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Insights into FRS 116: Major changes to lease accounting

This publication explains the key changes to the accounting for leases by lessees and provides practical insights into its application and impact.

Introduction

From 1 January 2019, SFRS(I) 16 or FRS 116 Lease (collectively referred as FRS 116) is effective in Singapore for listed and unlisted companies respectively. The standards are aligned with IFRS 16 Leases issued by the IASB.

FRS 116 will require lessees to account for leases 'on-balance sheet' by recognising a 'right-of-use' asset and a lease liability. For any businesses, however, exemptions for short-term leases and leases of low value assets is expected to greatly reduce the impact.

FRS 116 also:

- changes the definition of a lease
- sets requirements on how to account for the asset and liability, including complexities such as non-lease elements, variable lease payments and option periods
- changes the accounting for sale and leaseback arrangements
- largely retains FRS 17's approach to lessor accounting
- introduces new disclosure requirements.

IFRS 16 (and FRS 116) represents the first major overhaul of lease accounting for over 30 years. The IASB has long believed that IAS 17's split between operating and finance leases is flawed, and has resulted in too much structuring and off-balance sheet financing. The IASB's solution has remained the same throughout the project: to do away with the operating versus finance lease distinction and account for all leases 'on-balance sheet'.

While many agree that reforms to lease accounting are long overdue, bringing all leases on-balance sheet is controversial. The IASB hopes to reduce controversy through various compromises – in particular by exempting short-term and low value asset leases. As a result businesses that lease only assets such as printers and laptops will face only a limited impact. For businesses that lease 'big-ticket' assets, such as property and high value equipment, this will however be a major change.

Whatever your views on the new Standard, businesses would be well-advised to start an impact analysis sooner rather than later.

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In this publication we focus on lessees and bring you up to speed on the Standard's new requirements on accounting for leases by lessees.

FRS 116: Summary of key changes

FRS 116 represents the first major overhaul of lease accounting in decades. The new Standard replaces FRS 17 'Leases' along with three Interpretations (INT FRS 104 'Determining whether an Arrangement contains a Lease', INT FRS 15 'Operating Leases-Incentives' and INT FRS 27 'Evaluating the Substance of Transactions Involving the Legal Form of a Lease').

FRS 116 will affect most companies that are involved in leasing, and will have a substantial impact on the financial statements of lessees of property and high value equipment.

The table summarises the main changes at a glance:

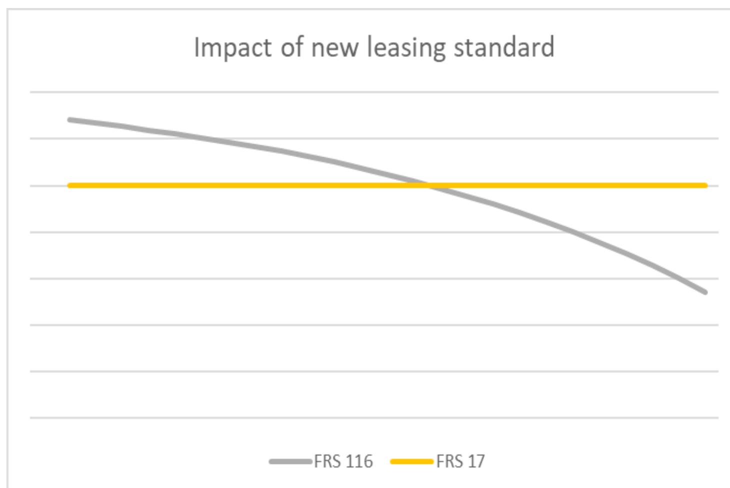
Issue	EFfect
Who is affected?	• entities that lease assets
What's the impact on lessees?	• all leases will be accounted for 'on-balance sheet', other than short-term and low value asset leases • lease expense will typically be 'front-loaded' • lease liability will exclude: - option periods unless exercise is reasonably certain - contingent payments that are linked to sales/usage and future changes in an index/rate
Other assets/exposures	• only minor changes from the current Standard – FRS 17
Are there other changes?	• a new definition of a lease will result in some arrangements previously classified as leases ceasing to be so, and vice versa • new guidance on sale and leaseback accounting • new and different disclosures
When are the changes effective?	• annual periods beginning on or after 1 January 2019 • various transition reliefs • early application is permitted if FRS 115 'Revenue from Contracts with Customers' is applied

As the new standard considers all leases as financing arrangements, a lessee would always recognize and present in the income statement amortisation of lease assets separately from interest on lease liabilities.

Impact on the balance sheet

For companies that currently have significant operating leases, the new lease standard is likely to result in increase in lease assets and corresponding lease liabilities and may have significant impact on key financial ratios derived from recognition of lease assets and liabilities (for example, leverage and performance ratios).

The following diagramme presents pattern of recognition of expense under the new and old leasing standards



Impact on the income statement

The impact on income statement of the new model will depend on the significance of leasing to the lessee and the length of its leases. EBITDA is likely to increase compared to the amounts reported today because, a lessee will present the implicit interest component operating lease payments as part of finance costs whereas, today, the entire lease expense is included within operating costs.

The net profit, however, is likely to decrease because interest expense is typically front loaded as the combined effect of amortization of lease asset and interest on lease liability is higher in the earlier years of a lease than in the later years and vice-versa. Over the lease term, the total amount of expense recognised remains the same.

Impact on the cash flow statement

Consistent with the balance sheet, the new model reduces operating cash outflows, with a corresponding increase in financing cash outflows for principal repayments, compared to the amounts reported today to reflect the economics of a financing arrangement.

Expected impact of various sectors

Major impact is expected on following sectors:

Airlines

Airline companies, as a common industry practice, finance aircrafts through sale and leaseback transactions, wherein the asset is sold and taken back on an operating lease. The guidance under FRS 116 will require companies to determine whether the sale of aircraft can be recognised under FRS 115 for such sale and leaseback transaction. If the transaction is determined to be a sale, then FRS 116 will require the recognition of leases on the balance sheet of airline companies. This could result in significant increase in lease assets and liabilities on day one.

Capital Goods

Companies in this sector generally enter into lease arrangement of land, warehouse facilities, offices and motor vehicles. FRS 116 will require the recognition of such operating leases in such transactions on the balance sheet.

Utilities

Power purchase agreements (PPA) will also need to be evaluated under the new leasing standard to determine if they meet the definition of lease. Such contracts may have to be segregated into lease and non-lease components and accounted for accordingly.

Telecommunication

Telecom companies often have leases of premises (such as land, offices, retail outlets, service centres and base stations) and network infrastructure (including tower sharing and contracts involving direct cable that is part of larger infrastructure). Under FRS 116 such contracts may meet the definition of an identified asset and will therefore be required to be accounted for on-balance sheet.

