



**Lease modifications – extending  
the lease term**

May 2019

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# Introduction

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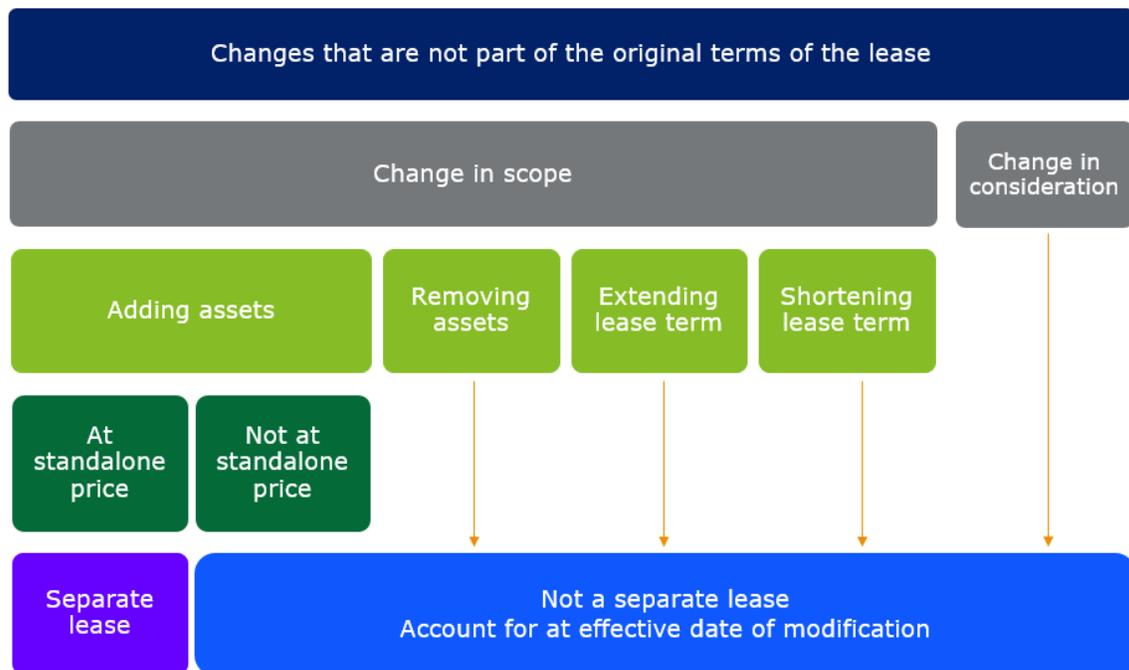
*Seemingly innocuous changes to an agreement could be a lease modification. They could affect your RoU asset and lease liability at unexpected times with major consequences for balance sheet ratios.*

*Are you prepared for them?*

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IFRS 16 contains detailed guidance on how to account for lease modifications. 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. A lease modification includes adding or terminating the right to use one or more underlying assets, or extending or shortening the contractual lease term.

IFRS 16's lease modification guidance can be summarised into the following diagram:



Broadly speaking, a lease modification is accounted for in one of two ways:

1. It is treated as a separate lease (IFRS 16.44); or
2. It is not treated as a separate lease (IFRS 16.45-46).

As can be seen from the diagram above, a modification will only be treated as a separate lease if it involves the addition of one or more underlying assets at a price that is commensurate with the standalone price of the increase in scope.<sup>1</sup> All other modifications are not accounted for as a separate lease.

The distinction between accounting for a modification as a separate lease or not as a separate lease is important because it affects (i) when and (ii) the amount at which the modified RoU asset and lease liability are recognised.

If a modification is a separate lease, a lessee applies the requirements of IFRS 16 to the newly added leased asset independently of the original lease.

In contrast, if a modification is not a separate lease, the accounting reflects that there is a linkage between the original lease and the modified lease. One of the consequences of this is that a lessee has to allocate the modified consideration to each separate lease component in the modified contract on the effective date of the modification<sup>2</sup>, resulting in a remeasurement of the existing lease liability and RoU asset on that date.

The application of these requirements are illustrated in the sections that follow.

The appendix to this document reproduces the relevant IFRS 16 guidance on lease modifications.

### *The focus of this publication*

This publication focuses on the extension of a lease. Specifically, it addresses the following issues:

- 1) What constitutes a lease modification?
- 2) When should a lease modification be accounted for?
- 3) What is the impact of a lease modification on the lease term?
- 4) How do the modification requirements interact with transition reliefs?

We have chosen to focus on modifications involving lease extensions because they are pervasive and could have a material impact on the amounts recognised in the financial statements; yet it is an area that is often overlooked by practitioners.

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<sup>1</sup> For an addition of a RoU asset to be accounted for as a separate lease, the increase in consideration must be 'commensurate with the stand-alone price for the increase in scope and any appropriate adjustments to that stand-alone price to reflect the circumstances of the particular contract' (IFRS 16.44(b)). For ease of reference, that notion has been shortened to an increase in consideration that is 'at market rates' throughout this publication.

<sup>2</sup> See the appendix for relevant definitions.

**Abbreviations**

RoU asset      Right-of-use asset  
DIA              Date of initial application

# Interaction with transition reliefs

When an entity applies IFRS 16 for the first time, IFRS 16.C3 allows an entity to grandfather the previous lease v. non-lease assessment of all existing contracts, even if applying the definition of a lease in accordance with IFRS 16 would result in a different conclusion. Nevertheless, if an entity enters into a new lease or if an existing contract is modified after the DIA, the entity needs to assess whether the contract is, or contains a lease, in accordance with the requirements of IFRS 16 (IFRS 16.C4).

