Hong Kong Institute of
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香港會計師公會

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Illustrative examples on rent concessions

In this publication, we provide examples to illustrate application of HKFRS 16 *Leases* to some common rent concession fact patterns observed in Hong Kong due to the recent market conditions. This publication identifies key considerations in accounting for rent concessions for both lessors and lessees for the fact patterns described in the background information. Other considerations and analysis may be necessary for different fact patterns.

Background information

Retailer X (Lessee) leases retail spaces in different shopping malls in Hong Kong to sell cosmetic products. Retailer X enters into the following non-cancellable lease arrangements with different lessors:

	Location	Lessor	Lease term#	Commencement date	Monthly lease payment*
Contract 1 for Shop 1	Shopping mall A	Lessor A	5 years	1 January 2019	$100,000
Contract 2 for Shop 2	Shopping mall B	Lessor B	3 years	1 May 2019	$80,000
Contract 3 for Shop 3	Shopping mall C	Lessor C	3 years	1 March 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*

Contract 3 contains a specific clause (referred to as a suspension clause) that provides for rent reduction or suspension of rent in the event that the premises (or any part of them) are destroyed or damaged by catastrophic fire, typhoon, force majeure or are affected by other adverse events beyond the control of the tenant and landlord so as to render the premises unfit or not available for use by the tenant. The suspension clause in Contract 3 creates a contractual obligation for Lessor C to compensate Retailer X if the leased premises are not available or unfit for use by Retailer X in such circumstances. Contracts 1 and 2 do not contain a similar specific clause.

Lessors A, B and C classify the leases with Retailer X above as operating leases and recognise the lease payments as income on a straight-line basis applying HKFRS 16.81.

Adverse events which are beyond the control of the Lessors and Retailer X took place and affected the business of Retailer X. Shops 1, 2 and 3 were not available for use as a result of the closure of Shopping malls A, B and C for five full days during September 2019. Retailer X's actual sales from July to September 2019 significantly underperformed in comparison to its projected sales and barely covered the lease payments and other outgoings.

As a result, Lessor A proactively approached and encouraged Retailer X to continue its business in Shopping mall A despite the current economic condition. In addition, Retailer X informed Lessor B of the difficulties in operating and maintaining its business and asked Lessor B for rent concessions in early October 2019.

To preserve their good relationships with Retailer X, all of the Lessors agreed to provide rent concessions to Retailer X. Lessors A and B each signed an addendum to the original lease contracts with Retailer X on 1 November 2019, which established their commitment in relation to the rent concession. Lessor C confirmed that it would execute the suspension clause in the original contract and provide a rent concession. Other terms and conditions of the original lease contracts remain unchanged. The rent concessions are summarised as follows:

	Lessor	Rent concession provided to Retailer X
Contract 1	Lessor A	One-off lump sum subsidy payment of $50,000 to be paid in December 2019.
Contract 2	Lessor B	Fifty percent rent reduction for the three months from August to October 2019, totaling $120,000 [calculated as $80,000 x 50% x 3]. The reduction takes the form of a one-off payment from Lessor B in January 2020.
Contract 3	Lessor C	Rent rebate of $20,000 [agreed to be calculated on a time apportioned basis: 5/30 x $120,000 (based on the original lease payment for September)] in respect of Shopping mall C closure under specified circumstances as stipulated in the suspension clause. The rebate is to be settled through Retailer X paying reduced rent of $100,000 in December 2019.

Question:
How do Retailer X and the Lessors account for the rent concessions under HKFRS 16?

Analysis:

<u>Contract 1</u>

Lessor A is not contractually obligated to provide a rent concession under the original lease contract, ie. the relief is given voluntarily by Lessor A as a result of fresh negotiation to encourage Retailer X to continue operating in Shopping mall A despite the change in the economic outlook.

The negotiation and agreement of the rent concession leads to a reduction in the consideration for the lease that was not part of the original terms and conditions of the lease. The change meets the definition of a lease modification in Appendix A of HKFRS 16.

