ISCA INSTITUTE OF SINGAPORE CHARTERED ACCOUNTANTS

NANYANG TECHNOLOGICAL UNIVERSITY
Nanyang Business School

Getting Ready for FRS 116 (Leases)

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Contents

Executive Summary

The International Accounting Standards Board (IASB) issued IFRS 16 *Leases* in January 2016 which will be effective from January 2019. IFRS 16 introduces major changes in lessee accounting while lessor accounting remains largely unchanged. In the current leases standard IAS 17, lessees account for leases according to the terms of the lease contracts as either operating leases or finance leases. In IFRS 16, lessees are generally not allowed to use the operating lease approach unless exempted as short leases or low value leases. IFRS 16 would bring majority of leases onto the balance sheet resulting in new assets and liabilities being recognised.

On 30 June 2016, the Accounting Standards Council (ASC) issued FRS 116 *Leases* as the Singapore equivalent of IFRS 16. The new Singapore leases standard will be effective in January 2019 and companies need to get ready for the adoption and implementation of FRS 116. 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.

Adopting and implementing FRS 116 would not be a bed of roses for businesses with significant number of lease contracts. Some of the challenges that these businesses may encounter include creating a centralized database of all the lease contracts and transactions they have, and updating or modifying the accounting information system to cope with the requirements of FRS 116, amongst others.

We surveyed companies that lease assets for their use (lessees) to gain an understanding of their readiness to implement FRS 116. An online survey was carried out in May and June 2016 and a total of 68 valid responses were collected.

We have captured the following key insights drawn from the survey results:

1. **Good Level of Awareness of FRS 116:** Majority of the companies appeared to possess a good level of awareness of the key changes to leases accounting under FRS 116.

2. **Companies Should Start Preparations for Adoption/Implementation of FRS 116:** Half of the companies have not started making preparations to adopt/implement FRS 116. When asked to describe what help they needed to adopt/implement FRS 116, a large number of the companies indicated that they needed training in FRS 116 and updating their accounting information system to capture the data necessary to comply with the new requirements of FRS 116.

3. **Adoption/Implementation of FRS 116 Considered to be a Major/Moderate Challenge and a Costly Exercise:** Half of the companies considered the challenge in adopting/implementing FRS 116 to be major/moderate. Companies reported that the two top challenges were educating investors and internal stakeholders, and ensuring proper lease accounting treatment and adequate documentation. While more than half of the companies agreed that FRS 116 would result in more relevant, faithful, transparent and comparable financial statements, a large percentage of companies indicated that FRS 116 will require significant implementation costs. Hence, only half of the companies were convinced that FRS 116 would be beneficial to users and the market and almost a third of the companies were uncertain.

4. **Companies' Borrowing Costs Expected to Increase:** Given that companies' financial ratios such as gearing ratio and current ratio would deteriorate under FRS 116, a large percentage of companies indicated that they expected interest rates for new debts to increase. Almost a third of the companies were uncertain about the impact of FRS 116 on existing debts. It is important for companies to critically evaluate the financial impact of FRS 116 on existing loans and renegotiate the loan agreements, if necessary.

5. **Expected Changes in Business Practices:** The expected change in business practices arising from FRS 116 includes reduction in "sale and lease back" transactions, increase in "borrow and buy" over leasing of assets, increase in the number of short – term leases (that is, lease period less than 12 months) and preference for service contracts instead of leases of assets. Majority of companies also indicated that more audit work is expected under FRS 116 as new assets and liabilities are recognised on the balance sheet.

6. **No Preferred Method to Determine Low Value Leases:** Companies did not show any strong preference on the method to use in determining a low value lease. 38% of companies indicated they would apply the materiality concept, 35% would apply a threshold and 26% have not decided on the method.

Introduction

In January 2016, the IASB issued the new leases accounting standard IFRS 16 which would require companies that lease assets for use in their business to record the leases in their balance sheets unless exempted by provisions in the standard. IFRS 16 will replace the current lease accounting standard IAS 17 with effect from January 2019. On 30 June 2016, the ASC issued the Singapore equivalent leases standard FRS 116 which is also effective beginning January 2019. This will replace the existing FRS 17 *Leases*.

Under FRS 17, a lease is to be accounted for as either a finance lease (also known as a capital lease) or an operating lease subject to meeting certain conditions. For a finance lease, the lessee recognizes a leased asset and a lease liability on the balance sheet; the lease payment is disaggregated into an interest expense and a repayment of the lease liability; and the leased asset is depreciated. For an operating lease, a lessee simply recognizes the lease payment as an operating cost and does not record any leased asset or lease liability on the balance sheet.

The key change in FRS 116 is that lessees will use a single lessee model based on the finance lease method. The rationale for the change in lease accounting for lessees is to better reflect the economic substance of the lease transaction. Sir David Tweedie's example of aircraft leasing is a classic explanation[1]. Airlines that lease aircrafts often account for them as operating leases with no trace of the aircrafts, or their financing, in the balance sheets. Yet, the airlines clearly control the aircrafts and reap economic benefits arising from the aircrafts (this is defined as asset). Moreover, the lease payments are unavoidable and of known amounts (this is defined as liability). Leased assets and lease liabilities should therefore be recognized as a matter of economic substance. Under FRS 17, the financial statements of airlines that lease aircrafts as operating lease and /or borrow-and-buy aircrafts are not comparable unless adjustments are made. Analysts often make such adjustments (i.e., constructive capitalization of operating leases) but face substantial difficulties because the disclosure of operating leases contracts in the notes of the financial statements is often inadequate and on an aggregated basis.

