to HKFRS 16 is effective for annual reporting periods beginning on or after 1 June 2020. Earlier application is permitted, including in financial statements – interim or annual – not authorised for issue at 4 June 2020, the date the amendment was issued [paragraphs C1A and BC205B of the Amendment to HKFRS 16].

If a rent concession provided for a particular lease contract either:

- a) does not meet the conditions to apply the practical expedient, or
- b) meets the conditions to apply the practical expedient, but the lessee does not elect to apply the practical expedient for lease contracts with similar characteristics and in similar circumstances to that particular lease contract (see paragraph 2 of HKFRS 16),

then the lessee must determine whether the rent concession meets the definition of a lease modification in Appendix A of HKFRS 16. If the rent concession is a lease modification, the requirements for lessee accounting under paragraphs 44-46 of HKFRS 16 apply (as described in the January illustrative examples).

Background information for the illustrative examples

This publication provides examples to illustrate the application of the Amendment to HKFRS 16 to common rent concession fact patterns observed in Hong Kong as described below. The examples do not consider the accounting for the related right-of-use asset in each of the contracts.

Other considerations and analysis may be necessary depending on the facts and circumstances of each lessee.

Details of Entity A's lease contracts

Entity A (Lessee) leases different locations in Hong Kong for operation as gym centers. Entity A enters into the following non-cancellable lease arrangements with different lessors:

	Location	Lessor	Lease term[#]	Commencement date	Monthly lease payment
Contract 1 for Gym 1	Plaza X	Lessor X	5 years	1 March 2019	\$100,000
Contract 2 for Gym 2	Plaza Y	Lessor Y	3 years	1 January 2019	\$80,000
Contract 3 for Gym 3	Plaza Z	Lessor Z	3 years	1 April 2019	\$120,000

Note: The numbers used in the table above are for illustration purposes only.

[#] *There are no renewal/ termination options provided by the contracts.*

Lease payments are made on the first day of each month for Contracts 1 and 2. Lease payments are made on the first day of April, July, October and January on a quarterly basis for Contract 3 (i.e. payment of next 3 months' rent in advance).

None of the contracts contain a *force majeure* or similar clause that could trigger rent reduction or suspension of rent in the event that the premises (or any part of them) are affected by events beyond the control of the contracted parties so as to render them unfit or unavailable for use by the tenant.

Rent concessions provided to Entity A

Certain social events took place and affected Entity A's business during the second half of 2019. Gym 1 was not available for use for 9 full days during November 2019 due to the closure of Plaza X. In addition, Entity A's business was affected by the

covid-19 pandemic outbreak in Hong Kong in early 2020. Gyms 1, 2 and 3 were all closed for 42 full days during March to May 2020 due to the government closure order. Entity A's actual performance during these affected periods was significantly worse than forecast. In view of the situation, all of the Lessors agreed to provide rent concessions to Entity A as described below.

Lessor X signed an addendum to the original lease contract with Entity A on 1 January 2020 (Addendum 1) and another addendum on 1 April 2020 (Addendum 2). Based on the negotiation between Entity A and Lessor X, and as specified in the addendums:

- as agreed on 1 January 2020, the 10% rent reduction for the three months from November 2019 to January 2020 was compensation to Entity A for the closure of Plaza X in November 2019 as a result of the social events.
- as agreed on 1 April 2020, the rent concession was a forgiveness of the rent for Gym 1 in April 2020 as a result of the HKSAR government actions due to the covid-19 pandemic.

Lessors Y and Z each signed an addendum to the original lease contract with Entity A on 1 April 2020. The reason for the rent concession is not specified in the addendums. However, the main issue discussed during the negotiation of the rent concession between Entity A and Lessors Y and Z was the effect of covid-19 and related government closure order.

The signed addendums established the lessors' commitment in relation to the rent concessions and the rent concessions are unconditional upon signing the addendums. Other terms and conditions of the original lease contracts remain unchanged. The rent concessions provided to Entity A are summarised as follows:

	Lessor	Rent concessions provided to Entity A
Contract 1	Lessor X	<p>Addendum 1: A 10% rent reduction for the three months from November 2019 to January 2020, totaling \$30,000 for the 9 days' closure [calculated as \$100,000 x 10% x 3].</p> <p>Addendum 2: Forgiveness of rent for April 2020 of \$100,000.</p>
Contract 2	Lessor Y	Deferral of rent for April, May and June 2020, which is to be paid in January, February and March 2021 (i.e. a

		three-month rent holiday from April to June 2020, but a revised monthly lease payments of \$160,000 during January to March 2021).
Contract 3	Lessor Z	A 20% rent rebate for the month of March 2020 (paid in cash on 1 April 2020) and a 20% rent reduction for the month of April 2020, totaling \$48,000 [calculated as \$120,000 x 20% x 2].

