

Technical Clinic

FRS 116 Leases – A New Right-Of-Use Approach to Lessee Accounting

Mr Ng Kian Hui
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Authors of slides:

- Ms Lim Ju May, Deputy Director, FRS & Corporate Reporting (jumay.lim@isca.org.sg)
- Ms Alice Tan, Manager, FRS & Corporate Reporting (alice.tan@isca.org.sg)

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Introduction

Facilitator's Profile

Mr Ng is an Audit Partner with BDO Singapore and has more than 19 years of experience in providing audit and assurance services to clients in Singapore and China. His clients are owner-managed companies, state owned enterprise, listed companies and multinational corporations from diverse industries. His expertise in audit and assurance covers statutory audits, accounting advisory, internal audit, pre-IPO audits as well as reporting accountant for IPO engagements.

He is the IFRS Country Leader of BDO Singapore under the BDO IFRS Global Team as well as a member of the BDO Singapore Accounting Technical Committee.

Mr Ng is a practising member of the Institute of Singapore Chartered Accountants (ISCA). He holds a Bachelor degree of Accountancy (Honours) from the Nanyang Technological University. He is also a member of Assurance and Auditing Standards Committee of ISCA.

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New Leases Standard – FRS 116 Leases

- Issued by the Accounting Standards Council on 30 June 2016
- For entities under the Singapore FRS Framework or the new Singapore financial reporting framework equivalent of IFRS for Singapore-incorporated listed entities
- Effective for annual periods beginning on or after 1 January 2019

Scope of FRS 116

All leases are in the scope of FRS 116, including leases of right-of-use assets in a sub-lease, except for:

- Leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources;
- Leases of biological assets within the scope of FRS 41 *Agriculture* held by a lessee;
- Service concession arrangements within the scope of INT FRS 112 *Service Concession Arrangements*;
- Licences of intellectual property granted by a lessor within the scope of FRS 115 *Revenue from Contracts with Customers*; and
- Rights held by a lessee under licensing agreements within the scope of FRS 38 *Intangible Assets* (motion picture films, video recordings, plays, manuscripts, patents and copyrights etc).

Discussion points

Q1. What is a lease?

Identifying a Lease

Definition of a lease

-A contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration.



Discussion points

Q2. How do you determine whether a contract contains a lease?

- FRS 116 allocates an entire segment, 22 paragraphs of application guidance and 10 illustrative examples to the matter of “identifying a lease”.
- ISCA has expounded on this area and published the Leases Roadmap, which is equipped with instructions to negotiate the roadblocks in your journey to determine whether there exists a lease or a service contract at the end of the road.

ISCA Leases Roadmap (1)

The single on-balance sheet lease accounting model for lessees that

or contains, a lease may require the exercise of significant judgement. This

Leases Roadmap

Roadblock 1: Is there an identified asset? If NO, the journey ends. If YES, proceed to **Roadblock 1A**.

Roadblock 1A: Does the supplier have substantive asset substitution rights? If YES, the journey ends. If NO, proceed to **Roadblock 2**.

Roadblock 2: Does the customer have the right to control the use of the identified asset? If YES, the contract contains a lease.

Roadblock 2A: Does the customer have the right to obtain “substantially all” of the economic benefits from the use of the identified asset? If NO, the journey ends. If YES, proceed to **Roadblock 2B**.

Roadblock 2B: Does the customer have the right to direct the use of the identified asset? If NO, the journey ends. If YES, the contract contains a lease.

Roadblock 2B(i): Does the customer have the right to direct how and for what purpose the asset is used throughout the period of use? If YES, the contract contains a lease. If NO, consider **Roadblock 2B(ii)**.

Roadblock 2B(ii): Are the relevant decisions about how and for what purpose the asset is used predetermined? If YES, (i) does the customer have the right to operate the identified asset throughout the period of use without the supplier having the right to change those operating instructions, or (ii) did the customer design the asset in a way that predetermines how and for what purpose the asset will be used throughout the period of use? If YES to either (i) or (ii), the customer can still direct the use of the asset and hence, the contract contains a lease.

