FOCUS FRS 116

GETTING READY FOR FRS 116 (LEASES)

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ARE COMPANIES PREPARED FOR THE NEW STANDARD?

Ahead of the new Singapore leases standard FRS 116: Leases, which comes into effect from January 2019, companies need to start making preparations for its adoption and implementation. A study by ISCA and Nanyang Business School (NBS) at Nanyang

Technological University (NTU), has found that while 72% of companies surveyed show a good level of awareness of the new standard, more than half (53%) have not started preparing for it.

BACKGROUND

In January 2016, the International Accounting Standards Board issued IFRS 16: Leases, 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 the majority of leases onto the balance sheet, resulting in new assets and liabilities being recognised.

On 30 June 2016, the Accounting Standards Council 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.

FRS 116 and lessor accounting

FRS 116 remains largely unchanged for companies that provide assets for lease, that is, the lessor. Lessor accounting continues to classify leases as either operating leases or finance leases, and accounts 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 and 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, FRS 116 requires the company to recognise lease assets and liabilities on the balance sheet initially measured at the present value of unavoidable future lease payments; recognise 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.

The resulting consequence of FRS 116 is that most leases would be recorded on the balance sheet which makes financial statements more comparable and transparent.

ABOUT THE STUDY

The ISCA-NBS “Getting Ready for FRS116 (Leases)” survey seeks to understand how ready companies are for FRS 116, and the challenges they face in implementing the new leases accounting standard. An online survey, conducted between May and June 2016, collected data from ISCA members holding senior management positions in 68 companies. The following key insights were drawn from the survey results.

Good level of awareness of FRS 116

The majority of companies appear to possess a good level of awareness of the key changes to leases accounting under FRS 116, with 72% of respondents answering at least four out of five questions about the standard correctly.

Half of companies yet to start preparations

Some 53% of companies have not started making preparations to adopt and implement FRS 116. Of these, more than half (68%) are non-listed companies. The top three areas which companies have not made any preparations are:

- Upgrade and modification of the organisation's accounting information system for FRS 116 (62%);
- Analysis of FRS 116 tax considerations and implications (60%), and
- Preparation and approval of an implementation roadmap 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%).

According to KPMG, 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 key to ensuring the success of such organisation-wide changes. There is a lot of 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.

When asked to describe what help they need to adopt/implement FRS 116, a large number of the companies indicated that they need training in FRS 116 and updating of their accounting information system to capture the data necessary to comply with the new requirements.

Adoption/Implementation of FRS 116: a moderate to major challenge and a costly exercise

Adopting and implementing FRS 116 can be challenging for businesses, especially those with a significant number of lease contracts.

Some 54% of the companies consider the challenge in adopting and implementing FRS 116 to be moderate to major. Companies reported that the two top challenges lay in educating investors and internal stakeholders, and ensuring proper lease accounting treatment and adequate documentation. While 69% of companies agreed that FRS 116 would result in more relevant, faithful, transparent and comparable financial statements, 78% indicated that FRS 116 will require significant implementation costs. Hence, only half (52%) 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.

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 (62%) of companies indicated that they expect interest rates for new debts to increase. At the same time, only a third (28%) of 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.

Companies may have existing 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. Companies are divided on the statement, "The organisation's existing debts will not be affected because covenants are on a frozen GAAP basis". We note that almost a third (28%) 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.

Expected changes in business practices

The expected change in business practices arising from FRS 116 includes a 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 of less than 12 months) and preference for service contracts instead of leases of assets.

About 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 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 recognises 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. Some 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.

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. About 69% of companies agree/strongly agree that a company is more likely to enter into short-term leases of less than 12 months.

Some 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 leases under FRS 17 and service contracts do not recognise 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 FRS 116, companies may decide to forego the right to control the use of an asset for service contracts instead, as the survey result shows.

Some 81% of companies surveyed also indicated that more audit work is expected under FRS 116 as new assets and liabilities are recognised on the balance sheet.

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. About 38% of companies indicated they would apply the materiality concept, 35% would apply a threshold, and 26% have not decided on the method.

The “Getting Ready for FRS 116 (Leases)” survey was launched by ISCA and NBS, NTU.