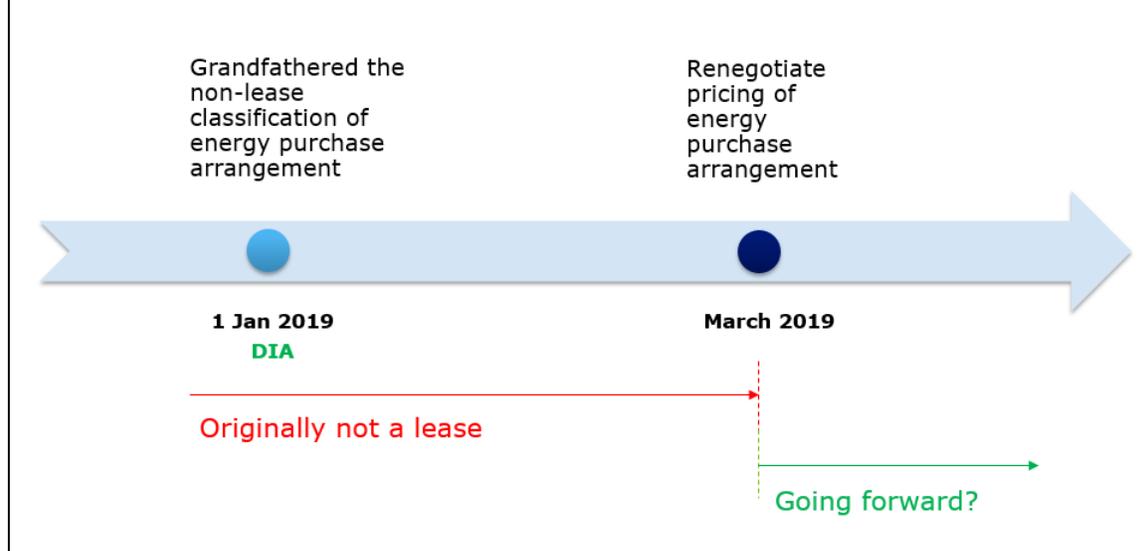
In other words, the grandfathering practical expedient is not an immunity from future changes. This can be seen in examples 1 and 2.

## Example 1

### Change in price to a grandfathered non-lease contract

Entity A has a long-term energy purchase arrangement with a solar farm owner. The arrangement is assessed **not** to be a lease under IAS 17 and IFRIC 4. On transition to IFRS 16 on 1 January 2019, Entity A chooses to grandfather the lease v. non-lease assessment in accordance with IFRS 16.C3.

In March 2019, Entity A renegotiates the pricing of the energy purchase arrangement with the solar farm owner to align to market rates.



## **Analysis**

A change in consideration is a modification as defined because the change was not contemplated in the original terms of the contract. Consequently as required by IFRS 16.C4, Entity A should assess whether the long-term energy purchase contract is a lease by applying the definition of a lease in IFRS 16 upon pricing renegotiation.

If Entity A concludes that the contract is a lease in terms of IFRS 16, it will have to recognise the related RoU asset and lease liability in March 2019.

## **Observation**

Something as innocuous as a change in price is a modification. Does your system flag this to you as such? If not, what manual processes have you put in place to identify such changes?

It is also worth noting that in example 1, the purchase contract was *not* accounted for as a lease on transition to IFRS 16. It is probably recorded outside Entity A's leases database and potentially not covered by Entity A's normal procedures on identifying lease modifications. What processes have you put in place to ensure modifications to such *non-lease contracts* are identified and brought to your attention for a fresh assessment of whether it is a lease in terms of IFRS 16? This is particularly important for borderline cases under IFRIC 4.

Looking back at example 1, we can see that while the contract was off balance sheet on transition to IFRS 16 and continues to be so in January and February 2019, the contract could be brought on balance sheet in March 2019 if it is determined to be a lease under IFRS 16. Are you prepared for that?

## **Example 2**

### **Extending the term of a lease to which the para C10(c) practical expedient was applied**

Entity B's DIA of IFRS 16 is 1 January 2019. On the DIA, Entity B has various leases of retail shops that end on 30 November 2019. As the leases have a remaining lease term of less than 12 months from the DIA, Entity B elects to use the IFRS 16.C10(c) practical expedient to account for the leases in the same way as short-term leases. These leases are therefore kept off balance sheet on the DIA.

These leases do not contain any extension options. On 1 June 2019, each of these leases are extended for 12 months from 1 December 2019 to 30 November 2020.

Entity B has a December year-end and reports interim results in June.

- Entity B has various leases of retail shops
- B elects to use the <12-month remaining lease term practical expedient

B and the lessor agree to extend each of the retail shop leases



### Analysis

The application of IFRS 16.C10(c) is tantamount to treating the leases as short-term leases from the DIA. Accordingly, Entity B applies the guidance in IFRS 16.5-8 to such leases. In accordance with IFRS 16.7(a), when a short-term lease is modified, the lease is considered to be a new lease on the effective date of the modification.

Extending the lease term is a modification as defined because the extension was not contemplated in the original terms of the lease. Consequently, Entity B should account for the leases as new leases from 1 June 2019, being the effective date of the modification.

