

ARE YOU READY?

Changes to accounting for leases in accounting standard FRS 116 could have an impact on an SME which owns or leases its premises

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ACCOUNTING changes have often been regarded as mundane changes that only the accounting department needs to think about. However, changes to accounting for leases in accounting standard FRS 116 could have an impact on a small or medium-sized enterprise (SME) which owns or leases its premises. Its proposed changes may have a significant impact on the company's financial statements, even though there has been no fundamental change in its business.

FRS 116, which will affect the way that companies account for the assets that they lease, will affect all financial years beginning on or after Jan 1, 2019. The new standard is expected to make financial statements more comparable and transparent, as lease assets and liabilities are recorded on the balance sheet.

Consider this example of a company which has entered into a long operating lease for a commercial property, say the rental of a unit from JTC. When we look at the company's financial statements, we see monthly rental payments made to the landlord. It is entirely probable that the following scenario will apply after FRS 116 takes effect:

- You will no longer see rental payments in the company's financial statements, which could seem a little strange considering that the company still has that lease for the property.
- The company's interest expense has increased even though it has not borrowed more money.
- The company's net profit decreased as a result of the accounting standard change.

The above scenario will be particularly relevant for companies with long leases for properties and other high-value assets such as construction equipment and vehicles. The larger the portfolio of property leases or high-value assets, the more significant the impact of these changes.

Without going into the technical details, the changes to lease accounting could result in changes to your company's financial statements. Examples include the lease contract being recorded as a right-of-use asset and a rental liability on your balance sheet. Under the old rules, the lease would not have shown up on your balance sheet.

Other possible changes include:

- Rather than recording rental payments in the company's profit and loss statement, you will now record interest and depreciation expenses.
- Leases will be accounted for as if your company had borrowed funds to purchase the asset.
- Similar to amortising debt or a mortgage housing loan, the interest expense will be higher in earlier years (ie front loaded) than in later years of the lease term, even where monthly rental payments are constant.
- As interest expense is higher in the earlier years of a lease contract, your company's net profit will be lower in the earlier years – all other things remaining constant.

If your company has a significant portfolio of leases, these changes may have a significant impact on key financial statistics and ratios. The expected adverse impact on ratios such as debt to equity and interest cover may greatly affect companies that are heavily leveraged. Therefore, companies that need to satisfy debt covenants or any other balance sheet-based key performance indicators (KPIs) may need to relook their debt obligations.

Broadly, we expect earnings before interest, taxes, depreciation and amortisation (Ebitda), total assets and gearing to increase. On the flip side, we expect earnings per share (EPS) in earlier years of a lease contract, net assets, interest cover and asset turnover to decrease.

This means that you may look less profitable than you really are, with more debt than you really have, even as your Ebitda increases.

Of perhaps greater interest, will your company pay more taxes as a result of these changes? This question is hardly far-fetched. What was previously a relatively straightforward tax

deductible rental expense (assuming that the property was leased to carry on a business) has now become a combination of interest and depreciation expenses.

Depreciation expenses are most certainly not tax deductible while interest expenses relating to non-income producing assets are also not tax deductible. The jury is still out regarding potential tax adjustments that may need to be made as a result of FRS 116.

What we do know is that the Inland Revenue Authority of Singapore has formed a FRS Joint Working Group to study the impact on current tax rules but has not issued any formal clarification. It certainly seems unfair if a company's tax bill increases as a result of the change in accounting standard.

THE END OF PROPERTY SALE & LEASEBACK?

A popular financing strategy that many companies have adopted is the sale and leaseback of their commercial real estate. This monetisation strategy, which is particularly popular with operating companies that have sizeable commercial real estate, allows companies to convert their property assets into cash that may be used for debt repayment and working capital or simply redeployed into higher yielding investments. This ability to enhance cash holdings is especially valuable in an uncertain economic environment, such as the one that we are in today.

FRS 116 essentially eliminates sale and leaseback transactions as a potential source of off-balance sheet financing. Under the new standard, the leaseback leg will almost always be recognised on the balance sheet unless the leaseback is short or the underlying asset is of low value – which is not likely for property transactions.

Companies that are considering or have executed a sale and leaseback transaction where getting the asset off the balance sheet is of paramount importance will now have to think twice.

However, the good news is that the standard is effective for financial years beginning on or after Jan 1, 2019 so

companies will have time to prepare for the change. There are exemptions for a) low value leases even if large volumes of such items are leased (eg IT equipment such as laptops, mobile phones, printers etc) and b) short leases that are expected to be less than 12 months in duration.

WHAT'S NEXT?

If your company is likely to be affected by changes in FRS116, you should consider looking into the following:

- Assess existing contracts to identify whether the agreement is, or contains a lease. Do note that contracts that are currently treated as leases may not be so under the new standard and vice versa, contracts that are not currently treated as leases may be leases under the new standard.
- Re-assess debt arrangements and renegotiate any covenants that may be impacted when the changes take effect. If you are negotiating debt arrangements, you may wish to seek flexibility in determining appropriate debt covenants to minimise the impact of the new standard.
- Reconsider certain contract terms or business practices (eg structuring or pricing of a transaction, particularly lease length and renewal options) to minimise the impact of the changes.

FRS 116 seeks to improve the transparency and comparability of financial statements by bringing leases on-balance sheet for lessees. What this mean is that analysts will, for the first time, be able to see a company's own assessment of its lease liabilities.

On the flip side, it does mean more compliance costs and information gathering for companies. We certainly hope that the benefits outweigh the costs. ■

The writers are Head of Real Estate and Technical Partner for Lease Accounting at KPMG in Singapore respectively. The views and opinions are those of the authors and do not necessarily represent KPMG in Singapore. All information provided is of a general nature and is not intended to address the circumstances of any particular individual or entity.



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