PHILIPPINE INTERPRETATIONS COMMITTEE (PIC)
QUESTIONS AND ANSWERS (Q&As)

Q&A No. 2020-06

PFRS 16 - Accounting for payments between and among lessors and lessees

Issue

What is the accounting treatment, from both the lessor's and the lessee's perspectives, in respect of payments made between and among lessors and lessees (both old lessees and new lessees)?

Fact Pattern

1. Lessor pays:

    A. Old lessee to get out of a lease agreement as it intends to redevelop or renovate the property. The lease is classified by the lessor as an operating lease.

    B. Old lessee to get out of the lease agreement as the lessor intends to or has already re-let the same premises to a new lessee that will pay a significantly higher rent than the old lessee, or is of higher quality, or both. No amount or portion paid to old lessee is for redevelopment or renovation of the property. The lease is classified by the lessor as an operating lease.

    C. A new lessee in the form of an incentive to occupy the property immediately.

    D. For alterations to the building specific to the new lessee, which the new lessee makes on its own behalf, that have no further value to the lessor after the completion of the lease period. The alterations are owned by the new lessee. The lease contract does not contain any renewal options.

2. Old lessee pays:

    A. The lessor to enable the old lessee to immediately vacate the leased premises. The lease is classified by the lessor as an operating lease.

    B. A new lessee to immediately take over the lease.

3. A new lessee pays:

   A. The lessor (at or before lease commencement) in order to secure the right to obtain a lease agreement. The amount paid is non-refundable.

   [In this fact pattern, the leased asset meets the definition of property, plant and equipment in Philippine Accounting Standard (PAS) 16.]

   B. An old lessee to buy out the lease agreement effective immediately (commonly known as payment of "key money").

Consensus

1. ***Lessor pays:***

A. Old lessee to get out of a lease agreement as it intends to redevelop or renovate the property. The lease is classified by the lessor as an operating lease.

Lessor accounting: This is a lease modification and so the lessor will have to recalculate the revised lease payments (net of the one-time/off amount to be paid to the old lessee) at modification date. Any prepaid or accrued lease existing at modification date that arose from the contract prior to modification shall be included as part of the lease payments under the modified contract. The revised lease payments will be amortized as income on a straight-line basis or another systematic basis over the revised/shortened lease term.

A net payable (i.e., if the one-time payment by the lessor exceeds the amounts to be received by the lessor over the remaining lease term) by the lessor to the lessee will be recognized by the lessor as an expense at the time of lease modification, unless the payment to the old lessee meets the definition of construction costs under PAS 16 or PAS 40. If a payment meets the definition of construction costs, it is capitalized as part of the associated property. For example, an entity that acquired a shopping mall and made payments to evict existing retail lessees in order to redevelop the property into an office building would capitalize the payments.

Old lessee accounting: The accounting involves the following:

1) The old lessee determines the proportionate decrease in the carrying amount of the right-of-use asset based on the remaining right-of-use asset (i.e., for the remaining period at the effective date of the modification rather than the original lease term) and calculates the

remaining lease liability as the present value of the remaining lease payments (net of any amount to be received from the lessor) discounted using the original discount rate of the lease. Based on the amounts calculated, the old lessee reduces the carrying amount of the right-of-use asset and the carrying amount of the lease liability and recognize the difference as a gain or loss in profit or loss at the effective date of the modification.

2) The old lessee remeasures the remaining lease liability calculated above using the revised discount rate (i.e., the interest rate implicit in the lease for the remainder of the lease term or the incremental borrowing rate as of the effective date of the lease modification). Any adjustment to the remaining lease liability is also recognized as an adjustment to the right-of-use asset.

3) The old lessee revisits the amortization period of the right-of-use asset and related leasehold improvement, if any, following the shortening of the term.

B. Old lessee to get out of the lease agreement as the lessor intends to or has already re-let the same premises to a new lessee that will pay a significantly higher rent than the old lessee, or is of higher quality, or both. No amount or portion paid to old lessee is for redevelopment or renovation of the property. The lease is classified by the lessor as an operating lease.

<u>Lessor accounting</u>: Conclusion is same as A. above.

<u>Old lessee accounting</u>: Conclusion is same as A. above.

C. A new lessee in the form of an incentive to occupy the property immediately.

<u>Lessor accounting</u>: If the lease is a finance lease, PFRS 16 requires the lessor to deduct, at commencement date, any lease incentives payable, from the lease payments included in the measurement of the net investment in the lease. Accordingly, when the incentive is payable after lease commencement (i.e., it was payable but not paid on or before the lease commencement), the incentive payable is credited with an offsetting debit entry to the net investment in the lease.

