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PwC Alert

MFRS 16 'Leases'

A new era of lease accounting

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Why change lease accounting?

The International Accounting Standards Board (IASB) finally published its long awaited revised standard on leases, IFRS 16 'Leases', in January 2016. This marks a new era for lease accounting as almost all leases will be recorded on the lessees' balance sheet.

The MASB issued MFRS 16 'Leases' on 15 April 2016. It is identical to IFRS 16. MFRS 16 supersedes MFRS 117 'Leases' and its related interpretations.

When launching IFRS 16, Hans Hoogervorst, the IASB Chairman commented:

"These new accounting requirements bring lease accounting into the 21st century, ending the guesswork involved when calculating a company's often-substantial lease obligations.

The new Standard will provide much-needed transparency on companies' lease assets and liabilities, meaning that off balance sheet lease financing is no longer lurking in the shadows. It will also improve comparability between companies that lease and those that borrow to buy."

In this article, we give an overview of MFRS 16 and highlight its expected impact on a company's financial statements. We also discuss the transition to MFRS 16 when the standard becomes effective.

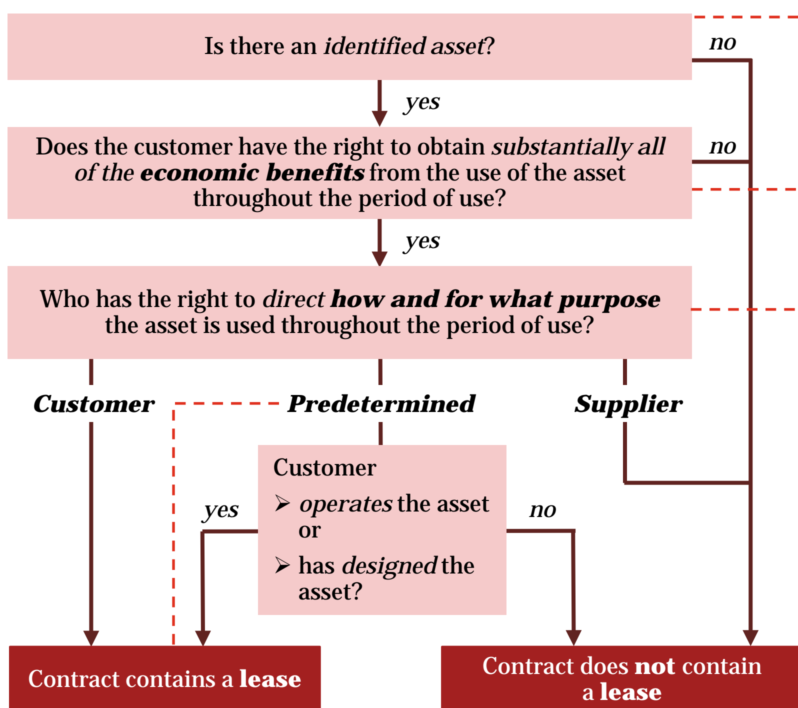
MFRS 16 at a glance

When is the effective date?	Annual periods beginning on or after 1 January 2019. Earlier application is permitted but only if MFRS 15 'Revenue from Contracts with Customers' has been or is applied on the same date.
What is the definition of a lease?	A lease is a contract (or part of a contract) that conveys the right to use an asset for a period of time in exchange for consideration. A contract contains a lease if fulfilment depends on an **identified asset** and it conveys the **right to control the use** of that identified asset throughout the period of use. Each lease component should be identified and accounted for separately.
What is an identified asset?	An asset can be identified explicitly or implicitly. There is no identified asset if the supplier has a substantive right to substitute the asset.
What is the "right to control the use" of an asset?	An entity has the right to control the use of an identified asset if it has the right to obtain substantially all of the economic benefits from the use of the asset and the right to direct the use of the asset, i.e. to decide how and for what purpose it is used.
What does a lessee recognise on the balance sheet?	A lessee recognises almost all leases on the balance sheet as "right-of-use assets" and corresponding "lease liabilities".
What does a lessee recognise in profit or loss?	A lessee recognises: • interest expense on the lease liability; and • depreciation of the right-of-use asset. Variable lease payments not included in the lease liability are recognised in the period the obligation is incurred.
Are there any exemptions?	A recognition and measurement exemption for short term leases and leases of low value assets is available as a policy choice. However, this exemption is only available to the lessee.
Is lessor accounting affected?	MFRS 16 does not make any substantial changes to lessor accounting. A lessor still classifies a lease as either a finance lease (recognises a lease receivable) or an operating lease (continues to recognise the underlying asset).

Identifying a lease

The question of whether a contract contains a lease determines if the contract is recognised on the balance sheet at inception or off the balance sheet as a service contract.

