FRS 116: LEASES

Getting a Balanced Perspective

By
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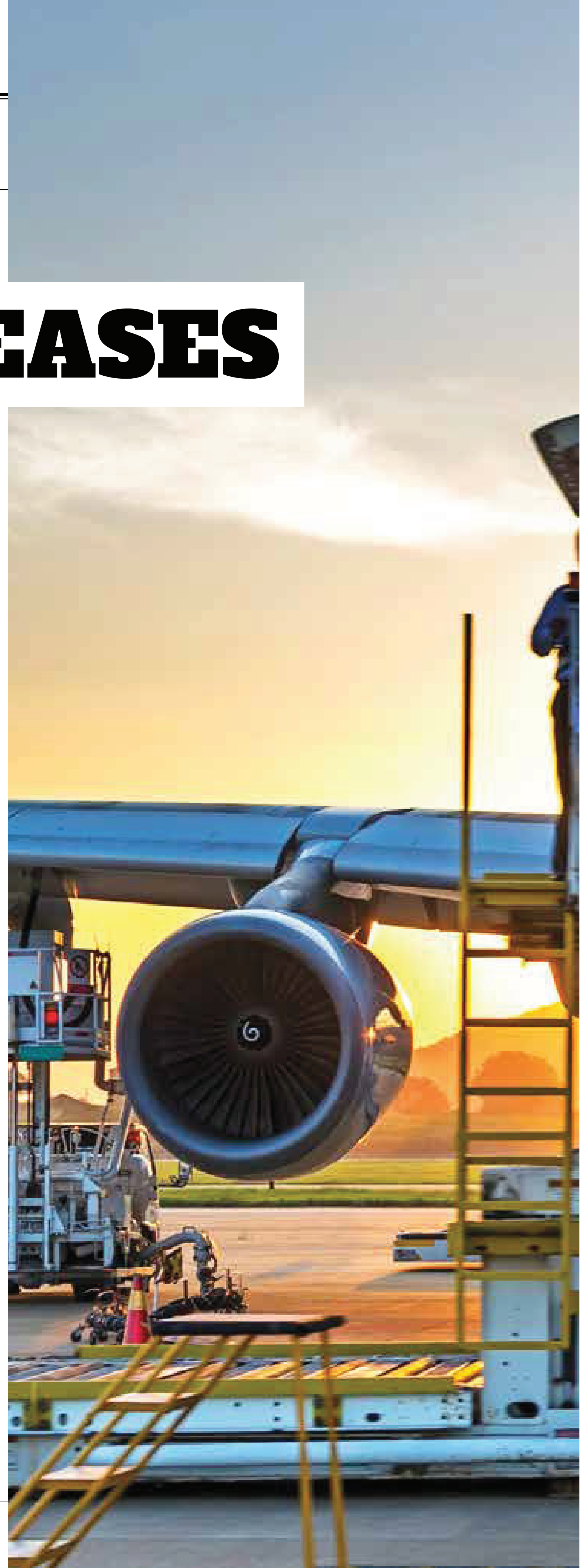
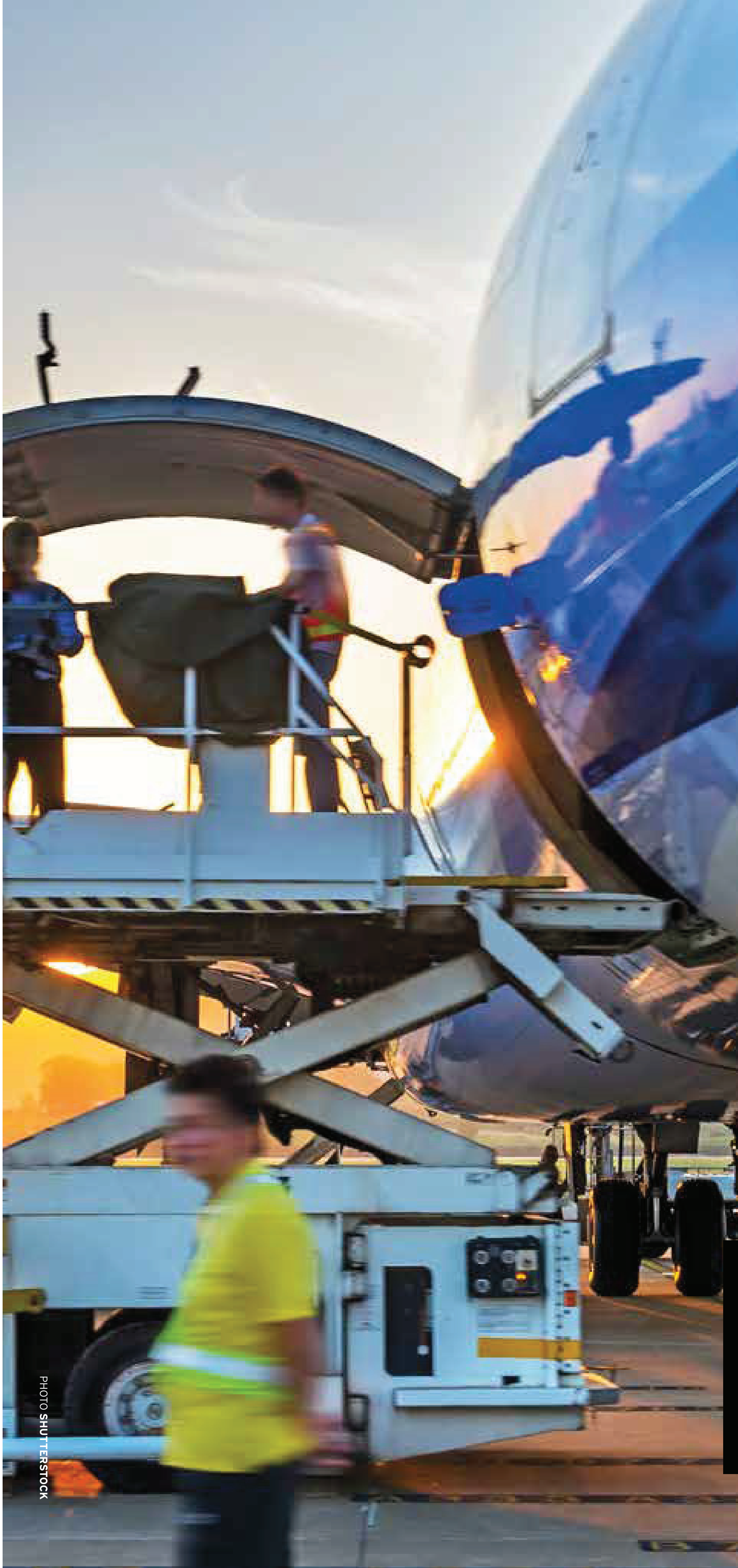


