# Quick read – New Leasing Standard under SFRS(I) 16/FRS 116

September, 2019

pwc

# Quick read – SFRS(I) 16/FRS 116

## I. Significant change in lessee accounting

SFRS(I) 16/FRS 116 Leases no longer makes a distinction between operating and finance lease for a lessee and is effective for financial periods beginning 1 January 2019. Except for exempted short-term and low value leases, entities with off-balance sheet leases may now be required to record these leases on the balance sheet as lease assets (right-of-use assets) and liabilities. Lessor accounting remains largely unchanged from SFRS(I) 1-17/FRS 17.

A simple illustration of this change under the new lease accounting standard for lessees is as follows:

| Primary statements | SFRS(I) 1-17/ FRS 17[1] | SFRS(I) 16/FRS 116 | Accounting implications |
|---|---|---|---|
| Balance Sheet ("BS")[2] | • Off-balance sheet transaction | • Right-of-use asset ("ROU asset") is recognised separately or together with existing property, plant and equipment/investment properties[3]<br>• Lease liability is recognised separately or together with other financial liabilities | • Amounts recognised on balance sheet are determined by the lease payments over the lease term.<br>• Lease term includes optional lease periods that an entity is reasonably certain to exercise.<br>• Variable lease payments may be included depending on the terms of the lease. |
| Profit or Loss ("P&L") | • Rental expenses are recorded on a straight-line basis | • Depreciation of ROU asset is generally recorded on a straight-line basis<br>• Interest expense from lease liability is recognised based on the effective interest method | • Total impact on net profit is the same under the previous and new lease standards for the full contract period. However, lease expenses are front-loaded in the P&L during the first half of the lease term (due to higher interest expense arising from higher lease liability balance) under the new lease standard. |
| Cash Flow statement ("CFS") | • Rental payments are recognised under operating activities | • Principal element of lease payments is recognised under financing activities<br>• Interest element of lease payments is recognised under operating or financing activities | • While there is no underlying change in business activities, cash flows from operating activities would show an improvement. |

Under the new standard, other accounting changes include accounting for sub-leases, lease modifications, and sale and leaseback arrangements. To support the new recognition and measurement requirements, changes to information technology systems and data gathering processes may be required. The new standard could also impact entities beyond accounting, as discussed on the next page.

[1] Operating lease under SFRS(I) 1-17/FRS 17

[2] Virtually all leases will be capitalised, except for exempted short-term leases and low value asset leases.

[3] Right-of-use asset that meets the definition of investment property ("IP") are required to be presented as IP in the BS.

## II. SFRS(I) 16/FRS 116 implications beyond accounting

### a) Key financial metrics may change for lessees

Under the new standard, comparability of financial statements would improve as nearly all off-balance sheet accounting for lessees are eliminated. However, despite there being no fundamental change to underlying business activities or cash flows, the new leasing requirements would impact many commonly used financial metrics/measures. Some examples are as follows:

| Measures | Examples of common quantitative measures | Change | Explanation |
|---|---|---|---|
| Gearing ratios | Debt-to-equity ratio | ↑ | Financial liabilities increase with the recognition of lease liability. |
| Asset usage ratios | Asset turnover rate | ↓ | Total assets increase with the recognition of ROU asset. |
| Liquidity ratios | Current ratio | ↓ | Current liabilities increase due to the current portion of lease liability. |
| Profitability ratios | Earnings before interest, tax, depreciation and amortisation ("EBITDA") to sales ratio | ↑ | EBITDA increase as lease expense, which primarily consists of depreciation and interest, is excluded. |
| Free Cash Flows ("FCFs") | Cash flow from Operating Activities + Interest expense – Capital Expenditure | ↑ | Cash flow from operating activities increase as payment of lease liability is included within financing activities. |

The adoption of the new standard may also affect covenants, credit ratings, borrowing costs and other key performance measures used by the entity's stakeholders.

Loan covenants may need to be renegotiated while key performance measures could be redefined for more consistent year-on-year analysis. It is important for entities to communicate the impact of the new accounting standard and the corresponding changes to performance measures. Some of the early adopters of the new standard have made changes to key performance measures to allow for better consistency in the performance measures presented to investors. Some examples include EBITDA after leases and operating free cash flows adjusted for lease payments.

### b) More adjustments may be needed for business valuations

The adoption of new accounting policies in principle should not have an impact on business valuation fundamentals. However, the expected increase in EBITDA and FCFs, along with changes to the discount rate, may affect valuation results. It is important for entities to have a clear understanding of the effect that remaining lease obligations have on valuation results and to make relevant adjustments, where necessary.

