

## COVER STORY

# MFRS 16: SHORT- TERM PAIN, LONG-TERM GAIN

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**T**he conversation about MFRS 16, the new accounting standard for leases — which supercedes the old standard, MFRS 117 — is not entirely new, given that the standard has been in effect from Jan 1 this year.

But as 2019 draws to an end, it has become clear that the standard has impacted the profitability of companies — especially those in the retail, airline and services sectors — that rely heavily on leases. Proof of this lies in the financial performance of, for example, AirAsia X Bhd, Berjaya Food Bhd and Media Prima Bhd in the quarter ended Sept 30.

MFRS 16 has yet to affect retailers such as Padini Holdings Bhd and Parkson Holdings Bhd, which are due to adopt the standard in their books from their first financial quarter ended Sept 30 (1QFY2020).

At press time, Padini and Parkson had not announced their financial results for 1QFY2020 yet.

In a nutshell, with MFRS 16, there is no longer a distinction between finance and operating leases for lessee accounting, as was the case under MFRS 117. For those unfamiliar with accounting jargon, in a finance lease, ownership of a property is transferred to the lessee at the end of the lease term but in an operating lease, the ownership of the property is retained during and after the lease term by the lessor.

Under MFRS 117, operating leases were expensed in the profit or loss statement and kept off the balance sheet; only finance leases were recognised on the balance sheet.

However, under MFRS 16, a “right of use” approach is applied, which requires a lessee to recognise assets and liabilities for the rights and obligations created by lease contracts.

PwC Malaysia assurance partner Siew Kar Wai says the standard is positive for users of financial statements, such as investors. “[In the past], the [treatment] of operating leases under MFRS 117 received some criticism because of the off-balance sheet element. As and when the lessee used the assets, the rental payments were recorded on the profit or loss statement but were kept off the balance sheet. In other words, this ignored the financial position of the lessee, where the

[right of use] asset and corresponding [lease] liabilities were understated. This will not help users who want to make informed decisions about the companies they want to invest in.

“Under MFRS 16, the books of lessees have been revamped. Now, the lessees recognise the right of use of the asset as well as the corresponding lease liability on the balance sheet. However, from the perspective of the lessors, not much has been changed from MFRS 117. So you would still see operating and finance leases on the books of the lessors,” she tells *The Edge* in a recent interview.

Siew adds that MFRS 16 is also a boon for sophisticated users of financial statements, such as business analysts.

“Under MFRS 117, analysts used to rely on commitment disclosures in the notes accompanying financial statements and work out on their own the balance sheet liability to figure out the funding or liquidity needs of a company. That, to a certain extent, was a guesstimate because not much guidance was provided in the commitment disclosures.

“Now, under MFRS 16, this has been made clearer as to what sort of lease liability should be recognised on the books and for how long the lease contracts are. While accounting estimates may still be involved, there is now a more consistent framework and principle for analysts to work on,” she says.

Bringing assets and corresponding lease liabilities that were previously off-balance sheet onto the balance sheet entails higher depreciation and finance charges in the profit or loss statement of companies that were previously unaccounted for, thus eroding the profitability of companies.

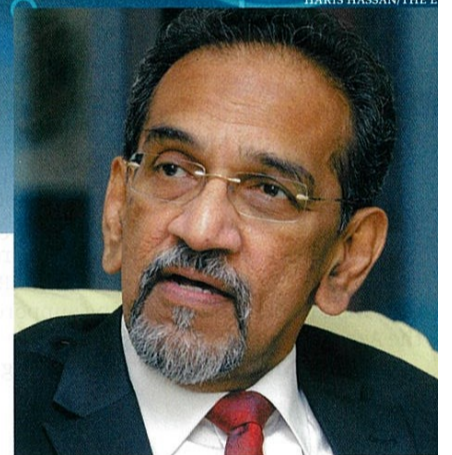
Nevertheless, says Baker Tilly Malaysia group managing partner Andrew Heng, there are benefits to be reaped by companies from the adoption of MFRS 16.

“With the increased transparency of leases, companies will be able to make more economic lease decisions, thus enabling lease portfolio optimisation or making potential cost savings.

“Analysts and agencies will also be able to make a more accurate assessment of the company’s financial position and performance rather than just relying on the lease commitments disclosed in the financial statements like before. This may result in a more accurate rating and a likely reduction



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**Devanesan:** Minority shareholders will get a better feel of the whole commitment as opposed to what is annually expensed off it



**Heng:** With the increased transparency of leases, companies will be able to make more economic lease decisions

in the cost of borrowing for the company.

“MFRS 16 may also impact the outcomes of valuations and introduces new attention areas in business valuations and mergers and acquisitions. Although equity values should not change, the enterprise values of companies are expected to increase as a result of higher Ebitda (earnings before interest, tax depreciation and amortisation) and higher net present value of free cash flow,” he tells *The Edge* in an email interview.