FRS116 - Lessor Accounting

Under FRS 116, lessor accounting is basically unchanged. Lessor accounting continues to classify leases as either operating leases or finance leases, and account for those two types of leases differently with additional disclosure about how the lessor manages risks related to its residual interest in assets subject to leases.

FRS 116 - Lessee Accounting

The key change in FRS 116 is that lessees are not allowed to account for leases using the operating lease method unless the lease is less than 12 months or of low value. For leases previously accounted as operating lease under FRS 17, FRS 116 requires the company to recognize lease assets and liabilities on the balance sheet initially measured at the present value of unavoidable future lease payments; recognize depreciation of lease assets and interest on lease liabilities in the income statement over the lease term; and separate the total amount of cash paid into a principal portion (presented within financing activities) and interest (typically presented within either operating or financing activities) in the cash flow statement.

[1] Tweedie, D. (2007) "Can Global Standards be Principle Based?" Journal of Applied Research in Accounting and Finance, Vol. 2(1): 3-8.

FRS 116 does not change substantially the accounting for finance leases in FRS 17. The main difference relates to the treatment of residual value guarantees provided by a lessee to a lessor. This is because FRS 116 requires that the company recognise only amounts expected to be payable under residual value guarantees, rather than the maximum amount guaranteed as required by FRS 17.

Expected Impact on Lessees with Significant Operating Leases under FRS 17

Assuming that a company currently carries a significant amount of leases off its balance sheet as operating leases, the effects of the FRS 116 are predictable from comparing the different accounting treatments for finance and operating leases as discussed in the following table.

Table 1

Metric	What it Measures	Calculation	FRS 116 effect	Explanation
Leverage (gearing)	Long term solvency	Liability/ Equity	Increase	Increase because financial liabilities increase (and equity is expected to decrease).
Current Ratio	Liquidity	Current Asset/ Current Liability	Decrease	Decrease because current lease liabilities increase while current assets do not.
Asset turnover	Profitability	Sales/Total Asset	Decrease	Decrease because lease assets will be recognised as part of total asset
EBIT (Earnings before interest and tax)	Profitability	Various	Increase	Increase because the depreciation charge added is lower than the expense for off balance sheet leases excluded.
EBITDA (Earnings before interest, tax and depreciation)	Profitability	Various	Increase	Increase because expenses for off balance sheet leases are excluded.
Operating cash flow	Profitability	Various Methods	Increase	Increase because at least part of the lease payments (those payments relating to the principal) will be moved to the financing section of the cash flow statement.
Net cash flow	Profitability and liquidity	Difference between cash inflows and cash outflows	No change	No change because cash will not be affected.

Source: Extracted from IASB's IFRS 16 Effect Analysis

Adopting FRS 116 is expected to have financial implications for lessees. It can be seen that the leverage ratio and current ratio, which are commonly used in debt covenants, will deteriorate with the proposed accounting change. This change may trigger a breach of covenants for existing debts and increase the cost of raising new debts. A 2013 study[2] showed that Singapore companies could see an increase in the book value of debts by 30% and debt/equity ratio by 33% if operating leases were capitalised.

Adopting FRS 116 is also expected to have behavioural implications for lessees. For example, applying FRS 116 can affect companies' decisions to lease or buy an asset. There are clear advantages for lessees in leasing instead of buying an asset such as avoidance of ownership risks like obsolescence, repair and maintenance costs, flexibility to change asset, and avoiding financing and liquidity constraints. However, FRS 116 eliminates the opportunity for off balance sheet financing[3] by lessees and, all else being equal, may favour buying over leasing an asset.

Research Questions

Companies were surveyed on the following six areas using the questionnaire in Appendix A:

- Companies' awareness of FRS 116
- Companies' readiness and challenges faced in adoption/implementing FRS 116
- Companies perceived benefit of adopting FRS 116
- Expected financial implications of FRS 116
- Expected changes in business practices arising from FRS 116
- Determination of low value leases

METHOD

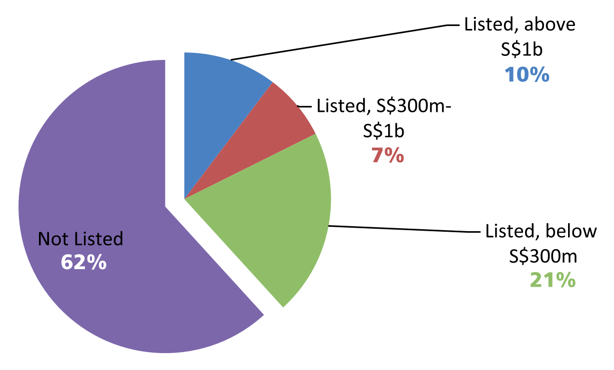
We collected survey data from 68 companies using an online survey issued from May to June 2016 to ISCA members holding senior positions (for example, Chief Finance Officer, Financial Controller, Vice President of Finance or the equivalent) in companies.

The study was approved by the Institution of Review Board (IRB) of Nanyang Technological University, Singapore (NTU).

Profile

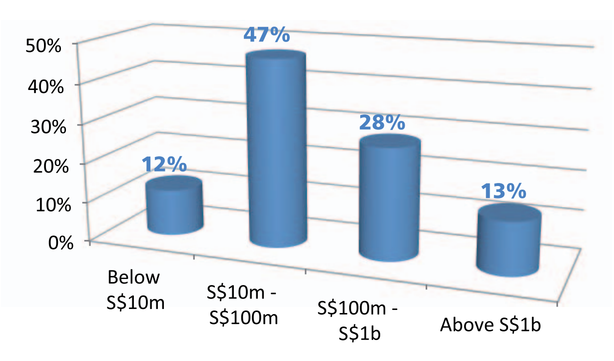
62% of the companies are not listed. Of the listed companies, 10% of the companies have market capitalisation above S$1billion, 7% with S$300 million to S$1 billion and 21% below S$300 million.