Consumer sector

Rental contracts for retail outlets meet the definition of lease under existing and new leasing standards. However, unlike the old standard, FRS 116 will require bringing these on the balance sheet. Further, in this sector, leases with variable payments (for example where lease payments that are dependent on the consumer price index or rate) are common and will need to be re-measured at each date of change of the future contractual cash flows. This recurring re-measurement may introduce volatility in the balance sheet. Another impact area is likely to be treatment of initial direct costs, such as commissions, which may have to capitalised as part of the right of use asset and amortized over the anticipated lease term. A third significant impact on the retail and consumer sector will be the arrangements with non-lease components such as property management, maintenance, etc which in some cases may have been bundled together as "operating lease" expense.

Scope

FRS 116 applies to all leases for both the lessee and lessor, except for a few scope exclusions. These exclusions, some of which are similar to FRS 17's, are summarised in the table:

Scope exclusion	Standard to apply
Leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources	None specified. Depending on the circumstances FRS 106 'Exploration for and Evaluation of Mineral Resources' or FRS 38 'Intangible Assets' might apply
Leases of biological assets in scope of FRS 41 held by a lessee	FRS 41 'Agriculture'
Service concession arrangements in scope of INT FRS 112	INT FRS 112 'Service Concession Arrangements'
Licences of intellectual property granted by a lessor in scope of FRS 115	FRS 115 'Revenue from Contracts with Customers'
Rights held under licensing agreements in scope of FRS 38 for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights*	FRS 38 'Intangible Assets'

** for leases of other types of intangible asset a lessee is permitted to apply FRS 116 but not required to do so*

In addition, FRS 116 provides optional accounting simplifications for short-term and low-value asset leases. These are discussed in the lessee accounting section below.

Practical insight – impact on investment property

Under FRS 17 and FRS 40 'Investment Property', a lessee of property classified as investment property applies:

- FRS 40 to its interest in the property if the lease is a finance lease (and can choose either the cost model or the fair value model)
- FRS 17 if the lease is an operating lease. However, an investor-lessee can alternatively elect to treat the lease as a finance lease and apply FRS 40's fair value model to its interest in the property.

FRS 116 makes extensive consequential amendments to FRS 40, including expanding its scope to include all investment property held under leases (including leases that would be classified as operating under FRS 17). FRS 116 also applies to these leases. As a result, an investor-lessee recognises a lease liability and a right-of-use asset. The 'right-of-use' asset is accounted for:

- at fair value in accordance with FRS 40 if the investor-lessee uses the fair value model for owned investment property; or
- otherwise at cost less depreciation and impairment in accordance with FRS 116.

The main change is therefore the accounting for investment property held under an operating lease (as defined by FRS 17). Under FRS 116 these leases can no longer be accounted for 'off-balance sheet' (unless the lease is short-term).

Definition of a lease

Because the new lease accounting results in many more leases being 'on-balance sheet', the evaluation of whether a contract is (or contains) a lease becomes even more important than today. FRS 116 changes the definition of a lease and provides new guidance on applying the definition.

In practice, the main impact of the new lease definition will be on contracts that are not in the legal form of a lease but involve the use of a specific asset and therefore might contain a lease – such as outsourcing, contract manufacturing, transportation and power supply agreements. Currently, this evaluation is based on INT FRS 104. FRS 116 replaces INT FRS 104 with new guidance that differs in some important respects.

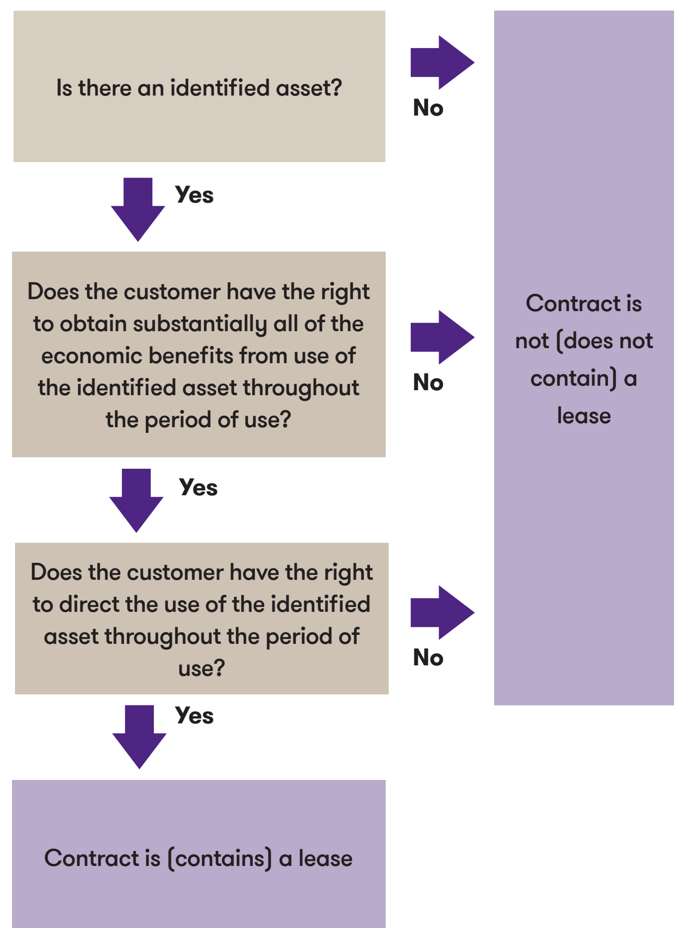
Practical insight – key changes from INT FRS 104

One of the main changes from INT FRS 104 is the relevance of pricing when evaluating whether a contract to supply goods or services contains a lease. Under INT FRS 104, such contracts do not contain leases if the unit price paid by the customer is either fixed or at fair value at the time of delivery. FRS 116 does not include this 'pricing exemption'.

As a result, some contracts that do not contain a lease today will do so under FRS 116, and vice versa. If a contract contains a lease, the lease component is accounted for on-balance sheet in the same way as a standalone lease (unless it is a short-term or low-value asset lease).

Applying the new definition therefore involves three key evaluations. These are summarised in the flowchart:

Flowchart: the three key evaluations



Lease definition:

Under FRS 116 a lease is defined as: 'a contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration'. A contract can be (or contain) a lease only if the underlying asset is 'identified'. Having the right to control the use of the identified asset requires having the right to:

- obtain all of the economic benefits from use of the identified asset; and
- direct the use of the identified asset.

The new Standard provides extensive guidance and illustrative examples to help apply this definition. The following table and simplified examples summarise the key points.