### c) Change in business models

The new standard may affect lessors' business models and offerings as the leasing needs and behaviours of lessees change. It may also accelerate existing market developments in leasing such as:

- Increased focus on services such as software-as-a-service[4], platform-as-a-service, infrastructure-as-a-service rather than physical assets;
- Reduced sale and leaseback activities as such arrangements are unlikely to be avenues for off-balance sheet financing[5]; and
- Increase in short-term lease arrangements arising from the availability of the short-term exemption option.

[4] Refer to IFRIC agenda decision relating to Customer's Right to Receive Access the Supplier's Application Software Hosted on the Cloud for further information https://www.ifrs.org/projects/2019/customers-right-to-access-suppliers-application-software-ias-38/

[5] Refer ISCA publication Getting Ready for FRS 116 (Leases) for further information https://isca.org.sg/media/779571/isca_lease-accounting-report.pdf

## III. Two approaches for transition

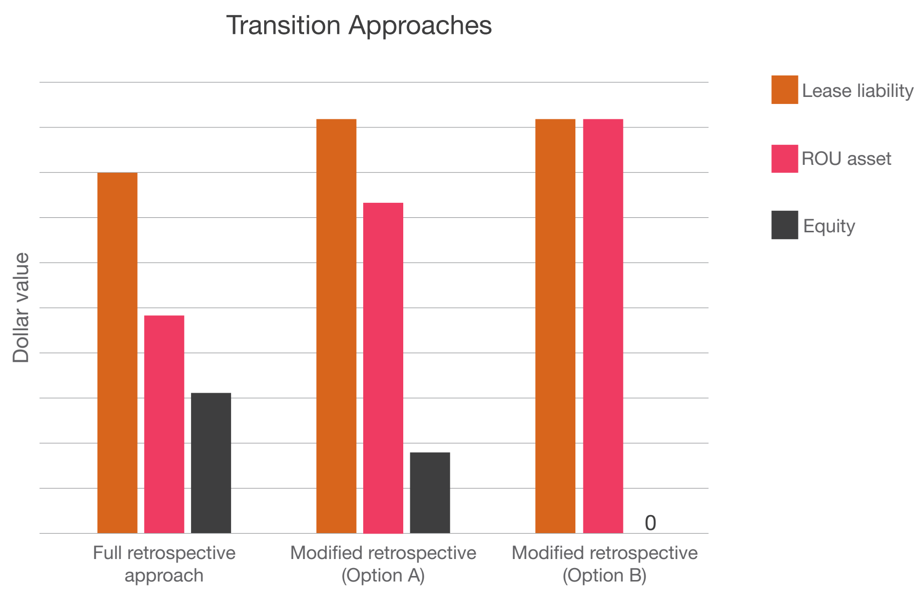
Entities have two transition options as set out below. The selected approach has to be applied to the entire lease portfolio.

i. Under the full retrospective approach, entities apply the new standard as if it had always been applied. Comparative information is restated and an additional balance sheet at the beginning of the earliest comparative period is required. The discount rate at contract inception should be applied.

ii. Under the modified retrospective approach, entities need not restate comparative information. Instead, the cumulative effect of initial application of the new standard is adjusted to the opening balance of equity as at date of initial application. For lessees with leases previously classified as operating lease, the entity will:

- Recognise the lease liability which is measured at the present value of the remaining lease payment, discounted using the lessee's incremental borrowing rate at the date of initial application; and
- Recognise the right-of-use asset on transition (on a lease-by-lease basis), by measuring the asset using the two options:
  a) as if the new standard had always been applied ("Option A"); or
  b) at an amount equal to the lease liability adjusted for any previously recognised prepaid or accrued lease payment ("Option B").

Entities should be aware that the transition option applied to existing leases might have differing effects on future profits. These differences may arise due to the different discount rate used under the full retrospective approach and the modified retrospective approach[6]. Refer to an illustration below showing the impact as at 1 January 2019, using the various transition methods on the same lease.




The results of applying the full retrospective approach or the modified retrospective (Option A) approach could be the same in certain circumstances such as when the discount rate at contract inception and at date of initial application is the same.

[6] For the purpose of the illustration above, it is assumed that the discount rate is higher at contract inception as compared to that at transition date.

