
What Company Directors Should Know About MFRS 16 LEASES

By MASB secretariat
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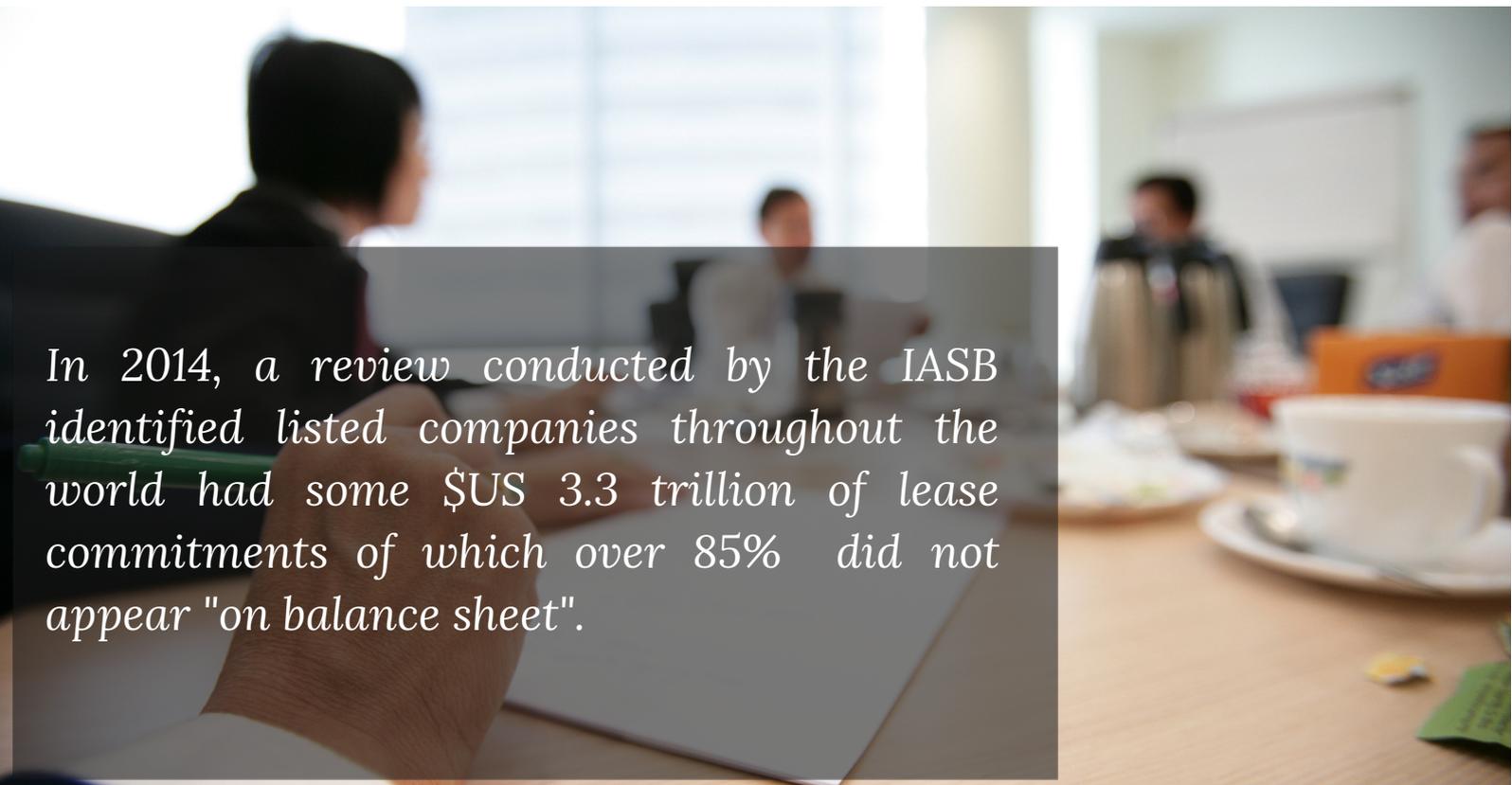


Operating leases no longer “off balance sheet”

In April 2016 MASB issued MFRS 16 *Leases* in response to the International Accounting Standards Board (IASB) issuing IFRS 16 *Leases* in January 2016. MFRS 16 is a word-for-word adoption of IFRS 16 and applies to financial reporting years beginning on or after 1 January 2019. Consequently, the requirements of MFRS 16 have impacted first quarter reporting by listed entities with a 31 December 2019 year end and therefore it is timely to remind directors of listed entities, investors, financiers and others interested in the capital markets of the impact of MFRS 16.