Component of definition	Guidance
Is there an identified asset?	• an asset is 'identified' if it is explicitly specified in the contract, or implicitly specified when made available to the customer • as asset is not identified if the supplier has a substantive right to substitute another asset • a physically distinct portion of an asset can be an identified asset but a portion of an asset's capacity cannot
Does the customer have the right to obtain substantially all of the economic benefits from use of the identified asset throughout the period of use?	• considers direct and indirect benefits such as using, holding, or sub-leasing the asset • considers only the economic benefits within the defined scope of a customer’s rights to use an asset
Does the customer have the right to direct the use of the identified asset throughout the period of use?	• normally present if the customer has the right to decide how and for what purpose the asset is used • if relevant decisions about use of the asset are predetermined, the customer has control if it (i) has the right to operate the asset; or (ii) designed the asset (or aspects of it) in a way that predetermines its use

Example 1 – Executive jet
A multi-national business (the customer) enters into a five-year contract with an aviation company for the exclusive use of a particular executive jet. The contract details the interior and exterior specifications for the jet. The aviation company is permitted to use an alternative aircraft but this would be uneconomic due to various factors such as the cost of customising the aircraft to meet the contractual specifications.

Subject to certain restrictions, the customer decides where the executive jet will fly and which passengers will use it. The aviation company operates the aircraft using its own crew.

Analysis
The contract contains a lease. The contract specifies an executive jet. The aviation company's right to substitute another aircraft is not substantive because it would be uneconomic to exercise this right. The customer decides how and for what purpose the jet is used which provides it with the right to control the use of the jet.

Example 1 – Ship
A car manufacturer enters into a contract with a shipping company to transport cars from Hamburg to Singapore. The contract specifies a particular ship and the cars to be transported, which will require the full capacity of the ship. The shipping company operates and maintains the ship and is responsible for the safe passage of the cars to Singapore. The car manufacturer is not able to make changes (eg to the destination or nature of the cargo) once the contract has been signed.

Analysis
The contract does not contain a lease. After signing the contract the customer is not able to direct how and for what purpose the ship is used and does not therefore control the use of the asset. The contract pre-determines how and for what purpose the ship will be used and the customer neither operates nor designed the ship.

Example 3 - Contract manufacturing
A retailer enters into a contract manufacturing arrangement with a manufacturer to supply an own-brand food product for a three-year period. The recipe, packaging and quantity of the food product are specified in the contract.

The contract does not specify which factory (or factories) will be used, but the manufacturer has only one suitable factory. Constructing another factory would not be viable. Fulfilling this contract will not require all of the factory's capacity.

The manufacturer makes all decisions about the operations of the factory, including how to utilise the available capacity and what output to produce with that capacity.

Analysis
The contract does not contain a lease. Although the contract implicitly specifies an asset (the one suitable factory), the retailer does not have the right to decide how this factory is used after the contract has been signed. The recipe, packaging and quantity of the food product are pre-specified in the contract. Also, the retailer does not have the right to obtain substantially all the benefits from use of the factory because the manufacturer decides how to use the available capacity.

Example 4 - Power supply

A utility company contracts with a windfarm operator to purchase all of the electricity produced by a new windfarm for 30 years. The operator owns the windfarm. The utility company designed the windfarm before it was constructed and hired experts to assist in determining the location, obtaining permits and specifying the turbines to be used. The operator constructs the windfarm to the contractual specifications and then operates it. The operator will receive tax amortisation deductions on the windfarm, while the utility company receives green certificates.

Analysis
The contract contains a lease. The utility company has the right to obtain substantially all of the economic benefits from use of the windfarm over the 30-year contract period. The contract pre-determines how and for what purpose the windfarm is used, so neither party is able to take these decisions after the contract is signed. In this circumstance, the utility company's role in designing the windfarm means that it has control for FRS 116 purposes.

The new lessee accounting model

Subject to the optional accounting simplifications for short-term and low-value asset leases (see below), a lessee will be required to recognise its leases on the balance sheet. This involves recognising:

- a 'right-of-use' asset; and
- a lease liability.

Lessees have the option to apply the model to a portfolio of similar leases if the effect is reasonably expected to be materially the same as a lease-by-lease approach.

Optional accounting simplifications

FRS 116 provides important reliefs or exemptions for:

- low-value asset leases
- short-term leases.

If these exemptions are used, the accounting is similar to operating lease accounting under FRS 17 i.e. Lease payments are recognised as an expense on a straight-line basis over the lease term or another systematic basis (if more representative of the pattern of the lessee's benefit).

The two exemptions are discussed further below.

Low-value asset leases

FRS 116 provides an optional exemption for leases of 'low-value' assets. The assessment of value is based on the value of the underlying asset when new, regardless of its actual age. The exemption is available whether or not these leases are (individually or collectively) material to the reporting entity.

Accordingly, leases of assets such as low value IT equipment, office equipment and furniture would typically qualify, but vehicle leases would not. It should be noted that the standard does not establish a 'bright-line' rule to determine what is "low value".

The use of this exemption is an accounting policy choice that is available on a lease-by-lease basis.

Example - Low value asset leases

A financial services company enters into a single lease contract for ten office printers/copiers. The lease has a three year, non-cancellable term. One of the assets is a high-end production printer with a purchase price when new of $20,000. The other nine assets are more basic models with prices when new of $3,000 each.

Although the ten assets are under the same lease, the company concludes that each asset is a separate 'lease component' because:

- the company benefits from each asset on its own
- the assets are not highly interrelated

Analysis

Because each asset is a distinct lease component, FRS 116 treats this contract as containing ten separate leases in principle. The total lease payments are then allocated to each of the ten components on a relative stand-alone selling price basis.

The company can then elect to apply the low-value asset exemption to some or all of the nine basic model lease components. If it does so, these are accounted for similarly to operating leases under FRS 17.

The lease of the high-end production printer must be accounted for 'on-balance sheet'.

Short-term leases

FRS 116 provides another optional exemption for short-term leases. A lease is short-term if it has a lease term of 12 months or less at the commencement date. However, a lease cannot qualify if it contains a purchase option.

Importantly, the lease term excludes any optional extension periods unless the lessee is reasonably certain to exercise its option (or reasonably certain not to exercise an option to terminate the lease).

The use of this exemption is an accounting policy choice that must be made consistently for each class of underlying asset.

Practical insight – impact on investment property

A mining company has entered into several leases of transport vehicles. Each lease has a stated term of 36 months, but with break clauses allowing the company to terminate each lease after 12 months and 24 months without penalty.

