

**PHILIPPINE INTERPRETATIONS COMMITTEE (PIC)
QUESTIONS AND ANSWERS**

Q&A No. 2019-10

Accounting for variable payments with rent review

Some lease contracts provide for market rent review in the middle of the lease term to adjust the lease payments to reflect a fair market rent for the remainder of the lease term. This Q&A provides guidance on how to measure the lease liability when the contract provides for a market rent review.

Fact pattern

A lessee entered into a lease contract for the lease of land for 10 years. The contract provides for annual lease payments of Php10,000 payable at the end of each year with fixed annual escalation of 2% up to Year 5. At the beginning of Year 6, a rent review will be done and lease payments will be reset to reflect market including the subsequent escalation rates, if any. Assume there is no floor or ceiling on the rent review at the beginning of Year 6.

Issue 1

What payments should be included in the initial calculation of the lease liability?

Consensus

For initial measurement, the lessee uses the current rate of Php10,000 with escalation of 2% up to Year 5 and considers the remaining lease payments from Years 6 -10 as variable lease payments that depend on an index or rate because these vary to reflect changes in market rental rates as contemplated in PFRS 16 paragraph 28. In this case, the variability comes from the rent review which will only be resolved at the beginning of Year 6 and not from the application of the fixed annual escalation.

Applying the requirement of PFRS 16 paragraph 27(b), which provides that variable lease payments that depend on an index or rate that will be included in the measurement of the lease liability should be measured using the index or rate as at commencement date, the lessee should use the inception rate of Php10,000 as the assumed market rental rate from Years 6 - 10 until such time that the variability is resolved when the rent review is completed at the beginning of Year 6. This is consistent with PFRS 16 paragraph 42(b) where the finalization of rent review triggers reassessment of lease liability as it is considered as an event that resolves variability.

Refer to **Appendix** for the illustration of the calculation of the lease liability.

Issue 2

Assume that after the rent review, the agreed rate for Year 6 is Php12,000 with annual increase of 1% thereafter; how should the lessee update the lease payments for Years 6-10?

Consensus

Upon the agreement on the new rates at the beginning of Year 6, the lease liability should be updated to reflect the revised lease payments. The agreement on the new rates following the rent review at the beginning of Year 6 means that the variability has been resolved for Years 6 - 10; hence the cash flows should be updated in the liability calculation [PFRS 16.42(b)].

PFRS 16 paragraph 42(b) provides that, "A lessee shall determine the revised lease payments for the remainder of the lease term based on the revised contractual payments." Therefore, in calculating the revised lease liability at the beginning of Year 6, the cash flows for Years 6 - 10 should be updated to reflect the result of the market rent review. Accordingly, lease payments will now be at Php12,000 starting from Year 6 plus 1% annual escalation for Years 7 - 10.

Refer to **Appendix** for the illustration of the calculation of the lease liability and related adjustment.

Effective date

The effective date of the consensus in this Q&A follow that of Appendix C of PFRS 16, upon approval by the FRSC.

Date approved by PIC: December 17, 2019

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Date approved by FRSC: December 23, 2019

Appendix

Issue 1 – Illustration of the calculation of the lease liability

<u>Year</u>	<u>Lease Payment</u>	<u>Discount Factor @ 8%</u>	<u>Present Value of Lease Liability</u>
1	Php10,000	0.9259	Php9,259
2	10,200	0.8573	8,744
3	10,404	0.7938	8,259
4	10,612	0.7350	7,800
5	10,824	0.6806	7,367
6	10,000	0.6302	6,302
7	10,000	0.5835	5,835
8	10,000	0.5403	5,403
9	10,000	0.5002	5,002
10	10,000	0.4632	4,632
			Php68,603

Notes:

1. For the purpose of this illustration, assume that the incremental borrowing rate of the lessee is 8%.
2. Escalation of 2% per annum was effected for Years 2 to 5. For Years 6-10, Php10,000 rent rate was used.

Amortization table of lease liability

<u>Year</u>	<u>Lease Payment</u>	<u>Interest Expense</u>	<u>Amortization</u>	<u>Carrying amount of lease liability</u>
0				Php68,603
1	10,000	5,488	4,512	64,091
2	10,200	5,127	5,073	59,018
3	10,404	4,721	5,683	53,335
4	10,612	4,267	6,345	46,990
5	10,824	3,759	7,065	39,925
6	10,000	3,194	6,806	33,119
7	10,000	2,650	7,350	25,769
8	10,000	2,062	7,938	17,831
9	10,000	1,426	8,574	9,257
10	10,000	741	9,257	–

Illustrative journal entries:

Year 0

ROU asset	68,603	
Lease liability		68,603
<i>To recognize the ROU asset and lease liability at commencement date</i>		

Years 1 -5

Amortization expense	34,302	
Accumulated amortization		34,302
<i>To recognize the amortization of the ROU asset for Years 1-5 (Php68,603 x 5/10 years)</i>		
Lease liability	28,678	
Lease interest expense	23,362	
Cash		52,040
<i>To record lease payments and interest expense on lease liability for Years 1-5</i>		

Issue 2 – Illustration of the calculation of the lease liability after rent review

<u>Year</u>	<u>Lease Payment</u>	<u>Discount Factor @ 8%</u>	<u>Present Value</u>
6	12,000	0.9259	Php11,111
7	12,120	0.8573	10,390
8	12,241	0.7938	9,717
9	12,363	0.7350	9,087
10	12,487	0.6806	8,499
			Php48,804

Note:

1. In this scenario, the original incremental borrowing rate of 8% shall be used to discount the remaining lease payments.

Adjustment to the lease liability and ROU asset is computed as follows:

PV of lease liability after rent review	Php48,804
Carrying of original lease liability at end of Year 5	39,925
Adjustment to lease liability and ROU asset	Php8,879
Carrying of the ROU asset at end of Year 5	Php34,301
Adjustment to ROU asset	8,879
Adjusted carrying amount of ROU asset*	Php43,180

**To be depreciated over the remaining lease term.*

Illustrative journal entries:

Year 6

ROU asset	8,879	
Lease liability		8,879
<i>To adjust lease liability and ROU asset due to the rent review</i>		
Amortization expense	8,636	
Accumulated amortization		8,636
<i>To recognize the amortization of the ROU asset for Year 6 (Php43,180 / 5 years)</i>		

Lease liability	8,096	
Lease interest expense	3,904	
Cash		12,000
<i>To record lease payment and interest expense on lease liability for Year 6</i>		