

Client Alert

Corporate Finance

21 December 2018

Stock Exchange clarifies classification of lease transactions involving variable lease payments

On 28 September 2018, The Stock Exchange of Hong Kong Limited (**Exchange**) published a set of frequently asked questions (**FAQs**) providing guidance on the application of notifiable and connected transaction rules relating to lease transactions entered into by listed issuers adopting Hong Kong Financial Reporting Standard/International Financial Reporting Standard 16 “Leases” (**HKFRS/IFRS 16**), which will be effective for annual periods beginning on or after 1 January 2019. Please refer to [our previous client alert](#) for a summary of the Exchange’s guidance provided in the FAQs.

It is not uncommon for lease payments (particularly, for leasing of retail outlets) to include:

- a fixed dollar amount (**fixed lease payments**); and
- a variable amount determined as a percentage of the issuer’s annual sales generated from the leased properties (**variable lease payments**).

According to HKFRS/IFRS 16, an issuer will recognize a right-of-use asset taking into account the **fixed** lease payments. However, the actual **variable** lease payments **linked to sales** will be recognized as expenses in the issuer’s profit or loss accounts in the periods in which they are incurred.

On 7 December 2018, the Exchange published [updated FAQs](#) clarifying the applications of notifiable and connected transaction rules relating to lease transactions entered into by listed issuers as **lessees** involving **variable lease payments**.

Implications under notifiable transaction rules

Where a listed issuer enters into a lease transaction as a lessee and the lease payments include both fixed lease payments and variable lease payments linked to sales, the issuer’s recognition of a right-of-use asset in relation to the **fixed** lease payments will be regarded as an acquisition of asset under the definition of transaction set out in Main Board Rule 14.04(1)(a). The issuer is therefore required to compute the assets and consideration ratios by using the value of the right-of-use asset as the numerator.

The variable lease payments linked to sales will be expenses incurred by the issuer in its ordinary and usual course of business, and are revenue in nature, and therefore are **not** subject to the notifiable transaction rules.

Implications under connected transaction rules

Where the lessor is a connected person and the lease payments include both fixed lease payments and variable lease payments linked to sales, the issuer will have to compute two sets of percentage ratios:

	Fixed lease payments	Variable lease payments linked to sales
One-off or continuing connected transaction?	One-off connected acquisition	Continuing connected transaction
Percentage ratios to be computed	Assets and consideration ratios (using the value of the right-of-use asset as the numerator)	Revenue, assets and consideration ratios (using the annual caps on the variable lease payments to be made each year under the lease agreement as the numerator)

The lease will be classified under Chapter 14A of the Main Board Listing Rules by reference to the largest percentage ratio.

If the issuer enters into a framework agreement for leases with both fixed lease payments and variable lease payments linked to sales, again, the issuer will have to compute two sets of percentage ratios for the continuing connected transactions in respect of the leases under the framework agreement:

	Fixed lease payments	Variable lease payments linked to sales
Annual caps	Total value of right-of-use assets relating to the leases to be entered into by the issuer in each year	Total amount of variable lease payments to be made by the issuer in each year
Percentage ratios to be computed	Assets and consideration ratios	Revenue, assets and consideration ratios

The framework agreement will be classified under Chapter 14A of the Main Board Listing Rules by reference to the largest percentage ratio.

It should be noted that there are other types of variable lease payments (e.g. variable lease payments depending on an index or rate) that are included in the initial measurement of right-of-use asset under HKFRS/IFRS 16. The treatment would be the same as fixed lease payments for the purpose of Chapters 14 and 14A of the Main Board Listing Rules.

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