## IV. Increased disclosures for the lessee's financial statements ("FS")

Some of the new disclosure requirements[7] for a lessee, who had previously accounted for its leases as operating leases under the previous leasing standard, are as follows:

| Disclosure requirements |
| --- |
| • Disclose for each class of underlying assets:<br>o Depreciation charge for ROU asset<br>o Carrying amount of ROU asset at end of reporting period<br>• Additions of ROU asset<br>• Interest expense on lease liabilities<br>• Expenses relating to:<br>o variable lease payments not included in the measurement of lease liabilities<br>o short-term leases for which the short-term exemption has been applied<br>o low-value leases for which the low-value exemption has been applied<br>• Income from sub-leasing of ROU asset<br>• Total cash outflow for leases<br>• Maturity analysis of lease liabilities disclosed separately from maturity analysis of other financial liabilities.<br>• For entities applying the modified retrospective transition approach, a reconciliation between the operating lease commitments disclosed prior to SFRS(I) 16/FRS 116 adoption and the lease liabilities capitalised on date of initial application is required. Common reconciling items excluded from lease liabilities include short-term leases and low value leases.<br>• For entities applying the full retrospective transition approach, a line by line comparison disclosure between the new and old leasing standards for affected comparatives is required. |

## V. Frequently Asked Questions[8]

### Recognition

1. **What is the difference between a lease and a service agreement?**

   A lease conveys the right to use and the control of an asset for a period of time. In a service agreement, the supplier may use an asset to deliver the service, however they retain control of that asset. The facts and circumstances of each arrangement (in particular, related party arrangements) should be carefully analysed, as the determination may be highly judgemental.

2. **How are lease and non-lease components within a contract accounted for?**

   Lessees should allocate the lease consideration to each component based on relative stand-alone prices. As a practical expedient, lessees may elect not to separate lease and non-lease components, such as maintenance services, and account for these components as a single transaction. This will however result in a higher right-of-use asset and lease liability.

   No practical expedient is available for lessors. Accordingly, they are required to separate lease and non-lease components. The allocation to each component is based on the relative stand-alone selling prices (concept under the SFRS(I) 15/FRS 115 revenue standard).

3. **How is the lease of low-value assets exemption applied?**

   Lessees may apply, on a lease-by-lease basis, the low-value lease asset exemption whereby instead of recognising a ROU asset and corresponding lease liability, entities may recognise the lease payments as expenses on a straight-line basis.

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[7] The list above is not exhaustive. Refer to SFRS(I) 16/FRS116 for the full list of disclosure requirements.

[8] The list above is not exhaustive. Refer to PwC Manual of accounting for updated list of frequently asked questions.

The new leasing standard does not define what is 'low-value'. Entities should focus on the nature of the asset in the context of their business. Examples of low-value items may be tablets, personal computers, small items of office furniture and telephones. The International Accounting Standards Board ("IASB") had in mind that low-value assets are, when new, approximately USD 5,000 or less. This is however not a quantitative threshold as the focus should be on the nature of the asset.

Be aware that a lease does not qualify for low-value lease exemption if a lessee sub-leases, or expects to sub-lease, the leased asset.

## Measurement

### 4. How are variable rent leases by JTC Corporation accounted for?

Many entities in Singapore have operating leases with JTC Corporation that are accounted for under the new standard. JTC leases typically includes clauses where the annual rent is subject to revision based on prevailing JTC-posted rates. The Institute of Singapore Chartered Accountants ("ISCA") has released a Tech Bite that concluded that JTC-posted rates may be considered as market rates, and accordingly should be considered a variable lease payment that is dependent on an index or rate.[9]

### 5. What is incremental borrowing rate?

Incremental borrowing rate is the rate of interest that a lessee would have to pay to borrow over a similar term and with similar security, the funds necessary to obtain an asset of a similar value to the ROU asset in a similar economic environment. The new leasing standard does not prescribe how the incremental borrowing rate is determined, as it is entity specific.

### 6. How do termination and extension options affect the lease term?

The lease term includes the non-cancellable period for which the lessee has the right to use an underlying asset. Periods covered by an option to extend the lease term are included in the lease term if the lessee is reasonably certain to exercise that option. The period covered by a termination option is included in the lease term if the lessee is reasonably certain not to exercise the option. Factors to consider include the contractual terms of the lease as compared to market conditions, whether significant leasehold improvements have been incurred by the lessee, costs related to terminating or replacing the leased asset and the importance of the underlying asset to the lessee's operations.

### 7. How are lease modifications accounted for?

A lease modification is a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions. Scope changes include increasing or decreasing the underlying assets in the agreement and modifying lease terms. The accounting varies depending on how the lease is modified, which often results in either a re-measurement of the lease liability and ROU asset or recognition of a separate lease. Decreases in scope may result in amounts being recognised in the P&L relating to the partial or full termination of the ROU asset.