Figure 1: Size - Market Capitalization



Almost half of the companies recorded S$10 million to S$100 million annual revenue and one third of the companies recorded S$100 million to S$1 billion annual revenue.

Figure 2: Size - Annual Revenue



[2] Koh, W.C. and Tan, P. (2013) "Impact of the Leases Exposure Draft on Lessees Leverage Ratios" IS Chartered Accountant, September issue 2013: 50-53.

[3] This point is made explicitly on p.39 of a KPMG report available at https://home.kpmg.com/content/dam/kpmg/pdf/2016/01/leases-first-impressions-2016.pdf

COMPANIES' AWARENESS OF FRS 116

We assessed the respondents' level of awareness of the key aspects of FRS 116 by asking them to indicate whether the statements in Table 2 are "True" or "False" under FRS 116. All but one statement had at least 80% of respondents who answered correctly. The question that recorded the lowest percentage of correct response (only 18%) was "FRS 116 requires lessor to account for all leases essentially as finance leases (except for certain exempted leases)".

We found that the surveyed companies were generally aware of FRS 116 with 72% of respondents having answered at least four out of five questions correctly. The distribution of the number of correct answers by respondents is captured in Table 3 below.

Table 2

Question	Correct Answer	% of respondents who answered correctly
FRS 116 significantly limits the use of operating leases as a mechanism for off-balance sheet financing.	True	96%
FRS 116 requires lessor to account for all leases essentially as finance leases (except for certain exempted leases).	False	18%
The decision-making rights differentiate a lease from a contract for purchasing supplies or services.	True	90%
FRS 116 eliminates the classification of leases as either operating leases or finance leases for a lessee.	True	79%
For lessees, FRS 116 will bring more off-balance sheet operating leases onto the balance sheets and show higher gearing ratios and asset bases.	True	94%

Table 3

Number of correct answers	% of respondents
0	0%
1	1%
2	7%
3	19%
4	57%
5	15%

**Note: Percentages may not add to 100% due to rounding*

COMPANIES' READINESS AND CHALLENGES IN ADOPTING/IMPLEMENTING FRS 116

The survey seeks to understand how ready companies are for FRS 116 and what are the implementation challenges they face in implementing the new leases accounting standard. To assess the level of readiness of companies, we surveyed them on the six aspects of implementation readiness modified from Deloitte's 2014 report entitled "Lease Accounting Survey: Preparing for Implementation"[4]. The results are tabulated in Table 4.

Table 4

Readiness	Not started	Unsatisfactory	Satisfactory	Very Satisfactory	Not Certain
Preparation and approval of an implementation road map for FRS 116	57%	12%	25%	3%	3%
Identification of organisation's transactions or contracts that are, or contain, leases under FRS 116	46%	13%	29%	10%	1%
Gathering and validation of the necessary data for an organisation's lease database	44%	18%	28%	9%	1%
Training of accounting staff on FRS 116	49%	21%	21%	9%	1%
Analysis of FRS 116 tax considerations and implications	60%	15%	18%	6%	1%
Upgrade and modification of organisation's accounting information system for FRS 116	62%	18%	13%	4%	3%

**Note: Percentages may not add to 100% due to rounding*

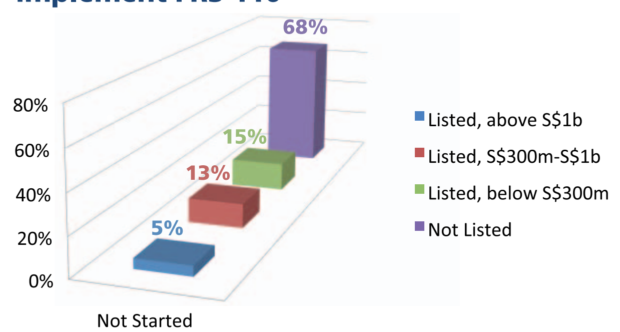
On average, about half of the companies (53%) indicated that they have not started preparations for adoption/ implementation of FRS 116 (see Table 4 above). In particular, the top three areas which companies have not made any preparations are:

(i) Upgrade and modification of the organisation's accounting information system for FRS 116 (62%),
(ii) Analysis of FRS 116 tax considerations and implications (60%); and
(iii) Preparation and approval of an implementation road map for FRS 116 (57%).

For companies that have started making preparations for FRS 116, at least half have started to identify leases in accordance with FRS 116 (54%), compile a lease database (56%) and provide training to the accounting staff (51%).

Figure 3 shows the profile of the companies that have not started preparations to adopt/implement FRS 116. We noted that more than half of the companies that have not started are not listed.

Figure 3: Profile of Companies that have not started preparations to adopt/ implement FRS 116



**Note: Percentages may not add to 100% due to rounding*

[4] http://www2.deloitte.com/content/dam/Deloitte/us/Documents/finance/us-fas-lease-accounting-report.pdf,on page 10 and 12.