Good level of Awareness of FRS 116

72%
answered at least 4 of 5 questions correctly

Borrowing Costs Expect to Increase

New Debt

62%
expect interest rate increase due to worsened financial ratios

Existing Debt

28%
uncertain about impact on current debt

Expected Change in Business Practice

Increase in

Preparation for adoption and implementation of FRS116

53%
have not started preparations

68%
are non-listed companies

Top 3 areas that companies have not started

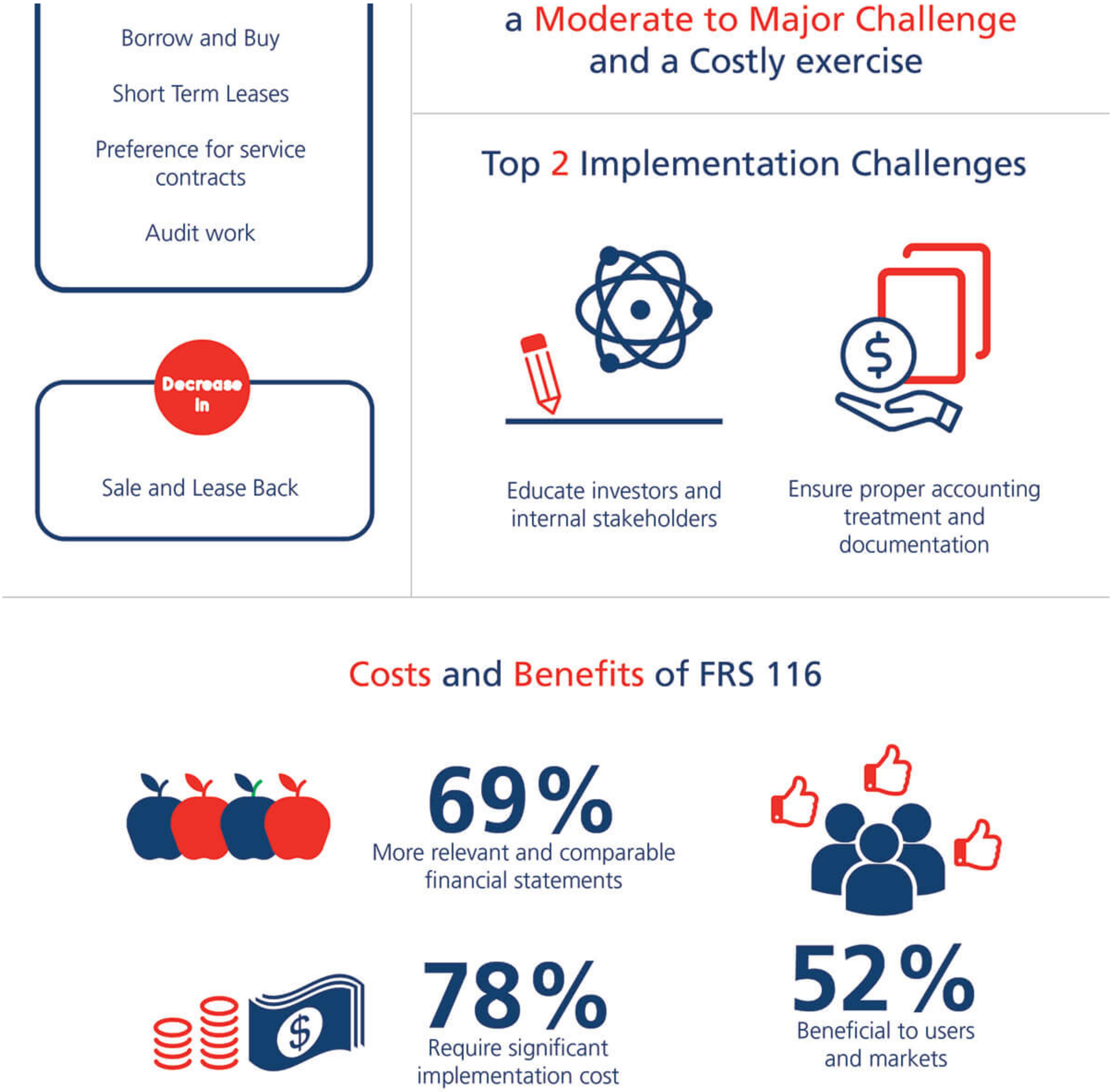
62%
Upgrade and modification of accounting information system

57%
Implementation road map

TAX%

60%
Tax considerations and implications

54%
consider adoption and implementation of FRS 116


Borrow and Buy
Short Term Leases
Preference for service contracts
Audit work
Decrease in
Sale and Lease Back
a Moderate to Major Challenge and a Costly exercise
Top 2 Implementation Challenges
Educate investors and internal stakeholders
Ensure proper accounting treatment and documentation
Costs and Benefits of FRS 116
69%
More relevant and comparable financial statements
78%
Require significant implementation cost
52%
Beneficial to users and markets