



Insights

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How will your business be impacted by the new lease accounting standard?

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Anyone employed in a Malaysian company whose job description encompasses the words “accounting” and “financial reporting” would have heard of the new lease accounting standard: MFRS 16 Leases. Whilst there is a wealth of material available out there to read and learn from, it will be a significant challenge to practically apply and adapt the new requirements. Finding a new “business-as-usual” after transitioning to a new accounting standard will be as important as incorporating the new accounting requirements into the statutory financial statements.

Hence, this article focuses on the key commercial decisions that business owners should consider as part of their companies’ transition to MFRS 16. The issues raised here, critical to how a company can move forward, should be discussed robustly at both management and board levels. A consensus at those levels should be reached as early as possible, allowing sufficient time to communicate relevant strategies and impacts with key stakeholders.



MFRS 16 at a glance

Balance sheet

MFRS 16 eliminates the distinction between finance and operating leases for all lessees. This means that when an arrangement is within the scope of MFRS 16, a lessee presents on its balance sheet a liability representing its obligation to make rental payments to the asset owner, and recognises a corresponding asset representing its right to control the use of another’s asset to generate income.

Income statement

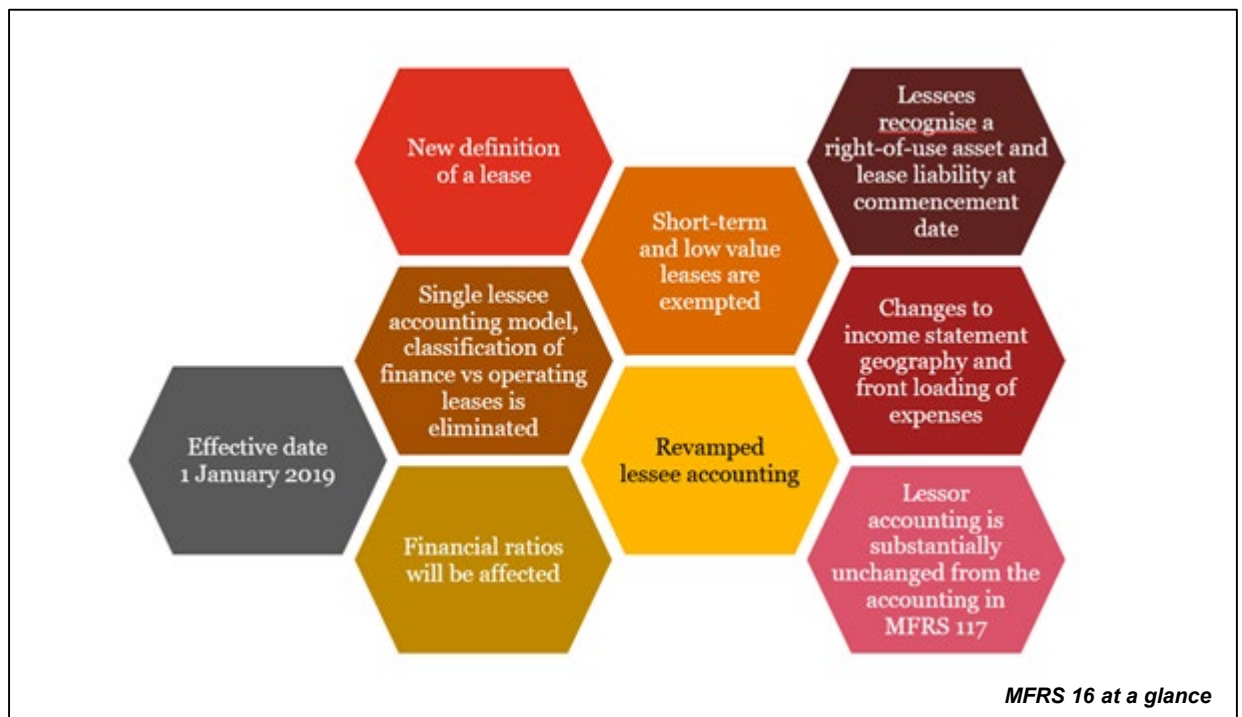
Under MFRS 16, rental expenses are replaced by a pair of new expenses: interest from amortisation of the lease liability and depreciation of the right-of-use asset. This effectively relegates what used to be an element of operating expense to two “below-the-line” expense items. The first key impact of this is a higher EBITDA. Secondly, companies will now have an additional financing cost.