Beyond accounting and financial reporting, FRS 116 will have an impact on IT systems and processes, internal controls, training, procurement, taxes, budgeting, and operational functions of a business. According to KPMG[5], lease data today are often managed through disparate manual spreadsheets and databases in various locations. This alone makes the lease data gathering step a significant undertaking. As leases are regularly being undertaken, renewed, modified or cancelled, the data gathering process is further prolonged, which makes it a tedious one. Lease contracts (or contracts containing leases) can be complex depending on the terms and conditions. This would require judgement to be exercised on the accounting treatment based on the principles set out in FRS 116. Additionally, the current accounting information system may require upgrading or modifications to be able to store new or updated data, calculate the new journal entries, and generate the analysis and disclosure reporting required by FRS 116. This may also require changes to internal control processes. Having well trained staff is the key to ensuring the success of such organisational wide changes. There is a lot preparatory work to be done and it would be wise, in particular, for those companies with numerous leases, to plan ahead and prepare the company for changes expected on the horizon.

In the survey, we have also asked the respondents to describe the type of help their companies need in implementing FRS 116. A large number of the responses indicated training. Other respondents indicated that help was needed for adapting the accounting information system while a small group indicated no help was needed.

Having an understanding of the challenges in adoption/implementing new accounting standards can help companies to allocate the necessary resources to ensure adequate preparations are made to ensure smooth transition to the new standard. We surveyed the respondents on how they would rate the degree of challenge that their companies faced in preparing for FRS 116. Table 5 shows that half of the companies considered the challenges in adopting/implementing FRS 116 to be major/moderate.

Table 5

Area of Preparation	Major Challenge	Moderate Challenge	Minor Challenge	No Challenge	Not Certain
Adequacy of the organisation's accounting information system to comply with FRS 116	12%	41%	34%	10%	3%
Ensuring proper lease accounting treatment and adequate documentation under FRS 116	10%	46%	32%	9%	3%
Creating a database of all the lease contracts and transactions of the organisation	12%	40%	29%	18%	1%
Educating investors and internal stakeholders	19%	37%	25%	16%	3%

**Note: Percentages may not add to 100% due to rounding*

[5] https://advisory.kpmg.us/deal-advisory/lease-accounting.html

To understand the relative rankings of the four areas of preparation for adoption/implementation of FRS 116, we computed an index by assigning the following weights – major challenge (4), moderate challenge (3), minor challenge (2), no challenge (1) and not certain (0) – to the percentage of response in Table 5 after adjusting those percentages by removing respondents who were uncertain. Table 6 shows the computed indices[6] and the ranking of challenges.

The computed indices indicate that companies found the biggest challenge in educating investors and internal stakeholders, followed by ensuring proper lease accounting treatment and adequate documentation under FRS 116.

Table 6

Area of Preparation	Challenge Index [7]	Rank
Adequacy of the organisation's accounting information system to comply with FRS 116	2.56	3
Ensuring proper lease accounting treatment and adequate documentation under FRS 116	2.59	2
Creating a database of all the lease contracts and transactions of the organisation	2.46	4
Educating investors and internal stakeholders	2.61	1

COMPANIES PERCEIVED BENEFIT OF ADOPTING FRS 116

We surveyed companies' perception of the costs and benefits of adopting FRS 116.

Table 7 shows that 69% of companies agree/strongly agree that FRS 116 result in more relevant and faithful representation of leases in the lessees' financial statements, and users (for example, lenders and analysts) are able to make better decisions with the increased comparability and transparency of financial statements. The companies that agree/strongly agree are about three times more than those that disagree/strongly disagree.

Table 7 also shows that majority of the companies agree/strongly agree that adopting FRS 116 will result in significant costs including both once-off costs (for example, cost from training and configuring the accounting system) and recurring costs (for example, cost from handling increased data requirement). The companies that agree/strongly agree that the once-off costs are substantial are eight times more than those who disagree/strongly disagree. For recurring costs, this ratio is nearly four times as much.

Though majority indicated that adopting/implementing FRS 116 would be costly, about half (52%) of the companies indicated that they agree/strongly agree that the overall benefits will exceed the overall costs of adopting FRS 116. However, we noted that almost a third of the companies were uncertain whether FRS 116 would bring about net benefits to users and the market.

[6] The computed indices are useful for understanding the relative standings of the identified challenges but should not be interpreted as their relative difficulties (for example, a challenge with an index of 3 does not imply that it is three times more challenging than another challenge with an index of 1).

[7] The average index value is 2.5 which is the average of 1 to 4.

Table 7

Perceived Costs and Benefits	Strongly Disagree	Disagree	Agree	Strongly Agree	Not Certain
FRS 116 will result in more relevant and faithful representation of leases in the lessees' financial statements	6%	18%	53%	16%	7%
FRS 116 will better benefit users (e.g., lenders and analysts) by making financial statements more comparable and/or transparent	6%	13%	43%	22%	16%
For companies that currently have significant lease activities as lessees and account for them as operating leases, FRS 116 will substantially increase once-off business costs such as costs in training and configuring accounting system	1%	9%	49%	35%	6%
For companies that currently have significant lease activities as lessees and account for them as operating leases, FRS 116 will substantially increase recurring costs such as handling increased data requirement	1%	18%	53%	18%	10%
Considering all users and market participants as a whole, the overall benefits of adopting FRS 116 will exceed the overall costs	6%	15%	40%	12%	28%

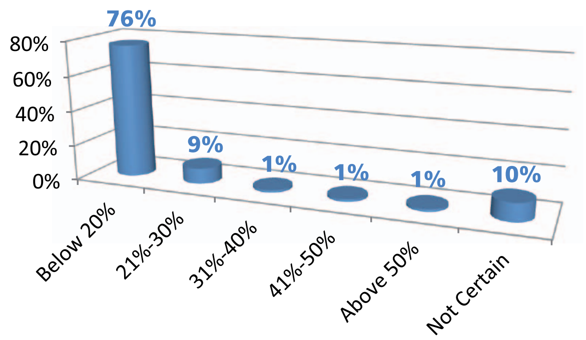
**Note: Percentages may not add to 100% due to rounding*

EXPECTED FINANCIAL IMPLICATIONS OF FRS 116

Koh and Tan (2012) estimated that Singapore companies could increase the book value of their debts by 30% if they were to capitalize their operating leases[8]. However, three quarters of the companies surveyed (76%) responded that bringing the operating leases onto their balance sheet would increase total liability by less than 20%. The results of the financial impacts of FRS 116 by respondents are summarized in Figure 4.