FRS 116 *Leases*, the Singapore equivalent of IFRS 16 *Leases*, was issued by the Accounting Standards Council on 30 June 2016, and is effective for annual financial periods beginning on or after 1 January 2019, for entities under the Singapore Financial Reporting Standards Framework or the new Singapore financial reporting framework equivalent of IFRS for Singapore-incorporated listed entities. Industry sectors most impacted are airline, retail, travel and leisure, transport, telecommunications and energy, that is, businesses which lease major items such as aircraft, properties, manufacturing facilities, ships, transportation equipment, and other high-value assets.

The extent of impact to individual entities will generally be influenced by their current and expected future usage/leasing of what under current rules are off-balance sheet operating leases. Key financial metrics such as gearing, liquidity and return on capital will be affected, which in turn affect assessments of entities' operating performance and possibly entities' cost of borrowings. More importantly,



changes to lease accounting could result in the failure to comply with financial debt covenants resulting in loan defaults. Hence, FRS 116 has consequences that may go beyond the entity's accounting department and financial reporting compliance exercise. Business decisions or strategies regarding "buy or lease" and contract terms may need to be reassessed in light of the above.

NEW APPROACH TO LEASE ACCOUNTING

This new approach to lease accounting is a significant change driven by the accountancy profession's quest to provide more relevant financial information that faithfully represents leasing transactions. So challenging were the issues to be resolved that the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) came to different decisions regarding the accounting for leases that were formerly classified as operating leases, especially with respect to the recognition of lease expenses and the reporting of lease-related cash flows. Although this divergence was disappointing, both Boards agreed on key fundamentals – that a lessee should be required to recognise assets and liabilities for all leases (with limited exceptions), the identification of arrangements that are leases, the measurement of lease liabilities and how to account for leases that were formerly classified as finance leases, and the decision to not substantially change lessor accounting. Apart from the aforementioned income statement

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display of lease-related costs for former operating leases, the Boards reached satisfying consistent conclusions.

LESSEES' OPERATING LEASES WILL BE OFF-BALANCE SHEET NO MORE

Businesses use leasing as a means of gaining access to assets, obtaining financing, and reducing exposure to the risks of asset ownership. Leasing activities which qualify as operating leases under the existing leasing accounting standard FRS 17 (or IAS 17) are accounted for off-balance sheet, that is, both the assets utilised and the contractual obligations to pay the lessor over the lease term are not recognised as assets or lease liabilities respectively on the balance sheet.