Entity A's reporting period

Entity A has a December year-end and chooses to early adopt the Amendment to HKFRS 16 in its interim financial statements for the period ending 30 June 2020 (i.e. the date of initial application of the Amendment to HKFRS 16 is 1 January 2020). Entity A elects to apply the practical expedient to all eligible rent concessions for all of its lease contracts applying paragraph 2 of HKFRS 16.

Question: How does Entity A account for the rent concessions for the six-month financial period ending 30 June 2020?

Note: The following analysis would also be applicable to an entity with a March year-end that is currently preparing its annual financial statements for the year ended 31 March 2020 and chooses early application of the Amendment to HKFRS 16 in those financial statements.

Contract 1

Rent concession under Addendum 1 signed on 1 January 2020

Considering the reason for the negotiation of the rent concession, the amount granted by Lessor X on 1 January 2020 is for the 9 days' closure of Plaza X in November 2019. Entity A judges such rent concession is not occurring as a direct consequence of the covid-19 pandemic. Therefore, the practical expedient in paragraph 46A of the Amendment to HKFRS 16 cannot be applied.

Therefore, Entity A must determine whether the reduction in the consideration for the lease meets the definition of a lease modification in Appendix A of HKFRS 16. (See the January illustrative examples for further guidance).

Rent concession under Addendum 2 signed on 1 April 2020

Considering the timing and the reason for the rent concession granted by Lessor X, Entity A judges that the rent concession is occurring as a direct consequence of the

covid-19 pandemic. The rent concession also meets the conditions in paragraphs 46B(a)-(c) of the Amendment to HKFRS 16 because it reduces the consideration for the lease, it is a forgiveness of lease payments originally due on or before 30 June 2021 (forgiveness of the payment due in April 2020), and there are no substantive changes to other terms and conditions of the contract. Therefore, all the conditions in paragraph 46B of the Amendment to HKFRS 16 are met.

Entity A applies the practical expedient in paragraph 46A of the Amendment to HKFRS 16 and accounts for the rent concession under Addendum 2 as follows:

- Entity A accounts for the forgiveness of the April 2020 lease payment of \$100,000 as a variable lease payment recognised in profit or loss in the period in which the event or condition that triggers the payment occurs (i.e. on 1 April 2020 because the forgiveness of rent became unconditional on that date) [paragraph 38 of HKFRS 16].
- The forgiveness of the lease payment results in a partial extinguishment of Entity A's lease liability and so Entity A makes a corresponding adjustment of \$100,000 to the lease liability.

Notes on Contract 1:

Differentiation of the effect of the covid-19 pandemic from other negative events

Paragraph 46B of the Amendment to HKFRS 16 states that the practical expedient applies only to rent concessions occurring as a direct consequence of the covid-19 pandemic. In some cases, it may be difficult to differentiate whether the rent concession is occurring as a direct consequence of the covid-19 pandemic or due to the combination of the covid-19 pandemic and other situations. In such cases, entities should apply judgement when assessing if the rent concession is occurring as a direct consequence of the covid-19 pandemic based on its specific facts and circumstances.

An explicit statement in the supplementary agreement between the lessor and the lessee specifying the reason for the rent concession may not be conclusive. Other factors to consider may include, but are not limited to, the following:

- the reasons for the initial negotiation between the lessor and the lessee regarding the rent concession;
- the timing of the negotiation and agreement of the rent concession; and
- the relevant laws and regulations in the specific jurisdiction.



Timing of recognition of reduction in lease payments

If an entity accounts for a reduction in lease payments (such as forgiveness of payments) as a variable lease payment applying paragraph 38 of HKFRS 16, it generally recognises the variable payment in profit or loss in the period in which the event or condition that triggers the payment occurs. The lessee would also make a corresponding adjustment to the lease liability—in effect derecognising that part of the lease liability that has been extinguished.

If a lessor agrees to give a lessee a rent concession in a form of reduction in lease payments over a period of time (e.g. several months) and the lessee applies the practical expedient in paragraph 46A of the Amendment to HKFRS 16, a question may arise regarding whether the lessee should recognise the rent reduction in profit and loss:

- i) at the time when the lessor and the lessee agree on the rent concession; or
- ii) over the period of the rent concession granted (i.e. over the months of reduced rent).

