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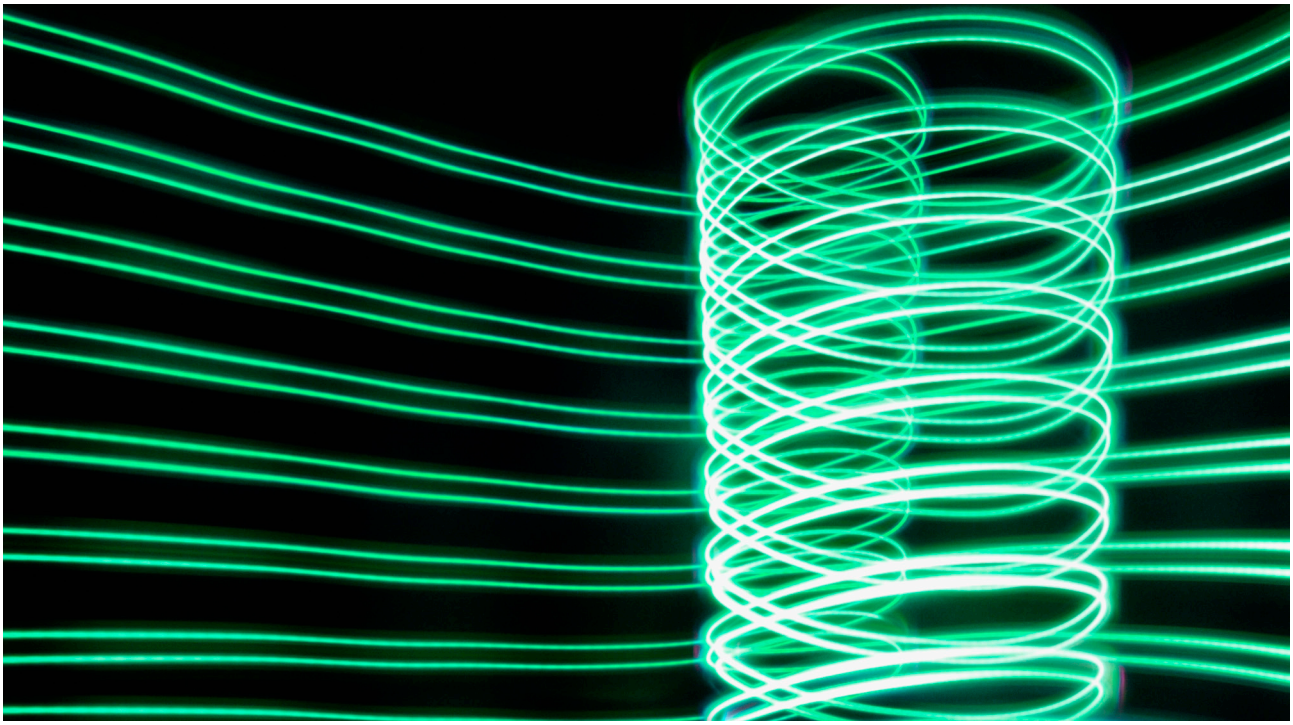
Get ready for MFRS 16

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

Right to control the use

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

Identified asset

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.

Right to control

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.

Short-term and low value lease exclusion

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.

Note: The standard applies to all leases, including subleases, except for leases to explore for or use non-regenerative resources, leases of biological assets, service concession arrangements, licenses of intellectual property granted by a lessor, rights held by a lessee under licensing agreements for items within the scope of IAS 38 Intangible Assets.

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

	Profit/loss	Balance sheet	Ratios
↑ $	EBITDA	Total assets	Gearing
↓ $	EPS (in early years)	Net assets	Interest cover Asset turnover

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.

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.

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.

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.

Deloitte Anaplan IFRS 16 App is a cloud hosted "plug & play" solution enabling fast implementation and interaction with any existing consolidation and ERP platform.

- Customisable and easy to use interface, with a good audit trail.
- Features a lease dashboard that allows a general analysis of lease data, lease accounting calculations, and individual and consolidated disclosures, including MFRS 16 transition options analysis.

Communication

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

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