The diagram below illustrates the decision tree used in identifying whether a contract is, or contains, a lease.



PwC Observation

The new concept of "pre-determined" introduced by MFRS 16 can be very complex and judgmental where decisions are made before the inception of the lease. When analysing these decisions, there are several questions to consider, such as:

- Do any decisions that are not predetermined have a significant effect on how and for what purpose the asset is used?
- To what extent are decisions about how and for what purpose the asset is used predetermined?
- Do the decisions predetermine how and for what purpose the identified asset is used or do they only establish protective rights?
- Which party to the contract has made the decisions?

Identified asset

An asset can be identified either explicitly in the contract (for example, the serial number) or implicitly (for example, a supplier can fulfil the contract only by the use of a particular asset).

But, there is no identified asset if the supplier has a substantive right to substitute the asset i.e. the supplier has the practical ability to substitute an alternative asset and would benefit economically from it.

If the cost of substitution exceeds the benefits, the substitution right is not substantive.

PwC Observation

At the inception date, a customer who could not readily determine whether the supplier has a substantive substitution right shall presume that the right is not substantive.

Economic benefits

Economic benefits can be obtained directly or indirectly from the ***use*** of the identified asset. The economic benefits should be related to the use (and not the ownership) of the underlying asset.

How and for what purpose

Only decision-making rights that affect the economic benefits to be derived from the ***use*** of the identified asset are considered relevant to determine if a customer can direct how and for what purpose the asset is used.

Lease vs. service

A confectionary company (Customer) enters into a contract with a mall operator (Supplier) to use a space in the mall to sell its goods for a three-year period. The contract states the size of space and that the space may be located at any one of the concourse areas in the mall. The Supplier has the right to change the location of the space allocated to the Customer at any time during the period of use. There are minimal costs to the Supplier to reallocate the space. The Customer uses a kiosk (that it owns) that can be moved easily to sell its goods. There are many areas in the mall that are available that meets the space specification in the contract.

The contract does not contain a lease because there is no identified asset.

The contract is for space in the mall, and this space can be changed at the discretion of the Supplier. The Supplier has the substantive right to substitute the space Customer used because:

a) the Supplier has the practical ability to change the location of the space at any time without Customer's approval.

b) the Supplier would benefit economically from substituting the space.

In contrast, if the contract specifies a shop in the mall and the Supplier does not have the contractual right to relocate the Customer during the lease period, this contract is a lease. This is because:

a) The shop is an identified asset;

b) Customer has exclusive use of the shop and obtains substantially all of the economic benefits from use of the shop; and

c) Customer has the right to direct how and for what purpose the shop is used.

PwC Observation

The definition of a lease in MFRS 16 is driven by the question of which party to the contract controls the use of the underlying asset throughout the period of use.

A customer needs to obtain substantially all of the benefits from the use of an asset ('benefits' element) and have the ability (right) to direct the use of the asset ('power' element) for a contract to contain a lease.

The definition of a lease under MFRS 16 is not entirely identical to the current IC Interpretation 4 'Determining whether an Arrangement contains a Lease'. Hence, contracts currently identified and accounted for as leases in accordance with MFRS 117 and IC Interpretation 4, may be treated differently under MFRS 16.

Lessee's accounting

MFRS 16 changes lessee accounting substantially. A lessee is required to recognise a new leased asset (representing the right-of-use (ROU) of the leased item for the lease term) and lease liability (representing obligation to pay rentals to the lessor).

Initial measurement of lease liability

Lease liability is initially recognised at the commencement date and measured at the present value of the unpaid ***lease payments*** during the ***lease term.***

Estimating the lease term

MFRS 16 defines a lease term as the non-cancellable period of the lease plus periods covered by an option to extend or an option to terminate if the lessee is ***reasonably certain*** to exercise the extension option or not exercise the termination option.

In assessing whether the lessee is reasonably certain to exercise, or not to exercise the option (for example , extension of lease period, purchase of the underlying asset or termination of the lease), entities need to consider all relevant facts and circumstances that create an economic incentive for the lessee to do so.

Lease term =

***Non-cancellable* period of lease**

+

Periods covered by *option to extend*

+

Periods covered by *option to terminate*

Example: Is the lessee reasonably certain to extend the lease period?

A fashion label retailer enters into a 5-year contract with a mall operator to lease a retail store at a strategic location in the mall; high visibility and high traffic volume. The lease can be renewed for another 5 years at the prevailing market rental at the point of renewal. The retailer has spent significant amounts of money on renovation and fittings to customise the store to its brand image.

In this case, the location is much sought-after and the lessee has incurred significant cost on leasehold improvements. The lessee has significant economic incentive to renew the lease. Therefore, the lease term is 10 years at the commencement of the lease.