It is plausible that the difference between the survey results and Koh and Tan (2012) study could be due to respondents in this survey underestimating the financial impact of capitalizing their operating leases, or perhaps, there is a change in the financial circumstances of Singapore companies in the period between the two studies.

Figure 4: Increase in Total Liability as a result of adopting FRS 116



**Note: Percentages may not add to 100% due to rounding*

[8] Koh, W.C. and Tan, P. (2013) "Impact of the Leases Exposure Draft on Lessees Leverage Ratios" IS Chartered Accountant, September issue 2013: 50-53.

We have two hypotheses about the financial implications of FRS 116 on the new debts of companies. One, FRS 116 would cause financial ratios, such as the liquidity ratio, to deteriorate and lenders would perceive higher risks and correspondingly charge companies higher interest rates on their debts. Two, lenders had over-adjusted for operating leases under FRS 17 because of insufficient disclosure of operating leases and FRS 116 now provides the needed transparency to correctly price the risk which leads to lower interest rates[9].

To test these hypotheses, we surveyed the respondents on the financial impact of FRS 116 on companies' new debts. Table 8 tabulates the results for the questions on new debt.

Table 8

Financial Impact for New Debts	Strongly Disagree	Disagree	Agree	Strongly Agree	Not Certain
The organisation's new debts will have higher interest because the ratios have deteriorated under IFRS16.	0%	24%	47%	15%	15%
The organisation's new debts will have lower interest rate because with greater transparency banks no longer need to adjust for off-balance sheet leases.	10%	43%	25%	3%	19%

**Note: Percentages may not add to 100% due to rounding*

The results show that 62% of the companies agree/strongly agree that interest rates (i.e., borrowing costs) for new debts will increase because the companies' financial ratios would deteriorate under FRS 116. At the same time, only a third (28%) of the companies agree/strongly agree that interest rate for their new debts will decline because banks no longer need to adjust for off-balance sheet leases due to increased transparency under FRS 116. Taken together, these findings indicate that more companies are skewed towards expecting borrowing costs to increase under FRS 116.

We also investigate the effect of FRS 116 on existing debts. Companies may have debt contracts that are on a "frozen GAAP" basis, meaning that the debt contract specifies that the financial ratios described in the covenants are calculated based on the accounting standards when the debt was secured. Table 9 tabulates the response whether frozen GAAP will cause covenants to be affected by FRS 116.

[9] IASB has pondered on the same two hypotheses in a report (p.57). The report is available at: http://www.ifrs.org/Current-Projects/IASB-Projects/Leases/Documents/IFRS_16_effects_analysis.pdf

Table 9

Financial Impact for Existing Debts	Strongly Disagree	Disagree	Agree	Strongly Agree	Not Certain
The organisation's existing debts will not be affected because covenants are on a frozen GAAP basis (i.e. ratios are calculated based on the GAAP when the loan was secured).	6%	26%	35%	4%	28%

**Note: Percentages may not add to 100% due to rounding*

Table 9 shows that respondents were divided on the statement "The organisation's existing debts will not be affected because covenants are on a frozen GAAP basis (i.e. ratios are calculated based on the GAAP when the loan was secured)". We note that almost a third (28%) of the companies were uncertain about the financial impact of FRS 116 on existing debts. It is important for companies to critically evaluate the financial impact of FRS 116 on existing loans and renegotiate the loan agreements, if necessary.

EXPECTED CHANGES IN BUSINESS PRACTICES ARISING FROM FRS 116

We surveyed companies on the likely changes to business practices arising from the introduction of FRS 116 and the results are tabulated in Table 10 below.

Table 10

Business Impacts	Strongly Disagree	Disagree	Agree	Strongly Agree	Not Certain
Auditors will be performing more audit work because essentially all leased assets and lease liabilities will be recognized in the balance sheet under FRS 116 than it does under FRS 17	3%	12%	50%	31%	4%
The organisation is likely to engage in fewer "sale and lease back" arrangements under FRS 116 than it does under FRS 17	3%	10%	57%	13%	16%
The organisation is more likely to "borrow and buy" required assets than to directly lease them under FRS 116 than it does under FRS 17	3%	26%	49%	9%	13%
The organisation is more likely to enter into short-term leases of less than 12 months under FRS 116 than it does under FRS 17	1%	22%	51%	18%	7%
The organisation is more likely to enter into leases with variable lease payments not based on an index or rate under FRS 116 than it does under FRS 17	0%	28%	41%	3%	28%
The organisation is more likely to enter into contracts for services (derived from assets) than contracts for leases of assets under IFRS16 than it does under FRS 17	3%	15%	60%	12%	10%

**Note: Percentages may not add to 100% due to rounding*

81% of companies agree/strongly agree that the introduction of FRS 116 will lead to auditors performing more audit work. Further research to understand how FRS 116 leads to an increase in audit work and the corresponding impact on audit risks and fees would be useful.