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Leases Roadmap (2)

- **Roadblock 1:** Is there an identified asset? If NO, the journey ends. If YES, proceed to **Roadblock 1A**.
 - To have a lease, a specific leased asset must be identified, either explicitly or implicitly. Hence, even in a situation where the asset is not explicitly specified in a contract, an asset can be implicitly identified if the supplier can fulfil the contract only by use of a particular asset.

Leases Roadmap (3)

- **Roadblock 1A:** Does the supplier have substantive asset substitution rights? If YES, the journey ends. If NO, proceed to **Roadblock 2**.
 - If a supplier has a substantive right to substitute the asset through the use, the supplier effectively controls the use of an asset. This means the supplier uses the asset to provide a service rather leases out an asset. Hence, to have a lease, the supplier cannot have substantive rights.
 - For the right to be substantive – the supplier must have the practical ability to substitute the asset and be able to benefit economically from doing so. However, if the supplier has a right or obligation to substitute the asset only on or after either a particular date or the occurrence of a specified event, the supplier’s substitution right is not substantive because the supplier does not have the practical ability to substitute alternative assets throughout the period of use.

Leases Roadmap (4)

- **Roadblock 2:** Does the customer have the right to control the use of the identified asset? If YES, the contract contains a lease.

Leases Roadmap (5)

To overcome Roadblock 2, both the hurdles in Roadblock 2A and Roadblock 2B must be overcome.

- **Roadblock 2A:** Does the customer have the right to obtain “substantially all” of the economic benefits from the use of the identified asset? If NO, the journey ends. If YES, proceed to Roadblock 2B.

Leases Roadmap (6)

- **Roadblock 2B:** Does the customer have the right to direct the use of the identified asset? If NO, the journey ends. If YES, the contract contains a lease.
 - To control the use of an asset, a customer is required to have both:
 - The right to obtain substantially all of the economic benefits from the use of an asset throughout the period of use (a “benefits” element/Roadblock 2A); and
 - The ability to direct the use of that asset (a “power” element/Roadblock 2B)
 - This means a customer must have decision-making rights over the use of the asset that give it the ability to influence the economic benefits derived from the use of the asset throughout the period of use. These decision-making rights differentiate a lease from a contract for purchasing suppliers or services.

Leases Roadmap (7)

An entity which overcomes either of the sub-hurdles in Roadblock 2B(i) or Roadblock 2B(ii) would satisfy Roadblock 2B.

- **Roadblock 2B(i):** Does the customer have the right to direct how and for what purpose the asset is used throughout the period of use? If YES, the contract contains a lease. If NO, consider **Roadblock 2B(ii)**
 - In assessing this “power” element, decision –making rights of both the entity/customer and supplier are considered, and an entity considers who/which party has the rights that are most relevant to changing how and for what purpose the asset is used throughout the period of use.
 - However, rights to operate an asset may grant the customer the right to direct the use of the asset if the relevant decisions about how and for what purpose the asset is used are predetermined.

Leases Roadmap (8)

An entity which overcomes either of the sub-hurdles in Roadblock 2B(i) or Roadblock 2B(ii) would satisfy Roadblock 2B.

- **Roadblock 2B(ii):** Are the relevant decisions about how and for what purpose the asset is used predetermined? If YES, (i) does the customer have the right to operate the identified asset throughout the period of use without the supplier having the right to change those operating instructions, or (ii) does the customer design the asset in a way that predetermines how and for what purpose the asset will be used throughout the period of use? If YES to either (i) or (ii), the customer can still direct the use of the asset and hence, the contract contains a lease.

“Predetermined” (1)

- A new concept introduced by FRS 116 where relevant decisions about how and for what purpose the asset is used are made before the inception of the lease.
- May require substantial use of judgement.
- Could happen when both the customer and supplier cannot make decisions about how and for what purpose an asset is used during the period of use.
- Eg where decisions about how and for what purpose an asset is used are agreed between the customer and supplier in negotiating the contract and cannot be changed after the commencement date, or are predetermined by the design of the asset. In such a situation, FRS 116 clarifies that a customer can still direct the use of an asset if it has the right to operate the asset, or if it has designed the asset in a way that predetermines how and for what purpose the asset will be used.