According to PwC Malaysia’s Siew, bringing lease commitments onto balance sheets

also improves communications between companies and stakeholders.

“With the asset and corresponding lease liability now on the balance sheet, their treatment is not much different from that of a secured borrowing. [Stakeholders] will now be able to have a better understanding of the return on assets of a company and how it manages its liquidity. And when it comes to dividend payments, it gives stakeholders a clearer picture of the solvency of the company,” she says.

In its article “How Will Your Business Be Impacted by The New Lease Accounting Standard?” PwC Malaysia says companies should consider whether the transition to MFRS 16 will have any impact on their ability to pay dividends.

The firm explains that under MFRS 16, a lease would have a front-loaded expense profile, which tapers off towards the end of the lease term. This occurs because interest expense is at its highest at the commencement of a lease when its related lease liability represents the maximum principal to be paid.

This is in contrast to the straight-line expense profile of the lease term adopted by MFRS 117.

“While on an overall basis there should not be any income statement difference between an MFRS 16 lease and an MFRS 117 operating lease, the former will cause a lower amount of net profit at its start. In practice, however, a company may have multiple leases that a



# Assessing the tax implications

While grappling with MFRS 16, the new accounting standard that superseded MFRS 117 from Jan 1 this year, companies will also need to take into account its tax implications.

EY Asean and Malaysia Tax Leader Amarjeet Singh says companies need to be aware of the potential divergence between the accounting and tax treatments of lease arrangements.

He explains that from the accounting treatment perspective, MFRS 16 requires lessees to recognise right-of-use assets and lease liabilities for most leases (except for short-term leases and low-value assets) in the statement of financial position.

"Lessees are required to separately recognise the interest expense on the lease liabilities and the amortisation expense on the right-of-use assets to the income statement," he tells *The Edge*.

As for the tax treatment of the lease arrangements, Amarjeet says the latter are still subject to the same taxation rules as before, particularly in relation to eligibility

for capital allowance and deductibility of expenses.

However, says Amarjeet, the right-of-use asset will not be considered as qualifying capital expenditure for capital allowance purposes.

"The annual amortisation of the right-of-use and accretion of lease interest expense in accordance with MFRS 16 will not be tax deductible. However, taxpayers shall claim tax deduction on the actual contractual lease payments as incurred.

"Companies will need to track the accounting or tax differences in respect of such leases to ensure the correct tax position is taken, and to consider the impact on deferred taxes," he says, adding that the latter may arise because of the change in accounting treatment and on-balance sheet recognition.

PwC Malaysia, in a note titled "How Will Your Business Be Impacted by The New Lease Accounting Standard?" says expenses relating to MFRS 16 in the financial statements are unlikely to be relevant to tax reporting, given that they will not be based on actual cash rental payments.

"Previously, operating leases typically led to no capital allowance whilst financial leases typically led to the eligibility of capital allowance. Going forward, all leases in a lessee's balance sheet will be represented by a right-of-use asset and more work will be required to ascertain if capital allowance is available or not," the note says.



Amarjeet: Companies will need to track the accounting or tax differences in respect of leases to ensure the correct tax position is taken

On whether the adoption of MFRS 16 and recognition of the right-of-use asset on the balance sheet would constitute real property and impact Real Property Gains Tax calculations, Amarjeet says, "No, it will not impact RPGT calculations in determining RPTG liabilities. RPTG legislation prescribes the determination of whether a real property has been acquired and what its acquisition price and disposal price are. Such determination is not affected by MFRS 16 requirements.

"However, again, given the divergence between the accounting and tax treatments, companies should, all the more, ensure that they maintain and retain sufficient documentation for tax purposes as the financial statements may not reflect the tax treatment. For example, there was no acquisition of real property for RPTG purposes whereas a right-of-use was recognised in accordance with MFRS 16."

## Impact on a lessee's balance sheet

PRESENTATION	MFRS 117		MFRS 16
	OPERATING LEASE ACCOUNTING	FINANCE LEASE ACCOUNTING	MFRS 16 IN SCOPE LEASES*
Asset	No asset recognised	Property plant and equipment	Right-of-use asset
Liability	No liability recognised	Lease liability	Lease liability
Income statement	Straight-line single lease expense	Depreciation and interest expense	Depreciation and interest expense

\* Optional election not to apply recognition and measurement requirements to short-term leases and leases of low-value assets  
Source: PwC Malaysia

### Practical impact

Balance sheets of all affected companies will be grossed up by an asset and liability

### Practical impact

Higher gearing ratio, lower return on asset, potential impacts on debt covenants

unlikely to begin and end at the same time.

"Companies at a higher risk of failing to meet their dividend policy commitments are those that do not have sufficient profit or expect a concentration of leases to begin at the same time, resulting in a significant hit to profit.

"Shareholder expectations should also be managed in advance through communication of estimated impact," the firm says.

### A rethink of leases and performance measures

The adoption of MFRS 16 requires a rethink of leasing activities by organisations and questions whether measures such as Ebitda are still appropriate to be used as a key metric of performance.