70% of companies agree/strongly agree that they will likely engage in fewer "sale and lease back" arrangements under FRS 116.This is in line with a KPMG publication[10] which stated that IFRS 16 (in our case, FRS 116) largely eliminates "sale and lease back" arrangement as an avenue for off-balance sheet financing. The reason is because a seller-lessee always recognizes a "sale and lease back" arrangement on balance sheet unless the arrangement is for the short term or of low value. While there are valid commercial considerations for companies to continue with "sale and lease back", our findings suggest that FRS 116 is expected to change some business decisions.

58% of companies agree/strongly agree that they are more likely to "borrow and buy" required assets than to lease them under FRS 116. Given that FRS 116 requires all leases to be on the balance sheet, companies are now possibly reconsidering the "borrow and buy" option. It may be useful to do a research to identify actual changes in business behaviours after FRS 116 comes into effect.

Under FRS 116, a lessee can elect to apply the short term leases exemption. This means that assets with lease periods of 12 months or lesser need not apply the lessee accounting model. Table 10 shows that 69% of companies agree/strongly agree that a company is more likely to enter into short term leases of less than 12 months.

44% of the companies agree/strongly agree that a company is more likely to enter into leases with variable lease payments not based on an index or rate under FRS 116. At the same time, 28% of the respondents are uncertain of this behaviour. Of note, this is comparatively higher than the other questions with only 4% to 16% of respondents indicating "Not Certain". This higher proportion of uncertain responses may be due to more respondents not being fully aware of the accounting treatment for variable lease payments not based on an index or rate under FRS 116.

72% of respondents agree/strongly agree that a company is more likely to enter into contracts for services (derived from assets) than contracts for leases of assets under FRS 116. Both operating lease under FRS 17 and service contracts do not recognize any liability on the balance sheet. The difference is that a lease contract provides the company with the right to control the use of an asset whereas a service contract does not do so. Therefore, companies should generally prefer leases over service contracts. However, after weighing the advantages of controlling the asset against the economic costs of leasing under FRS116, companies may decide to forego the right to control the use of an asset for service contracts instead as the survey result shows.

Overall, the above findings suggest that FRS 116 is expected to lead to changes in business practices. However, whether the expected business changes have other economic impact on companies (or society as a whole) will require further research.

DETERMINATION OF LOW VALUE LEASES

A low value lease is exempted from applying FRS 116 and an entity is required to use its professional judgment to assess whether a lease is of low value. Table 11 summarizes the responses on how companies would determine whether a lease is of low value.

Table 11

Method to Determine Low Value Lease	%
Use a threshold	35%
By comparing their materiality (on a portfolio basis) to the overall materiality of the financial statements	38%
We do not know yet	26%

**Note: Percentages may not add to 100% due to rounding*

[10] https://home.kpmg.com/content/dam/kpmg/pdf/2016/01/leases-first-impressions-2016.pdf.

The results show that there is no preferred method by companies in determining a low value lease. The results show 35% of the respondents will use a threshold in determining low value leases; 38% will using the materiality concept and the remaining 26% have not decided on the basis for determining a low value lease.

CONCLUSION

It is heartening that majority of the companies surveyed appeared to possess a good level of awareness of the key changes to leases accounting under FRS 116. However, it is worrying that half of the companies have not started making preparations to adopt / implement FRS 116 which would require companies to adopt a new approach to accounting for leases especially for lessees.

Companies generally considered adopting/implementing FRS 116 to be a major /moderate challenge. The top two challenges companies faced in adopting/implementing FRS 116 were educating investors and internal stakeholders and, ensuring proper lease accounting treatment and adequate documentation.

While companies generally agreed that FRS 116 would result in more relevant, faithful, transparent and comparable financial statements, they indicated that adopting/implementing FRS 116 would incur significant implementation costs. Hence, only half of the companies were convinced that FRS 116 would be beneficial to users and the market and almost a third of the companies were uncertain.

FRS 116 would bring most leases on the balance sheet which requires recognising new assets and liabilities. The implication is that some financial ratios, such as gearing ratio and current ratio, would deteriorate under FRS 116. Given this, a large percentage of companies indicated that they expected the cost of borrowing (i.e. interest rates) for new debts to increase. Almost a third of the companies were uncertain about the impact of FRS 116 on existing debts. It is important for companies to critically evaluate the financial impact of FRS 116 on existing loans and renegotiate the loan agreements, if necessary.

Last but not least, FRS 116 is expected to result in changes in business practices which includes reduction in “sale and lease back” transactions, increase in “borrow and buy” over leasing of assets, increase in the number of short – term leases (that is, lease period less than 12 months) and preference for service contracts instead of leases of assets. Audit work is also expected to increase as there will be new assets and liabilities on the balance sheet.

With only two years away to the effective date of FRS 116 *Leases* in Singapore, companies should start making plans to adopt/implement the new leases standard so as to transition smoothly.

Appendix A: Survey Form

ISCA-NTU LEASE ACCOUNTING SURVEY 2016

We invite you to participate in this research survey on the new accounting standard for leases (IFRS16) issued in January 2016 by the International Accounting Standards Board.* The research objective is to understand the response of Singapore businesses to the new standard and the implementation challenges.