PwC Observation

One of the primary reasons for including extension options (and not limiting to the non-cancellable lease term) is to avoid the potential for structuring opportunities to achieve a particular accounting outcome (for example, to artificially achieve a lower lease liability).

Significant judgement would be needed to determine whether it is reasonably certain the lessee will renew a lease because there is no guidance in the standard on how to weight the individual factors that create an economic incentive for the lessee to exercise the option in the contract.

Determining lease payments

Lease payments comprise of unpaid payments for the right to use the underlying asset during the lease term (i.e. exclude payments made before or on commencement date).

Certain contingent rentals or variable lease payments are included in the measurement of lease liabilities. MFRS 16 distinguishes three types of contingent payments:

(i) Variable lease payments based on an **index or a rate** (for example, a consumer price index, a benchmark interest rate or a market rental rate) are part of the lease liability because these payments are unavoidable to the lessee. Any uncertainty relates only to the measurement of the liability but not to its existence. Lessees use the index/rate at commencement date to measure the variable lease payments.

(ii) Variable lease payments based on **any variable, other than an index/rate** (for example, payments linked to the use of the underlying asset), are excluded from the lease liability. Such payments are recognised in profit or loss in the period in which the event or condition that triggers those payments occurs. So, variable lease payments that do not vary based on an index/rate (for example, payments vary based on sales achieved by the lessee) do not form part of the lease liability at the inception of the lease.

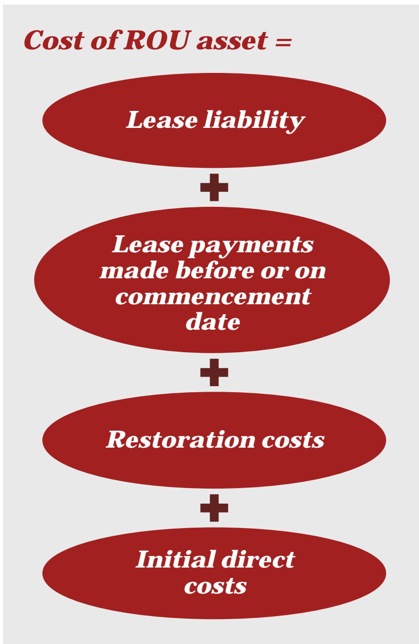
(iii) In-substance fixed payments i.e. lease payments that, in form, contain variability but, in substance, are fixed are included in the lease liability. A lease payment is in-substance fixed if there is no genuine variability (for example, payments must be made only if an event occurs and there is no genuine possibility of the event not occurring).

The existence of a choice for the lessee within a lease agreement can also result in an in-substance fixed payment. For example, if the lessee can only choose either (a) to extend the lease term or (b) to purchase the underlying asset, the lower cash outflow (that is, either the discounted lease payments throughout the extension period or the discounted purchase price) represents an in-substance fixed payment because the lessee cannot argue that neither the extension option nor the purchase option will be exercised.

Besides, payments that are initially structured as variable lease payments linked to the use of the underlying asset may become in-substance fixed payments when the variability is resolved.

PwC Observation

Determining whether a contingent payment is a 'disguised' or in-substance fixed lease payment will require a significant judgement, as the standard includes limited guidance on how to interpret what constitutes 'in-substance fixed payments'.



Initial measurement of right-of-use (ROU) asset

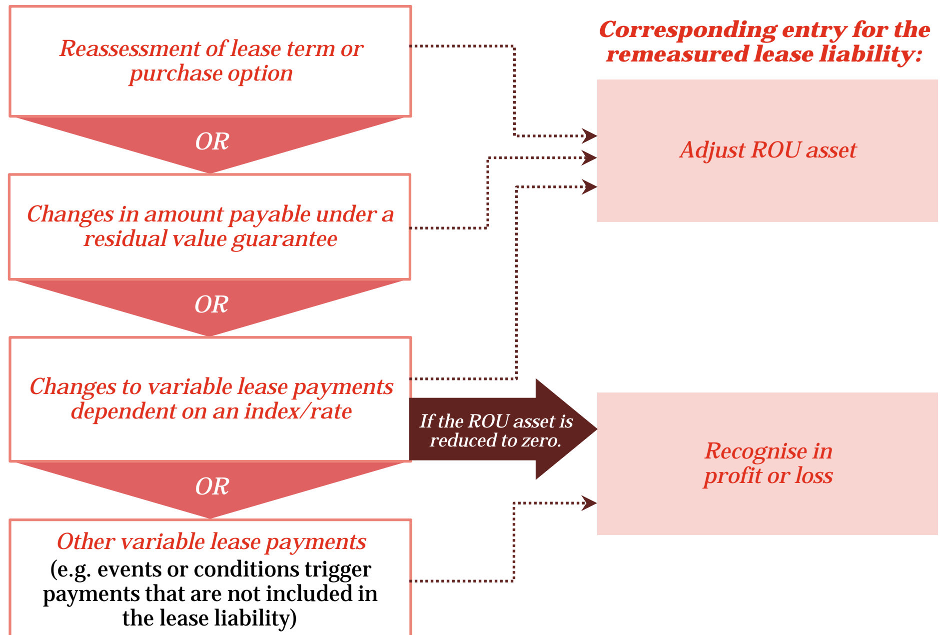
ROU asset is initially recognised and measured at the same amount of the lease liability and also include initial estimate of restoration costs and initial direct costs. This is consistent with the initial measurement principle in MFRS 116 'Property, Plant and Equipment' to measure the cost of a purchased property, plant and equipment.