Judgement may be required in determining the timing of recognition of the reduction of rent in profit or loss and will depend on the facts and circumstances of the entity. Factors to consider in applying this judgement may include whether the reduction in lease payments is unconditional, i.e. depends only on the passage of time, or whether it is subject to future conditions (e.g. the government closure order must still be in place at a future date for the lessee to be entitled to the rent concession). For example:

- if a lessor agrees to give an upfront rent reduction with no future conditions, it may be appropriate to recognise the reduction of rent at the time of the agreement, or
- if a lessor agrees to grant a 20% rent reduction for one month, and depending on the development of the covid-19 pandemic (and hence whether the government closure order will continue for the next month), the lessor may grant a 20% rent reduction for the following month, it may be appropriate to recognise the reduction of rent on a month by month basis.

Contract 2

The reason for the rent concession granted by Lessor Y to Entity A is not explicitly stated in the addendum. However, the concession is granted subsequent to the outbreak of covid-19 and the related government closure order of gyms, and this was the main issue discussed during the negotiations between Entity A and Lessor Y.



Therefore, Entity A judges the rent concession is occurring as a direct consequence of the covid-19 pandemic.

The arrangement with Lessor Y does not increase the consideration for the lease. The rent concession meets the conditions in paragraphs 46B(a) and (b) that the revised consideration for the lease is substantially the same as the consideration immediately preceding the change, and the reduction in lease payments is related to payments originally due on or before 30 June 2021 (payments due in April to June 2020). Furthermore, the three-month rent holiday in April to June 2020 (i.e. before 30 June 2021) followed by three additional months of substantially equivalent payments in January to March 2021 would not fail the third condition in paragraph 46B(c) [paragraph BC205D(c) of the Amendment to HKFRS 16]. Therefore, all the conditions in paragraph 46B of the Amendment to HKFRS 16 are met.

Entity A applies the practical expedient in paragraph 46A of the Amendment to HKFRS 16 and accounts for the rent concession by remeasuring the lease liability on 1 April 2020 based on the revised lease payments, continuing to recognise interest on the lease liability and reducing the lease liability for payments made to Lessor Y applying paragraph 36 of HKFRS 16 as follows:

- no reduction in the lease liability from April to June 2020, as no payments are made to the lessor;
- a reduction in the lease liability of \$80,000 for each month from July 2020 to December 2020, and from April 2021 to December 2021; and
- a reduction in the lease liability of \$160,000 for each month during January to March 2021 to reflect the increased lease payments made.

Notes on Contract 2:

Accounting for reduction in present value of lease liability

For simplicity, the interest element for lease payments is ignored in this example. However, the reduction in the present value of the lease liability upon remeasurement of that liability to reflect the change in timing of individual payments would be recognised in profit or loss at the date of the addendum signed between Entity A and Lessor Y (i.e. 1 April 2020).

Assessment of change in consideration

Paragraph BC205D(a) of the Amendment to HKFRS 16 explains that “substantially the same as” in paragraph 46B(a) ensures an increase in payments that reflects only the time value of money would not preclude a lessee from applying the practical



expedient (i.e. an increase in the nominal amount of deferred lease payments that reflects only the time value of money should not prevent a lessee from applying the practical expedient).

Contract 3

Based on the same reasoning as for Contract 2, Entity A also judges the rent concession granted by Lessor Z is occurring as a direct consequence of the covid-19 pandemic. The rent concession also meets the conditions in paragraphs 46B(a)-(c) of the Amendment to HKFRS 16 because it reduces the consideration for the lease, it is a reduction of lease payments originally due on or before 30 June 2021 (the March 2020 lease payment was due on 1 January 2020 and the April 2020 lease payment was due on 1 April 2020), and there are no substantive changes to other terms and conditions of the contract. Therefore, all the conditions in paragraph 46B of the Amendment to HKFRS 16 are met.

Entity A applies the practical expedient in paragraph 46A of the Amendment to HKFRS 16 and accounts for the rent concession as follows:

- Entity A paid the March 2020 lease payment for the use of Gym 3 on 1 January 2020. The related reduction of lease payment of \$24,000 (calculated as \$120,000 x 20%) is paid to Entity A in a form of a lump sum cash rebate on 1 April 2020.
- Entity A is due to pay the April 2020 lease payment for the use of Gym 3 on 1 April 2020. The related reduction of lease payment is provided to Entity A in a form of rent reduction (\$24,000 direct reduction in April 2020).
- Entity A accounts for the 20% reduction of March and April 2020 lease payments of \$48,000 (\$24,000 x 2) as a variable lease payment recognised in profit or loss in the period in which the event or condition that triggers the payment occurs (i.e. on 1 April 2020 because the rent concession became unconditional on that date) [paragraph 38 of HKFRS 16], with a corresponding adjustment to cash (\$24,000 for the March 2020 rent rebate) and the lease liability (\$24,000 for April 2020 rent reduction).