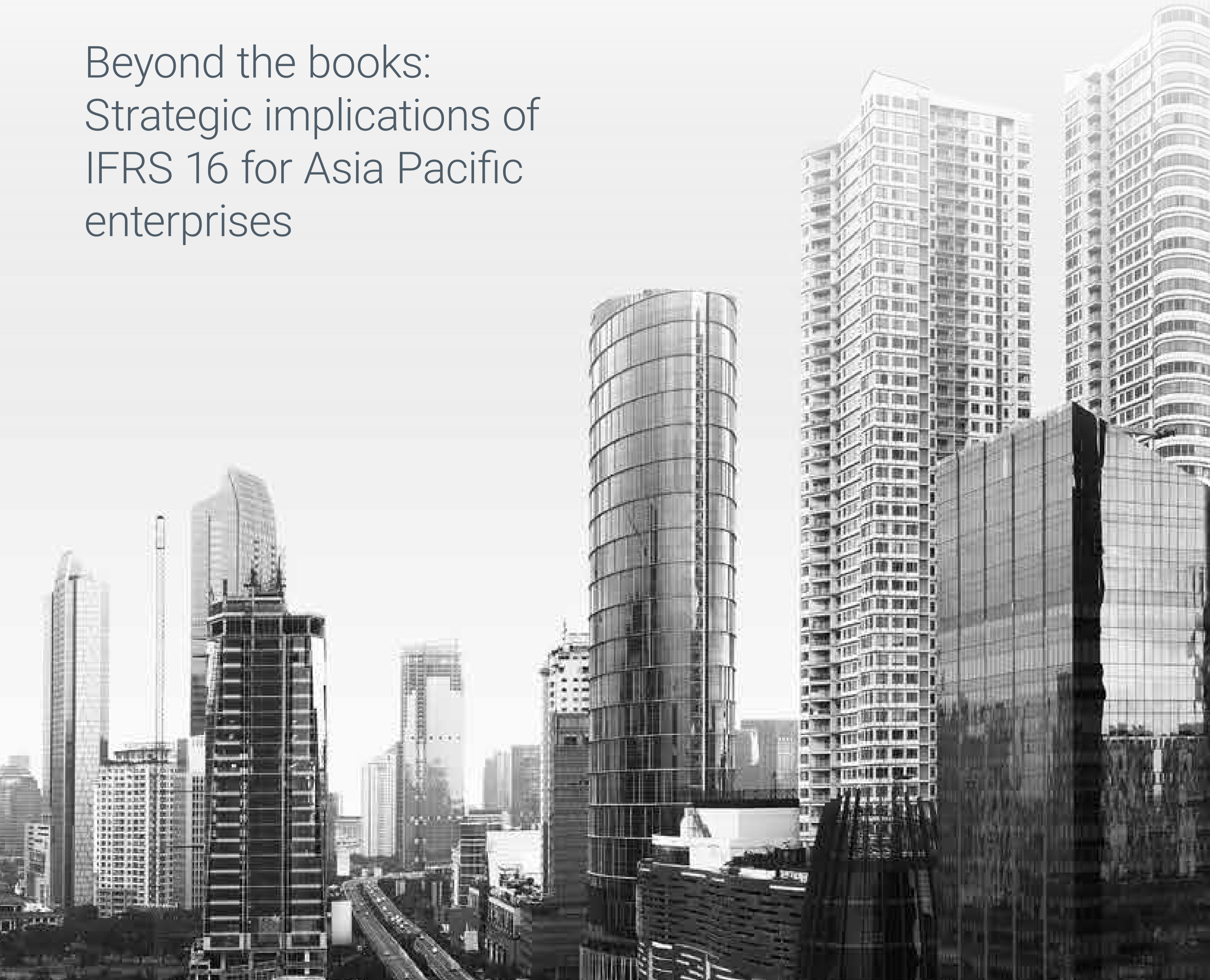
TMF GROUP

Global reach
Local knowledge

IFRS 16
IN ASIA PACIFIC

Beyond the books:
Strategic implications of IFRS 16 for Asia Pacific enterprises



ABOUT TMF GROUP

TMF Group helps its clients operate internationally, ensuring they are properly set up to do business in any country, fully compliant with local and international regulations.

Our work includes helping companies of all sizes with business services such as HR and payroll, accounting and tax, corporate secretarial, global governance, administration and fiduciary services for capital markets activities, private equity and real estate investments. We offer consultancy services to extend our clients' capabilities and help companies deal with the complexities arising from growth and expansion.

