Get ready for MFRS 16
A new accounting standard for leases
Get ready for MFRS 16
A new accounting standard for leases
Background

MFRS 16 Leases is intended to provide greater transparency by eliminating off-balance sheet leasing transactions.

MFRS 16 requires that a lessee applies a “right-of-use asset” accounting approach that would recognise an asset on the lessee’s balance sheet, representing its right to use the leased asset over the lease term, and recognise a corresponding liability to make lease payments. As such, a lessee’s current operating lease accounting model will be significantly changed, where its balance sheet will show an increase in both assets and liabilities, and its expense pattern will change from a generally straight-line operating lease expense, to a front-end loaded expense pattern arising from interest costs and asset amortisation. Key performance metrics such as return on assets, gearing ratios and EBITDA will be impacted significantly as a result.

The lessor accounting model will largely be unchanged from the application under current guidance. The changes aim to primarily align with the newly issued revenue recognition guidance, as leasing is fundamentally a revenue-generating activity for lessors. The new standard will also require additional disclosures related to the lessor’s exposure to asset risk and credit risk.

MFRS 16 is mandatorily effective for annual periods beginning on or after January 1, 2019 and will replace the existing MFRS 117 and its related interpretations. Early adoption is permitted, provided that the new revenue standard MFRS 15 has also been applied.

Entities should plan for the implementation early to manage the significant changes and implications arising from the new standard.
A quick glance at the standard

A lease conveys the right to control the use of an identified asset for a period of time in exchange for consideration.

An identified asset may be explicitly or implicitly specified in a contract. If a supplier can substitute the asset and has both the practical ability to do so and the supplier would benefit economically from doing so, such right is a substantive substitution right and thus the contract is not or does not contain a lease.

Contract must convey a right to control the identified asset, which is conveyed through the entity’s right to (1) obtain substantially all of the economic benefits from the asset’s use and (2) right to direct the use of the identified asset.

Lessees can elect not to recognise a lease liability and right of use asset for leases (1) with a lease term of 12 months or less and containing no purchase options – this election is made by class of underlying asset; and (2) where the underlying asset has a low value when new – this election can be made on a lease-by-lease basis.

Balance sheet

Asset = “Right-of-use” of underlying asset
Liability = Obligation to make lease payments.

P&L

Lease expense = Depreciation + Interest = Front-loaded total lease expense

• Impact on Balance Sheet is that companies with operating leases will appear to be more asset-rich, but also more heavily indebted.
• Impact on the P&L is that the total lease expense will be front-loaded even when cash rentals are constant.
• Impact on financial ratios

<table>
<thead>
<tr>
<th>Profit/Loss</th>
<th>Balance sheet</th>
<th>Ratios</th>
</tr>
</thead>
<tbody>
<tr>
<td>EBITDA</td>
<td>Total assets</td>
<td>Gearing</td>
</tr>
<tr>
<td>EPS (in early years)</td>
<td>Net assets</td>
<td>Interest cover Asset turnover</td>
</tr>
</tbody>
</table>
Operational and implementation challenges may be significant

The new standard will likely present several key implementation challenges for entities (particularly lessees) in addition to technical accounting challenges. For large entities, these could be overwhelming if not planned early. These potential operational challenges include:

**Policy formulation**
An entity's finance team should be well equipped with the knowledge of MFRS 16 in order to formulate and document the accounting policies for leasing transactions on initial and subsequent application of the new standard. This will involve adequate training of the finance teams and communication to key stakeholders within the organisation on the potential impact of the new accounting. Entities will have to manage the commercial impact arising such as gearing ratios, KPI measurement and factor them in their future decision-making process.

**Data challenges**
Many companies have numerous lease agreements across multiple decentralised locations and, in many instances, the lease data is maintained in spreadsheets or manual documents. Consequently, the collection and extraction of data can be a resource-intensive effort and may represent a longer lead-time activity for companies with higher lease volumes. A decentralised information repository may be critical to the development of a complete inventory of leases.

**Information Technology (IT) systems**
The new standard will likely require enhancements to an entity’s existing IT infrastructure to comprehend the storage, calculation, and reporting requirements. Companies should consider whether to develop functionality within an existing enterprise resource planning system or implement new modules or systems in order to comply with the new standard. Given the long lead times of system initiatives, other bridge solutions may also be needed.

**Process**
The efforts to migrate to the new system or change over the existing system are often given primary consideration, but the vital component of data maintenance cannot be overlooked. Entities should also consider establishing new controls, overcoming design challenges, creating customised reports, and conducting adequate training when outlining the implementation process. Furthermore, asset valuation frequently proves to be a challenge. Outside experts may be needed to support the process of determining an accurate measurement of assets, providing a consistent valuation framework, and delivering ongoing support. All these activities require significant resources and, in particular, time.