If the lease incentive has been paid to the lessee at or prior to the commencement date, the incentive is included in the calculation of gain or loss on disposal on a finance lease. Accordingly, after the payment is made, the amount of the net investment in the lease is the same, whether the incentive is payable or paid at lease commencement.

If the lease is an operating lease, PFRS 16 requires the lessor to add initial direct costs incurred in obtaining an operating lease to the carrying amount of the underlying asset and recognize those costs as an expense over the lease term on the same basis as the lease income.

New lessee accounting: The receipt is recorded as a deduction from the cost of the right-of-use asset. Any lease incentive receivable is also included (as reduction) in the measurement of lease liability. Therefore, a separate financial asset is not recognized due to the existence of a lease incentive receivable. After lease commencement, when the lessee receives the lease incentive payment, the amount received is debited with an offsetting credit entry to the lease liability.

D. ***For alterations to the building specific to the new lessee, which the new lessee makes on its own behalf, that have no further value to the lessor after the completion of the lease period. The alterations are owned by the new lessee. The lease contract does not contain any renewal options.***

Lessor accounting: The payment is accounted for in the same manner as C. above.

New lessee accounting: The receipt is accounted for in the same manner as C. above.

The costs incurred by the new lessee for the alterations to the building are capitalized as leasehold improvement (i.e., PPE) if they qualify for capitalization under PAS 16, or as investment property if they qualify for capitalization under PAS 40. The new lessee should depreciate its PPE or investment property over the shorter of the lease term or the asset's useful life, assuming it applies the cost model for PPE and investment property.

2. ***Old lessee pays:***

A. ***The lessor to enable the old lessee to immediately vacate the leased premises. The lease is classified by the lessor as an operating lease.***

Old lessee accounting: The payment is recognized as an expense immediately unless the payment was already stipulated in the contract (e.g., as a lease pre-termination option) and the probability criterion under paragraph 19 of PFRS 16 was previously met, in which case the amount would have already been recognized as part of the lease liability. Because the giving up of the leased premises is immediate, the old lessee will also derecognize any remaining lease liability and right-of-use asset with the difference recognized in profit or loss.

Lessor accounting: The receipt is recognized as income immediately unless the payment was already stipulated in the contract (e.g., in relation to a lease pre-termination option exercisable by the lessee) and the probability criterion was previously met under paragraph 19 of PFRS 16, in which case the financial impact would have been recognized already as income using either a straight-line basis or another systematic basis. Because the pre-termination is immediate, the lessor would also derecognize any remaining lease receivable (net of any amount that would still be collected prior to pre-termination) and any prepaid/deferred rent on account of straight lining, with a charge to profit and loss.

B. A new lessee to immediately take over the lease.

Old lessee accounting: The payment is recognized as an expense immediately. Because the giving up of the leased premises in favor of the new lessee is immediate, the old lessee will also derecognize any remaining lease liability and right-of-use asset with the difference recognized in P&L.

New lessee accounting: The receipt is recognized as income immediately.

3. A new lessee pays:

A. The lessor (at or before lease commencement) in order to secure the right to obtain a lease agreement. The amount paid is non-refundable.

New lessee accounting: The payment is recognized as cost of the right-of-use asset.

Lessor accounting: If finance lease, PAS 16 requires the gain or loss arising from the derecognition of an item of PPE to be determined as the difference between the net disposal proceeds and the carrying amount of the item. PAS 16 requires that the gain or loss is included in profit or loss when the item is derecognized.

If operating lease, the receipt (including a lease payment received prior to lease commencement date) is recognized as deferred revenue and amortized over the lease term on a straight-line basis or another systematic basis.

B. An old lessee to buy out the lease agreement effective immediately (commonly known as payment of "key money").

Old lessee accounting: The receipt is recognized as a gain immediately. Any remaining lease liability that will no longer be settled and right-of-use asset will be derecognized with the difference recognized in P&L.

New lessee accounting: The payment to the previous lessee should be accounted for as an initial direct cost included in the measurement of the right-of-use asset of the new lease in accordance with PFRS 16. The payment is not in the scope of PAS 38, *Intangible Assets*.

Note: For ease of reference, the consensus for each of the scenarios is summarized in tabular format in Appendix 1.

Basis for Consensus

PFRS 16 deals with costs incurred by a lessor in relation to a lease and payments between lessees and lessors on recognition of a lease. PFRS 16 deals with how incentives and lease modifications should be accounted for both by lessors and lessees.