This research survey is a joint initiative between ISCA and the Nanyang Business School. We are giving away four vouchers (one $500, one $300 and two $100 each) as a token of appreciation to four randomly selected lucky winners. Based on past online surveys, the number of people expected to participate is about 200. The survey will take approximately 20 minutes. The survey findings will form the basis of a report that will be discussed in the Singapore Accountancy Convention in August 2016.

Please note that ISCA and NBS are committed to protect the privacy of your personal data. Note that you are free to decide whether to participate in the survey. There is no anticipated risk to you in participating in the survey. You can also discontinue any time during the survey without any penalty. All information that you provide during the survey will be kept private. Only the principal researchers will have access to your responses. In the event of publication of this research, no personally identifying information will be disclosed. Data collected from this study would be kept for 10 years after publication.

Please contact ISCA (research@isca.org.sg) or NTU's Institution Review Board (IRB) Secretariat (irb@ntu.edu.sg and +65-65922495) should you have any question on your rights as participants.

- I understand that my participation in the survey is voluntary. I have the option to refuse to participate or discontinue any time from the study without any penalty. I declare that I am at least 18 years of age.

Please click **ENTER** to participate in the survey, or **EXIT** if you do not wish to participate. Thank you.

1. Awareness of IFRS 16

Please indicate whether the following statements are 'True' or 'False' for IFRS16?

	Statement	True	False
a.	IFRS 16 significantly limits the use of operating leases as a mechanism for off-balance sheet financing.	✓	
b.	IFRS 16 requires lessors to account for all leases essentially as finance leases (except for certain exempted leases).		✓
c.	A lessee must have decision-making rights over the use of the asset that gives 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 supplies or services.	✓	
d.	IFRS 16 eliminates the classification of leases as either operating leases or finance leases for a lessee.	✓	
e.	For lessees, IFRS 16 will bring more off-balance sheet operating leases onto the balance sheets and show higher gearing ratios and asset bases.	✓	

2. Implementation Readiness and Challenges

2.1 The usual approach in the transition arrangement (i.e. full retrospective) is to determine the carrying amount of all leases in existence at the earliest comparative period as if those leases had always been accounted for by IFRS16. The standards setter allows a modified retrospective approach on a lease-by-lease basis where the leasee recognises the cumulative effect of initially applying the standard as an adjustment to equity at the date of initial application. Which approach will your company take?

- Full retrospective
- Modified retrospective
- Have not decided

2.2 Please use the following scale to answer the following questions on your organization's readiness to implement IFRS 16:

- **Not Started** – My organization has not commenced any preparation work to implement the new lease standard
- **Unsatisfactory Preparation** – My organization has commenced the preparation work to implement the new lease standard but the progress is less than satisfactory
- **Satisfactory Preparation** – My organization has commenced the preparation work to implement the new lease standard and the progress is satisfactory
- **Very Satisfactory Preparation** – My organization has commenced the preparation work to implement the new lease standard and the progress is more than satisfactory

Please indicate the extent of your organisation's progress in the following preparation work to implement IFRS 16:	Not started	Unsatisfactory	Satisfactory	Very Satisfactory	Not Certain
a. Preparation and approval of an implementation road map for IFRS 16	•	•	•	•	•
b. Identification of organisation's transactions or contracts that are, or contain, leases under IFRS 16	•	•	•	•	•
c. Gathering and validation of the necessary data for an organisation's lease database	•	•	•	•	•
d. Training of accounting staff on IFRS 16	•	•	•	•	•
e. Analysis of IFRS 16 tax considerations and implications	•	•	•	•	•
f. Upgrade and modification of organisation's (accounting) information system for new lease standard	•	•	•	•	•

2.3 Please use the following scale to answer the following questions on your organisation's challenges in implementing IFRS 16:

- **Major Challenge** – Require major changes and additional resources
- **Moderate Challenge** – Require moderate changes and additional resources
- **Minor Challenge** – Require minor changes and additional resources
- **Not a challenge** – Require no changes and additional resources

Please indicate the extent of changes and additional resources needed in the following areas to implement IFRS 16:	Major Challenge	Moderate Challenge	Minor Challenge	No Challenge	Not Certain
a. Adequacy of organisation's (accounting) information system to comply with IFRS 16	•	•	•	•	•
b. Ensuring proper lease accounting treatment and adequate documentation under IFRS 16	•	•	•	•	•
c. Creating database of all organisation's lease contracts and transactions	•	•	•	•	•
d. Educating investors and internal stakeholders	•	•	•	•	•

In view of the challenges and readiness, what help does your organization need?

3. Views on moving from IAS 17 to IFRS 16

Moving from IAS 17 to IFRS 16, lessees will bring most leases on balance sheet as right-of-use assets and lease liabilities (i.e., essentially similar to finance lease accounting). There are two exemptions for short-term leases and low-value leases to ease the application of IFRS 16. Lessor accounting remains essentially unchanged from IAS 17, save for enhanced lessor disclosure about risk management of residual interest in assets subject to leases. State your agreement with the following statements about IFRS 16 (new lease standard) compared to IAS 17 (current lease standard)

		Strongly Disagree	Disagree	Agree	Strongly Agree	Not Certain
a.	IFRS 16 will result in more relevant and faithful representation of leases in the lessees' financial statements	•	•	•	•	•
b.	IFRS 16 will better benefit users (e.g., lenders and analysts) by making financial statements more comparable and/or transparent	•	•	•	•	•
c.	For companies that currently have significant lease activities as *lessees* and account for them as *operating leases*, IFRS 16 will substantially increase one-off business costs such as costs in training and configuring accounting system	•	•	•	•	•
d.	For companies that currently have significant lease activities as *lessees* and account for them as *operating leases*, IFRS 16 will substantially increase recurring costs such as handling increased data requirement	•	•	•	•	•
e.	Considering all users and market participants as a whole, the overall benefits of adopting IFRS 16 will exceed the overall costs	•	•	•	•	•

4. Financial Impact on Organization

Suppose an organisation has substantial leases as a lessee, which are currently accounted for as operating leases under IAS 17. With the adoption of IFRS 16 in Singapore, the organisation's Debt/Equity ratio and liquidity ratio (Current Asset/ Current Liability) will deteriorate. State your agreement with the following statements concerning the application of IFRS 16 to the organisation's leases.