In today's environment, increasing business complexity means that a one-size-fits-all approach doesn't work, while the penalties for getting it wrong are becoming heavier. Operating in over 80 jurisdictions, we provide 15,000 clients with on-the-ground compliance and administration services so they can venture further, faster. We keep things running seamlessly, enabling them to focus on the bigger picture.

Our people localise the global world to help businesses succeed, which in turn helps communities prosper. We believe the only way to be truly 'global' is to put local first, which is what our team of 7,800 in-country experts do for businesses of all sizes, every day.

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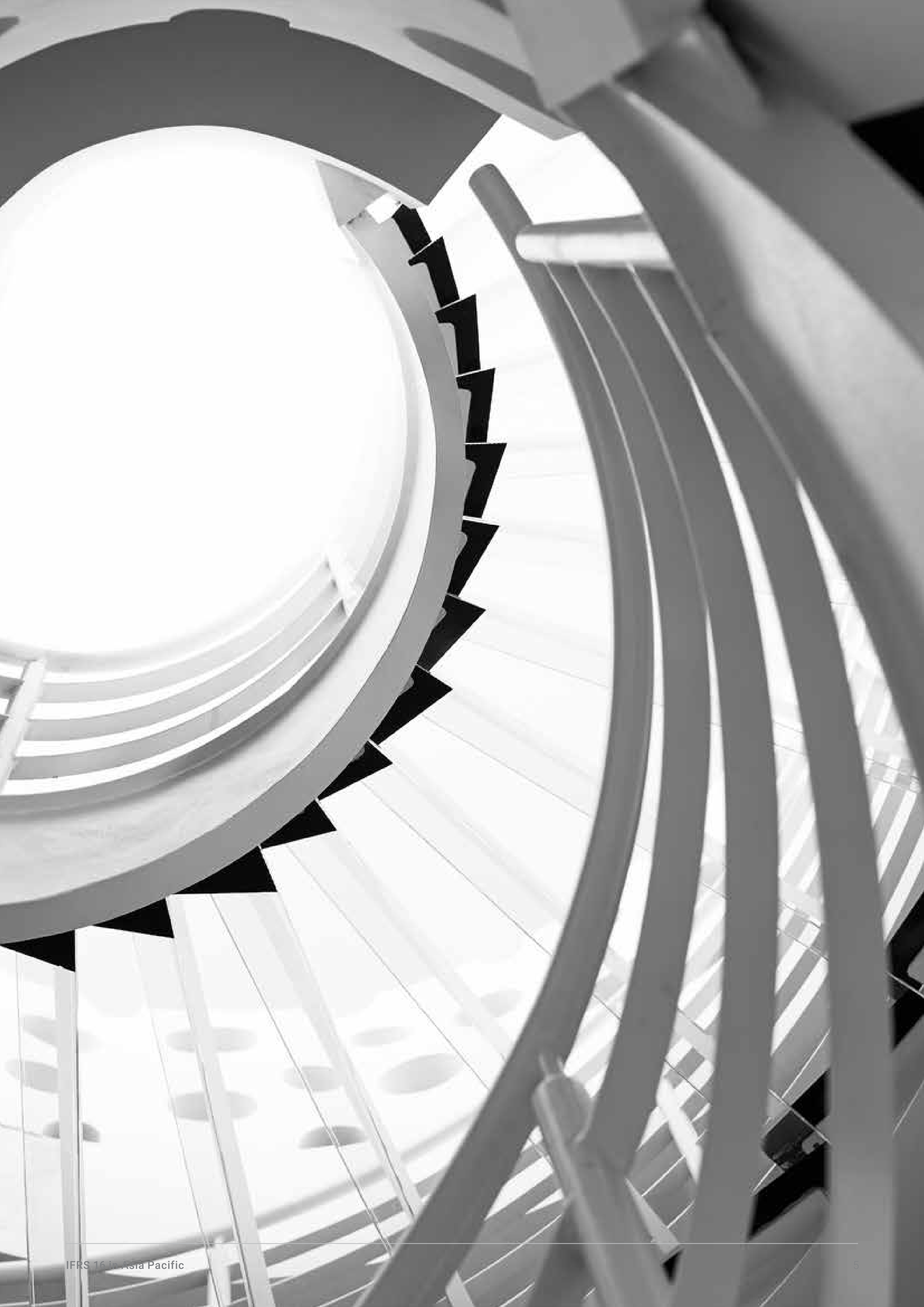
EXECUTIVE SUMMARY

Most enterprises in Asia Pacific are aware that International Financial Reporting Standard (IFRS) 16 has taken effect, entailing significant changes to the way leases are accounted for, particularly for lessees. Less understood are the broader impacts of the standard, which will have ramifications beyond finance in virtually all business operations, from information technology to human resources.