1. Lessor pays:

A. Old lessee to get out of a lease agreement as it intends to redevelop or renovate the property. The lease is classified by the lessor as an operating lease.

Lessor accounting: The transaction qualifies as a lease modification in accordance with paragraph 87 of PFRS 16 in which the lessor will have to recalculate the revised lease payments and amortize over the revised lease term after deducting the payments to be made to the old lessee.

In situations where the amount to be paid by the lessor exceeds the remaining lease receipts over the revised lease term, the net liability is deemed as an incentive given by the lessor to the old lessee to vacate, but such cost may be not be recouped through the existing lease contract. Instead, it may be recovered through the development of the underlying asset. It does not make sense for a lessor to be in a net expense/liability position in consideration of the right to use its property. Therefore, the cost, which is not directly attributable to the lease, is to be recognized immediately rather than amortized over the remaining lease term.

If the payment meets the definition of construction costs of an item of property, plant and equipment contained in paragraph 6 of PAS 16, or investment property in accordance with paragraph 21 of PAS 40, it must be capitalized.

Old lessee accounting: This is a lease modification that is not accounted for as a separate lease which involves shortening of the lease term representing a partial termination of the lease, assuming this was not included in the original agreement (e.g., as an option that can be exercised by the lessee). Under paragraph 45 of PFRS 16, if a transaction qualifies as a lease modification, the lessee is required to remeasure the lease liability by discounting the revised lease payments (net of any amount to be received from the lessor) using a revised discount rate.

Example 18 of Illustrative Examples of IFRS 16 issued by the IASB illustrates how to account for the effects of shortening the lease term from the lessee's point of view. Based on that illustrative example, the old lessee is required to recognize the difference between the decrease in the lease liability and the decrease in the right-of-use asset as a gain or loss in profit or loss at the effective date of the modification.

The lessee should also revisit the amortization period of the right-of-use asset and any related leasehold improvement following the shortening of the term in accordance with paragraphs 56-57 of PAS 16.

B. Old lessee to get out of the lease agreement as the lessor intends to or has already re-let the same premises to a new lessee that will pay a significantly higher rent than the old lessee, or is of higher quality, or both. No amount or portion paid to old lessee is for redevelopment or renovation of the property. The lease is classified by the lessor as an operating lease.

The conclusions and bases for conclusion are same as in A. above.

A payment by a lessor to a lessee to terminate the lease in order to re-let it to another lessee does not meet the definition of initial direct cost for arranging a new lease (paragraph 83 of PFRS 16). This is because this cost is incurred in relation to the lease with the old lessee and is not directly related to the new lease, even if the new lease has been entered into.

C. A new lessee in the form of an incentive to occupy the property immediately.

<u>Lessor accounting</u>: A payment by a lessor to a new lessee to occupy the property is an integral part of the net consideration agreed for the use of the leased asset. This meets the definition of lease payments that were paid at or before the lease commencement date.

In case the lease is classified as a finance lease, paragraph 68 of PAS 16 states that "The gain or loss arising from the derecognition of an item of property, plant and equipment shall be included in profit or loss when the item is derecognized (unless PFRS 16 requires otherwise on a sale and leaseback)." Paragraph 71 of PAS 16, on the other hand, states that "The gain or loss arising from the derecognition of an item of property, plant and equipment shall be determined as the difference between the net disposal proceeds, if any, and the carrying amount of the item." The lessor will therefore account for the prepaid lease payment as part of the net disposal proceeds and recognize any gain or loss in profit or loss when the item is derecognized.

In case the lease is classified as an operating lease, paragraph 83 of PFRS 16 states that "A lessor shall add initial direct costs incurred in obtaining an operating lease to the carrying amount of the underlying asset and recognize those costs as an expense over the lease term on the same basis as the lease income."

New lessee accounting: The new lessee recognizes the receipt as a reduction of the lease liability and right-of-use asset. Paragraph 24 of PFRS 16 states that "The cost of the right-of-use asset shall comprise:

a. the amount of the initial measurement of the lease liability, as described in paragraph 26;
b. any lease payments made at or before the commencement date, less any lease incentives received;
c. any initial direct costs incurred by the lessee; and
d. an estimate of costs to be incurred by the lessee in dismantling and removing the underlying asset, restoring the site on which it is located or restoring the underlying asset to the condition required by the terms and conditions of the lease, unless those costs are incurred to produce inventories. The lessee incurs the obligation for those costs either at the commencement date or as a consequence of having used the underlying asset during a particular period."