But all these will change for operating leases under the new FRS 116. Financial statements of lessees will be more transparent with the recognition of lease assets and lease liabilities on the balance sheet, the recognition of depreciation on right-of-use assets and interest expense for lease liabilities on the income statement, and the reduction in operating cash outflows and increase in financing cash outflows in the cash flow statement. Key financial statement implications are the bringing of more debts onto the balance sheet and the front loading of total lease expenses. Concerning the latter, operating lease expenses are currently charged to the income statement on a straight-line basis over the life of the lease, but this will change with higher interest expenses charged in the earlier years, which together with typically straight-line depreciation of the right-of-use asset, will result in the front loading of total lease expenses.

SIMPLIFICATIONS

FRS 116 contains a number of simplifications and practical expedients to address concerns about costs and complexity. The measurement requirements for a lessee's lease liability have been simplified considerably from the detailed proposals in the 2010 Joint Exposure Draft (2010 ED), which required that in estimating lease payments, a lessee should:

(a) assume the longest possible term that was more likely than not to occur, taking into account any options to extend or to early terminate the lease, and
(b) include an estimate of variable lease payments, if those payments could be measured reliably.

FRS 116 requirements on the lease term replaces the "more likely than not to occur" with a "reasonably certain" criterion when considering options to extend or terminate the lease. "Reasonably certain" sets a higher threshold than "more likely than not" and hence requires less subjective judgement and estimation. Many stakeholders disagreed with the "more likely than not to occur" threshold because, in their view, it would have been complex to apply to thousands of leases (which some entities have), and it would include payments in optional periods, which many stakeholders did not view as liabilities.

In the Board's second attempt – the 2013 Joint Exposure Draft (2013 ED) – it replaced the "more likely than not to occur" threshold with a "significant economic incentive" threshold. However, in light of feedback received that the "reasonably certain" threshold terminology in IAS 17 was well understood and would help to achieve consistent application between entities, IASB decided to retain the concept in IAS 17 that the lease term used to measure a lease liability should include optional periods to the extent that it is reasonably certain that the lessee will exercise its option to extend (or not to early terminate) the lease.

FRS 116 requirements on variable

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lease payments have also been substantially simplified, whereby variable lease payments linked to future performance or use of an underlying asset are excluded from the measurement of lease liabilities. Only variability that arises from payments linked to price changes due to changes in a market rate of the value of an index are included. On initial recognition, such variable lease payments are to be measured by using the index or rate at the commencement date, and are to be reassessed only when there is a change in the cash flows resulting from a change in the reference index or rate.

For lessor accounting, IASB concluded that the costs associated with making changes would be difficult to justify, because most stakeholders were of the view that lessor accounting in IAS 17 is not "broken". Hence, the lessor accounting model in IAS 17 is substantially carried forward to IFRS 16 with the exception of accounting for subleases, the definition of a lease, treatment of initial direct costs, and required lessor disclosures. Requirements regarding lease modifications are also included.

The single on-balance sheet lease accounting model for lessees that is similar to current finance lease accounting is also a key simplification, with the effect that lessees do not need to classify leases into either finance lease or operating lease. 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.

Practical expedients include permitting a lessee not to recognise assets and liabilities for short-term leases and leases of low-value assets. This exemption will especially benefit smaller companies with smaller balance sheets.

JUDGEMENTAL AND COMPLEX AREAS

Determining whether a contract contains a lease can be challenging because the line between a lease contract and a service contract can sometimes appear blurred. Hence, identifying whether an agreement is, or contains, a lease may require the exercise of significant judgement. This area has been expounded upon in my article on leases published in the March 2016 issue of ***IS Chartered Accountant*** journal. Reproduced in the blue box below is the Leases Roadmap, 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.

Other complexities do exist in areas such as multi-element arrangements, in-substance lease payments, lease modifications, sale and leaseback transactions and transition provisions.

CLOSING REMARKS

FRS 116 impacts entities with material off-balance sheet leases. An entity's existing disclosures in its financial statements of future minimum lease payables under non-cancellable operating leases would give an indication of the materiality of such off-balance sheet leases.

Last but not least, do remember that the concept of materiality in the Conceptual Framework and in FRS 1 *Presentation of Financial Statements* applies to leases, and that immaterial leases are excluded from the scope of FRS 116. Hence, even when an entity has a large number of leases but these are low in value, particularly when the aggregate value of those leases would have little effect on the financial statements as a whole, materiality considerations apply and a lessee would not be required to apply the recognition and measurement requirements in FRS 116. Accordingly, it may be well worth the effort to perform a scoping exercise before plunging into the intricacies of FRS 116. As usual, when making materiality-based decisions to forego compliance with FRS, preparers should consider near-future actions that might trigger the need to fully comply with the standard, so that non-comparability issues do not become a concern in later periods.

The journey has begun and the clock is ticking... ISCA

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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.