At the commencement date of each lease the company assesses the likelihood that it will exercise its 12-month termination option. This assessment considers all relevant facts and circumstances that create an economic incentive to not terminate the lease early. Management concludes that it is not 'reasonably certain' that the termination option will not be exercised (said differently, there is a realistic possibility that the 12-month termination option will be exercised). In reaching this conclusion, management takes into account that:

- there is no significant termination penalty
- the rentals in years 2 and 3 are not below market
- the business's transport needs tend to change with sufficient speed that the existing vehicle fleet may no longer be optimal in 12 months' time and alternative vehicles could be sourced and introduced into the operations without significant cost or disruption.

Analysis

The leases of transport vehicles qualify for the short-term election. The mining company has an accounting policy choice to either apply the general FRS 116 lessee model or account similarly to operating leases under FRS 17 (ie recognise the lease payments on a straight-line basis over the lease term or another systematic basis if more representative of the pattern of benefit). This accounting policy must be applied consistently to all short-term leases of underlying assets of the same class (eg all short-term leases of transport vehicles).

Applying the new lessee accounting approach

Initial accounting

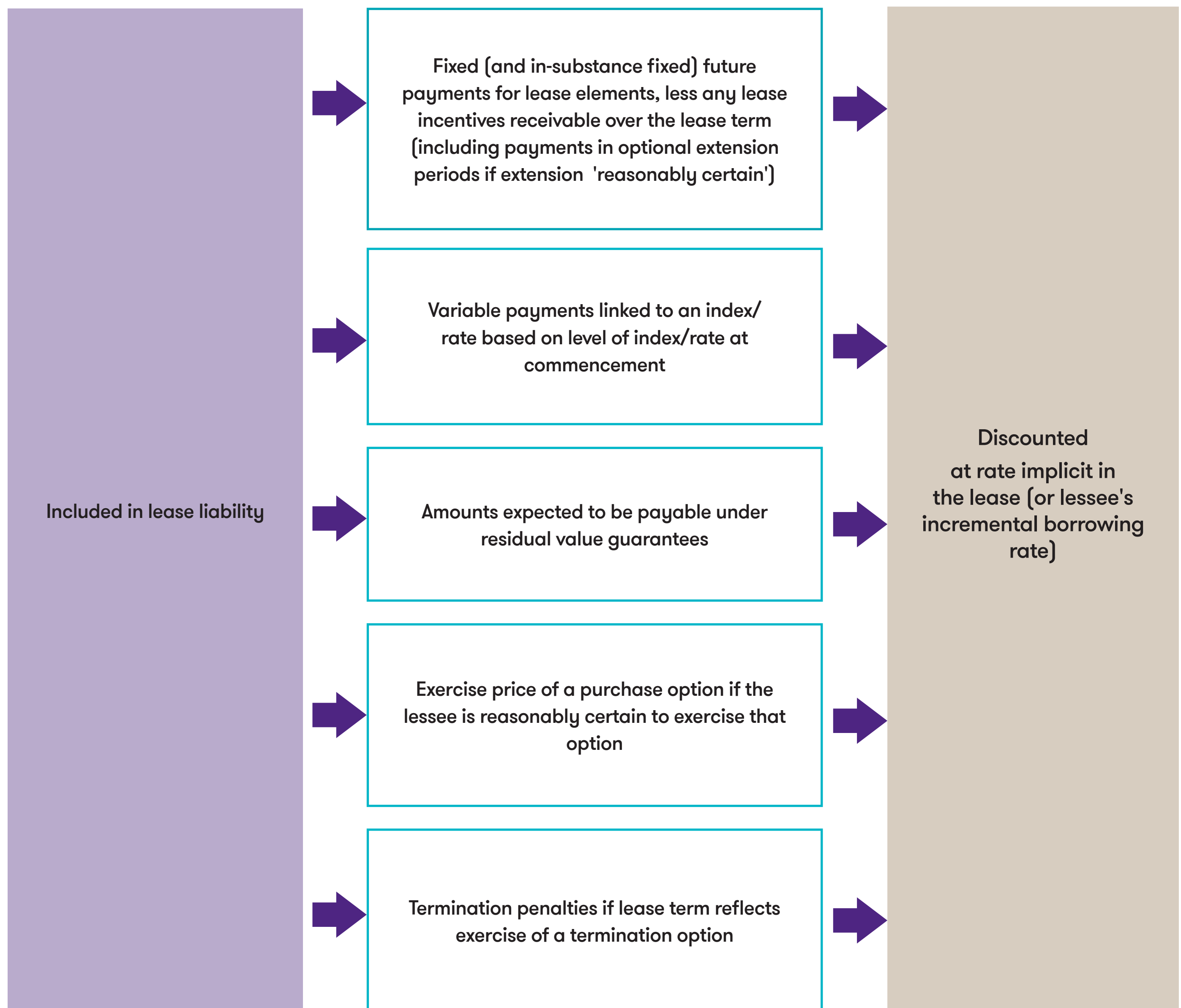
At the commencement date the lessee recognises a lease liability and a right-of-use asset. The liability is initially measured at the present value of future lease payments. For this purpose, lease payments include fixed, non-cancellable payments for lease elements, amounts due under residual value guarantees, certain types of contingent payments and amounts due during optional periods that are 'reasonably certain'. Termination penalties are included if the lease term reflects the exercise of a termination option.

The lease liability does not include:

- payments for non-lease elements (unless the practical expedient permitting non-separation of non-lease elements is applied – see below)
- payments in optional extension periods unless extension is 'reasonably certain'
- future changes in variable payments that depend on an index or rate
- variable payments linked to the lessee's future sales or usage of the underlying asset.

The discount rate is the rate implicit in the lease, if readily determinable. If not, the lessee's incremental borrowing rate is used. The diagramme summarises the initial measurement of the lease liability:

Diagramme: initial measurement of the lease liability



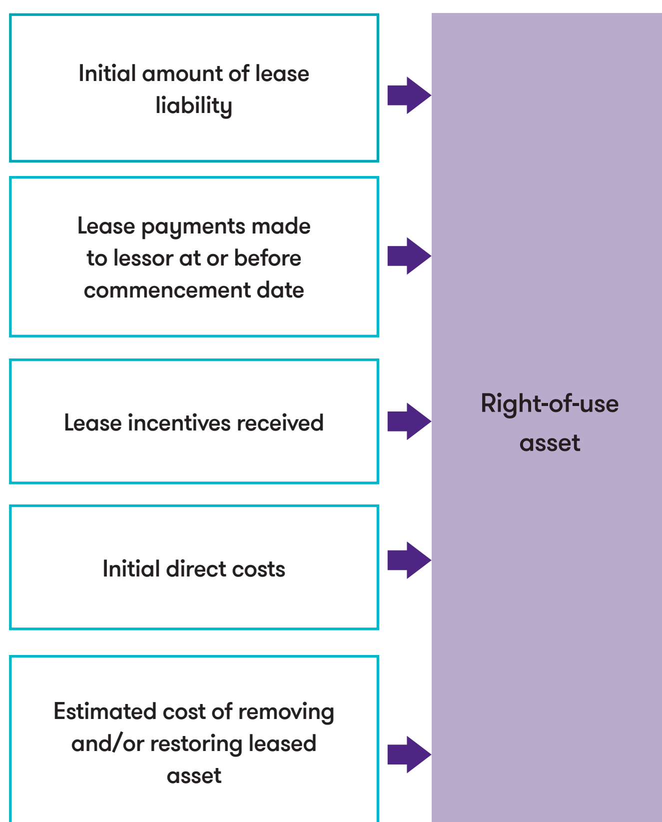
The initial measurement of the right-of-use asset is based on the lease liability. Adjustments are made for any:

The lease liability does not include:

- prepaid lease payments
- lease incentives received
- initial direct costs incurred
- an estimate of costs the lessee is obliged to incur to dismantle, remove or restore the underlying asset and/or site.