MFRS 16 at a glance (continued)

Cash flow statement

Rentals paid will no longer be presented as cash outflows from operating activities. This will be separated into payments of principal and interest on the lease liability. Whilst payments of principal will be presented as cash outflows from financing activities, companies shall apply their selected accounting policy when presenting payments of interest, showing them either within operating or financing activities.

This article does not cover all technical aspects of MFRS 16 so as not to duplicate available accounting literature. However, to ensure completeness, the following diagram has been included to highlight the key MFRS 16 headlines (note that not all of them are addressed in this article):



MFRS 16 at a glance (continued)

A deep dive into the broad MFRS 16 requirements shown in the diagram above will reveal many practical challenges. Here are a few of the more common judgmental areas (non-exhaustive, of course) which requires careful consideration:

- whether a contract meets the definition of a “lease” under MFRS 16. It is critical to revisit some existing contracts which are currently classified as leases given that there are new rules on this matter. Contracts on rental of asset capacity (e.g. warehouse, fibre optic cable), or contracts where its legal owner has the right (and economic incentive) to replace the leased asset with another (e.g. retail space) might be worth another look;
- determining the discount rate for each (or a portfolio of similar) leases may require extensive planning, consideration and work;
- determining a lease contract’s lease term, in particular where a lease contract provides a lessee with the option to extend, or an option for the lessee and/or lessor to terminate; and
- identifying the appropriate transition option under MFRS 16.



5 key considerations for businesses to think about

1. Is leasing still feasible?

Leasing was a commercial option for companies that did not have the funds or ability to borrow for an outright asset purchase. A leasing structure, implemented innovatively, was also used by companies to deliberately reduce their gearing or produce an “asset-light” structure which maximised returns to shareholders.

Since leasing will now be reflected as a borrowing – no different from a bank loan – companies need to reassess the attractiveness of leasing as an alternative source of funding, and whether this fits in with their respective business models. In assessing this, it is also vital that companies consider the applicable tax implications. This is now a good time for companies to carefully reassess their financing options to arrive at an optimum decision. Borrowings and existing lease contracts could also be renegotiated.

Whilst MFRS 16 need not necessarily trigger drastic shifts in business models of all lessees, it is important that lessees start to think about the messages that they will communicate to their key stakeholders, explaining the impact of the addition of new right-of-use assets and lease liabilities on balance sheets. Alternatively, lessees (who are mainly service providers) may begin to consider new business models such as the formation of joint ventures with assets owners. Structures which would enable lessees to continue offering expertise in running operations or acquiring strategic concessions whilst permitting asset owners to utilise their credit strength to viably fund asset acquisitions could become attractive.

5 key considerations for businesses to think about (continued)

2. If your company has borrowed externally, have you considered how transitioning to MFRS 16 might impact those borrowings?

Where a company has borrowed from an external financier, there will likely be imposition of certain conditions and restrictions on the company. Typical debt covenants could include the need to ensure that the company's level of gearing does not exceed a specified threshold. As MFRS 16 effectively introduces new debt to the balance sheet, thereby inflating gearing measures, companies need to be careful that such debt covenants are not inadvertently breached. Whilst a company's cash flows continue to be the same under MFRS 16, the additional debt shown on its balance sheet may trigger additional collateral requirements or raise financing costs. To address this, companies should start engaging their respective financiers to ensure that the impact of MFRS 16 to their gearing levels is managed upfront.

3. If your company has borrowed externally, have you considered how transitioning to MFRS 16 might impact those borrowings?