	Strongly Disagree	Disagree	Agree	Strongly Agree	Not Certain
a. The organisation's new debts will have higher interest because the ratios have deteriorated under IFRS16	•	•	•	•	•
b. The organisation's new debts will have lower interest rate because with greater transparency banks no longer need to adjust for off-balance sheet leases	•	•	•	•	•
c. The organisation's existing debts will not be affected because covenants are on a frozen GAAP basis (i.e. ratios are calculated based on the GAAP when the loan was secured)	•	•	•	•	•

I estimate the value of my organisation's existing debts on a frozen GAAP basis is ______ (0 to 100) percent of all existing debts.

5. Behavioral Impact on Organization

Suppose an organisation has substantial leases as a lessee, which are currently accounted for as operating leases under IAS17. With the adoption of IFRS 16 in Singapore, state your agreement with the following statements concerning the application of IFRS 16 to the organisation's leases.

	Strongly Disagree	Disagree	Agree	Strongly Agree	Not Certain
a. Auditors will be performing more audit work because essentially all leased assets and lease liabilities will be recognized in the balance sheet under IFRS 16 than it does under IAS 17	•	•	•	•	•
b. The organisation is likely to engage in fewer "sale and lease back" arrangements under IFRS 16 than it does under IAS 17	•	•	•	•	•
c. The organisation is more likely to "borrow and buy" required assets than to directly lease them under IFRS 16 than it does under IAS 17	•	•	•	•	•
d. The organisation is more likely to enter into short-term leases of less than 12 months under IFRS 16 than it does under IAS 17	•	•	•	•	•
e. The organisation is more likely to enter into leases that are shorter in term under IFRS 16 than it does under IAS 17	•	•	•	•	•

f. The organisation is more likely to enter into leases with variable lease payments not based on an index or rate under IFRS 16 than it does under IAS 17	•	•	•	•	•
g. The organisation is more likely to enter into contracts for services (derived from assets) than contracts for leases of assets under IFRS16 than it does under IAS 17	•	•	•	•	•

6. Low Value Leases

There are two optional exemptions to make the IFRS16 easier to apply – short leases (below 12 months, elected by class of asset) and low value leases. For low value lease, a threshold of USD5000 (about SGD6700) was suggested in the basis of conclusion of the exposure draft, but the standards leave the choice to the judgment of the accountants. How would your company decide what are low value leases?

- Use a threshold
- By comparing their materiality (on a portfolio basis) to the overall materiality of the financial statements
- We do not know yet

7. Profile

Name of your current organization: ____

7.1 Choose one of the following that best describes your role in your organisation.

a. Senior finance officer (e.g. Chief Financial Officer, Financial Controller, Vice President of Finance,)

b. Senior management (e.g. Chief Executive Officer, directors)

c. Others, please state ________________

7.2 Choose one of the following sectors that best fits your organization.

- Real estate
- Airlines
- Power and utilities
- Retail
- Shipping and logistics
- Others, please state ________________

7.3 Market Capitalization is the market value of the outstanding shares of a listed company. Choose one of the following that best describe your organisation's market capitalization.

- A listed company with market capitalisation of below S$300m
- A listed company with market capitalisation between S$300m and S$1b
- A listed company with market capitalisation of above S$1b
- Not a listed company, please state shareholder equity in S$ __________

7.4 Choose one of the following that best describe your organisation's annual revenue (in SGD).

- Below $10m
- $10m-$100m
- $100m-$1b
- Above $1b

7.5 If existing operating leases in your organisation's latest financial statements are accounted for as finance lease, total liability will increase because of increased lease liability. How much will total liability increase if this change were to occur?

	Below 20%	21%-30%	31%-40%	41%-50%	Above 50%	Not Certain
Increase in total liability if lease liabilities from operating leases are hypothetically captured in balance sheet	•	•	•	•	•	•

7.6 How significant are operating leases in your organisation's latest financial statements?

	Below 20%	21%-30%	31%-40%	41%-50%	Above 50%	Not Certain
Non-cancellable operating lease payables/Total debt (i.e. total long-term and short-term debts)	•	•	•	•	•	•
Non-cancellable operating lease payables/Total shareholder's equity	•	•	•	•	•	•

7.7 How many operating leases does your organization have as a *lessee*?

- Not certain
- 0
- 1-99
- 100-999
- More than 1,000

Please provide your name and email if you wish to participate in the lucky draw. The prizes are vouchers worth $500, $300 and $100 (two prizes).

Name: ______________________________

Email: ______________________________

Thank you for participating in this survey.

About the **INSTITUTE OF SINGAPORE CHARTERED ACCOUNTANTS**

The Institute of Singapore Chartered Accountants (ISCA) is the national accountancy body of Singapore. ISCA's vision is to be a globally recognised professional accountancy body, bringing value to our members, the profession and wider community. There are over 30,000 ISCA members making their stride in businesses across industries in Singapore and around the world.

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