FRS 116 LEASES

Beat the Deadline

BY
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o the victor goes the glory. The starting pistol for FRS 116 will go off on 1 January 2019 for companies with a December 31 year-end. How companies prepare today will determine the type of future race course they encounter and how they finish in the FRS 116 2019 race.

In fact, many companies in the affected industry sectors, such as retail and airline, would agree that the FRS 116 race began on 30 June 2016, upon issuance of the standard by the Accounting Standards Council. This is because the implementation requirement of FRS 116 is akin to a marathon and not a century sprint.

FRS 116 will be like a tsunami to affected entities that are not prepared. But to the well-prepared, it is an opportunity to reap various benefits from the improved quality of financial reporting. More importantly, companies which manage this well would demonstrate to investors and other stakeholders the quality of their management, Board of Directors and corporate governance.

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Companies have slightly over two years to prepare and for affected companies, this is actually a very short timeframe. It is thus critical for affected companies which have not already started preparations to begin now.

BEYOND ACCOUNTING

For the accounting compliance requirements alone, preparing for FRS 116 is a massive exercise with huge accounting implications and complexities. But the challenge goes beyond the accounting department and accounting implementation – to the boardroom where commercial and business considerations are equally if not more challenging. Commercial aspects which include areas such as project/investment evaluation, lease negotiations, re-assessment of contract terms and funding will need considerable time and effort, and would involve other departments such as business, legal and treasury. The time and effort required to address the commercial aspects of FRS 116 may be overlooked by companies that do not have an in-depth understanding of the implications of FRS 116. This may explain why the recent study by ISCA and Nanyang Business School, titled "Getting ready for FRS 116 (Leases)", found that half the companies surveyed have not started making preparations to adopt/implement FRS 116. Singapore's English business newsdaily *The Business Times* reported on 26 August 2016

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that "more than half (54%) of the companies surveyed considered the challenge in adopting and implementing FRS 116 to be moderate to major. Yet, most have not made preparations in terms of upgrading and modifying their accounting information system, analysing the new standard's tax considerations, or preparing an implementation roadmap".

Going forward, lessees will recognise leases on the single on-balance sheet lease accounting model, and account for operating leases in a manner similar to finance leases. The new accounting standard, FRS 116 *Leases* does not change substantially the accounting for finance lease under the old accounting standard FRS 17 *Leases*. The main difference relates to the treatment of residual value guarantee provided by a lessee to a lessor, for which FRS 116 requires that the lessee recognises only amounts expected to be payable under residual value guarantees, rather than the maximum amount guaranteed, as required by FRS 17.

In an exclusive interview, Lee Fook Chiew, Chief Executive Officer of ISCA, speaks about preparing for the impending changes.

1. How will the new accounting standard regarding the treatment of leases affect the way businesses operate?

Under FRS 17, companies that lease assets which qualify as operating leases do not recognise any lease liabilities (together with the corresponding right-of-use asset) on the balance sheet. Lessors could always structure lease agreements so as to meet the operating lease classification requirements, providing companies with the benefit of not having to recognise these lease obligations on the balance sheet, which in most cases also have the effect of reducing gearing.

Businesses that currently lease sizeable assets under "off-balance sheet operating leases" may decide to reassess their business decisions on "buy or lease". With off-balance sheet operating

Lee Fook Chiew, Chief Executive Officer, ISCA

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leases required to be recognised on the balance sheet together with the requirement to determine the interest charged in these leases, the efficiency of such leases comes into question and companies may rethink how best to finance or operate their business. For some, taking loans to buy assets may now be a more efficient way of financing their business while for others, leasing could still be the preferred option. Alternatively, they may decide to enter into service contracts instead of lease contracts, or negotiate for shorter lease tenures to minimise the recognition of lease liabilities.

On the other hand, lessors also need to raise their game as they would now operate in a more competitive environment in which there is little or no distinction between an operating lease, a finance lease or an asset-backed loan, which are also provided by other financial institutions. This is because from the lessees' perspective, under the new FRS 116 *Leases*, operating leases will no longer be off-balance sheet, resulting in more debt on the balance sheet (just like traditional debt instruments), front loading of total lease expenses, and increased volatility. Total lease expenses are front loaded because higher interest expenses are charged in earlier years together with typically straight-line depreciation of right-of-use asset. Previously, lessors can differentiate themselves from other financiers like banks in helping to keep financing off the balance sheet through operating leases (even in marginal circumstances) as long as the financing structure meets the criteria stipulated under FRS 17 in form. With the new standard, this advantage for lessors is nullified.

With the new financial reporting standard, key financial metrics such as gearing, liquidity and return on capital will be affected, which will in turn impact assessments of a company's operating performance and credit worthiness, as well as possibly cost of borrowings. More importantly,

Five questions for a CFO to ask when preparing the FRS 116 implementation roadmap

Q1 Does my accounting team have adequate knowledge and understanding of the accounting requirements of FRS 116, do I know the impact on key financial metrics/ratios (example, gearing, EBITA, liquidity, return on capital), and am I able to prepare post-FRS 116 mock-up financial statements?