“Predetermined” - Example (2)

A customer enters into a contract with a supplier where the customer will purchase 100% of the energy produced by a bio-mass facility. That the energy must be produced from this particular facility is specified in the contract and the supplier does not have substantive substitution rights. The supplier received tax incentives from various levels of government for building the facility as it produces clean, renewable energy. The customer designed the bio-mass facility before it was constructed by hiring experts in the field to assist in determining the location of the facility and the engineering of the equipment to be used. The supplier is responsible for building the facility to the customer’s specifications, and then operating and maintaining it. There are no decisions to be made about whether, when or how much electricity will be produced because the design of the asset has predetermined those decisions.

Assessment:

In assessing the “right to direct use of asset” criterion, the functionality of the facility is predetermined based on its design, and those predeterminations were made by the customer, therefore, the criterion is met.

*Example extracted from BDO’s “Need to Know – IFRS 16 Leases”

Lease and Non-lease Components

- For a contract that is, or contains, a lease, an entity shall account for each lease component within the contract as a lease separately from non-lease components of the contract, unless the entity applies the practical expedient in paragraph 15 of FRS 116.
- The right to use an underlying asset is a separate lease component if:

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.



The underlying is neither highly dependent on, nor highly interrelated with, the other underlying assets in the contract.

Discussion points

Q3. What is the difference between FRS 17 and FRS 116?

FRS 17 vs FRS 116

- **FRS 116 does not change substantially the accounting for finance lease in FRS 17.**

- **The main difference relates to the treatment of residual value guarantees provided by a lessee to a lessor, whereby FRS 116 requires that the entity recognises only amounts expected to be payable under residual value guarantees, rather than the maximum amount guaranteed, as required by FRS 17.**

Discussion points

Q4. How do lessees measure the cost of right-of-use asset and lease liability?

Initial measurement (1)

– Right-of-use asset

Cost of right-of-use asset

PV of the
lease
payments



Lease payments made at
or before the
commencement date
(less lease incentives
received)