Provision for the restoration costs is recognised as a separate liability in accordance with MFRS 137 'Provisions, Contingent Liabilities and Contingent Assets'.

Remeasurement of ROU asset and lease liability

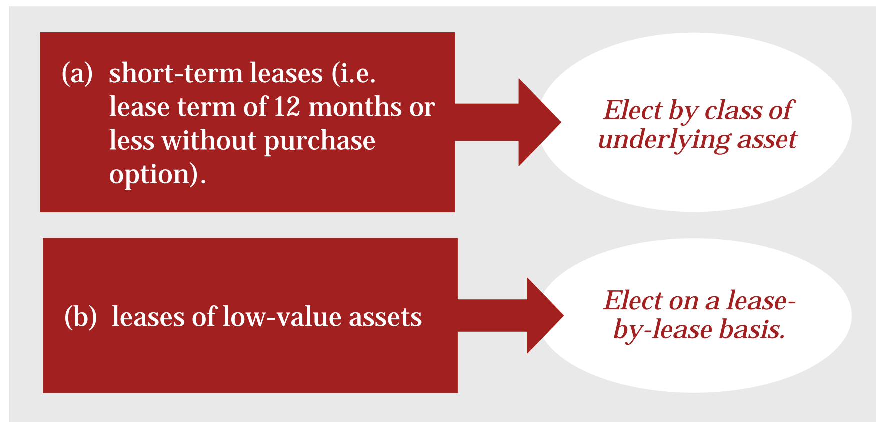
MFRS 16 requires lease liability to be reassessed when there are changes to the lease payments based on the contractual terms in the lease agreement. A lessee remeasures the lease liability to reflect changes to the lease payments.

Remeasurements during the lease term cause volatility to the ROU assets and lease liabilities.



Recognition and measurement exemptions

Lessees can elect not to apply the MFRS 16 lessee accounting model on the following two types of leases below but, this exemption is not available to lessors.

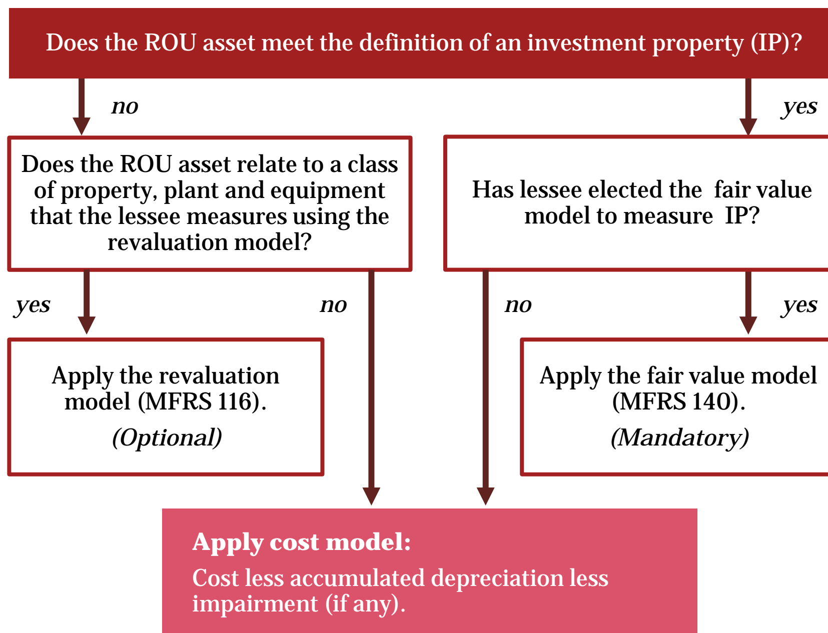


PwC Observation

The term 'low value' is not defined in MFRS 16. The Basis for Conclusions of IFRS 16 indicates a value of USD5,000 or less when the asset is new.