Q2 Will my debt covenants be affected and do I need to engage the banks?

Q3 Do I need to change my business model and re-negotiate my leases contracts?

Q4 Do I need to align my processes and internal controls to capture the required data?

Q5 Is my IT and accounting system robust enough to handle the FRS 116 requirements?

with more debt on the balance sheet, businesses may now find themselves breaching their financial debt covenants and risk loan defaults (which were agreed with lenders based on previous financing reporting standards).

For businesses that obtain important economic benefits from lease transactions such as financing and reduced exposure to risks of asset ownership, switching from leasing to buying would not be a viable option. Such businesses may consider switching to service contracts if they can forego their rights over the control of the use of the leased assets.

2. Which industries will be most affected and how can they prepare for the changes?

The airline, retail, travel, transportation, telecommunications, and energy sectors will be more affected than others, as businesses in these industries tend to lease big-ticket items.

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To prepare for the change, companies will first need to identify arrangements that are lease contracts or contain a lease in accordance with a "right-to-control the use of an asset" framework. This is the most challenging aspect of FRS 116 and requires the exercise of substantial judgement because the line between a lease contract and a service contract can be blurred at times.

Companies should first perform an initial scoping of all arrangements that may contain a lease. The next step would be for the terms of the arrangements to be scrutinised and examined for the existence of stipulated rights to determine if the arrangement is a lease. The Leases Roadmap by ISCA provides guidance for companies to perform a step-by-step assessment of each stipulated right in determining whether an arrangement contains a lease.

Designing systems, processes and controls to capture, store and validate lease data is another important preparation step. IT and accounting systems need to be equipped to perform lease calculations and to generate the information to satisfy the requirements of the new leases standard. Taking the necessary steps to identify existing system gaps would aid companies in deciding whether to upgrade their existing systems or to invest in new software solutions or IT systems.

Companies should also ensure timely communications with stakeholders on the impact of the new leasing standard, kick-start re-negotiations on financial debt covenants on existing and future financing arrangements, and consider tax consequences.

3. What do companies and auditors need to do to ensure smooth implementation of this new set of accounting rules?

To ensure the smooth implementation, both companies and auditors need to commence preparations and stakeholder communications early. By now, companies should have an implementation roadmap in place, and commenced impact assessments, while taking into consideration materiality and the practical expedients for short-term leases and leases of low-value assets.

Auditors need to engage their clients early to kick-start discussions and agree on the audit plan to address the new accounting rule for leases. For audit engagements with significant off-balance sheet operating leases, it is advisable that auditors first discuss and agree with their clients on the feasibility of their implementation roadmap. Subsequent audit procedures can then be performed interlaced with the client's implementation roadmap, on a piecemeal basis.

4. Now that "operating leases" are on the balance sheet for lessees, how far does this go towards meeting investors' needs, and strengthening market confidence?

With the new standard, financial statements would provide a more faithful representation of a company's financial position and greater transparency about the company's financial leverage and capital employed. Investors would see such leases reported on the lessees' balance sheets and have a more complete picture of the assets controlled and used in operations, as well as unavoidable lease payments. This helps investors better assess and compare the financial leverage and operating flexibility of companies.

Under the existing accounting standard for leases, information about a company's undiscounted commitments for off-balance sheet leases are provided in the notes to the financial statements. While more sophisticated investors could use this information to estimate

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Five "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, is there a need for a task force committee?
3. Key performance indicator re-assessments
4. Tax and dividend policy considerations
5. Engage internal (example, board of directors, audit committees) and external stakeholders (example, analysts, investors)

assets and liabilities arising from such leases, many investors, especially retail investors, are not in a position to make such adjustments and do not have visibility on information such as the actual financial leverage of companies.

The new standard would pave the way for a more level playing field for all investors and companies, resulting in the strengthening of market confidence. Hence, limiting operating leases as a mechanism for off-balance sheet financing is a significant step towards increased transparency and comparability in financial reporting between companies that lease and those that borrow to buy.

While the new standard is a step in the right direction, investors should be mindful that not all lease obligations are captured in the financial statements. This is because particular requirements on variable lease payments have been substantially simplified to address concerns about costs and complexity. Variable lease payments linked to future performance or use of an underlying asset are excluded from the measurement of lease liabilities.

CLOSING REMARKS

This is the third article in ISCA's series of articles on leases, with a call for companies to start thinking about the implications of FRS 116 on their business and to commence preparations early.

Early preparation is vital. This message also came through loud and clear during ISCA's Singapore Accountancy Convention in August, where a panel of distinguished members including an accounting standard-setter, CFOs, analysts and practitioners, had discussed the implications of FRS 116 on businesses and decision-making, implementation challenges faced by preparers, benefits to analysts and investors, and the necessary steps to take in order to embrace the new leasing accounting requirements. ISCA

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