The diagramme summarises how the initial right-of-use asset is measured starting with the lease liability:

Diagramme: initial measurement of the right-of-use asset



Subsequent accounting for right-of-use asset and lease liability

In subsequent periods, the right-of-use asset is accounted for similarly to a purchased asset. The lease liability is accounted for similarly to a financial liability. Accordingly:

- the right-of-use asset is depreciated
- the lease liability is accounted for under the effective interest method. Lease payments are apportioned between interest expense and a reduction of the lease obligation.

Said differently, the accounting is similar to today's accounting for finance leases.

The initial and subsequent accounting for a simple 3-year lease are illustrated in the following example.

Example: lessee accounting for a simple three-year lease

On 1.1.20X1 a company enters into a three-year lease of office premises. The rentals are $10,000 payable at the end of each year. There are no services or other non-lease elements. No initial direct costs are incurred or incentives received. The applicable discount rate (see below) is 5%.

Analysis

The initial measurement of the right-of-use asset and lease liability is $27,232 (10,000/1.05 + 10,000/1.05^2 + 10,000/1.05^3). The table below summarises the cash flows and balance sheet and profit and loss account treatment (assuming straight-line depreciation over three years):

Cash flow & P&L ($):	1.1.20X1	20X1	20X2	20X3
Lease payments	-	10,000	10,000	10,000
Depreciation expense	-	9,077	9,077	9,078
Interest expense	-	1,362	930	476
Total expense	-	10,439	10,007	9,554
Balance sheet ($):				
Right-of-use asset	27,232	18,155	9,078	-
Lease liability	27,232	18,594	9,524	-

The accounting entries on initial recognition are:

	Dr ($)	Cr ($)
Right-of-use asset	27,232	
Lease liability		27,232

The subsequent accounting entries in Year 1 are:

	Dr ($)	Cr ($)
Depreciation expense	9,077	
Interest expense	1,362	
Lease liability	8,638	
Cash		10,000
Right-of-use asset		9,077

The accounting entries in Years 2 and 3 continue in the same pattern.

Practical insight – front-loading of lease expense

In this example rentals over the three years are $30,000 in total. Under FRS 17, assuming this is an operating lease (which is likely for a three-year property lease), the annual expense will be CU10,000. Under FRS 116 the total expense over the three years is also CU30,000 but this is 'front-loaded' – in other words the expense is higher in the early years. This results from recognising interest at a constant rate of return on the outstanding liability.

The lease liability is re-measured (with a corresponding adjustment to the right-of-use asset) when:

- the lease term is revised
- future lease payments based on an index or rate are revised
- the lease is modified
- there is a change in the amounts expected to be paid under residual value guarantees.

Renewal and termination options

As noted above, the initial lease liability takes into account lease payments during option periods only if exercise of an option to extend is considered reasonably certain (or non-exercise of an option to terminate the lease is reasonably certain). This is consistent with FRS 116's definition of the 'lease term'.

Definition of lease term:

FRS 116 defines the lease term as the non-cancellable period of the lease, together with both of the following:

- periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option; and
- periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option.

The lessee must reassess whether it is reasonably certain to exercise an extension option, or not to exercise a termination option, if there is a significant event or change in circumstances that:

- is within the lessee's control; and
- affects whether exercise (or non-exercise) is reasonably certain.

A change in this assessment triggers a re-measurement of the lease liability. Similarly, re-measurement is required if the lessee actually exercises an extension option that was not considered reasonably certain, or does not exercise a termination option that was considered reasonably certain. To account for these events the lessee:

- adjusts the lease liability by (i) including the lease payments over the revised term; (ii) applying a revised discount rate (the interest rate implicit in the lease for its remaining term if readily determinable, or the lessee's incremental borrowing rate at the date of reassessment if not)
- makes a corresponding adjustment to the right-of-use asset.

The accounting for a reassessment of an extension option is illustrated in the following example:

Example: reassessment of an extension option

A restaurant operator enters into a five-year lease of real estate on 1.1.20X1 (the commencement date). The annual rental is $5,000 payable in advance. The contract contains an option for the operator to extend the lease for a further five years at an annual rental of $6,000. At the commencement date, management concludes that exercise of the extension option is not reasonably certain. This takes account of all relevant facts and circumstances, including that:

- the site will be used for a new restaurant format that is not yet proven in the local market
- leasehold improvements are expected to be at the end of their useful economic lives by the end of year five
- the rentals during the extension period are not expected to be below market rates.

Accordingly, management concludes that the lease term is five years. On 1.1.X1 the operator recognises a right-of-use asset and lease liability using its incremental borrowing rate of 4% (having concluded that the interest rate implicit in the lease is not readily determinable):

1.1.20X1	Dr ($)	Cr ($)
Right-of-use asset	23,150	
Lease liability		18,150
Cash		5,000

The right-of-use asset will be depreciated on a straight-line basis over five years.

After three years, on 31.12.20X3, it is evident that the new restaurant brand has been unsuccessful. Management decides to make a significant investment in rebranding the site to another format that has been very successful. Management determines that this is a significant change of circumstances that makes exercise of the extension option reasonably certain. Accordingly, management reassesses the total lease term to be ten years, of which seven years remain. At the date of reassessment the operator's incremental borrowing rate is 3% (the interest rate implicit in the lease for its remaining term is not readily determinable).

Analysis

As a result the lease liability is re-measured at 31.12.20X3. The new liability is the present value of two payments of $5,000 due on 1.1.X4 and 1.1.X5, plus five payments of $6,000 due from 1.1.X6 to 1.1.X10, discounted at 3% ($36,533). The lease liability at 31.12.20X3 before reassessment is $9,808. The increase ($26,725) is added to the lease liability and the right-of-use asset:

31.12.20X3	Before reassessment	Adjustment	After reassessment
Right-of-use asset	9,260	26,725	35,985
Lease liability	9,808	26,725	36,533

Subsequently, the revised right-of-use asset is depreciated over its revised useful life (eg straight-line over seven years). The revised lease liability is measured using the new effective interest rate of 3%.

