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*The HKICPA's Standard Setting Department welcomes your comments and feedback on this guidance, which should be sent to [commentletters@hkiipa.org.hk](mailto:commentletters@hkiipa.org.hk).*

This guidance has been updated to incorporate the analysis and conclusion in the agenda decision *Lessor Forgiveness of Lease Payments (IFRS 9 and IFRS 16)* published by the IFRS Interpretations Committee (IC) in October 2022. In that agenda decision, the IC clarified the accounting for a particular type of rent concession from the perspective of a lessor.

The analysis and conclusion in that agenda decision are relevant to entities applying HKFRS as HKFRS are converged with IFRS Accounting Standards. As such, we have added Part II to this guidance to provide an example to illustrate the application of the agenda decision. In addition, minor edits have been made to Part I of this guidance to clarify the fact patterns of the rent concessions. New text is underlined and deleted text is struck through in Part I.

Please note that none of the rent concessions contemplated in this guidance is related to the COVID-19 pandemic and so the Amendment to HKFRS 16 *Covid-19-Related Rent Concessions* does not apply. Readers should refer to our [separate publication](#) for guidance on that amendment.

## **Part I - Illustrative examples on common 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 when this publication was first issued in January 2020. 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:

	<b>Location</b>	<b>Lessor</b>	<b>Lease term<sup>#</sup></b>	<b>Commencement date</b>	<b>Monthly lease payment<sup>*</sup></b>
Contract 1 for Shop 1	Shopping mall A	Lessor A	5 years	1 January 20 <u>X</u> 9	\$100,000
Contract 2 for Shop 2	Shopping mall B	Lessor B	3 years	1 May 20 <u>X</u> 9	\$80,000
Contract 3 for Shop 3	Shopping mall C	Lessor C	3 years	1 March 20 <u>X</u> 9	\$120,000

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

<sup>#</sup> *There are no renewal/ termination options provided by the contracts*

<sup>\*</sup> *Lease payments are contractually due and paid on the first day of each month unless otherwise stated*

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 20X9. Retailer X's actual sales from July to September 20X9 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 prevailing 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 20X9. As at 31 October 20X9, Retailer X has fully settled the original amount of lease payments up to the month of October 20X9 and thus, there is no operating lease receivable in the lessors' financial statements in relation to the three lease contracts.

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 20X9, 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 20X9.
Contract 2	Lessor B	Fifty percent rent reduction for the three months from August to October 20X9, 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 20Y0.
Contract 3	Lessor C	Rent rebate of \$20,000 [agreed to be calculated on a time apportioned basis: $5/30 \times \$120,000$ (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 20X9.

**Question:**

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

Analysis:

**Contract 1**

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 20X9, 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
<ul style="list-style-type: none"> <li>- 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)].</li> <li>- 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).</li> <li>- 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 20X9) [HKFRS 16.45(c)].</li> <li>- 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)].</li> </ul>	<ul style="list-style-type: none"> <li>- <u>As there is no outstanding operating lease receivable in relation to this contract, HKFRS 9 <i>Financial Instruments</i> is not applicable.</u></li> <li>- 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].</li> <li>- 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 20X9 to December 20Y3. 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].</li> </ul>

**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 20X9, Retailer X and Lessor B account for the rent concession as follows:

Retailer X	Lessor B
<p>- 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)].</p>	<p>- <u>As there is no operating lease receivable relating to the lease payments from August to October 20X9, HKFRS 9 is not applicable.</u></p> <p>- Lessor B <u>applies the lease modification requirements in HKFRS 16.</u> 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 20X9 to April 20Y2. 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].</p>

Note:

For Contracts 1 and 2, the accounting treatment would be the same from the perspective of the lessee (Retailer X) 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.~~



As for the lessors, the accounting treatment involves a two-step process, viz. a consideration of HKFRS 9 and then HKFRS 16. Part II of this publication illustrates the accounting for a modified rent concession of Contract 2 where the rent concession involves a waiver of operating lease receivable (i.e. amounts contractually due but not paid) as well as a reduction in lease payments that are not yet contractually due. As can be seen in Part II, the accounting outcome of the rent concession will differ depending on the terms of the rent concession as well as whether there is an operating lease receivable the settlement of which has been forgiven.

### **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 20X9, 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, Retailer X recognised a lease liability and a right-of-use asset including all lease payments (ie \$120,000 x 36 months) [HKFRS 16.22]. By the same token, Lessor C recognises operating lease income on a straight-line basis based on a monthly rental of \$120,000.