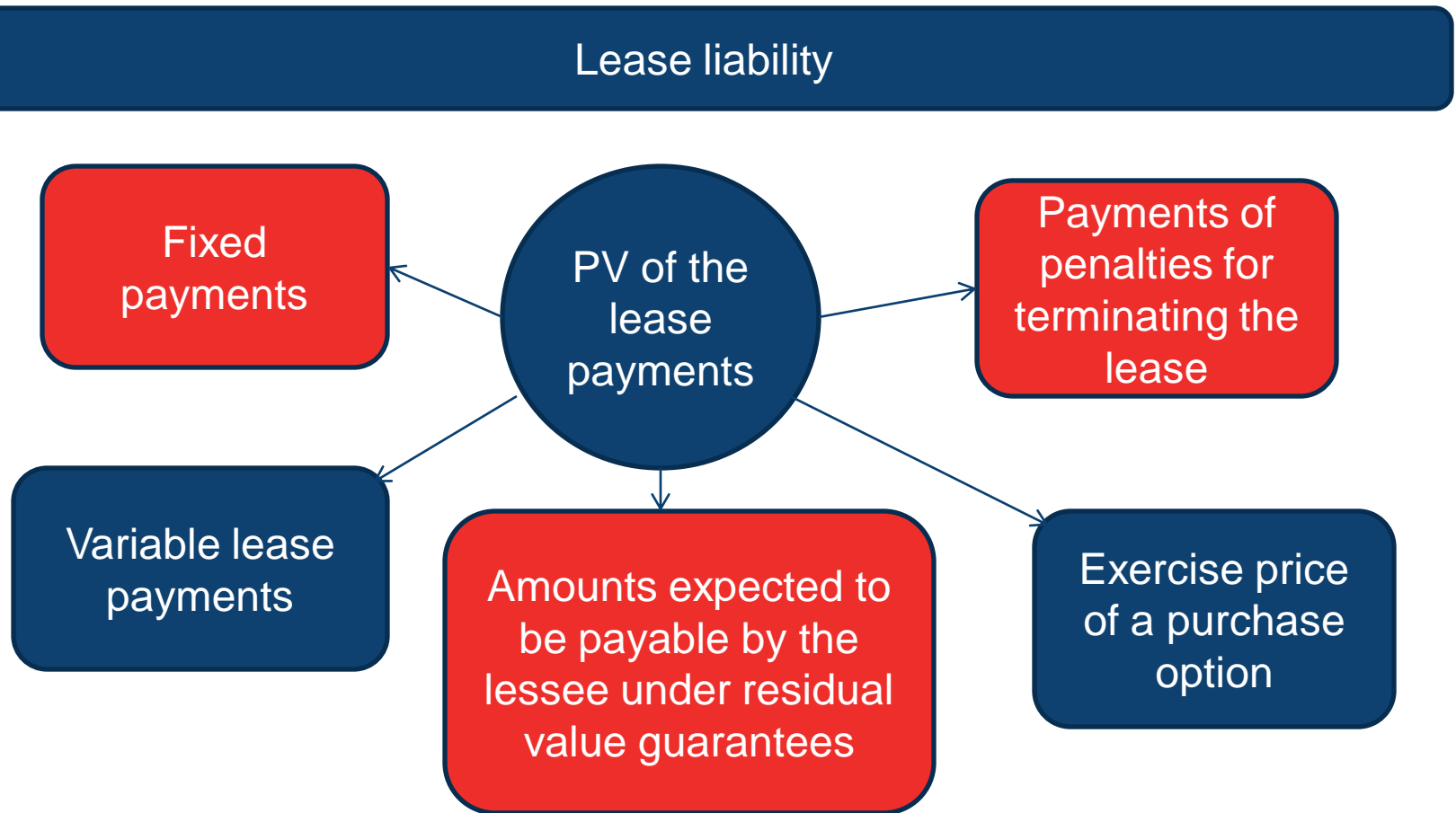
Initial
direct
costs



Estimate of costs to dismantle and remove the underlying asset, restore the site on which it is located or restoring the underlying asset to the condition required by the terms and conditions of the lease

Initial measurement (2)

– Lease liability



Discussion Points

Q5. How is the lease term identified?

Lease term

Non-cancellable period of lease



Periods covered by an option to extend the lease



Periods covered by an option to terminate the lease

If the lessee is reasonably certain to exercise that option

If the lessee is reasonably certain not to exercise that option

Discussion Points

Q6. Can any leases be exempted?

Exemptions for lessees

Short-term leases

- Lease terms \leq 12 months
- Election by class of underlying asset

Leases for which the underlying asset is of low value

- Election on lease by lease basis
- Assessment is performed on an absolute basis

Discussion points

Q7. What financial statement implications would FRS 116 have on entities?

Impact of FRS 116 on lessees with operating leases

Balance sheet	Income statement	Key metrics
Right-of-use assets ↑	Depreciation on right-of-use asset ↑	Net debt and gearing ratio ↑
Lease liabilities ↑	Interest on lease liability ↑	EBITDA ↑
	Operating profit ↑	Liquidity ratio ↓
	Operating expenses ↓	Net assets ↓
	Lease expense ↓	
	EPS ↓	

Discussion points

Q8. What should entities do to prepare themselves to manage the implementation process of FRS 116?



5 Questions for a CFO to ask when preparing the FRS 116 implementation roadmap

Will my debt covenants be affected and do I need to engage the banks?

Do I need to change my business model and re-negotiate my leases contracts?

Do I need to align my processes and internal controls to capture the required data?

Is my IT and accounting system robust enough to handle the FRS 116 requirements?

Does my accounting team have adequate knowledge and understanding of FRS 116? Do I know the impact on key financial metrics? Am I able to prepare post-FRS 116 mock-up FS?