This paper, based on extensive research and the input of TMF Group experts, is intended as a guide to these impacts and the strategies enterprises should adopt in response. Its key conclusions include:

- While implementation patterns vary across the region, the far-reaching impacts of IFRS 16 argue for an early response regardless of where a company operates.
- As well as the balance sheet implications, companies need to consider the indirect changes IFRS 16 will bring to performance measurement and data management, particularly in a region where lease structures and information vary.
- Treasury departments should anticipate increased demands for discount rate calculations, and closely monitor the consequences of IFRS 16 for loan covenants and foreign exchange hedging strategies.
- A company's IFRS 16 transition approach should be based on careful assessment of data resources and the input of all functions involved. The importance of talking to stakeholders early and managing their expectations on the financial impacts of IFRS 16 should not be underestimated.
- Careful balancing of resources and strategic partnerships can help ease firms through the difficult transition phase and pave the way for ongoing compliance.



IFRS 16: REGIONAL READINESS

Put simply, to enhance transparency for lessees, IFRS 16 eliminates the distinction between finance leases, which were previously capitalised on corporate balance sheets, and operating leases, which were not.

Virtually all businesses lease property and other assets and equipment and in some industries, such as retail and airlines, leases are central to the business model. With all leases (bar a few short-term, lower-value exemptions) brought on the balance sheet, both the total liabilities and assets of lessees adopting IFRS 16 will increase.

This will have knock-on effects on key financial ratios like profit and loss (P&L) and earnings per share (EPS), which will decline in the early years of a lease; and earnings before taxes, depreciation and amortization (EBITDA), which will increase as rental expenses are no longer presented above the line.

Impact on key metrics of lesses

Balance sheet	Profit and lost	Cash inflows	Ratios
• Total assets • Total liabilities (interesting- bearing)	• EBITDA • Operating profit	• Operating activities	• Gearing
• Net assets	• Profit (towards beginning of lease term)	• Financing activities	• Asset turnover • Current ratio • Interest cover

IFRS 16 came into effect on 1 January 2019, and has been adopted relatively consistently across most Asia Pacific markets. However, there will be variances in implementation influenced by different reporting periods and local regulatory requirements.

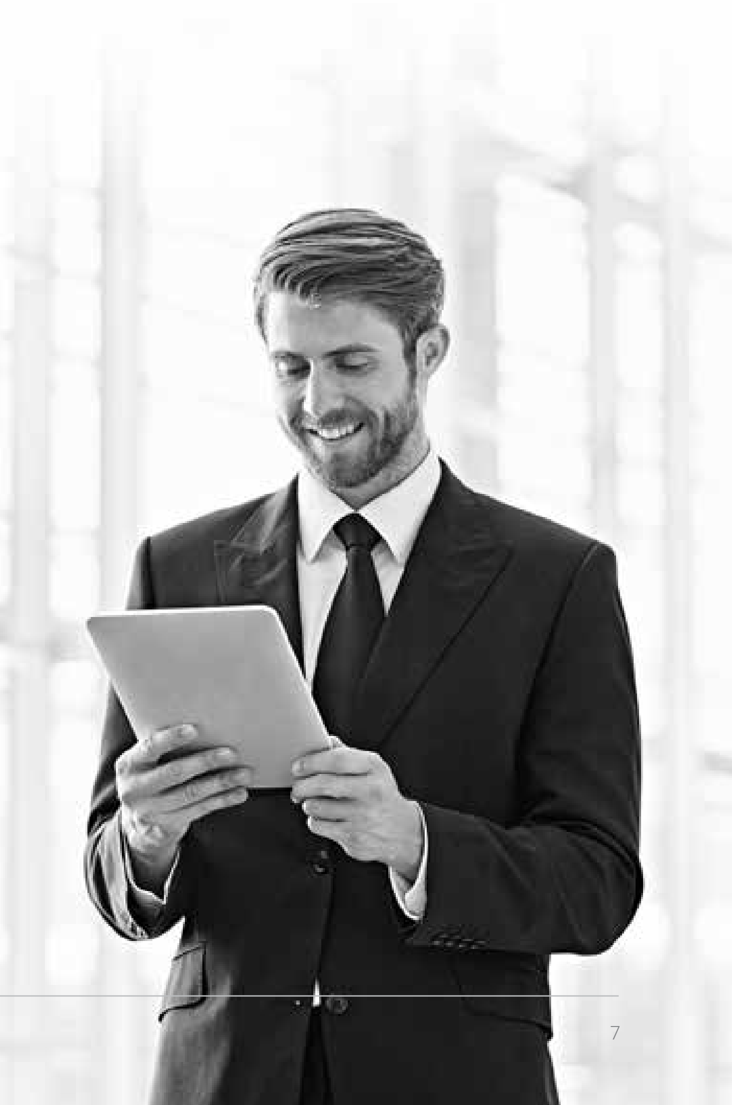
In Hong Kong, for example, most companies have a December financial year-end and submit financial statements to the Inland Revenue Department in August the following year. IFRS 16 impacts may become more apparent when listed companies release interim results in July 2019. In Australia, most year-ends are in June, so some companies will not technically need to grapple with IFRS 16 until the second half of 2019.

