

## Quick Understanding on the Impact under the New Standard HKFRS 16 Lease

HKFRS 16 Lease becomes effective for annual periods beginning on or after 1st January 2019. It requires lessee to recognize 'right-of-use' assets with the corresponding lease liabilities for most of the property leases. This requirement does not apply to leases with lease term within 12 months or for which the underlying asset is of low value. Apart from this, companies which rent offices or lease machineries may be affected by this new financial reporting standard.

Basically, this new requirement puts the 'off-balance sheet' accounting items on the balance sheet of lessee. In financial term, key measures and ratios are affected, such as EBITDA and debt-to-equity ratio, and as a result companies, especially SMEs, may expose to higher financial risk such as breaching financial covenants. An example for fixed payment is illustrated below:

Lease term	10-year lease with an option to extend for 5 years
Lease payment	\$30,000 per year for the 10-year lease and \$35,000 per year during the optional period
Lessee's incremental borrowing rate	5% per annum

Cash outflow for lease	Year 1	Year 2	Year 3	Year 4	Year 5
Cash payment for lease	\$30,000	\$30,000	\$30,000	\$30,000	\$30,000
Discount factor at 5% p.a.	1.0000	0.9524	0.9070	0.8638	0.8227
PV of payment for lease	\$30,000	\$28,572	\$27,210	\$25,914	\$24,681
	Year 6	Year 7	Year 8	Year 9	Year 10
Cash payment for lease	\$30,000	\$30,000	\$30,000	\$30,000	\$30,000
Discount factor at 5% p.a.	0.7835	0.7462	0.7107	0.6768	0.6446
PV of payment for lease	\$23,505	\$22,386	\$21,321	\$20,304	\$19,338
<b>Sum of present value of lease payment</b>	<b>\$243,231</b>				

In the above example, lessee has cash payment in Year 1 at \$30,000 on the contract commencement date (for simple illustration, ignore other related costs) and further recognizes the lease liability at \$213,231 and 'right-of-use' asset at \$243,231 for the subsequent term. Also, depreciation and lease interest will be charged at \$24,323 (straight line depreciation over 10 years lease term) and \$10,662 (5% p.a. interest charge for lease liability) respectively at the end of first year.

In addition, in order to lessen the burden of the balance sheet, the tenant may intend to negotiate for a shorter lease term or a higher portion of variable lease payment based on turnover rent before entering into new lease contract. This results in a change of behavior of leasing activities towards the tenants in the commercial market. Entities should start the planning for timely assessment to address the potential challenges for the new standard and seek for professional advice on a variety of leasing structures in favour to the companies.

For more details about our professional development and standard, research and market information, please contact Mr. Gary Man at [gary.man@gca-group.com](mailto:gary.man@gca-group.com) or Ms. Joanne Law at [joanne.law@gca-group.com](mailto:joanne.law@gca-group.com).

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