Variable lease payments

The accounting for variable lease payments depends on the nature of the variability. Payments that vary based on an index or rate are included in lease payments for classification and measurement purposes based on the prevailing index or rate at the measurement date. The lease liability is re-measured when the index or rate changes and the lease payments are revised. This differs from current practice; future changes in inflation are often not included in minimum lease payments under FRS 17.

Payments that vary based on future usage of the leased asset are not included in lease payments for classification and measurement purposes. However, variable payments that are in-substance fixed payments are included in the lease payments.

Practical insight – in-substance fixed lease payments

FRS 116 provides the following examples of lease payments that are variable in legal form but should be treated as fixed in-substance:

- payments that must be made only if an asset is proven to be capable of operating during the lease
- payments that must be made only if an event occurs that has no genuine possibility of not occurring
- payments that are initially variable but for which the variability will be resolved in future (which become 'in-substance fixed' when resolved)
- arrangements in which there is more than one set of payments that a lessee could make, but only one of those sets of payments is realistic. In this case the lease payments are the realistic set of payments.

The diagramme summarises the initial and subsequent accounting requirements for variable lease payments:

Diagramme: accounting for variable lease payments

Type of variable payment	Initial accounting	Subsequent accounting
Variable lease payments that depend on an index or a rate	Include in lease liability and asset based on level of index/rate at the commencement date	Adjust lease liability and asset when revised index/rate changes the lease payments (using original discount rate)
Other variable lease payments (eg payments linked to sale or usage)	Exclude from lease liability and asset	Recognise an expense in the period that the event or condition that triggers the payments occurs
In-substance fixed lease payments	Treat as fixed lease payments	Treat as fixed lease payments

Non-lease elements

Many contracts contain both lease and non-lease elements. Examples of non-lease elements include: maintenance, security and other onsite services in a property lease, the supply of goods in a contact manufacturing agreement, operational services in a transport or outsourcing contract and the lessor paying insurance costs or property taxes that relate to the underlying asset. The lessee needs to account for non-lease elements separately from the lease element(s). This requires an allocation of the total contractual payments to lease and non-lease elements based on relative stand-alone selling prices. Non-lease elements are then accounted for under the applicable IFRS guidance.

FRS 116 includes a practical expedient allowing lessees to make an accounting policy election (by class of underlying asset) to treat non-lease elements as part of the lease.

Practical insight – including non-lease elements in the lease accounting

Taking advantage of the practical expedient to not separate non-lease components from lease components will certainly simplify the accounting for a contract that contains a lease. However, this will also increase the amount of assets and liabilities recognised and could have implications for impairment.

Effective date and transition approach

FRS 116 is effective for annual periods beginning on or after 1 January 2019. Early application is permitted for entities that apply FRS 115 at or before the date of initial application of this Standard.

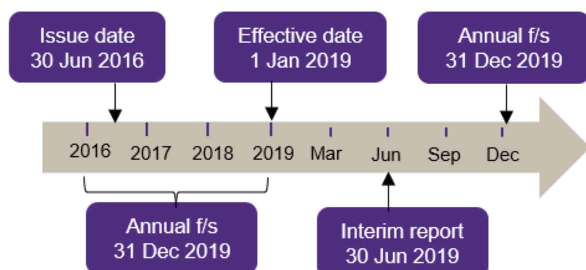
FRS 116 includes two possible transition methods as follows:

- full retrospective application
- partial retrospective application

These are explained in more detail below.

The transition timeline (for an entity that produces interim financial statements half-yearly) is summarised in the diagramme:

Diagramme: Implementation timeline



FRS 116 provides lessees with a choice between two transition methods:

- **full retrospective application** - with restatement of comparative information in accordance with FRS 8 'Accounting Policies, Changes in Accounting Estimates and Errors'.[Option 1]
- **partial retrospective application -** without restating comparatives. Under this approach the cumulative effect of initially applying FRS 116 is recognised as an adjustment to equity at the Date of Initial Application (DOIA) (eg 1 January 2019 for a lessee that adopts FRS 116 on the effective date and has a 31 December year-end) [Option 2].

If a lessee chooses partial retrospective application, a number of more specific transition requirements and optional reliefs also apply. These are summarised in the table:

Transition provisions for lessees when using partial retrospective application

Area	Requirement or optional relief
Leases previously classified as operating leases	• lease liability at the DOIA is measured at the present value of the remaining lease payments, discounted at the lessee's incremental borrowing rate at the DOIA • choice to measure right-of-use asset at either: o carrying amount as if FRS 116 had been applied since commencement, but discounted at the incremental borrowing rate at the DOIA (Option 2a); or o amount of lease liability, adjusted for prepaid or accrued rentals (Option 2b) • the right-of-use asset is measured at fair value at the DOIA for leases of investment property that were accounted for as operating leases under FRS 17 but to which the FRS 40 fair value model will apply in future • optional reliefs are available in relation to: o low-value asset leases and leases for which the lease term ends within 12 months of DOIA o leases of investment property to which the FRS 40 fair value model has been applied o use of a single discount rate for a portfolio of leases with reasonably similar characteristics o relying on the FRS 37 'Provisions, Contingent Liabilities and Contingent Assets' 'onerous' assessment instead of an impairment review on transition (in which case the right-of-use asset is reduced by the amount of any onerous lease provision) o excluding initial direct costs from the right-of-use asset o use of hindsight in determining the lease term if lease contains extension or termination options
Leases previously classified as finance leases	• right-of-use asset and lease liability are measured at the same amounts as under FRS 17 at the DOIA
Disclosures	• relief from disclosing the current period impact in accordance with FRS 8 if entity elects the partial retrospective application approach • some additional disclosures required in year of transition

FRS 116 also provides both lessees and lessors with optional transition relief from reassessing whether contracts in place at the DOIA are, or contain, a lease.

Example - Transition options in practice

- 5 year lease, entered into on 1 January 2018
- CU100k payable on second day of each year
- 8% discount rate at lease commencement
- 12% discount rate at transition
- Straight line depreciation of ROU asset

Option 1

Under Option 1 the liability and asset are both calculated as if FRS 116 had always been applied, with comparative amounts restated. The liability on the commencement date of the lease is calculated as the present value of the future rentals, discounted using a rate of 8 per cent.

Option 2a

Under this option comparative amounts are not restated and the liability is calculated as the present value of the three outstanding rentals of CU100, discounted using the incremental borrowing rate at the date of transition of 12 per cent.