The exemption is applicable even if low-value assets in aggregate are material. But, if the assets are dependent on, or highly interrelated with, other underlying assets, the exemption is not applicable.

Subsequent measurement of ROU asset



Measuring ROU asset at fair value

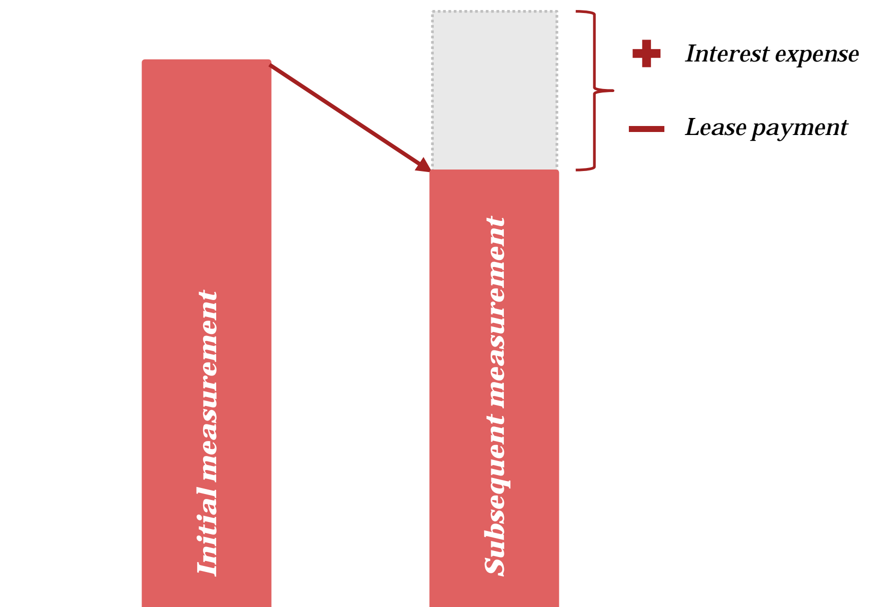
If a lessee measures a ROU asset using the fair value model in MFRS 140 'Investment Property' (IP) or revaluation model in MFRS 116 'Property, Plant and Equipment' (PPE), it shall measure the ROU asset and not the underlying property at its fair value.

MFRS 16 permits a lessee to revalue ROU assets held as PPE only if it relates to a class of PPE which the lessee applies the revaluation model.

On the other hand, a ROU IP must be measured at fair value if the lessee adopted the fair value model in MFRS 140.

Subsequent measurement of lease liability

After initial measurement, lease liability is measured similarly to other financial liabilities by accreting interest on the lease liability and reducing the carrying amount by payments made.



Expected impact on financial position

The new lessee accounting model is expected to increase liabilities on a company's statement of financial position.

Meanwhile, a company's net assets is expected to decrease during the initial years of a lease as the carrying amount of ROU assets are generally decreasing faster than the lease liability.

PwC Observation

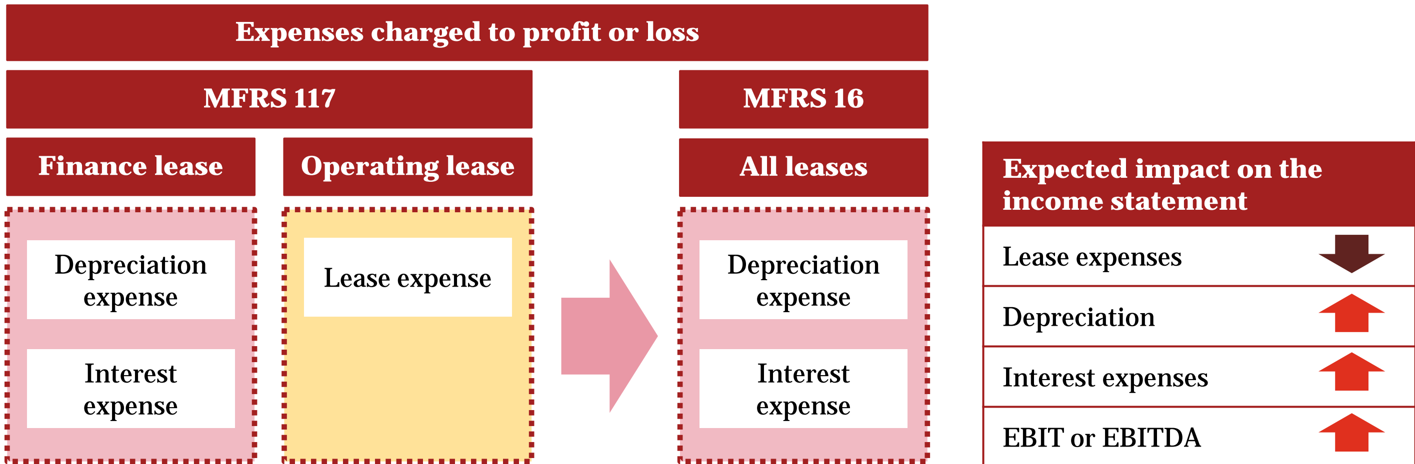
Companies with material 'off balance sheet' operating leases under MFRS 117 are expected to experience significant changes to the balance sheet and balance sheet related ratios (for example, debt/equity ratio).

