

Financial Reporting Hot Topics: Coronavirus Relief for lessees on rent concessions

Issue 3 | May 2020

On 28 May 2020, the International Accounting Standards Board (the IASB® Board) finalised an amendment to IFRS 16 *Leases* that allows a lessee to bypass the need to evaluate whether certain qualifying COVID-19-related rent concessions are "lease modifications". The Hong Kong Institute of Certified Public Accountants (HKICPA) is expected to issue an equivalent amendment to HKFRS 16 shortly. This one-off relief is available for immediate application and impacts the period over which a lessee recognises the profit or loss effects of qualifying rent concessions.

This issue of the *Financial Reporting Hot Topics* newsletter summarises the IFRS 16 amendment (and the equivalent HKFRS 16 amendment), and explains the qualifying criteria and other considerations on whether and how to take advantage of the one-off relief.

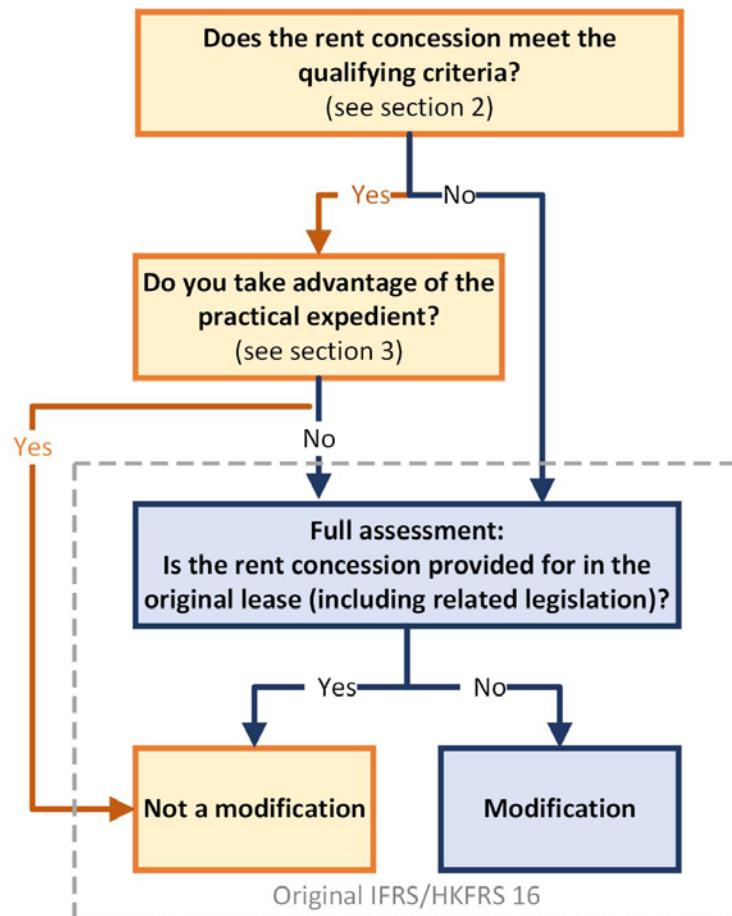
1. Highlights of the amendment

IFRS 16 contains requirements that specify the accounting for changes in lease payments, including rent concessions. Applying those requirements to a large volume of COVID-19-related rent concessions could be practically difficult, especially when the determination involves legal interpretation or when a modification necessitates the re-measurement of lease liabilities using revised discount rates.

In light of the potential practical challenges, the amendment to IFRS 16 allows lessees, as a voluntary practical expedient, not to assess whether particular COVID-19-related rent concessions are lease modifications and, instead, account for those rent concessions as if they were not lease modifications.

The diagram on the right highlights how the amendment (highlighted in orange) interacts with the original requirements in IFRS 16. Lessees shall apply the practical expedient consistently to contracts with similar characteristics and in similar circumstances.

The practical expedient is not available to lessors.



Effective date and transition

The amendment is effective for annual reporting periods beginning on or after 1 June 2020. Earlier application is permitted. Changes arising from applying the amendment are accounted for retrospectively, with the cumulative effect of initially applying the amendment recognised as an adjustment to the opening balance of retained earnings at the beginning of the annual reporting period.

In practical terms, that means:

- a lessee with 31 March 2020 year-end can still take advantage of the practical expedient in its 31 March 2020 financial statements, as long as their financial statements are authorised for issue on or after the relevant amendment was issued (i.e. 28 May 2020 for IFRS reporters).
- a lessee that does not apply the practical expedient in its 31 March 2020 year-end financial statements can nevertheless elect to apply the practical expedient in its financial statements for the period beginning 1 April 2020. In this case, any adjustments relating to lease payments originally due in January – March 2020 would be accounted for retrospectively by way of an adjustment to the opening balance of retained earnings on 1 April 2020 with no restatement to the comparatives for the year ended 31 March 2020.