MFRS 16 replaces MFRS 117 which required both lessees and lessors to classify leases as finance leases or operating leases. Under MFRS 117, lessees would recognise finance leases “on balance sheet” whereas operating leases remained “off balance sheet” (with lease commitments only disclosed in notes to the financial statements). However, the new Standard, MFRS 16, requires lessees to recognise all leases “on balance sheet”, with a few practical exceptions. The requirements for lessors under MFRS 16 remain largely unchanged from MFRS 117.

Why the change by IASB?



In 2014, a review conducted by the IASB identified listed companies throughout the world had some \$US 3.3 trillion of lease commitments of which over 85% did not appear "on balance sheet".

For lessees, the finance lease/operating lease distinction, which applied under both international accounting standards (with which MFRS 117 was consistent) and US generally accepted accounting standards, became the subject of increasingly strong criticism from investors and others as it made comparison between companies difficult. This was particularly the case for certain industries where the leasing of assets was an inherent aspect of the funding model such as aircraft leases in the airline industry and store leases in the retail industry.

In response to these concerns, the IASB conducted a review which identified that in 2014, listed companies throughout the world had some \$US 3.3 trillion of lease commitments of which over 85% did not appear "on balance sheet". The review also found that in order to make comparisons between companies that leased assets and those that borrowed to buy assets, investors, credit rating agencies and others made adjustments to balance sheets for the leased assets but these adjustments usually overstated, and in some cases understated, the value of the off balance sheet leases.

Consequently, it was resolved to address these problems by requiring lessees to recognise all leases "on balance sheet" to increase the transparency around the extent of lessees' assets and liabilities rather than have this driven by the way in which assets were financed.

Why the change by IASB?

MFRS 16 removes for a lessee, the classification of leases as either operating or finance, with all leases being regarded as finance leases except for leases with a duration of less than 12 months or for low-value assets such as personal computers.

At the inception of a lease, a right-of-use asset representing the leased asset is recognised on the balance sheet at cost which, in most cases, equates to the related liability for future lease payments. That liability is recognised on the balance sheet at the present value of the future lease payments under the lease using the discount rate inherent in the lease. In subsequent periods, the right-of-use asset is depreciated over the term of the lease or its useful life dependent upon whether the lease contains an option to purchase the lease which the lessee is reasonably certain it will exercise. The liability is increased for the interest charge inherent in the lease for the period but reduced by the amount of lease payments during the period. Depreciation on the right-of-use asset and interest on the lease liability is recognised in the statement of net income. This compares with the MFRS 117 treatment of recognising lease payments as expenses in the statement of net income.

Possible implications

The pattern of expense recognition will often be affected by the move to MFRS 16 accounting. As a result, certain key indicators of operating performance such as earnings before interest, tax, depreciation and amortisation (EBITA) will change.

In addition to changes to EBITA, other key financial ratios such as gearing ratios will be affected due to the fact that more lease liabilities will now be recognised on balance sheet. Changes such as these may impact upon loan covenants and may have other implications for items such as the determination of executive bonuses based on attaining pre-determined operating performance benchmarks.



The impacts of MFRS 16 on each particular lessee will depend on the circumstances, including the lifecycle stage of its lease contracts. Early in the life of a lease contract, the lease liability and related interest expense will be larger than later in the life of a lease contract. However, in general, the depreciation of the right-of-use asset might be relatively stable throughout the life of a lease contract. This compares with the previous (MFRS 117) treatment of an operating lease where in many cases, the lease payments (expenses) were spread evenly over the life of the lease contract.

A desktop review of the Quarterly Announcements by some public listed companies (PLCs) which have substantial operating lease arrangements under MFRS 117 demonstrated the following impacts.

	Financial Year-End	Quarter Report	Total lease liabilities/Total Liabilities	Analysis of Impact (% of increase against comparable quarter)		
				Total Liabilities	Finance Cost	Total Depreciation
PLC 1	31-Dec-2018	31-Mar-2019	46%	81%	324%	60%
PLC 2	31-Dec-2018	31-Mar-2019	47%	91%	337%	143%
PLC 3	31-Oct-2018	31-Jan-2019	51%	69%	641%	554%
PLC 4	31-Dec-2018	31-Mar-2019	46%	75%	48%	143%
PLC 5	31-Dec-2018	31-Mar-2019	58%	138%	1112%	686%

Preparing for the change

Although MFRS 16 has substantial impact on lessees, it has little impact upon accounting by lessors although it may affect over time how companies elect to finance acquisition of some assets.