A new lease agreement relating to an existing leased asset could in-substance be a modification of the existing lease and should be carefully analysed to determine the accounting implication.

### 8. What are the tax implications of the new leasing standard in Singapore?

Under the new leasing standard, a lessee records a ROU asset and the corresponding lease liability on balance sheet at lease commencement. Lease expense is reflected in the P&L as depreciation of ROU asset and interest expense. However, for the purpose of income tax computations, tax deductions continue to be on a cash basis as lease payments are made. This creates a timing difference between the accounting and tax profits. Therefore, entities will need to consider the deferred tax implications whereby entities can currently either:

I. Apply the initial recognition exemption under SFRS(I) 1-12/FRS 12 Income Taxes and no deferred tax is recognised; or

II. Account for deferred taxes on the temporary differences arising from the ROU asset and lease liability.

[9] Refer to ISCA Tech Bite for further information https://journal.isca.org.sg/2019/03/07/technical-bite-size-guidance-frs-116/pugpig_index.html

Note that the IASB has proposed a narrow scope amendment to IAS 12 Income Taxes. If approved, it is likely that SFRS (I) 1 – 12/FRS 12 Income Taxes would similarly be amended and make option I unacceptable. This proposed amendment is expected to be applied retrospectively once approved[10].

### 9. What is the useful life of the right-of-use asset?

The lessee calculates the ROU asset depreciation in accordance with SFRS(I) 1-16/FRS16 Property, Plant and Equipment. The ROU asset is depreciated over the shorter of the lease term and the useful life of the ROU asset if ownership of the asset is not transferred at the end of the lease term. When there is a transfer of ownership or purchase option that is reasonably certain to be exercised at the end of the lease term, the lessee depreciates the ROU asset over the useful life of the underlying asset.

### 10. How is impairment of the right-of-use asset determined?

A lessee should apply SFRS(I) 1-36/FRS 36 Impairment of Assets to determine whether the ROU asset is impaired and to account for any impairment loss identified.

### 11. How are ROU assets that meet the definition of IP accounted for?

Such ROU assets are initially held at cost, in line with the requirements set out in the new leasing standard and subsequently remeasured to fair value if the fair value model is applied. Subsequent remeasurement of a leased asset from the amount initially recognised (cost) to fair value should not typically result in an initial gain or loss.

Entities should also take note that the discount rates applied for the initial recognition of the leased assets may not necessarily equate to the discount rate applied by valuers in property valuations.

## Group consolidation

### 12. Subsequent to the transition to the new leasing standard, how are leases acquired as part of a business combination accounted for?

In accordance with SFRS(I) 3/FRS 103 Business Combinations, the acquiring entity is required to measure the lease liability at the present value of the remaining lease payments as if the acquired lease were a new lease at the date of acquisition. The ROU asset is measured at the same amount as the lease liability, adjusted to reflect any favourable or unfavourable terms of the lease when compared with market terms. The acquirer may apply the short-term and low-value lease exemption to leases it acquires as part of a business combination. In the separate financial statements of the acquired entity, the lease is accounted for at the original lease commencement date.

As a result, entities need to be aware that the same lease may be accounted for differently in the Group accounts as compared to the separate financial statements of the acquired entity.

### 13. How has the new standard affected consolidation journal entries?

In preparing the consolidated financial statements, additional consolidation journal entries may be required as a result of the new standard. Examples of new consolidation journal entries include:

- Adjustments for leases acquired as part of a business combination as outlined above.
- Entries to eliminate intragroup operating leasing arrangments including the elimination of lease income, ROU asset, lease liability, and the associated depreciation and interest expense.

## VI. Other Available Resources

For additional information regarding the new leasing standard, refer to the below publications.

- IFRS 16 – A new era of lease accounting: PwC In depth INT2016-01[11]
- IFRS 16, 'Leases' – interaction with other standards: PwC In depth INT2019-02[12]
- PwC Illustrative Annual Report

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[10] Refer to IASB update for further information. https://www.ifrs.org/projects/work-plan/deferred-tax-tax-base-of-assets-and-liabilities/#current-stage

[11] https://inform.pwc.com/s/IFRS_16_A_new_era_of_lease_accounting_PwC_In_depth_INT2016_01/informContent/1647022702109561

[12] https://inform.pwc.com/ifrs-16-leases-interaction-with-other-standards-pwc-in-depth-int2019-02

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# Acknowledgements


The Quick read – New Leasing Standard under SFRS(I) 16/FRS 116 publication represents the efforts and ideas of many individuals within PwC. The following PwC people contributed to the content or served as technical reviewers of this publication:

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