D. For alterations to the building specific to the new lessee, which the new lessee makes on its own behalf, that have no further value to the lessor after the completion of the lease period. The alterations are owned by the new lessee. The lease contract does not contain any renewal options.

Lessor accounting: A payment by the lessor to a lessee to reimburse the lessee for the costs of leasehold improvements to the building at the direction of the lessee is a lease incentive and hence, accounted for by the lessor in the same manner and for the same reasons as C. above.

Lessee accounting: The amount received from the lessor is a lease incentive and is therefore accounted for by the lessee in the same manner and for the same reasons as C. above. If the costs incurred by the new lessee for the alterations to the building meet the capital expenditure criteria in PAS 16 or PAS 40, they are capitalized as either PPE or Investment Property as applicable.

2. Old lessee pays:

A. The lessor to enable the old lessee to immediately vacate the leased premises. The lease is classified by the lessor as an operating lease.

A payment made by the lessee to the lessor to immediately get out of a lease agreement does not meet the relevant definitions in PAS 16 or PAS 38 and is not accounted for under PFRS 16 since there is no longer a lease in existence. It is therefore generally expensed.

Similarly, from the lessor's perspective, income is recorded.

However, if the payment to the lessor for the lessee to vacate the premises was already stipulated in the original lease contract (e.g., an option to pre-terminate the lease at the sole option of the lessee) and the exercise of that option (and accordingly the related payment) was assessed as reasonably certain during the term of the lease, both the lessee and lessor would have revised the lease term in accordance with par. 18 of PFRS 16. For the lessee, all relevant amounts including exit costs would have been accrued and amortized over the revised lease term. For the lessor, the receipt of such payment from the lessee would have been amortized over the revised lease term from the time that the option became reasonably certain to be exercised.

B. A new lessee to immediately take over the lease.

A payment made by an existing lessee to a new lessee to take over the lease does not meet the definition of an asset under PAS 16 or PAS 38 and is not accounted for under PFRS 16 since there is no longer a lease in existence. It should therefore be expensed.

The new lessee recognizes the receipt as income at the commencement of the lease. The receipt does not qualify as a lease incentive in respect of the lease contract of the new lessee because the amount received did not come from the counterparty (i.e., the lessor) to the lease agreement. Appendix A of PFRS 16 states that payments or receipts qualify as lease incentives only if coming from the counterparty to the lease. Hence, the amount cannot be deferred and amortized over the lease term.

3. A new lessee pays:

A. ***The lessor (at or before lease commencement) in order to secure the right to obtain a lease agreement. The amount paid is non-refundable.***

A payment made by a new lessee to the lessor in connection with a lease arrangement is accounted for by the new lessee as part of the cost of the right-of-use asset in accordance with paragraph 24 of PFRS 16 and amortized over the lease term.

If the lessor classifies the lease as a finance lease, paragraph 71 of PAS 16 requires that the gain or loss arising from the derecognition of an item of property, plant and equipment be determined as the difference between the net disposal proceeds (including the prepayment made by the new lessee prior to lease commencement) and the carrying amount of the item. Such difference (i.e., the gain or loss) is included in profit or loss when the item is derecognized.

If the lessor classifies the lease as an operating lease, the lessor treats the receipt from the new lessee (including payment from the lessee prior to the commencement date) as income amortized over the lease term, using either a straight-line basis or another systematic basis. Paragraph 81 of PFRS 16 states that “A lessor shall recognize lease payments from operating leases as income on either a straight-line basis or another systematic basis.”

B. ***An old lessee to buy out the lease agreement effective immediately (commonly known as payment of “key money”).***

A payment made by a new lessee to an old lessee to buy out the old lessee’s lease (with a third-party lessor) is directly related to the new lessee’s lease (i.e., the agreement between the new lessee and the third-party lessor). The payment would not have been paid if the lease had not been obtained and therefore meets the definition of an initial direct cost under Appendix A and Example 13 in paragraph IE5 of PFRS 16. Therefore, it should be accounted for as part of the cost of the initially recognized right-of-use asset in accordance with paragraph 24 of PFRS 16.

From the perspective of the old lessee, the receipt is treated as a gain immediately and any remaining balances of the lease (i.e., right-of-use asset and lease liability) are removed from the accounts and netted off against the amount received to calculate any resulting gain.