Lessor C is contractually obliged to compensate Retailer X because of the closure of Shopping mall C in September 20X9 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
<ul style="list-style-type: none"> <li>- 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.</li>   <li>- Retailer X recognises the \$20,000 rebate in profit and loss in September 20X9 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 20X9). The lease liability would be discounted using the unchanged discount rate.</li> </ul>	<ul style="list-style-type: none"> <li>- Lessor C recognises the rebate of \$20,000 due to Retailer X in profit or loss in September 20X9.</li> </ul>

**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.

#### Assessment of whether the suspension clause has real economic substance

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).

#### The legal implication of suspension clauses

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 subject to the laws of other jurisdictions) 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.

#### Fair value measurement of investment property

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)].

## **Part II – Lessor forgiveness of lease payments**

In October 2022, the IC published an agenda decision *Lessor Forgiveness of Lease Payments* to clarify the accounting for a particular type of rent concession from the perspective of a lessor. In the submitted fact pattern, the lessor forgives certain lease payments due from the lessee, some of which are contractually due but not paid (i.e. the lessor has already recognised these amounts as operating lease receivable) and some of which are not yet contractually due. No other changes are made to the lease contract, nor are there any other negotiations between the lessor and the lessee that might affect the accounting for the rent concession.

The agenda decision addresses the following two questions:

- (a) How the lessor applies the expected credit loss (ECL) model in IFRS 9 to the operating lease receivable before the rent concession is granted if it expects to forgive payments due from the lessee under the lease contract; and
- (b) Whether the lessor applies the derecognition requirements in IFRS 9 or the lease modification requirements in IFRS 16 when accounting for the rent concession.

The IC concluded that the lessor accounts for the rent concession described in the fact pattern under both IFRS 9 and IFRS 16 – it applies the ECL model and derecognition requirements in IFRS 9 to the operating lease receivable forgiven, and the lease modification requirements in IFRS 16 to future forgiven lease payments (which had not been recognised as an operating lease receivable). The principles and requirements are further explained in the following example.

### **Illustrative example**

Building on the background information in Part I, we have modified the fact pattern of Contract 2 as follows for the purposes of this example:

- (a) On 31 October 20X9, Lessor B and Retailer X signed an addendum to the original lease contract to confirm the rent concession arrangement.
- (b) Retailer X has not yet paid the lease payment for October 20X9 at the time of signing the rent concession arrangement. As such, operating lease receivable with a gross carrying amount of \$80,000 remains outstanding in Lessor B's financial statements as at 31 October 20X9.

- (c) Instead of providing a one-off rent rebate of \$120,000 in January 20Y0 (see details in Part I), Lessor B decided to forgive the lease payment of \$80,000 for October 20X9 and reduce the lease payment to HK\$40,000 for November 20X9.
- (d) No other changes are made to the lease contract, nor are there any other negotiations between the lessor and the lessee that might affect the accounting for the rent concession.

**Question:**

**How should Lessor B account for the rent concession?**

**Analysis:**

Lessor B grants the rent concession to Retailer X on 31 October 20X9. Lessor B legally releases Retailer X from its obligation to make specifically identified lease payments comprising:

- (a) An amount of \$80,000 that is contractually due but not paid (i.e. October 20X9 lease payment). Lessor B has recognised such an amount as an operating lease receivable.
- (b) An amount of \$40,000 that is not yet contractually due (i.e. reduced lease payment for November 20X9).

Applying the agenda decision, the accounting considerations and financial impact to Lessor B on this rent concession are summarised below:

Accounting considerations	Financial impact to Lessor B
<b><i>Applying the impairment and derecognition requirements in HKFRS 9 to the operating lease receivable</i></b>	
<i>Before the rent concession is granted</i>	
<ul style="list-style-type: none"> <li>- By applying HKFRS 9.5.5.17, the ECL on the operating lease receivable is measured on a probability-weighted basis, by evaluating a range of possible outcomes, including its expectation of forgiving lease payments recognised as part of that operating lease receivable. The expectation of forgiving the lease payments reflects a potential cash shortfall which should be considered in the ECL model.</li> </ul>	<ul style="list-style-type: none"> <li>- Lessor B applies the ECL model to the gross carrying amount of the operating lease receivable of \$80,000.</li> <li>- In considering the cash shortfalls for measuring ECL, Lessor B considers the expectation of forgiving lease payment of \$80,000 and recognises an impairment loss of the same amount in profit or loss.</li> </ul>