Each of the new leases has a commencement date of 1 June 2019 and a lease term of 1.5 years (from 1 June 2019 to 30 November 2020). As the lease term is longer than 12 months, the new leases do not meet the definition of a short-term lease and their related RoU assets and lease liabilities will be recognised on 1 June 2019 and will appear in the 2019 interim financial statements.

### Observation

Similar to example 1, even though the leases were kept off balance sheet on the DIA, they are subsequently brought on balance sheet because of a modification. This could have a significant impact on your balance sheet ratios.

What processes have you put in place to make sure modifications of short-term leases are completely identified? When changes are made to the leases database, does the system flag them to you as a potential modification? What processes are in place to make sure modifications of short-term leases are treated as new leases with all the ensuing accounting requirements, including determination of the lease term, allocating the consideration to lease and non-lease components, determining the discount rate etc.?

# Steady-state application

*Extending a lease – when should the additional RoU asset and lease liability be recognised?*

It is very common for entities to extend their leases before expiry of the lease. A question arises as to when the RoU asset and lease liability relating to the extended period should be recognised:

- Upon conclusion of negotiation? or
- At the start of the extended period?

In cases where the original lease does not contain any extension options, the negotiation to extend a lease constitutes a modification as defined. As the modification does not add the right to use one or more underlying assets – it merely extends the entity’s right to use an existing leased asset to which it already has access – the modification is *not* accounted for as a separate lease. Instead, the modification is accounted for at the effective date of the lease modification, which is the date when both parties agree to a lease modification (IFRS 16.45). See example 3.

## Example 3

### Extending a lease: when should the additional RoU asset and lease liability be recognised?

Entity C has a lease that runs from 1 January 2019 to 31 December 2020 with no extension or early termination options. Six months before expiry, on 1 July 2020, Entity C and the lessor agree to extend the lease for another two years after expiry.



### **Analysis**

Since the original lease does not contain any extension options, the agreement to extend the lease constitutes a modification as defined. As the modification does not add the right to use one or more underlying assets, it is accounted for at the effective date of the lease modification, which is 1 July 2020.

Accordingly, Entity C remeasures the existing lease liability on 1 July 2020 to include the lease payments for the extended period (2021 and 2022) using a revised discount rate (IFRS 16.45(c)). A corresponding adjustment is made to the RoU asset (IFRS 16.46(b)).

The 'additional' RoU asset and lease liability relating to the extended period are therefore recognised on the date of modification and are not deferred until the start of the extended period.

### **Observation**

Is an extension of lease term identified as a modification by your system or other processes? At what date does your system recognise the additional RoU asset and lease liability? In addition to asking you for the start date of the extended period, does the system require you to input the effective date of the modification?

### *Extension via a new contract*

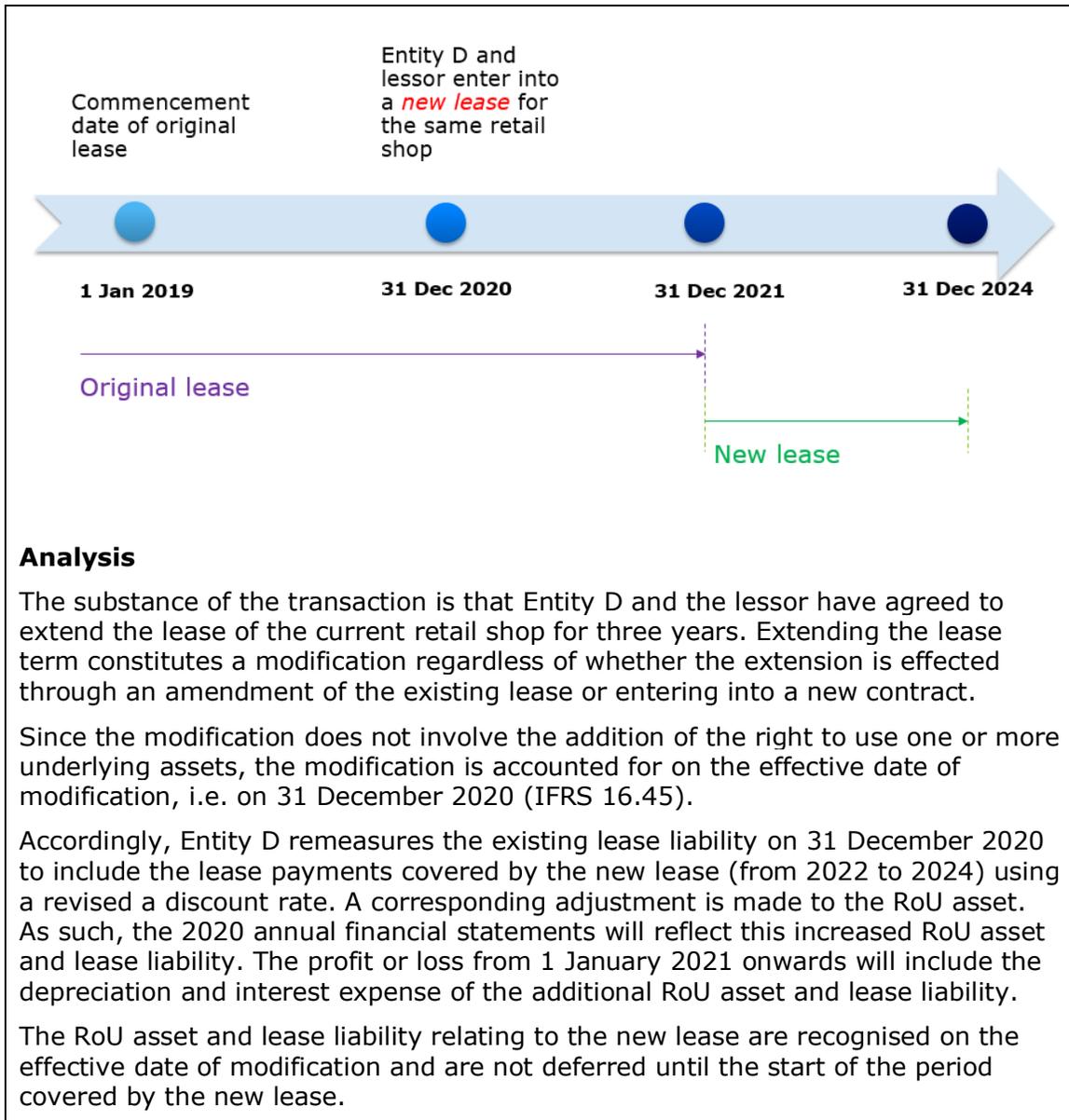
If a lessee enters into a *new contract* with a lessor (i.e. the original lease agreement remains unchanged) that has the effect of extending the lease term of the existing lease without adding the right to use one or more underlying assets, the new contract should be accounted for as a modification of the existing lease.