5 “Non- Accounting” areas companies must consider when implementing FRS 116

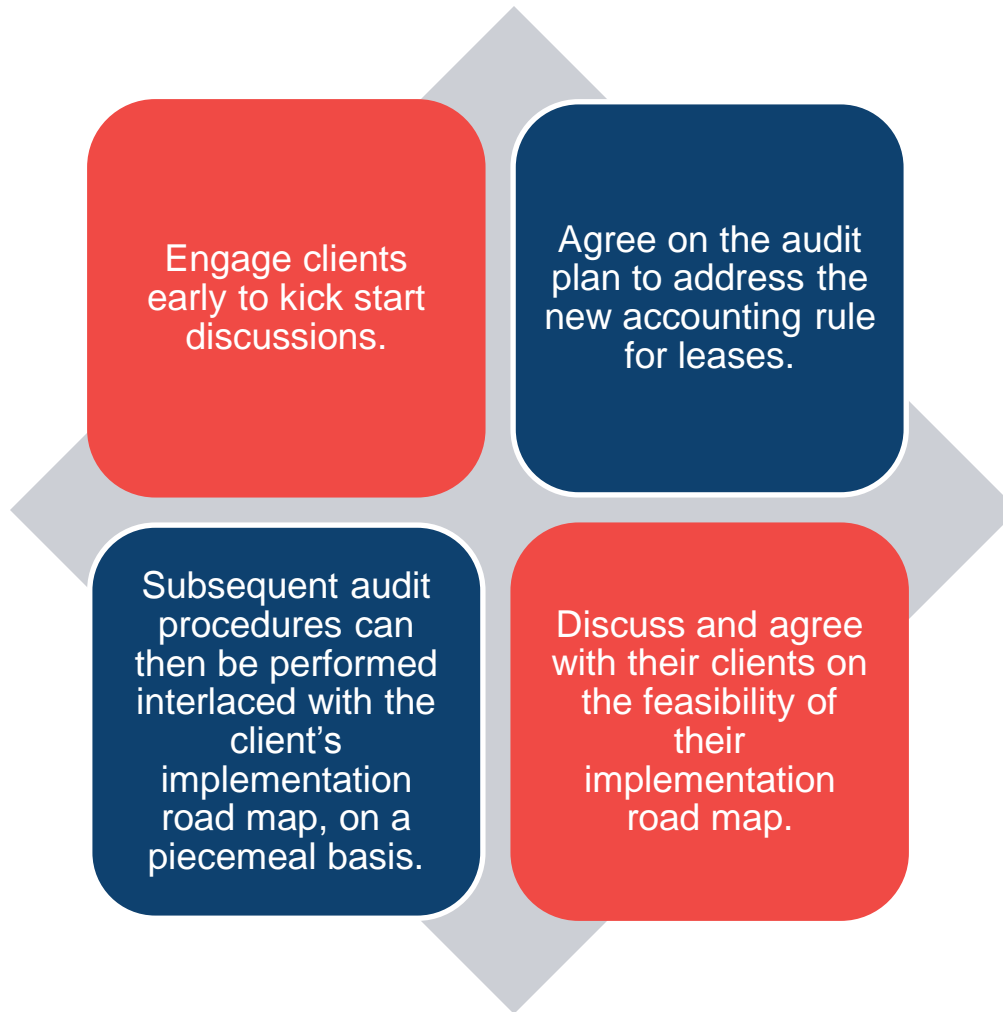


1. Time, involvement and resources required of other departments such as treasury, IT, internal audit, legal and business departments.
2. Resources consideration, for example, if there a need for a task force committee?
3. Key performance indicator re-assessments
4. Tax and dividend policy considerations
5. Engage internal (eg board of directors, audit committees) and external stakeholders (eg analysts, investors)

Discussion points

Q9. What should auditors do to prepare themselves to manage the implementation process of FRS 116?

Auditors should.....



Transition (1)

Applying the new lease definition

Companies can
choose whether to:

Apply the new
definition to all
contracts

or

Apply practical
expedient to
“grandfather”

Transition (2)

Applying the new standard

Lessees can choose whether to:

Adopt the standard retrospectively in accordance with FRS 8

or

Follow a modified retrospective approach

Operating lease

RoU Asset

- Retrospective discounted based on incremental borrowing rate at date of initial application; or
- amount of lease liability

Lease liability

- Present value of remaining lease payments

Finance lease

RoU Asset

- Carrying amount of lease asset immediately before date of initial application

Lease liability

- Carrying amount of lease liability immediately before date of initial application

Transition (3)

Applying the new standard

Lessors

- Not required to make any adjustments
- account for leases applying FRS 116 from date of initial application

Except
for

Intermediate lessor

- Reassess ongoing subleases at the date of initial application, to determine whether each sublease should be classified as operating lease or finance lease
- If operating subleases are now classified as finance leases, lessor shall account for sublease as new finance lease entered into at the date of initial application

Discussion Points

Any other questions?



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