Disclosure

A lessee applying the practical expedient shall disclose that it has applied the practical expedient to all qualifying COVID-19-related rent concessions or, if not applied to all such rent concessions, information about the nature of the contracts with similar characteristics and in similar circumstances to which it has applied the practical expedient. In addition, the lessee shall disclose 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 practical expedient has been applied.

2. A closer look at the qualifying criteria

The practical expedient 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. It may not be analogised to in other circumstances:

- (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.

Examples of qualifying rent concessions

The following examples illustrate the evaluation of different rent concessions against the qualifying criteria.

In all of the following examples, it is assumed that the rent concession is a direct consequence of the COVID-19 pandemic. A rent concession that is not a direct consequence of the COVID-19 pandemic is not eligible for the practical expedient. For example, if a tenant in Hong Kong agreed with its landlord in early January 2020 that a 20% rent rebate for November – December 2019 is offered due to the business disruption from social event, such rent concession does not qualify for the practical expedient as it is not a direct consequence of the COVID-19 pandemic.

Fact patterns	Analysis
<p>1. Due to the significant drop in the retail sales after the Chinese New Year (CNY), a tenant approached the landlord in early February for a rent concession. The landlord compared the trade of the retailer before and after the CNY and expected its business might not be recovered very soon due to the pandemic. As a result, in order to maintain a good relationship with the tenant, the landlord agreed to cut the rent of March and April by 50%. The remaining monthly payments and the lease term remain unchanged.</p>	<p>The tenant evaluates the concession against the three criteria as follows:</p> <ul style="list-style-type: none"> ▪ Criterion (a): As a pure rent reduction, the revised consideration for the lease is less than the original consideration. ▪ Criterion (b): The reduction in lease payments relates to payments originally due in March and April 2020, i.e. before 30 June 2021. ▪ Criterion (c): There is no substantive change to other terms and conditions of the lease. <p>Accordingly, the tenant concludes that the rent concession is within the scope of the practical expedient.</p>
<p>2. A tenant's business has been severely impacted by the outbreak of COVID-19 since the CNY. After negotiation with the landlord, the tenant is offered a three-month rent holiday for April – June 2020 amounting to HK\$100,000 in total. However, an additional payment of HK\$100,000 on top of the monthly rent will be charged at the end of the lease term in June 2021.</p>	<p>The tenant concludes that the concession qualifies for the practical expedient. Among other things, the tenant notes that:</p> <ul style="list-style-type: none"> ▪ Criterion (a): The arrangement is designed to change only the timing of payments originally due in April – June 2020 and defers them to the end of the lease in which the lease term remains unchanged. Hence the revised consideration is substantially the same as the consideration immediately preceding the change. ▪ Criterion (b): The rent holiday relates to payments originally due before 30 June 2021. ▪ Criterion (c): The additional payment at the end of the lease in 2021 which is equivalent to the amount of rent holiday would not be considered as failing the third condition.
<p>3. Same fact pattern as example 2, except that the landlord charges additional lease payments of HK\$104,000 instead of HK\$100,000 at the end of the lease in June 2021 to reflect the time value of money.</p>	<p>The tenant concludes that the concession qualifies for the practical expedient when evaluated against the three criteria. In addition to the considerations set out in example 2 above, the tenant notes that the additional HK\$4,000 charged by the landlord is to reflect only the time value of money from the deferral of lease payments for April – June 2020, and hence the revised consideration for the lease is still substantially the same with the original consideration.</p>
<p>4. A manufacturer entered into a 5-year non-cancellable lease with a factory owner. The lease commenced on 1 April 2018 with end date of 31 March 2023. During the outbreak of COVID-19 in February and March, the factory operation was almost suspended due to a significant drop in the production orders.</p> <p>After negotiation with the landlord, the rent in April – June 2020 is waived, amounting to RMB30,000 in total. At the same time, three months' fixed term is added immediately after the original expiry date of the lease (i.e. extended to 30 June 2023) and it is also charged at a rent of RMB10,000 per month.</p>	<p>The manufacturer concludes that criteria (a) and (b) are clearly met. However, a judgement is required on assessing criterion (c), i.e. whether the 3 months' lease extension is a substantive change to the lease.</p> <p>Considering the facts that the 3-month lease extension is agreed in exchange for the grant of the 3-month rental waiver and the extension period is relatively unsubstancial compared to the remaining lease term, the lease extension is not considered as a substantive change to other terms and conditions of the lease. Accordingly, the deferral of the lease payments for April-June 2020 together with the extension of the lease term is within the scope of the practical expedient.</p>

3. To adopt or not to adopt?

Whether the modification accounting applies to a rent concession could significantly impact the profit or loss profile of a lessee:

- If the modification accounting applies, a lessee does not recognise the benefits of the rent concession in profit or loss straight away. Instead, the lessee will recalculate its lease liability using a revised discount rate and adjust its right-of-use assets.
- If the modification accounting does not apply, the profit or loss impact of the rent concession would generally be more immediate.

As indicated at the outset, evaluating whether a rent concession is a lease modification and if so the resulting modification accounting could be costly in a complex lease portfolio. Lessees have to weigh the costs and benefits of electing to apply the practical expedient.

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