The asset is calculated as if FRS 116 had always been applied, but using the incremental borrowing rate at the date of transition of 12 per cent

Option 2b

Comparative amounts are not restated and the liability is calculated as the present value of the three outstanding rentals of CU100, discounted using the incremental borrowing rate at the date of transition of 12 per cent. The asset is then set equal to the liability.

The impact of three options on the Balance Sheet and income statement is presented in table below

	Full retrospective (Option 1)			**Cum catch-up Retro CV for ROU asset (Option 2a)**			**Cum catch-up ROU asset = lease liability (Option 2b)**		
Balance Sheet	**Jan 18**	**Dec 18**	**Dec 19**	**Dec 18**	**Jan 19**	**Dec 19**	**Dec 18**	**Jan 19**	**Dec 19**
ROU asset	431	345	259	-	323	242	-	340	255
Lease liability	(431)	(358)	(278)	-	(340)	(269)	-	(340)	(269)
Net assets	**-**	**(13)**	**(107)**	**-**	**(17)**	**(27)**	**-**	**-**	**(14)**
Income Statement									
Lease expense		-	-	(100)		-	(100)		-
Depreciation		(86)	(86)	-		(81)	-		(85)
Finance cost		(26)	(21)	-		(29)	-		(29)
Profit		**(113)**	**(107)**	**(100)**		**(110)**	**(100)**		**(114)**

Analysis of high market-cap companies with December 2018 year end

To understand the impact of the new leasing standard, we have reviewed the quarterly results of top companies listed on the SGX.

The objective was to gather understanding of the impact of new leasing standard on some of Singapore's largest corporations.

Assumptions:

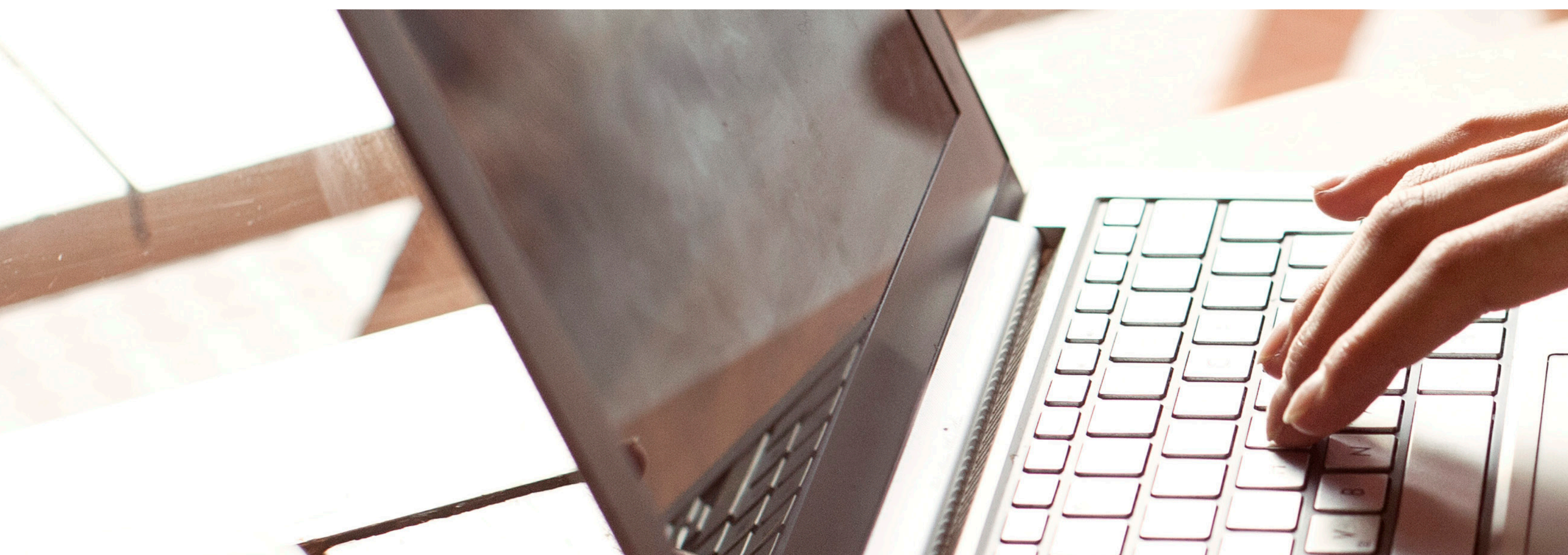
- All amounts are presented in SGD
- Financial information is analysed separately for companies depending on the year end date as follows:
- Companies which have transition date of 1 Jan 2019
- Companies which have transition date of 1 April 2019

Sectorwise impact on companies with transition date of 1 Jan 2019

Industry	Total Assets	Total Liabilities	Total Lease Liabilties	% of Lease liability to total assets	% of Lease liability to total liabilities
Consumer Services	156,123,657.17	91,587,306.16	2,421,936.24	1.6%	2.6%
Energy	4,266,182.56	2,571,155.70	32,198.18	0.8%	1.3%
Healthcare	1,182,865.00	347,807.00	19,430.00	1.6%	5.6%
Industrials	66,508,503.00	42,495,646.00	1,526,325.00	2.3%	3.6%
Information technology	3,328,616.00	894,135.00	16,028.00	0.5%	1.8%
Materials	2,645,551.00	1,037,453.00	2,258.00	0.1%	0.2%
Real Estate	93,326,623.77	41,684,947.11	595,016.33	0.6%	1.4%
Telecommunication Services	2,844,900.00	2,208,800.00	215,100.00	7.6%	9.7%
Transportation	5,370,700.00	2,276,800.00	211,600.00	3.9%	9.3%
Utilities	5,148,720.00	3,759,003.00	78,614.00	1.5%	2.1%
Grand Total	340,746,319	188,863,053	5,118,506		