In other words, extending the contractual term of a lease meets the definition of a lease modification regardless of whether the extension is effected through an amendment of the existing lease or entering into a new contract. See example 4.

### **Example 4**

#### **Extension via a new contract**

Entity D leases a retail shop for three years from 1 January 2019 to 31 December 2021. The lease does not have any renewal or early termination options. On 31 December 2020, the lessor calls for an open tender and Entity D decides to match the highest tender price. As a result, Entity D and the lessor enter into a *new lease agreement* for the same shop for three years to start after expiry of the current lease. The original lease remains unchanged.



**Observation**

How do your existing processes identify new leases that should be accounted for as a modification?

In example 4, if the new contract signed on 31 December 2020 was incorrectly accounted for as a new lease, it would only be recognised on 1 January 2022, resulting in an error from 2020 onwards. Not only are the RoU asset and lease liability understated for both 2020 and 2021, the depreciation, interest expense and retained earnings from 1 January 2021 onwards would also be incorrect.

### Extension plus a new asset – at market rates

When a modification involves both an extension of the existing lease and an addition of another leased asset, an entity should assess whether the existing leased asset and the newly leased asset are separate lease components.

The right to use an underlying asset is a separate lease component if:

- (a) the lessee can benefit from use of the underlying asset either on its own or together with other resources that are readily available to the lessee, and
- (b) the underlying asset is neither highly dependent on, nor highly interrelated with, the other underlying assets in the contract. (IFRS 16.B32)

If the existing leased asset and the newly leased asset are separate lease components in terms of the above criteria, then each of them should be accounted for as a separate lease (IFRS 16.12). This entails applying the modification guidance to each of the existing and newly added leased assets separately. Example 5 illustrates this point.

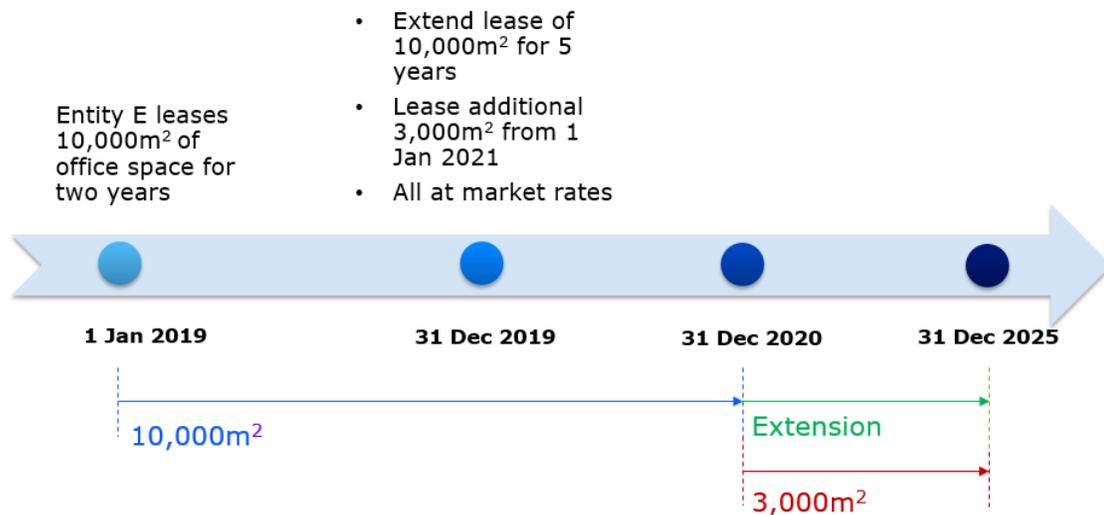
#### Example 5

#### Extension of lease plus a new asset – at market rates

Entity E leases 10,000m<sup>2</sup> of office space for two years from 1 January 2019 to 31 December 2020. On 31 December 2019, Entity E and the lessor amend the lease to:

- (i) extend the lease of the existing 10,000m<sup>2</sup> for five years; and
- (ii) lease an additional 3,000m<sup>2</sup> for five years, starting from 1 January 2021.