Accounting considerations	Financial impact to Lessor B
<ul style="list-style-type: none"> <li>- The lessor estimates the ECL to include <b>all</b> cash shortfalls, being the difference between:                             <ul style="list-style-type: none"> <li>• all contractual cash flows due under the lease contract with the lessee that are included in the gross carrying amount of the operating lease receivable, and</li> <li>• all cash flows the lessor expects to receive, using 'reasonable and supportable information' about 'past events, current conditions, and forecasts of future economic conditions'.</li> </ul> </li> </ul>	
<i>On the date the rent concession is granted</i>	
<ul style="list-style-type: none"> <li>- Immediately prior to the date the lease payments are forgiven, the lessor remeasures the ECL on the operating lease receivable and recognises any changes to the ECL in profit or loss.</li> <li>- The rent concession legally releases the lessee from its obligation to make specifically identified lease payments. The lessor applies the derecognition requirements in HKFRS 9.3.2.3 to derecognise the operating lease receivables relating to the forgiven lease payments including any associated ECL allowance.</li> </ul>	<ul style="list-style-type: none"> <li>- Lessor B considers that an impairment loss of \$80,000 on the operating lease receivable is appropriate.</li> <li>- Upon signing the addendum to the original lease contract on 31 October 20X9, Lessor B legally releases Retailer X from its obligation to make lease payments of \$120,000, of which \$80,000 for October 20X9 has been recognised as an operating lease receivable. Hence, Lessor B derecognises the operating lease receivable and the associated loss allowance, both at \$80,000.</li> </ul>
<b><i>Applying the lease modification requirements in HKFRS 16 to future lease payments which are not yet contractually due</i></b>	
<ul style="list-style-type: none"> <li>- Where the rent concession is not included in the original lease and it meets the definition of a lease modification in HKFRS 16, the lessor accounts for the modified lease as a new lease from the date of granting the rent concession under HKFRS 16.87.</li> <li>- The lessor applies the lease modification requirements to future lease payments, considering any prepaid or accrued lease payments relating to the original lease as part of the lease payments for the new lease. Operating lease receivables are not accrued lease payments.</li> </ul>	<ul style="list-style-type: none"> <li>- Lessor B accounts for the modified lease as a new lease from 31 October 20X9 and recognises the revised lease payments of \$2,360,000 (calculated as \$40,000 + \$80,000 x 29 months) as income on a straight-line basis from November 20X9 to April 20Y2. The reduced lease payment of \$40,000 for the month of November 20X9 results in a reduction of \$1,333 lease income per month (calculated as \$40,000/30 months) and the revised monthly lease income is \$78,667 (calculated as \$80,000 - \$1,333) [HKFRS 16.81].</li> </ul>

Note:

As we can see from this example, although the same amount of rent concession is granted by Lessor B (\$120,000), the accounting outcome here is different from that of Contract 2 in Part I.

It is because in this example, Lessor B intends to forgive and has subsequently forgiven lease payment *that is recognised as an operating lease receivable* to which the impairment and derecognition requirements of HKFRS 9 apply. In measuring the ECL, Lessor B should take into account the expectation of forgiving the lease payments as a potential cash shortfall, resulting in an impairment loss of \$80,000 in profit or loss even before the rent concession is granted.

In contrast, in Part I, Retailer X has fully settled the operating lease receivable at the time the rent concession was contemplated. As such, there is no operating lease receivable to which HKFRS 9 can be applied and the full amount of the rent concession is amortised over the remaining lease term by a reduction of monthly lease income under HKFRS 16. This results in Lessor B recognising a lower lease income per month in Part I (i.e. \$76,000 for Contract 2 in Part I as opposed to \$78,667 for Contract 2 in Part II).

***Further observation***

For Contracts 1 and 2 in Part I, if the lease payments are contractually due but have not been settled by the time the rent concession is contemplated, Lessors A and B would need to consider whether any rent concessions relate to rent for past months for which an operating lease receivable has been recognised and, if so, assess whether an impairment loss is required on those operating lease receivables. The lessors would also need to consider all the changes holistically to determine whether their contractual right to the cash flows from the operating lease receivable has expired in which case the derecognition requirements in HKFRS 9 would apply.

In light of the above, lessors that have previously granted rent concessions and/or intend to grant rent concessions in the future should pay attention to the accounting implications of this agenda decision, as it might impact the timing of recognising the effects of the rent concession in profit or loss. Lessors should revisit their accounting policy and consider reasonable and supportable information available without undue cost or effort about expectations of forgiveness of lease payments as at the reporting date for the purposes of assessing ECL for operating lease receivables.