**Limited time frame**
Time is truly of the essence. As the effective date, January 1, 2019 approaches, the most important action an entity can take is to start the efforts related to this accounting change now. It can be a challenge to anticipate the data gaps and overcome the data extraction hurdle. But with adequate support and sufficient time, it can be achieved.
Implementation of MFRS 16 in Malaysia

MFRS 16 is mandatorily effective for annual periods beginning on or after January 1, 2019 and will replace the existing MFRS 117 and its related interpretations. Early adoption is permitted, provided that the new revenue standard MFRS 15 has also been applied. Entities should plan for the implementation early to manage the significant changes and implications arising from the new standard.

Getting started

Some effective first steps to consider as you begin to evaluate the implications of the new standard may include:

- Perform a current state assessment of the entity’s lease landscape, including lease volumes and types; availability of electronic lease data and data gaps; and consideration of any potential accounting, tax, and process-related challenges.
- Identify resources and development of a cross-functional project team to coordinate implementation activities. Conduct training to the new standard implementation project team.
- Establish a granular project plan and roadmap to manage the efforts as needed across multiple functions, business units, and countries.
- Develop approach and resources for the lease data extraction efforts.
- Deliberation of accounting policies for initial and subsequent applications.
- Formulate and document accounting policies.
- Determine the company’s specific system requirements and develop a plan for enhancing system capabilities to comprehend the new storage, calculation, and reporting requirements of the new standard.

How Deloitte can help

Impact Assessment

In line with your individual requirements and using checklists and preliminary analysis, we develop the best approach to introducing MFRS 16.

Contract Analysis

We support you in extracting existing contract information for relevant data items to allow efficient contract management.

For entities with a large number of contracts, our Kira solution for lease contract extractions make detailed reviews of leases easier, allowing users to complete lease reviews in half the time.

Strategy

Together, we have a look at what effects MFRS 16 has on the current leasing strategy in your organisation, and work out an appropriate response in the most timely and cost efficient manner.

Training

We provide training through interactive workshops to equip finance teams with the knowledge to apply the new standard confidently. We provide illustrative tools to help finance teams formulate and document their accounting policy assessment.

Processes and Systems

We identify the processes affected by the changes and support you in adjusting the relevant process steps and interfaces, including impact or changes required to your financial or ERP systems.

Communication

We support you in communicating the impact of the new standard and the implemented changes both to external parties and within your organisation.
Contacts

Izzad Shamsudin  
Partner  
ishamsudin@deloitte.com  
+60 3 7610 8989

Mohamad Faisal Rasheed  
Director  
mrasheed@deloitte.com  
+60 3 7610 8081

Foo Mei Yin  
Senior Manager  
mefoo@deloitte.com  
+60 3 7610 8783

Choo Yung Siong  
Senior Manager  
yuchoo@deloitte.com  
+60 3 7610 7991

Northern Region

Muhammad Fairoz Abd Bahrin  
Senior Manager  
+60 4 218 9888  
mabahrin@deloitte.com

General enquiries at mybusinessadvisory@deloitte.com.
Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited ("DTTL"), its global network of member firms, and their related entities. DTTL (also referred to as "Deloitte Global") and each of its member firms are legally separate and independent entities. DTTL does not provide services to clients. Please see www.deloitte.com/about to learn more.

Deloitte is a leading global provider of audit and assurance, consulting, financial advisory, risk advisory, tax and related services. Our network of member firms in more than 150 countries and territories serves four out of five Fortune Global 500® companies. Learn how Deloitte's approximately 286,000 people make an impact that matters at www.deloitte.com.

About Deloitte Southeast Asia
Deloitte Southeast Asia Ltd – a member of Deloitte Touche Tohmatsu Limited comprising Deloitte practices operating in Brunei, Cambodia, Guam, Indonesia, Lao PDR, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam – was established to deliver measurable value to the particular demands of increasingly intra-regional and fast growing companies and enterprises.

Comprising approximately 340 partners and 8,800 professionals in 25 office locations, the subsidiaries and affiliates of Deloitte Southeast Asia Ltd combine their technical expertise and deep industry knowledge to deliver consistent high quality services to companies in the region.

All services are provided through the individual country practices, their subsidiaries and affiliates which are separate and independent legal entities.

About Deloitte Malaysia
In Malaysia, services are provided by Deloitte PLT (LLP0010145-LCA) (AF0080), a limited liability partnership established under Malaysian law, and its affiliates.

Disclaimer
This communication contains general information only, and none of Deloitte Touche Tohmatsu Limited, its member firms, or their related entities (collectively, the "Deloitte Network") is, by means of this communication, rendering professional advice or services. Before making any decision or taking any action that may affect your finances or your business, you should consult a qualified professional adviser. No entity in the Deloitte Network shall be responsible for any loss whatsoever sustained by any person who relies on this communication.

© 2018 Deloitte PLT