With operating lease expenses no longer recognised in the profit or loss statement, the result is a higher Ebitda for companies, although their net profit may come in lower due to the higher depreciation and interest expenses recognised below the Ebitda line.

"The implementation of MFRS 16 does not change the value of a business. So, if one concludes that performance has improved due to improved Ebitda, perhaps this needs a relook," says Siew.

"There is no right or wrong but we need to assess what the Ebitda ratio is used for. It would not be a complete picture to say that business performance has improved because of higher Ebitda as a result of the implementation of MFRS 16. Other ratios should be looked at as well, such as gearing, liquidity and solvency.

"To make a meaningful Ebitda comparison,

the comparatives should also be restated to reflect the effect of the new [lease] standard."

As the liabilities on the balance sheet rise with MFRS 16, the gearing level of a company increases in tandem. Companies then need to be careful not to breach any debt covenants with their lenders.

"This would require companies to reassess how their debt covenants are being defined, whether they include lease liabilities or only bank borrowings. If they cover just bank borrowings, then MFRS 16 will not have an impact on debt covenants," Siew explains.

On rethinking the effectiveness of leasing, Heng says the decision on whether to lease or buy an asset is driven largely by commercial reasons rather than accounting impact.

"Companies tend to lease rather than buy an asset for reasons of cash flow, tax and others such as the fact that leasing provides flexibility with free upgrades, scheduled support from lessors, the option to buy at discounted prices and fewer responsibilities related to ownership," he says.

"While accounting should not be the key driver of commercial lease negotiations, market behaviour might change towards shorter lease tenures and no purchase options to minimise the liabilities, which the new accounting model is expected to increase.

"Some may also want to include more variable lease payments based on the usage of an asset compared with fixed payments while others may want to move to more service type of agreements rather than leases."

It is worth noting that short-term leases (of less than a year) and those of low value are exempted from MFRS 16 requirements.

### The effect on companies so far

In an interview with *The Edge* in September, AirAsia Group Bhd co-founder and group CEO Tan Sri Tony Fernandes spoke briefly about MFRS 16. "The adoption of MFRS 16 has hit our profit and loss. We are still getting to grips with it. I think we have overprovided and it will take us a few quarters to catch up in terms of fares. But our load factors are still strong," he said.

In its latest financial results, AirAsia's long-haul carrier, AirAsia X, saw its net loss widen 16.4% to RM229.89 million for the three months ended Sept 30, 2019, due to the higher depreciation and finance cost charges as a result of the implementation of MFRS 16.

Retailers too were affected. Starbucks Malaysia and Brunei operator Berjaya Food, for one, said its profit before tax, which came in at RM8.57 million in its first quarter ended June 30, 2019 (1QFY2020), was adversely impacted by the adoption of MFRS 16.

According to Siew, the impact of MFRS 16 on retailers boils down to how their lease rental agreements are structured. "If retail outlets have not been booked on the balance sheet, there will be a significant impact on retailers with MFRS 16. However, this will also depend on the negotiation of lease rental contracts.

"Variable lease rentals are not recognised as lease liabilities, where the variability is solely based on the performance of the assets. A common example in the retail sector is rental paid [to the lessor] that is contingent on a certain percentage of sales achieved by the retailer.

"On that basis, and assuming a variable lease term agreement, the lessee will not book any right of use asset or lease liability but would need to disclose the lease arrangement [in the notes accompanying the financial statements]. As and when the per-

centage of sales is achieved, the rental will be charged to the profit or loss statement [like an operating lease] as your payment profile, which is the rental, is contingent on the usage of the asset.

"Therefore, with MFRS 16, it is possible that retailers may opt to negotiate and structure their lease agreements differently," she says.

### Looking at the big picture

From an investor's standpoint, the Minority Shareholders Watch Group lauds the application of MFRS 16. Its CEO, Devanesan Evanson, a chartered accountant, says under MFRS 16, minority shareholders will be able to see the whole iceberg as opposed to seeing only its tip under MFRS 117.

"Minority shareholders will get a better feel of the whole commitment as opposed to what is annually expensed off it. They get to see the big picture. Thus, shareholders and potential investors can make better investment decisions. MFRS 16 holds true to the age-old adage of 'substance over form' and is therefore much welcome," he tells *The Edge*.

Indeed, accounting standards today — such as MFRS 139: Financial Instruments and MFRS 15: Revenue from Contract with Customers, both of which came into effect last year, and now MFRS 16 — call for more disclosure, prudence and transparency.

Undoubtedly, it will be an uphill task for those who prepare financial statements to grasp the changes that these standards bring and for management to communicate their impact to stakeholders.

But judging from the slew of financial scandals, which are becoming more complex by the year, from Enron almost 20 years ago to our own 1Malaysia Development Bhd today, any call for more disclosure and transparency will do more good than harm to corporate governance.