Presentation of ROU asset and lease liability

A lessee can either present the ROU asset separately from other assets or include the ROU asset within the same line item in which the underlying asset would be presented (e.g. property, plant and equipment) in the statement of financial positon (SOFP) or in the notes to the financial statements. However, if the ROU asset meets the definition of investment property, it shall be presented as investment property in the SOFP.

Similarly, the lease liability can either be presented separately or within other similar liabilities in the SOFP or in the notes.

Expected impact on financial performance



Under MFRS 16, a lessee typically recognises depreciation of the ROU asset and interest expense on the lease liability (included within finance cost) in profit or loss as opposed to operating lease rental expenses under MFRS 117.

Lease payments for certain short-term leases and leases of low-value assets may continue to be recognised as expenses on a straight-line basis or another systematic basis that is more representative of the pattern of the lessee's benefit (i.e. similar to operating lease accounting in MFRS 117).

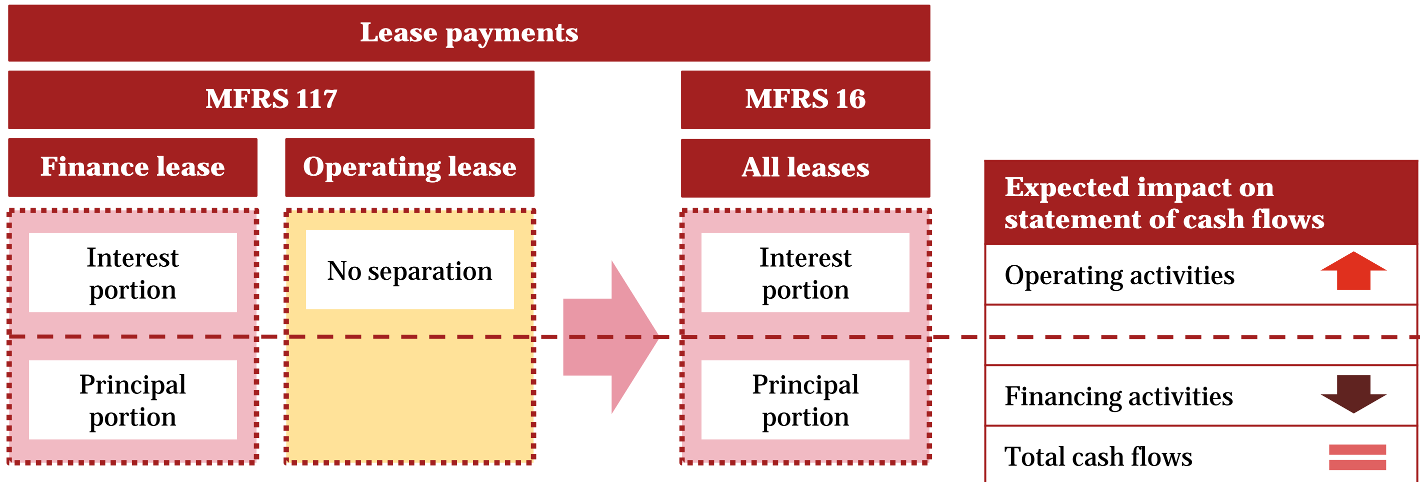
PwC Observation

Although earnings before interest and tax (EBIT) and earnings before interest, tax, depreciation and amortisation (EBITDA) are not presented in the statement of comprehensive income, these information are often used by users of financial statements to assess the performance of a company.

While EBIT and EBITDA may have improved, the combination of straight-line depreciation and application of the effective interest method results in higher charge to the profit or loss in the initial years of a lease. The total lease expense is expected to decrease throughout the lease term. This effect is sometimes referred to as 'frontloading'.

In the long term, the difference in the expense profile between MFRS 16 and MFRS 117 may become insignificant for many companies holding a portfolio of leases that start and end in different reporting periods.

Expected impact on cash flows



MFRS 16 requires a lessee to classify cash payments for the principal portion of a lease liability within financing activities in the statement of cash flows.

MFRS 107 'Statement of Cash Flows' permits a lessee to present interest payments within financing activities or operating activities. So, interest portion in a lease payment is classified consistently with other interest paid.