On 1 November 2019, the effective date of the lease modification (i.e. the date when Lessor A and Retailer X agreed to the terms of the rent concession), Retailer X and Lessor A account for the rent concession as follows:

Retailer X	Lessor A
- Retailer X determines there is no change in the lease term of the modified lease and remeasures the lease liability by discounting the revised lease payments using a revised discount rate [HKFRS 16.45(b) and (c)]. - The revised lease payments of $4,950,000 comprise the monthly lease payments over the remaining lease term less $50,000 receivable from Lessor A (calculated as $100,000 x 50 months - $50,000). - The revised discount rate is determined as the interest rate implicit in the lease for the remainder of the lease term. If that rate cannot be readily determined, Retailer X uses its incremental borrowing rate at the effective date of the modification (ie. 1 November 2019) [HKFRS 16.45(c)]. - The remeasurement of the lease liability is accounted for by making a corresponding adjustment to the right-of-use asset with no gain or loss recognised because the modification does not decrease the scope of the lease [HKFRS 16.46(b)].	- Lessor A accounts for the modification as a new lease, considering any prepaid or accrued lease payments relating to the original lease as part of the lease payments for the new lease [HKFRS 16.87]. - Lessor A recognises the rent concession of $50,000 as a lease incentive, which reduces the lease income on a straight-line basis from the effective date of the modification to the end of the lease term, ie. from November 2019 to December 2023. This results in a reduction of $1,000 lease income per month (calculated as $50,000/50 months) and the revised monthly lease income is $99,000 (calculated as $100,000 - $1,000) [HKFRS 16.81].

Contract 2

Based on the same reasoning as for Contract 1, the rent concession is accounted for as a lease modification by both Retailer X and Lessor B. At the effective date of the lease modification, 1 November 2019, Retailer X and Lessor B account for the rent concession as follows:

Retailer X	Lessor B
- Retailer X determines there is no change in the lease term of the modified lease and remeasures the lease liability by discounting the revised lease payments ($2,280,000, calculated as $80,000 x 30 months less $120,000 rebate receivable), using a revised discount rate at the effective date of the modification. There is a corresponding adjustment to the right-of-use asset with no gain or loss recognised because the modification does not decrease the scope of the lease [HKFRS 16.45(b) and (c) and 46(b)].	- Lessor B recognises the rent concession of $120,000 as a lease incentive, which reduces the lease income on a straight-line basis from the effective date of the modification to the end of the lease term, ie. from November 2019 to April 2022. This results in a reduction of $4,000 lease income per month (calculated as $120,000/30 months) and the revised monthly lease income is $76,000 (calculated as $80,000 - $4,000) [HKFRS 16.81].

Note:

For Contracts 1 and 2, the accounting treatment would be the same regardless of whether the rent concession is related to lease payments for past months (ie. before the effective date of the modification) or forthcoming months during the lease term given that the rent concession is not stipulated in the original contract. All lease modifications are accounted for at the effective date of the modification by the lessee applying HKFRS 16.44-46 and, for operating leases, as a new lease by the lessor applying HKFRS 16.87.

Contract 3

Contract 3 has a suspension clause specifying that compensation to Retailer X has to be made by Lessor C if Shop 3 is not available for use by Retailer X due to any adverse events beyond the control of Lessor C and Retailer X. When the contract was entered into in March 2019, both Retailer X and Lessor C considered it was extremely unlikely that adverse events would happen such that Shopping mall C would be closed and the shop would not be available for use. Nevertheless, Lessor C includes such a suspension clause in all of its lease contracts as protection for lessees.

Retailer X applied judgement and concluded at contract inception that the suspension clause has no real economic substance because the events covered by the suspension clause are extremely unlikely to occur. Retailer X considered the monthly lease payments in the contract essentially unavoidable and hence in-substance fixed lease payments [HKFRS 16.B42]. Therefore, on the commencement date of the lease, Retail X recognised a lease liability and a right-of-use asset including all lease payments (ie $120,000 x 36 months) [HKFRS 16.22].

Lessor C is contractually obliged to compensate Retailer X because of the closure of Shopping mall C in September 2019 in accordance with the suspension clause stipulated in the original terms and conditions of Contract 3. Therefore, the rent rebate is accounted for as part of the original lease, and not as a lease modification as defined in Appendix A of HKFRS 16.

Retailer X and Lessor C account for the rent concession as follows:

Retailer X	Lessor C
- Since the rebate is calculated based on the lost trading days due to the closure of Shopping mall C and is not dependent on an index or a rate as described in HKFRS 16.27(b), any variability to the lease payments is recognised when the event that triggers those payments occurs; ie. when Shopping mall C is closed [HKFRS 16.38(b)]. The rebate may be considered as a variable lease payment. - Retailer X recognises the $20,000 rebate in profit and loss in September 2019 because the rebate relates to closure of Shopping mall C which gave rise to the entitlement to the compensation under the suspension clause. There would be a similar reduction in the lease liability to reflect the fact the rebate is settled through paying a lower rent in a future month (i.e. December 2019). The lease liability would be discounted using the unchanged discount rate.	- Lessor C recognises the rebate of $20,000 due to Retailer X in profit or loss in September 2019.