The two office spaces are assessed as separate lease components in accordance with IFRS 16.B32. The consideration for the entire modification is commensurate with the sum of the market price of both components.



## Analysis

As the two office spaces are assessed to be separate lease components, they are accounted for as separate leases and the modification guidance is applied to each of them separately.

The modification to include the additional 3,000m<sup>2</sup> is accounted for as a separate lease because it increases the scope of the lease by adding the right to use an underlying asset (extra space) at market rates. Accordingly, the new RoU asset and lease liability relating to the additional 3,000m<sup>2</sup> are recognised at the new lease's commencement date, i.e. at 1 January 2021.

The modification to extend the lease term of the existing 10,000m<sup>2</sup> is not accounted for as a separate lease because it does not involve the addition of the right to use one or more underlying assets. Instead, consistent with examples 3 and 4, the extension is accounted for on the effective date of the modification, i.e. on 31 December 2019. Entity D remeasures the existing lease liability on 31 December 2019 to include the lease payments covered by the extended period (from 2021 to 2025) for the existing 10,000m<sup>2</sup> using a revised a discount rate. A corresponding adjustment is made to the RoU asset. The 2019 annual financial statements will reflect this increased RoU asset and lease liability.

### *Extension plus a new asset – not at market rates*

When a modification occurs through the addition of a RoU asset (e.g. leasing an extra floor of office space) at an off-market rate, the modification must be accounted for at the effective date of the modification in accordance with IFRS 16.45.

Off-market pricing could happen when, for example, due to changes in market conditions the lessee is paying above-market rent for an existing lease of property. If the lessee decides to lease another property from the same lessor, instead of adjusting the existing lease to market rent and paying market rent for the new property, both parties might agree to charge below-market rent for the new property such that on an aggregate basis the lessee is paying market rent for both leases.

IFRS 16.45 requires a lessee, at the effective date of the modification, to:

- (a) determine the lease term of the modified lease;
- (b) allocate the consideration in the modified contract; and
- (c) remeasure the lease liability.

Following the allocation of the consideration in the modified contract to the separate lease components (including the new and the existing lease components) at the effective date of the modification, the lessee remeasures the lease liability for the existing RoU asset.

Given the lack of clear guidance in IFRS 16, we believe that the RoU asset and lease liability relating to the newly added leased asset should be recognised only when it is made available for use by the lessee (i.e. at the commencement date of that separate lease component), even if this date is later than the effective date of the modification (IFRS 16.22). The amounts recognised would reflect the consideration allocated to this lease component at the effective date of the modification.

Example 6 illustrates this point.

### Example 6

#### Extension of lease plus a new asset – not at market rates

Entity F leases 10,000m<sup>2</sup> of office space for two years from 1 January 2019 to 31 December 2020. On 31 December 2019, Entity F and the lessor amend the lease to:

- (i) extend the lease of the existing 10,000m<sup>2</sup> for five years; and
- (ii) lease an additional 3,000m<sup>2</sup> for five years, starting from 1 January 2021.

The consideration for the additional space is **not** commensurate with the standalone price of the additional space. The original 10,000m<sup>2</sup> and the additional 3,000m<sup>2</sup> of office space are separate lease components in accordance with IFRS 16.B32.



#### Analysis

Since the increase in consideration for the increase in scope (the additional 3,000m<sup>2</sup>) is not at market rate, Entity F applies IFRS 16.45 to account for the modification. Accordingly, on 31 December 2019 which is the effective date of the modification, Entity F allocates the revised rentals for the modified contract to the two lease components, i.e. the existing 10,000m<sup>2</sup> and the additional 3,000m<sup>2</sup> of office space, based on their relative standalone prices at that date.

Following the allocation of the consideration to the separate lease components, Entity F accounts for each lease component independently (IFRS 16.12). Consequently, Entity F remeasures the lease liability and the RoU asset relating to

the existing 10,000m<sup>2</sup> on 31 December 2019 using a revised discount rate. The 2019 annual financial statements will therefore reflect a revised RoU asset and lease liability for the existing 10,000m<sup>2</sup> of office space.

As regards the lease of the additional 3,000m<sup>2</sup>, we believe that the related RoU asset and lease liability should be recognised at the commencement date of that separate lease component, i.e. on 1 January 2021 when this space is made available for use by Entity F. The amount recognised reflects the consideration allocated to this additional space on the effective date of modification of the original lease.

### **Observation**

As you can see from examples 5 and 6, regardless of whether the additional office space (leased asset) is accounted for as a separate lease for the purposes of the modification guidance, as long as it is a separate lease component from the existing leased asset, it will only be **recognised** on the commencement date which is the date when the additional asset is made available for use by the lessee.

Nevertheless, the **measurement** basis for both the pre-existing and the additional leased asset is different. If the modification is not accounted for as a separate lease, the modified consideration will be allocated to the pre-existing and the additional lease components on a relative standalone price basis. On the contrary, if the modification is accounted for as a separate lease in accordance with IFRS 16.44, no reallocation is made.

### **Observation**

See the *scope of the modification guidance* section below and example 10 for a discussion of whether the lease modification guidance applies when a lessee enters into a new agreement with the same lessor for different assets.