Payments for certain short-term leases and leases of low-value assets not included in the measurement of lease liability are presented within operating activities.

Variable lease payments not included in the measurement of lease liability (for example, contingent rent based on a specified percentage of sales) are also presented within operating activities.

PwC Observation

MFRS 16 does not change the amount of cash transferred between the lessor and the lessee, but the amounts presented within operating activities and financing activities in the statement of cash flows of a lessee are expected to change (as shown in the diagram).

If all else equal, lessees are expected to experience improved operating cash flows but lower cash flows (or possibly net cash outflows) from financing activities.

Lessor’s accounting is substantially the same

MFRS 16 has substantially retained the lessor accounting model in MFRS 117.

A lessor still has to classify leases as either finance or operating leases, depending on whether substantially all of the risks and rewards incidental to ownership of the underlying asset have been transferred to the lessee.

The dual accounting model for lessor may create a non-symmetrical accounting between lessor and lessee. Lessee recognises a MFRS 16 ROU asset and a lease liability to pay lease payments to the lessor. If lessor classifies the lease as an operating lease, lessor continues to recognise the underlying asset as PPE in accordance with MFRS 116 but the rights to receive lease rental from the lessee is not recognised on its statement of financial position.

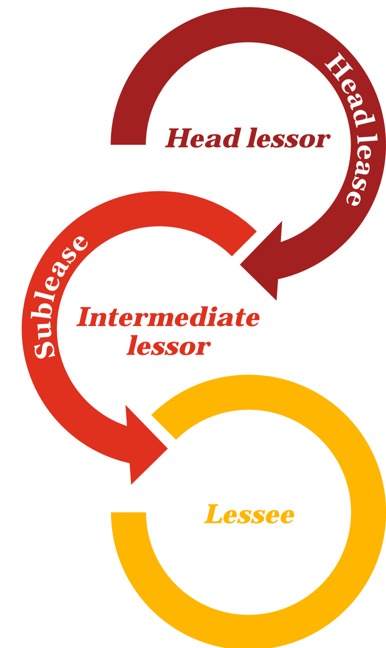
Lessor‘s accounting	
Classification	Distinction based on the extent of risk and rewards transferred to the lessee
Finance lease	Recognises a lease receivable (net investment in lease)
Operating lease	Continues to recognise the underlying asset (i.e. an asset for which its right to use has been granted to a lessee)

Subleases

An intermediate lessor is a lessee and a lessor in a sublease.

MFRS 16 requires the intermediate lessor to evaluate the sublease classification (as either finance or operating lease) with reference to the ROU asset it leased from the head lessor and not the underlying asset. Accordingly, subleases are more likely to be classified as finance leases under MFRS 16.

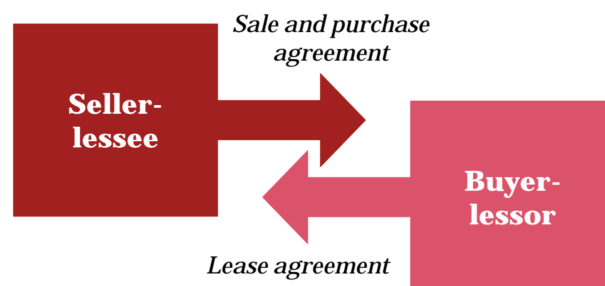
An intermediate lessor with regard to the head lease recognises a ROU asset (if the sublease is classified as an operating lease) or a lease receivable (if the sublease is classified as a finance lease) and a corresponding lease liability on its statement of financial position.



Statement of financial position – *Intermediate lessor*	**ROU asset** *(If sublease is an operating lease)*	**Lease liability** *(Head lease)*
	OR	
	Lease receivable *(If sublease is a finance lease)*	

Sale and leaseback transactions

In a sale and leaseback transaction, both the buyer-lessor and seller-lessee apply the requirements in MFRS 15 to determine whether a sale of the underlying asset has occurred.



Does the transfer of asset satisfy the requirements of MFRS 15 to be accounted for as a sale?

Yes, the transfer is a sale

Seller-lessee:

- *Measures the ROU asset at retained portion of the previous carrying amount.*
- *Recognises gain / loss on the rights sold to the buyer-lessor.*

Buyer-lessor:

- *Recognises the underlying asset in accordance with applicable standard (e.g. MFRS 116).*
- *Applies the lessor accounting model to the leaseback.*

Seller-lessee:

If selling price/future rental is:

- *Higher than fair value or market rate, recognises additional financing from the lessor;*
- *Lower than fair value or market rate, recognises a prepayment of lease payments.*

No, the transfer is not a sale

Seller-lessee:

- *Continues to recognise the underlying asset.*
- *Recognises a new financial liability for the amount received from the buyer-lessor.*

