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An Executive Summary of MFRS 16 Leases

By Tan Liang Tong

"They are off-balance sheet, I will put them on, says MFRS 16 Leases"

1. Why is lease accounting changed?

In April 2016, the MASB issued MFRS 16 *Leases* to introduce a new model for lessee accounting. The effective date of MFRS 16 is 1 January 2019. The new model would affect reporting entities with significant off-balance sheet leasing activities and may bring about fundamental changes to their current practice on operating leases.

Users of financial statements have consistently expressed concerns that the current IAS 17 has resulted in many assets and liabilities under lease contracts not being recognised on the balance sheet (i.e. off-balance sheet). The IASB noted that listed companies using IFRS or US GAAP disclosed almost US\$ 3 trillion of off-balance sheet lease commitments in 2014. In 2005, the US Securities and Exchange Commission (SEC) expressed concerns about the lack of transparency of information on lease obligations, reiterating concerns already expressed by investors and other users of financial statements.

2. Main features of MFRS 16

For lessee accounting, MFRS 16 applies a *"right-of-use"* approach which requires a lessee to recognise assets and liabilities for the rights and obligations created by lease contracts. This approach reflects that, at the commencement date of a lease, the lessee obtains a right to use an underlying asset for a period of time, and the lessor makes the underlying asset available for use by the lessee. With this approach, there would no longer be a distinction of finance leases and operating leases for lessee accounting. The new Standard would have the effect of recognising all lease assets and lease liabilities, including those that are currently treated as off-balance sheet operating leases.

For lessor accounting, MFRS 16 retains the *"rights and rewards"* approach of the current Standard on leases i.e. MFRS 117. The new MFRS basically carries forward the lessor accounting requirements in MFRS 117, and hence, there will be no significant changes to lessor accounting, except for some improved or enhanced disclosures.

3. Key Requirements

The definition of a lease has been changed to a contract, or part of a contract, that conveys to the customer the right to use an asset (the underlying asset) for a period of time in exchange for consideration. A lease exists when the customer controls the use of the identified asset throughout the period of use. This is when the customer has the right to: (a) obtain substantially all of the economic benefits from the use of the identified asset throughout the period of use; and (b) direct the use of the identified asset throughout that period.

At the inception of a contract, an entity shall determine whether that contract is, or contains, a lease, by assessing: (a) whether the fulfilment of the contract depends on the use of an identified asset; and (b) whether the customer controls the use of the identified asset. These conditions require a series of tests, such as whether: (i) there is an identified asset, (ii) the customer has the rights to all of the economic benefits from that asset, and (iii) the customer directs the use of that asset, including how and for what purpose.

At the commencement date, a lessee shall recognise a right-of-use asset and a lease liability. The right-of-use assets shall be measured similarly to other non-financial assets (such as property, plant and equipment) and lease liabilities similarly to other financial liabilities. Therefore, the right-of-use asset shall be measured initially at cost. Subsequently, it shall be measured at cost, unless the lessee elects to apply the fair value model for leases of investment property or the revaluation model for leases of particular classes of property, plant and equipment. The lease liability shall be measured by applying the amortised cost effective interest method in accordance with MFRS 9. As a consequence, a lessee recognises depreciation of the right-of-use asset and interest on the lease liability.

Assets and liabilities arising from a lease are initially measured on a present value basis. The measurement includes non-cancellable lease payments (including inflation-linked payments), and also includes payments to be made in optional periods if the lessee is reasonably certain to exercise an option to extend the lease, or not to exercise an option to terminate the lease.

4. Are there any exemptions?

Some respondents had commented that the recognition and measurement requirements can be cumbersome and costly to apply for short-term leases and low-value assets but with little benefit because the effect on profit or loss is about the same as the current treatment for operating leases. Consequently, MFRS 16 provides exemptions for lessees of short-term leases and low-value assets from applying the requirements of MFRS 16, whereby a lessee may elect to recognise the lease payments as expense in the profit or loss on a straight-line basis (or another systematic basis) over the lease term.

Short-term leases are leases that, at the commencement date, have a lease term of 12 months or less. The 12-month criterion shall include not just the non-cancellable lease period, but also any period covered by an option to extend, or an option not to terminate, a lease if the option to exercise the extension option or not to terminate a lease is reasonably certain.

Low-value assets shall be assessed on the absolute basis of the value of an asset when it is new, regardless of the age of the asset being leased or whether those leases are material to the lessee (i.e. the materiality concept does not apply in this assessment). For example, leases of motor vehicles would not qualify as leases of low-value assets because a new motor vehicle would typically not be of low value. Examples of low-value assets may include tablets, personal computers, and small items of office furniture and telephones.

5. Transitions

MFRS 16 provides for numerous transitional requirements and practical expedients. It requires that a lessee shall apply the Standard to its leases either:

- (a) retrospectively to each prior reporting period presented; or
- (b) retrospectively with the cumulative effect of initially applying MFRS 16 recognised at the date of initial application (“modified retrospective approach”).

6. Implications

The new MFRS 16 is expected to address the weaknesses and deficiencies in MFRS 117. The right-of-use model for lessee accounting would resolve the long-debated concern surrounding off-balance sheet financing. With MFRS 16, a lessee is required to recognise assets and liabilities for all leases with terms of more than 12 months, unless the underlying asset is of low value. This would affect the current practice of many entities with significant operating lease arrangements. For example, airline entities and shipping entities that currently treat rental of airplanes and ships as operating leases would be required to recognise the airplanes and ships as right-of-use assets and corresponding lease liabilities in the statement of financial position. Similarly, a utility entity that purchases power or energy in a concession arrangement might need to recognise a right-of-use asset on the power plant and a corresponding lease liability.

The adoption of MFRS 16 is expected to be significant for companies with material off-balance sheet leases. Key performance and reporting ratios (such as financial leverage, gearing ratio, etc.), credit ratings, compliance of borrowings covenants and capital management, amongst others, may be affected. Hence, such companies would need to quickly assess the extent of the Standard's impacts so that the wider business implications, if any, can be addressed promptly. For example, terms of lease arrangements and borrowing covenants may need to be re-negotiated and capital management policy may need to be reviewed.

The scope of the MFRS 16 is wide as it covers all contracts that convey an entity with a right to use an asset. A reporting entity would need to reassess all its contracts with counterparties to determine whether the contracts contain any embedded lease component. These may include outsourcing, sale or purchase contracts that contain a right to use an asset and manufacturing or service contracts that contain lease components.

For lessee accounting of an individual former off-balance sheet lease, MFRS 16 would result in a different total expense recognition pattern compared to MFRS 117. This is because interest expense is typically higher in the earlier years of a lease than in the later years. When combined with typically straight-line depreciation of lease assets, this results in a total lease-related expense (interest plus depreciation) that is higher than a straight-line lease expense during the first half of the lease term. The opposite is true in the second half of the lease term. Over the lease term, the total amount of expense recognised is the same.

MFRS 16 would provide a more complete picture of lessees' leasing arrangements. Capturing all lease assets and liabilities in the statement of financial position would result in greater transparency in financial reporting and enable users of financial statements to compare and analyse the financial statements of reporting entities better. For lessees, there will be increased costs of compliance (for example, costs to gather information and record operating leases that were previously off-balance sheet, costs to re-negotiate lease contracts and costs to change the accounting systems to capture the needed financial information for financial reporting purpose). However, the benefits to users of financial statements, in terms of improved financial reporting and disclosures, are expected to significantly exceed costs.

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