## *Assessment of the lease term upon a lease extension*

The determination of lease term upon a lease extension depends on whether the original lease was a short-term lease.

If the original lease was not a short-term lease, a lessee applies IFRS 16.44-46 to the modification. In the context of an extension of the lease term, since it does not add the right to use one or more underlying asset, the lease is accounted for as a continuation of the original lease and so the lease term spans from the commencement date of the original lease to the end of the extended period. See example 7.

If the original lease was a short-term lease, a lessee applies IFRS 16.7 to the modification. IFRS 16.7 requires any modification of a short-term lease to be considered a new lease on the effective date of the modification. This means that an

entity will need to reassess the lease term of the new lease to determine if it continues to qualify for the short-term lease exemption. See examples 8 and 9.

### Example 7

#### Assessment of lease term upon a lease extension – original lease is not a short-term lease

Entity A has a lease for two years that runs from 1 January 2019 to 31 December 2020. There are no extension options. The lease is extended on 1 October 2020 for six months from 1 January 2021 to 30 June 2021.



#### Analysis

The agreement to extend the lease is a modification because it was not contemplated in the original terms of the lease. Since the modification does not add the right to use one or more underlying assets, it does not meet the criteria in IFRS 16.44(a) to be accounted for as a separate lease. The commencement date of the modified lease remains to be 1 January 2019, i.e. the date when the RoU asset was first made available for use by Entity A.

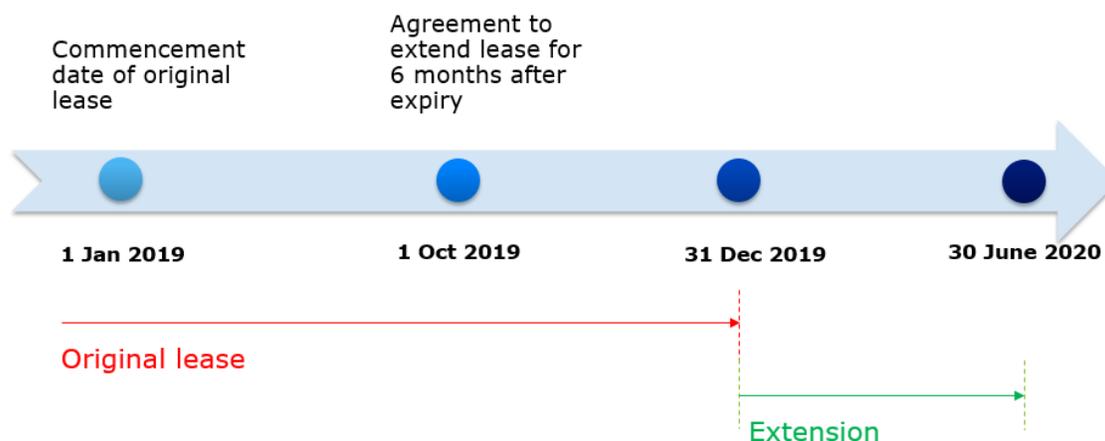
Accordingly, the total lease term of the modified lease is 2.5 years. It would be incorrect to treat the lease as a short-term lease from 1 October 2020, being the effective date of the modification, on grounds that the remaining term of the lease is nine months from that date.

## Example 8

### Original lease is a short-term lease – modification that qualifies for a short-term lease

Entity B has a short-term lease that runs from 1 January 2019 to 31 December 2019. There are no extension options. The lease is extended on 1 October 2019 for six months from 1 January 2020 to 30 June 2020.

Entity B elects to apply the short-term lease recognition exemption in accordance with IFRS 16.5 to all short-term leases.



### Analysis

Since the original lease is a short-term lease to which Entity B has elected to apply the short-term lease exemption, IFRS 16.6-8 applies.

In accordance with IFRS 16.7(a), the lease is considered to be a new lease if there is a modification or a change in the lease term. There is a modification on 1 October 2019 because the lease has been extended and this extension was not contemplated in the original terms of the lease.

Consequently, the new lease has a commencement date of 1 October 2019 and a lease term of nine months, thus it meets the definition of a short-term lease and qualifies for the short-term lease exemption from 1 October 2019.

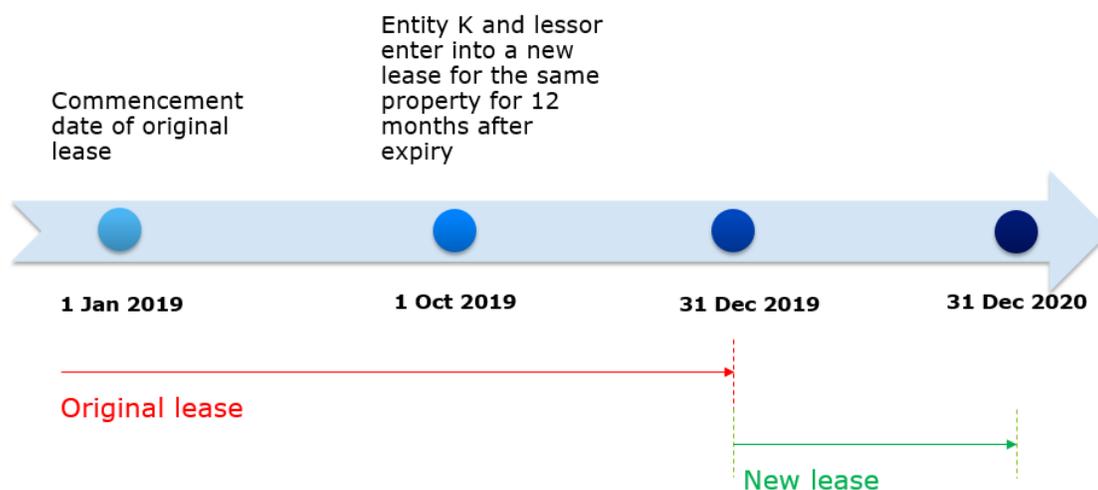
The consideration for the modified lease (i.e. existing rentals for October to December 2019 plus new rentals for January to June 2020) will be straight-lined over the term of the new lease from 1 October 2019 to 30 June 2020.