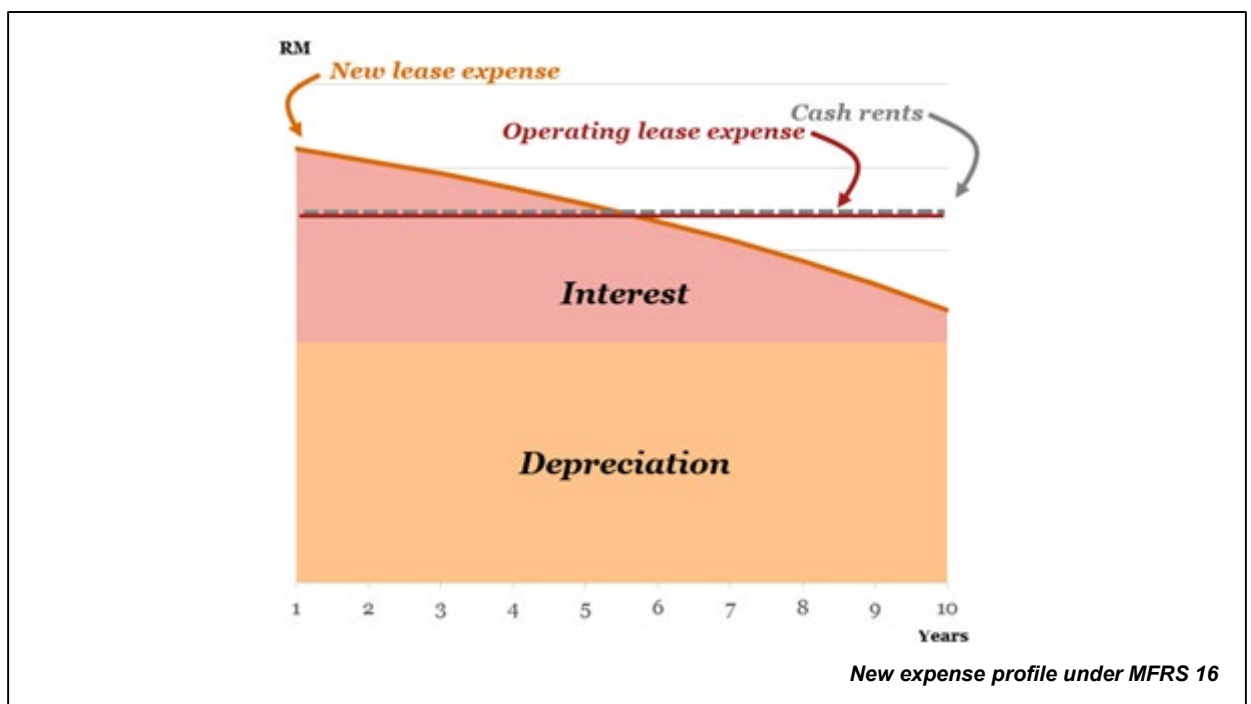
Companies commonly use key performance indicators such as earnings before interest, tax, depreciation and amortisation ("EBITDA") or return on assets in measuring business performance.

Lessees, especially those which expect to be significantly impacted by MFRS 16, should reassess EBITDA-linked performance measures to ascertain whether these are still appropriate. This is to ensure management is rewarded for effort and not as a by-product of changes in accounting policy. Upcoming budgets which drive critical business decisions such as allocation of resources should also be reviewed for validity. Growth forecasts benchmarked on EBITDA should be revisited to ensure prior year comparisons remain relevant. Additionally, acquisitive companies may want to comb through share purchase agreements with earn-out clauses, in particular where consideration to be paid is based on the acquired business achieving an EBITDA-based goal.

5 key considerations for businesses to think about (continued)

4. Will your shareholders be affected?

Companies may make a commitment on a dividend pay-out policy to shareholders. Consider the following chart, which depicts the lifecycle of a single lease, and how this might impact a company's level of available profits:



Under MFRS 16, a lease would have a front-loaded expense profile which gradually tapers off towards the end of the lease term. This occurs because interest expense is highest at the commencement of a lease when its related lease liability represents the maximum payments to be made (principal to be paid). In contrast, an identical lease accounted for as an operating lease under MFRS 117 will have a straight-line expense profile over the lease term. Whilst on an overall basis there should not be any income statement difference between an MFRS 16 lease and an MFRS 117 operating lease, all things being equal, an MFRS 16 lease will cause a lower net profit amount at the start of a lease. In practice however, a company may have multiple leases that are unlikely to begin and end at the same time so this expense trend may not be observable. Yet, having a good understanding of the new expense profile under MFRS 16 will be insightful.