Reminders:

Remeasuring lease liabilities and reassessing the discount rate

A lease modification is defined as a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease. In defining lease modifications, the IASB differentiated between scenarios that could result in the remeasurement of existing lease assets and lease liabilities that are not lease modifications (for example, a change in the lease payments based on contractual clauses included in the original contract) and those resulting in a lease modification (for example, a change in the consideration resulting from changes to the terms and conditions of the original lease).

For lease modifications that in substance do not represent the creation of a separate lease and do not decrease the scope of the lease (as illustrated for Contracts 1 & 2), the IASB decided that a lessee should remeasure the existing lease liability using a discount rate determined at the effective date of the modification and make a corresponding adjustment to the carrying amount of the right-of-use asset. The use of a revised discount rate in remeasuring the lease liability reflects that, in modifying the lease, there is a change in the interest rate implicit in the lease (which the discount rate is intended to approximate). The adjustment to the carrying amount of the right-of-use asset reflects the fact there is effectively a change in the cost of the right-of-use asset as a result of the modification. This approach results in accounting outcomes that faithfully represent the substance of a lease modification. [HKFRS 16.BC201-BC204]

The IASB decided that, in most cases, an entity should not reassess the discount rate during the lease term. This approach is generally consistent with the approach applied to financial instruments accounting for using the effective interest method. Nonetheless, in the IASB’s view, there are some circumstances in which an entity should reassess the discount rate to reflect current market economic conditions, for example, when there is a change in the assessment of the lease term. In the IASB’s view, in those circumstances, the economics of the lease have changed and it is appropriate to reassess the discount rate to be consistent with the change in the lease payments included in the measurement of the lease liability (and right-of-use asset) [HKFRS 16.BC193-BC194]. HKFRS 16 does not require the use of a revised discount rate to remeasure lease liabilities if the changes in future lease payments are in accordance with the terms and conditions of the original lease, provided that there are no changes to the lease term or the assessment of whether the lessee is reasonably certain to exercise an option to purchase the underlying asset.

<u>Assessment of whether the suspension clause has real economic substance</u>
When there is a specific clause in a contract that provides rights to the lessee and obligations to the lessor for rent reduction or suspension of rent upon the occurrence of specified events leading to the premises being unfit or not available for use, the lessee and lessor perform an assessment at contract inception of whether the lease payments related to such a clause are in-substance fixed or variable lease payments (e.g. they would consider whether the clause has real economic substance or not). The specific facts and circumstances of the lessor and the lessee, together with the relevant market and economic conditions should be considered in carrying out this assessment, including considering the likelihood of the leased premise not being

available under those specific circumstances.

A lessee may have determined that a suspension clause did not have real economic substance in the past. However, entities should assess the likelihood of such events occurring in the future when making judgement as to whether the suspension clause continues to have no real economic substance (for example, when entering into new lease contracts or on modification of existing lease contracts).

<u>The legal implication of suspension clauses</u>

Lease contracts in Hong Kong are not standardised. Both lessors and lessees are recommended to seek legal advice if they are unsure of the legal implications of suspension clauses, for example, advice about

- the enforceability of a specific clause in a lease contract under specified circumstances;
- in the absence of having a specific clause in the contract, whether any regulations or laws under the Hong Kong legal system (or under another legal system if the contract is signed in other jurisdiction) and/or customary business practice such that there is a legal obligation for the lessor to compensate the lessee.

In addition, if the lessor has not yet agreed to offer any payments or compensation to the lessee for events during a particular financial year, it may be necessary for both parties to seek legal advice and consider subsequent events in order to establish whether the lessor has an obligation to compensate for those events and the amount of compensation, respectively, at the year-end date.

<u>Fair value measurement of investment property</u>

When a lessor accounts for the leased asset as an investment property under HKAS 40 *Investment Property*, the fair value of the investment property should exclude the prepaid or accrued operating lease income because the lessor recognises it as a separate liability or asset [HKAS 40.50(c)].