## Example 9

### Original lease is a short-term lease – modification that does not qualify for a short-term lease

Entity K has a short-term property lease that runs from 1 January 2019 to 31 December 2019. There are no extension options. On 1 October 2019, Entity K and the lessor enter into a new lease to rent the same premises for 12 months from 1 January 2020 to 31 December 2020.

Entity K elects to apply the short-term lease recognition exemption in accordance with IFRS 16.5 to all short-term leases.



### Analysis

Since the original lease is a short-term lease to which Entity K has elected to apply the short-term lease exemption, IFRS 16.6-8 applies.

In accordance with IFRS 16.7(a), the lease is considered to be a new lease if there is a modification or a change in the lease term. As discussed in the 'extension via a new contract' section, entering into a new lease on the same underlying asset that has the effect of extending the lease term of the original lease is a modification as defined.

Consequently, the new lease for the purposes of IFRS 16.7(a) has a commencement date of 1 October 2019 and a lease term of 15 months, thus it does not meet the definition of a short-term lease. As such, Entity K should recognise a RoU asset and lease liability for the new 15-month lease on 1 October 2019. The RoU asset and lease liability will appear in the 2019 annual financial statements.

**Observation**

How did you set up your system and processes to identify whether something is a short-term lease? In example 9, the new legal contract signed on 1 October 2019 is for a term of 12 months so it would have met the definition of a short-term lease had it not been for the application of the modification requirements. If your system and processes merely ask whether the new lease has a lease term of 12 months or less, the answer to which is yes, you would have accounted for the modification incorrectly.

How do your processes identify new contracts that should be accounted for as a modification? Specifically, how do those processes identify new contracts or renewals that should be brought on balance sheet?

**Observation**

Example 9 is a very common example of rolling 12-month leases. The continued 12-month extensions every year before expiry of the original lease would cause the contract to fail the short-term lease definition. The lease will have to be brought on balance sheet upon the first extension as seen in example 9.

*Scope of the modification guidance*

As discussed previously, a lease modification can arise from a lessee and lessor modifying the terms of an existing lease or by entering into a new agreement without directly changing the terms of an existing lease.

Furthermore, a lease modification can arise when a lessee and lessor with existing lease contract(s) enter into a new lease for a different asset. Example 10 illustrates this scenario.

**Example 10****Scope of the modification guidance – entering into a new lease contract with an existing lessor for different assets**

Entity X leases two floors of an office building in Hong Kong (HK) from Lessor Y for six years. At the end of Year 4, due to expansion needs, Entity X enters into various new contracts with Lessor Y to lease properties in Beijing for five years to start immediately. The original lease remains unchanged.



### Analysis

As Entity X has a pre-existing lease arrangement with Lessor Y, Entity X should apply the modification guidance to assess how the new Beijing leases should be accounted for.

Since the Beijing leases add the right to use one or more underlying assets when compared to the original HK lease, Entity X assesses whether the consideration for the Beijing leases is at market rates in order to assess whether they should be accounted for as separate leases from the original lease of the HK office.

If the consideration for the Beijing leases is at market rates, the new contracts would be accounted for as separate leases (IFRS 16.44).

If, on the other hand, the consideration for the Beijing leases is *not* at market rates, Entity X should consider all relevant facts and circumstances to determine the business and commercial rationale for the off-market pricing.

If Entity X concludes that the consideration for the Beijing leases was influenced by the pricing of the original HK lease as opposed to other non-lease contracts, the lease modification guidance applies. In such a case, Entity X should allocate the consideration of the Beijing leases and the original HK lease to the separate lease components (i.e. each of the Beijing and HK properties) based on their relative standalone price at the end of Year 4, being the effective date of the modification.

Following the allocation of the modified consideration to the separate lease components, Entity X accounts for each lease component as a separate lease (IFRS 16.12). Consequently, Entity X remeasures the lease liability and RoU asset relating to the HK lease at the end of Year 4 using a revised discount rate.

As regards the new Beijing leases, the related RoU asset and lease liability are recognised at the commencement date of that separate lease component, i.e. at the end of Year 4 when the Beijing properties are made available for use by Entity X. The amount recognised for the Beijing leases reflects the consideration allocated to these properties as described in the paragraphs above.

In cases where the lessee has more than one pre-existing lease with the same lessor, the lessee should consider all relevant facts and circumstances to identify which of the pre-existing leases have been modified, which would then be accounted for in accordance with IFRS 16.45-46.

### **Observation**

Pricing is an important consideration when it comes to assessing whether a modification should be accounted for as a separate lease. In example 10, if the Beijing leases were priced at market, whether or not Entity X applies the modification guidance to them would result in the same answer – the new leases would be accounted for as separate leases from the HK lease.