For lessees, it is expected that additional costs will be incurred in implementing the changes. The size and nature of those costs will depend on the number and complexity of leases and the extent to which existing management information systems already gather the relevant information needed for applying MFRS 16. It will be necessary to review in detail the terms of each lease with a view to identifying the lease period and any option to extend each lease and the likelihood the lease will be extended as this affects the amount of the liability recognised in the balance sheet. Similarly, if readily determinable, the interest rate inherent in each lease will be used to calculate the present value of the lease and the amount and pattern of interest recognised. In the event the interest rate inherent in the lease cannot be readily determined, the lessee will need to determine an incremental borrowing rate for the purpose of calculating interest expense. It will also be necessary to determine the cost and effective useful life of each underlying right-of-use asset to establish the amount to be recognised in the balance sheet and income statement for the asset and depreciation.

To minimise the cost of applying MFRS 16, a lessee can also identify short term leases and those covering low-value assets which can continue to be treated as they were under MFRS 117.

The work involved in the collection and maintenance of this data will naturally vary across industries and according to the financing policies adopted by individual companies, but they are likely in many cases to include changes to systems. At a minimum, the changes to MFRS 16 will impact financial reporting and hence shareholders and other interested stakeholders.

Given this, it is important that directors and others responsible for company governance ensure they now understand and monitor the impact and implementation of MFRS 16 on a timely basis.

Further considerations



Although the deadline for lodging quarterly reports with Bursa Malaysia has passed for companies with a 31 December year end, it is advisable to now reassess the changes which have occurred since the previous quarter and corresponding period last year in the figures disclosed in the first quarter report for interest expense, depreciation and amortisation and borrowings (including the allocation between short and long term).

An examination of the reasons for these changes will assist in ensuring that the impact of MFRS 16 has been adequately reflected in these disclosures and communications with shareholders and other stakeholders. It may also facilitate a wider review of other financial policies such as foreign currency hedging. Whilst MFRS 16 is not expected to result in significant economic changes, there may be some consequences resulting from, for example, leases now being on balance sheet where some of the leases are denominated in a foreign currency similar to those which currently exist for other foreign currency borrowings.



Islamic finance arrangements

The IASB has established an Islamic Finance Consultative Group. The Group, which includes representatives from MASB, met in March 2018 to consider a paper prepared by MASB on how MFRS 16 might apply to three examples of Islamic Financial Institutions (IFI) arrangements. The key focus of the paper was on whether IFIs are acting in the capacity of lessors in three examples that essentially involve arrangements for the provision of financial services to customers that are widely used in Malaysia. For these arrangements, the paper concluded that an IFI is not a lessor under MFRS 16 with a key consideration in arriving at this conclusion being that an IFI did not obtain control of the underlying asset, and the arrangements constitute non-lease lending.

In the context of lessees, the IASB representatives at the Group meeting noted that, applying IFRS 16, a lessee may have the right to use the underlying asset even if the lessor never controlled the underlying asset.

The Group noted the importance of considering the individual fact patterns for each transaction in determining the appropriate accounting treatment.

Action checklist

- Have all leases been reviewed and their terms documented?
- Have all short-term leases and leases for assets of low value been separately identified?
- Has the interest rate inherent in each lease been calculated (or the incremental borrowing rate determined)?
- Has consideration been given to whether the lease contains an option to extend or purchase the asset at the end of the lease term and is this reasonably certain to be exercised?

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- Have the interest expense on leases and depreciation on the related right-of-use assets been separately identified and disclosed?
 - Has adequate consideration been given to the impact on loan covenants and gearing ratios?
 - Have information systems been upgraded to the extent necessary to produce the data needed to comply with the presentation and disclosure requirements?
 - Has the impact on net income and the balance sheet been adequately explained to investors and other interested stakeholders?

Conclusion

The mission of MASB is to develop and promote high quality accounting and financial reporting standards that are consistent with international best practice for the benefit of users, preparers, auditors and the public in Malaysia.

Whilst replacing the previous lease accounting standard with MFRS 16 will involve some challenges and costs for companies impacted by the change, it will enhance the credibility of their financial reporting in the eyes of investors both locally and internationally.

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