Buyer-lessor:

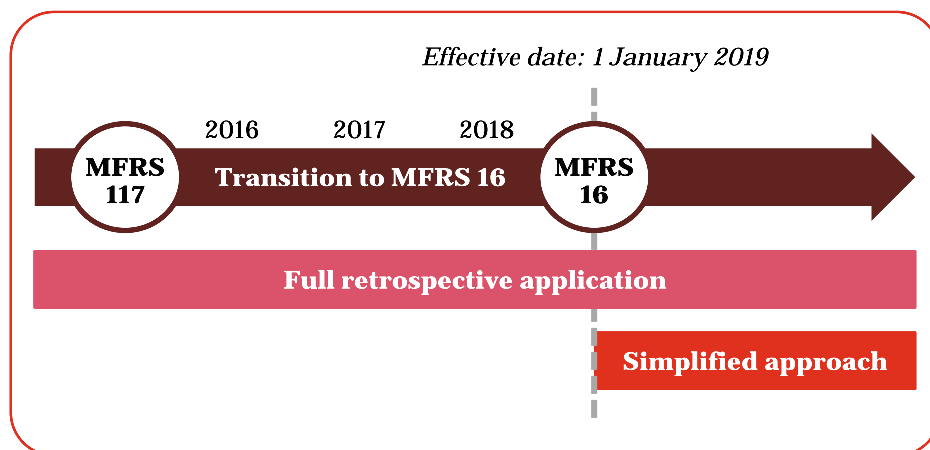
- *Recognises a financial asset (receivable from the seller-lessee).*

Transition to MFRS 16

On transition to MFRS 16, companies can choose to apply the 'full retrospective approach', in accordance with MFRS 108 'Accounting Policies, Changes in Accounting Estimates and Errors' or the "simplified approach" in MFRS 16.

Under the 'simplified approach':

- A company is not required to reassess whether existing contracts contain a lease based on the revised definition of a lease in MFRS 16.
- MFRS 16 shall only be applied to contracts that are entered into (or changed) on or after the date of initial application.
- Comparative information is not restated.
- The cumulative effect of initially applying MFRS 16 is recognised as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the date of initial application.



Simplified approach for lessee

Comparative information is not restated. The cumulative effect of applying the new standard is adjusted to the opening balance of retained earnings on the date of initial application.

Measurement of leases previously classified as operating leases:

Lease liability	Measure using remaining lease payments, discounted using incremental borrowing rate at the date of initial application.
ROU asset	Lessee can choose, on a lease-by-lease basis: a) retrospective calculation, discounted using incremental borrowing rate at the date of initial application; or b) based on amount of lease liability (adjusted by the amount of any previously recognised prepaid or accrued lease payments).

Measurement of leases previously classified as finance leases:

Lease liability	Carrying amount of the lease liability immediately before the date of initial application.
ROU asset	Carrying amount of the lease asset immediately before the date of initial application.

Simplified approach for lessor accounting in subleases

Intermediate lessors are required to:

- Reassess the classification of operating subleases.
- If operating subleases are to be classified as finance leases, these subleases are accounted for as new finance leases entered into on date of initial application.

Simplified approach for sale and leaseback

An entity is not required to reassess sale and leaseback transactions entered into before the date of initial application.

For ongoing finance leaseback, the seller-lessee continues to amortise any gain on sale over the lease term.

For operating leaseback, any deferred gain or loss due to off-market terms is adjusted against the leaseback ROU asset.

PwC Observation

The new standard will have significant impact on the financial statements for many companies in almost all industries. Balance sheets will be grossed up and rental expense will be replaced by depreciation and interest expense resulting in a 'frontloading' effect.

The wider potential business impact

The accounting change for leases is just the tip of the iceberg. Companies will need to undertake an in-depth review of the new lease standard and assess the wider potential business impact. Areas to be considered include:

- Effects on key financial metrics
  - The new accounting model will affect a range of key metrics monitored by stakeholders, including net debt and gearing ratio, EBITA, Return on Equity (ROE). This could affect various debt ratios and debt covenants may need to be re-assessed and potentially renegotiated.
  - Performance metrics for example employee's KPI based on EBITA or EBIT will probably need to be renegotiated or redefined.
- Financing policy
  - The revised profile of the P&L expense may affect the dividend distribution policy.
  - Cost of borrowing may increase and may affect the financing options available to companies.
  - While accounting should not be the key driver in commercial lease negotiation, market behaviour might change towards shorter lease tenures to minimise lease liabilities.
- System and process
  - Companies will have to put in place systems and processes that ensure that all information relevant for either measurement or disclosure can be collected.
- Communication with stakeholders
  - It is important for companies to communicate with their stakeholders about the impact of the new standard on financial position and performance.

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