It is when the pricing is not at market that applying the modification guidance would result in a different accounting outcome. When the off-market pricing was caused by the pricing of a pre-existing lease, applying the modification guidance would require the rentals for the new lease (Beijing properties) and the original lease (HK properties) to be added together and reallocated to the two lease components based on their relative standalone price as at the effective date of the modification. This reallocation of the revised consideration is logical given that the pricing of the original lease influenced the pricing of the new lease.

Significant judgement may be required in some cases to assess whether the pricing for the new lease is commensurate with the stand-alone price for the increase in scope *and any appropriate adjustments to that stand-alone price to reflect the circumstances of the particular contract* (IFRS 16.44(b)). We would recommend entities to consult their auditors and accounting advisors in such cases.

### *Interaction with the Hong Kong Listing Rules*

Chapter 14 *Notifiable Transactions* of the Main Board Listing Rules (LR) deals with certain transactions, principally acquisitions and disposals, by a listed issuer. It describes how they are classified (e.g. discloseable transaction, major transaction, very substantial acquisition, very substantial disposal), the details that are required to be disclosed and whether a circular and shareholders' approval are required for such transactions.

When a lease modification increases the scope of a lease (e.g. extending the lease term or leasing additional assets), the adjustment to the carrying amount of the RoU asset effectively represents the cost of acquiring additional RoU assets. Such modifications are treated as an acquisition of assets for the purposes of Chapter 14 of the LR and they are subject to the notifiable transaction requirements if the relevant ratios are exceeded. Examples include:

1. extending the lease term of a lease that was already recognised on balance sheet, resulting in an increase in the carrying amount of the existing RoU asset (see examples 3 to 7);
2. a short-term lease that was kept off balance sheet but after the modification, the lease no longer qualifies for a short-term lease and has to be recognised on balance sheet (see example 9).

# Key takeaways



## When to recognise the modification and impact on lease term

1. Seemingly innocuous changes e.g. a change in price or a lease renewal are modifications
2. Modifications include *new leases* of an existing leased asset
3. Recognise the RoU asset and liability for the extended period 'now' (on the effective date of the modification)
4. Modifications of contracts that were grandfathered as not a lease on the DIA – may now be a lease
5. Modifications of short-term leases – account for them as new leases on the effective date of the modification – assess lease term from that date

## Systems and processes

1. Does your system flag various changes to you as modifications?
2. Does your system flag modifications to you on contracts (especially non-lease contracts) that used the grandfathering practical expedient on transition?
3. Can your system perform the actual modification accounting? How do your systems and processes identify new leases of existing leased assets that should be accounted for as a modification, and modifications of short-term leases that must now be brought on balance sheet?
4. At what date does your system recognise the additional RoU asset and lease liability arising from lease extensions?

## **Scope and Listing Rules**

1. All arrangements with the same counterparty fall under the scope of the lease modification guidance – the key is to understand the pricing of the modification and the reasons for any off-market pricing
2. Recognising additional RoU assets from extending a lease, or modifying a short-term lease such that it no longer qualifies for a short-term lease after the modification – both are regarded as an acquisition of assets for Listing Rules purposes and they are subject to the notifiable transaction requirements

# Appendix - relevant IFRS 16 guidance

## Definitions

**Commencement date of the lease:** The date on which a lessor makes an underlying asset available for use by a lessee.

**Effective date of the modification:** The date when both parties agree to a lease modification.

**Lease modification:** 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 (for example, adding or terminating the right to use one or more underlying assets, or extending or shortening the contractual lease term).

22 At the commencement date, a lessee shall recognise a right-of-use asset and a lease liability.

## Relevant for short-term leases

- 7 If a lessee accounts for short-term leases applying paragraph 6 [i.e. keeping them off balance sheet and recognising the related expense on a straight-line basis], the lessee shall consider the lease to be a new lease for the purposes of this Standard if:
- (a) there is a lease modification; or
  - (b) there is any change in the lease term (for example, the lessee exercises an option not previously included in its determination of the lease term).

## Relevant for non-short-term leases

- 44 A lessee shall account for a lease modification as a separate lease if both:
- (a) the modification increases the scope of the lease by adding the right to use one or more underlying assets; and
  - (b) the consideration for the lease increases by an amount commensurate with the stand-alone price for the increase in scope and any appropriate adjustments to that stand-alone price to reflect the circumstances of the particular contract.
- 45 For a lease modification that is not accounted for as a separate lease, at the effective date of the lease modification a lessee shall:
- (a) allocate the consideration in the modified contract applying paragraphs 13–16;
  - (b) determine the lease term of the modified lease applying paragraphs 18–19; and

- (c) remeasure the lease liability by discounting the revised lease payments using a revised discount rate....
- 46 For a lease modification that is not accounted for as a separate lease, the lessee shall account for the remeasurement of the lease liability by:
- (a) decreasing the carrying amount of the right-of-use asset to reflect the partial or full termination of the lease for lease modifications that decrease the scope of the lease. The lessee shall recognise in profit or loss any gain or loss relating to the partial or full termination of the lease.
  - (b) making a corresponding adjustment to the right-of-use asset for all other lease modifications.

### **Transition**

**Date of initial application:** the beginning of the annual reporting period in which an entity first applies IFRS 16 (IFRS 16.C2)

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