Companies should consider whether transitioning to MFRS 16 will have any impact on their ability to pay dividends. Those at higher risk of failing to meet dividend pay-out policy commitments are those that do not have sufficient profits or expect a concentration of leases to begin at the same time, resulting in a significant hit to profits. Shareholders' expectations should also be managed in advance through communication of estimated impact.

5 key considerations for businesses to think about (continued)

5. Is your business prepared to operationalise the transition to MFRS 16?

It will not be immediately obvious that the implications of implementing a new accounting standard are not isolated to finance. Chances are, most companies will confine this project as solely an agenda item for the Finance team, which is far from the truth. It is important that awareness is achieved company-wide. This means briefing different teams – including tax, IT, legal and sales – and having them talk to each other to gauge the business' needs earlier rather than later. Proper alignment of these different teams will determine just how seamlessly a company will find its new "business as usual" post-transition.

To illustrate the point, here are a few examples of practical MFRS 16 issues that may impact different aspects of the company's business, other than finance:

<i>Tax</i>	<ul style="list-style-type: none"> • Expenses relating to MFRS 16 in the financial statements are unlikely to be relevant for tax reporting purposes given that they will not be based on actual cash payments of rental. • With the elimination of operating and finance leases for lessees, do you know which right-of-use assets will be eligible for capital allowance? Previously, operating leases typically led to no capital allowance, whilst finance leases typically led to eligibility of capital allowance. Going forward, all leases in a lessee's balance sheet will be represented by a right of use asset and more work will be required to ascertain if capital allowance will be available or not. • Have you considered Real Property Gains Tax ("RPGT") implications? With the booking of the right to use asset in the balance sheet, could this constitute real property if these relate to the lease of real properties?
<i>IT</i>	<ul style="list-style-type: none"> • Do you have adequate technological support to manage lease contracts? • Should you consider automating the required measurement for MFRS 16 financial reporting purposes? It will be important to consider the viability of in-house Excel spreadsheets to support lease calculations and recording. • Are your systems able to capture, process and produce data that will be required for all areas of the business e.g. financial reporting and tax reporting – especially as required information may be different?



5 key considerations for businesses to think about (continued)

5. Is your business prepared to operationalise the transition to MFRS 16? (continued)

Legal	<ul style="list-style-type: none">• Have your legal team ready to understand what rights are available to you as a lessee in a lease contract. Do you know your ability to control the use of the asset being leased? Can the lessor readily replace the asset being leased without needing to pay you any penalty? For example, if you were renting a retail space, can the landlord move you to another space without reimbursing you for fixture and fittings costs?
Sales	<ul style="list-style-type: none">• Is your sales team, who are out on the ground negotiating and entering into new contracts, aware of the impact of MFRS 16 and how these in turn affect their performance targets?• Does your sales team know how contractual terms from leasing arrangements impact recognition of lease expense for current and future years?

As resourcing and awareness will both be critical to transitioning to MFRS 16, companies should ensure that they have sufficient resources to support the transition, and that these people are appropriately trained. Ideally, a robust game plan will include a strategy which is properly supported by a detailed implementation plan covering all aspects of the company's business.



Suggested next steps

It is going to be an arduous task to properly understand and confidently apply the accounting standard. However, implementing the new lease accounting standard should not be completed by the finance team in isolation. The business needs to come together to properly operationalise this transition. In light of the content discussed, this article leaves you with some suggested areas to follow up on as next steps

<i>Action points</i>	<i>Whose responsibility?</i>
1. Key business considerations (as outlined above)	Board
2. Performance measures	Finance, Sales, Human Resources and Board
3. Tax impact	Finance and Tax
4. Technological needs	Finance, Tax and IT
5. Technical (and challenging) areas of MFRS 16	Finance, Treasury and Sales

Do you have any further questions on this topic?

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