Sectorwise impact on companies with transition date of 1 April 2019

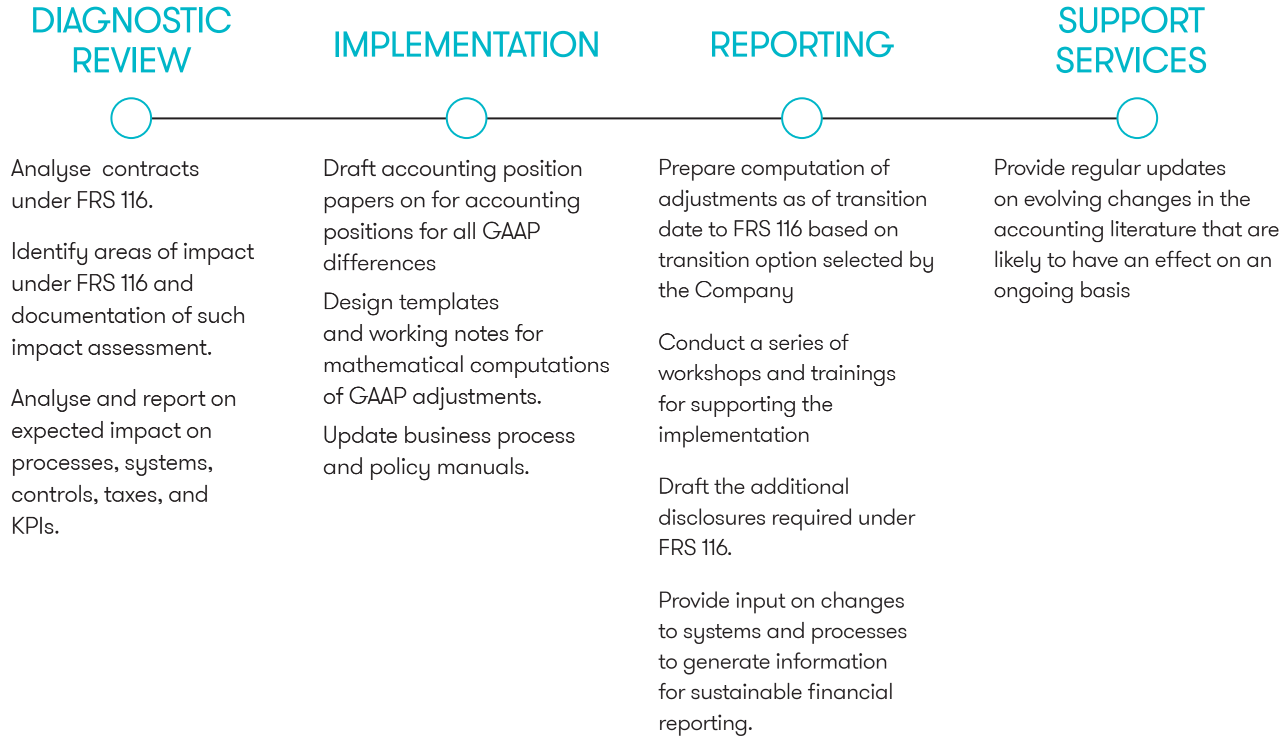
Industry	Total Assets	Total Liabilities	Total Lease Liabilties	% of Lease liability to total assets	% of Lease liability to total liabilities
Consumer Services	3,683,161,000	1,274,577,000	-	0.00%	0.00%
Industrials	4,729,177,000	1,448,603,000	195,286,000	4.13%	13.48%
Real Estate	16,523,462,000	5,595,456,000	49,349,000	0.30%	0.88%
Transportation	2,673,200,000	796,500,000	182,200,000	6.82%	22.88%
Airline	27,732,600,000	14,725,600,000	2,187,000,000	7.89%	14.85%
Grand Total	55,341,600,000	23,840,736,000	2,613,835,000		



How we can help

Grant Thornton's Financial Reporting Advisory Services team comprises financial reporting accounting, and industry experts, each having several years of hands-on practical experience across GAAPs and sectors. Our professionals uniquely combine their technical expertise with the intuition, insight and confidence gained from their extensive practical experience to develop a systematic, reliable, efficient and scalable reporting framework for converging to the new revenue standard.

This will entail a careful and well-documented evaluation (and suitable modifications) of the financial reporting process, in order to achieve an optimal balance between transparency, consistency, accuracy, reliability and speed, while also controlling costs.



About Financial Reporting Advisory Services (FRAS)

In today's competitive business environment and fast changing regulatory & reporting landscape, dynamic organisations face several challenges with respect to financial reporting which could potentially impact the value of the businesses.

There is a greater need for accurate and timely financial information now. As a part of our Audit and Assurance practice, Financial Reporting Advisory Services (FRAS) has developed innovative solutions to make financial reporting process smooth, time-bound and auditable.

The FRAS team at Grant Thornton is a multi-disciplinary team that designs and implements creative solutions to address these complexities. Most of our team members are former auditors and assist Companies design 'auditor ready' solutions such as whitepaper, reporting packages, reconciliations supporting financial report disclosures.

What differentiates us

- We pre-empt problems and draft solutions to them
- Most of our professionals have auditing experience, which helps them appreciate practical complexities in financial reporting
- Our team combines accounting knowledge with technological skills to deliver efficient and sustainable financial reporting solutions
- Our senior professionals are chosen experts with deep technical accounting knowledge and vast experience of advising clients on accounting matters
- Our size and structure create advantages for you. We adapt a flatter structure, with shorter decision making chains, empowered teams and no complex chains of command. Our teams are more responsive
- Access to wide pool of IFRS experts from our offices in the region as well as our office in US, UK. India and Ireland.

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Large international client basent base

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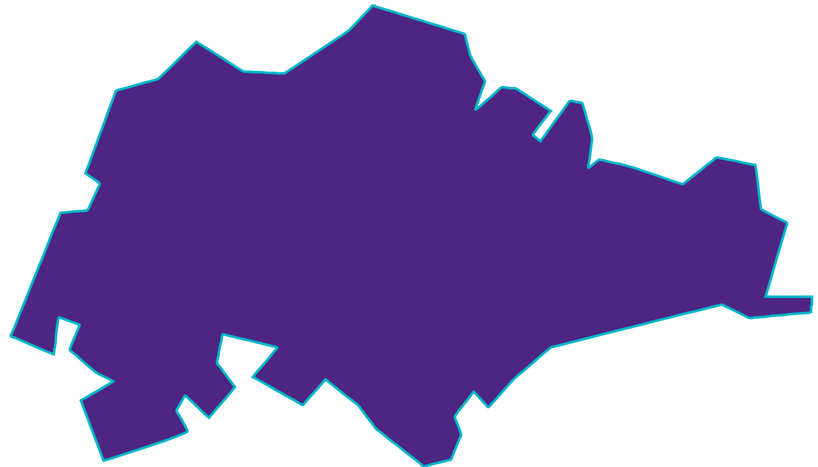

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Jeff Vibert
CEO, Grant Thornton Singapore Pte Ltd

To find out more, please visit **www.grantthornton.sg** or contact any of our offices as mentioned below:

Timothy Braun
Partner
Grant Thornton Singapore
T +65 6805 4130
E Timothy.Braun@sg.gt.com

Chetan Hans
Director
Grant Thornton Singapore
T +65 6805 4110
E Chetan.hans@sg.gt.com

GRANT THORNTON SINGAPORE PTE LTD
39 Robinson Road
#14-01 Robinson Point
Singapore 068911

+65 6805 4110
enquiries@sg.gt.com

For more information or for any queries, write to us at **enquiries@sg.gt.com**

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