Accounting treatment of payments made between lessors and lessees (both old lessees and new lessees)

	Treatment in the financial statements of			
Transaction	**Lessor**	**Old Lessee**	**New Lessee**	**Basis**
Lessor pays old lessee - lessor intends to renovate the building (fact pattern 1A)	i. Recalculate the revised leased payments (net of the one-off amount to be paid) and amortize over the revised lease term. ii. If net payable, recognize as expense unless the amount to be paid qualifies as capitalizable cost under PAS 16 or PAS 40; in which case it is capitalized as part of the carrying amount of the associated property if it meets the definition of construction costs under PAS 16 or PAS 40.	i. Recognize in profit and loss at the date of modification the difference between the proportionate decrease in the right-of-use asset based on the remaining right-of-use asset for the remaining period and remaining lease liability calculated as the present value of the remaining lease payments discounted using the original discount rate of the lease. ii. Recognize the effect of remeasurement of the remaining lease liability as an adjustment to the right-of use-asset by referring to the revised lease payments (net of any amount to be received from the lessor)		• PFRS 16; par. 87 • PAS 16; pars. 6, 16-17 • PAS 40; par. 21 • PFRS 16; par. 45 • Illustrative example 18 issued by IASB • PAS 16; pars. 56-57

	Treatment in the financial statements of			
Transaction	**Lessor**	**Old Lessee**	**New Lessee**	**Basis**
		and using a revised discount rate. iii. Revisit the amortization period of right-of-use asset and any related leasehold improvement following the shortening of the term.		
Lessor pays old lessee - new lease with higher quality lessee (fact pattern 1B)	Same as in fact pattern 1A.	Same as in fact pattern 1A.		• Same as in fact pattern 1A. • PFRS 16; par. 83
Lessor pays new lessee - an incentive to occupy (fact pattern 1C)	i. Finance lease: • If made after commencement date, incentive payable is credited with offsetting debit entry to the net investment lease. • If paid at or prior to commencement date, included in the calculation of gain or loss on disposal on finance lease. ii. Operating lease - add the initial direct costs to the carrying amount of underlying asset and recognize as expense over the		i. Record as a deduction to the cost of the right-of-use asset. ii. Lease incentive receivable is also included as reduction in measurement of lease liability. iii. When lessee receives the payment of lease incentive, the amount received is debited with a credit entry to gross up the	• PAS 16; par. 68 • PAS 16; par. 71 • PFRS 16; par. 83 • PFRS 16; par. 24

	Treatment in the financial statements of			
Transaction	**Lessor**	**Old Lessee**	**New Lessee**	**Basis**
	lease term either on a straight-line basis of another systematic basis.		lease liability.	
Lessor pays new lessee - building alterations specific to the lessee with no further value to lessor (fact pattern 1D)	Same as in fact pattern 1C.		i. Same as in fact pattern 1C. ii. Capitalize costs incurred by the lessee for alterations to the building as leasehold improvement in accordance with PAS 16 or PAS 40.	• Same as in fact pattern 1C. • PAS 40; par. 21 • PAS 16; pars. 16-17
Old lessee pays lessor to vacate the leased premises early (fact pattern 2A)	Recognize as income immediately, unless it was within the original contract and the probability criterion was previously met, in which case, the amount would have already been recognized as income using either a straight-line basis or another systematic basis.	Recognize as expense immediately unless it was within the original contract and the probability criterion was previously met, in which case, the financial impact would have been recognized already as part of the lease liability.		• PAS 16 • PAS 38 • PFRS 16; par. 18
Old lessee pays new lessee to take over the lease (fact pattern 2B)		Recognize as an expense immediately.	Recognize as income immediately.	• PAS 16 • PAS 38 • PFRS 16; Appendix A
New lessee pays lessor to secure the right to obtain a lease	i. If finance lease, recognize gain or loss in the profit or loss arising from the derecognition		Recognize as part of the cost of the right-of-use asset.	• PFRS 16; par. 24 • PAS 16; par. 71 • PFRS 16;

	Treatment in the financial statements of			
Transaction	**Lessor**	**Old Lessee**	**New Lessee**	**Basis**
agreement (fact pattern 3A)	of underlying asset on finance lease. ii. If operating lease, recognize as deferred revenue and amortize over the lease term on a straight-line basis or another systematic basis.			par. 81
New lessee pays old lessee to buy out the lease agreement (fact pattern 3B)		Recognize as a gain immediately. Any remaining lease liability and right-of-use asset will be derecognized with net amount through P&L.	Account for as initial direct cost included in the measurement of the right-of-use asset.	• PFRS 16; Appendix A • PFRS 16; Example 13 in par. IE5 • PFRS 16; par. 24

Effective Date

The consensus in this Q&A is effective from the date of approval by the FRSC.

Date approved by PIC: December 7, 2020

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Date approved by FRSC: December 9, 2020