Similar patterns are evident in Singapore, Malaysia, India and the Philippines, where common accounting periods and reporting practices mean many companies won't have to address IFRS 16 until later in the year. The equivalent standards in Thailand and Indonesia are not effective until January 2020. In China, the Ministry of Finance only released the local version of the standard in December 2018, giving non-listed companies up to 2021 to adopt.

The net result is that while IFRS 16 is already a reality, actual implementation is sporadic across Asia Pacific and is likely to remain so for some time. Firms that are listed, active across several markets or moving in line with the practices of international parents, are generally adopting a more proactive approach, but may still resort to boilerplate disclosures in their 2018 financial statements. Awareness and preparatory efforts among smaller, private firms remain limited.

The concern is that this will result in panic as subsequent reporting deadlines approach, with companies scrambling to comprehensively reflect IFRS 16 on their balance sheets for the first time; explain the changes that result to investors and other stakeholders; and manage the impacts on other aspects of their operations, all at the very last minute.

This process is likely to present specific challenges for companies whose business models depend on leasing, but will not prove easy for any business, as any potential fallout from IFRS 16 will only be apparent when it is adopted in full. This is why companies should begin integrating IFRS 16 into their financial, operational and strategic planning at the earliest opportunity - and to pay close attention to outcomes that may have been less discussed or expected.



BRACING FOR CHANGE

We have already seen unexpected impacts in the food and beverage and retail sectors in Hong Kong, where it is common for companies to enter into leases in which a portion of the rent is variable based on shop turnover. Under IFRS 16 variable lease payments will, in many cases, remain off the balance sheet, but the standard may change the appetite for agreements of this kind, and the way they are negotiated with landlords.

Examples like these point to the necessity of planning ahead and the need to involve non-finance personnel, especially in the following areas.

OPERATIONS

Performance measurement:

The changes IFRS 16 will bring to gearing ratios and common indicators of financial health (such as EBITDA) are clear, but companies may not have considered corresponding changes to the compensation structures that are connected to these metrics.

Firms should look closely at what higher EBITDA, for example, would mean for remuneration and bonus payments across the organisation, and work with human resources to develop new compensation packages that eliminate any distortions.

To date, we've seen firms adopt different approaches to this issue. Some are measuring EBITDA on a 'Frozen GAAP' basis. This preserves pre-IFRS 16 positions but is only viable for the short term. Others are refreshing remuneration schemes completely. When leases are integral to the core business they may be tied to an 'operational' P&L in which rental costs are measured and included for internal management reporting purposes.

However finance teams will eventually need to reconcile these with 'IFRS 16-compliant' P&Ls. Regardless of the approach a company adopts, it's essential that any changes and the reasoning behind them are communicated and explained to internal stakeholders early.

Data collection and management:

IFRS 16 will require more than a second look at the leases organisations hold. In many instances leases will need to be scrutinised carefully to gather granular data points that will have to be managed and shared in a way that supports all necessary calculations. The resulting data should be assessed for strategic or business implications.

For instance, the standard requires the separation of a leasing contract into lease and non-lease components. The latter include items such as maintenance fees that (until now) have been commonly bundled into rental expenses in many markets, and may prove difficult to carve out.

Discount rates, which IFRS 16 requires to measure a lessee's lease liability, could also prove a struggle, since they need to be based in part on the rate implicit in the lease - information many lessors will not be readily willing to supply. Companies may attempt to refer to their borrowing costs with banks as a starting point, but the reality is that for many no easy benchmarks will be available.

Enterprises active in multiple Asia Pacific markets may need to draw and standardise information from leases in various languages and formats. Adding to the complexity, what would meet the definition of a 'lease' under the new standard will not always be identified as such commercially. Service contracts and energy supply contracts, for example, could be caught up in the IFRS 16 'net'.

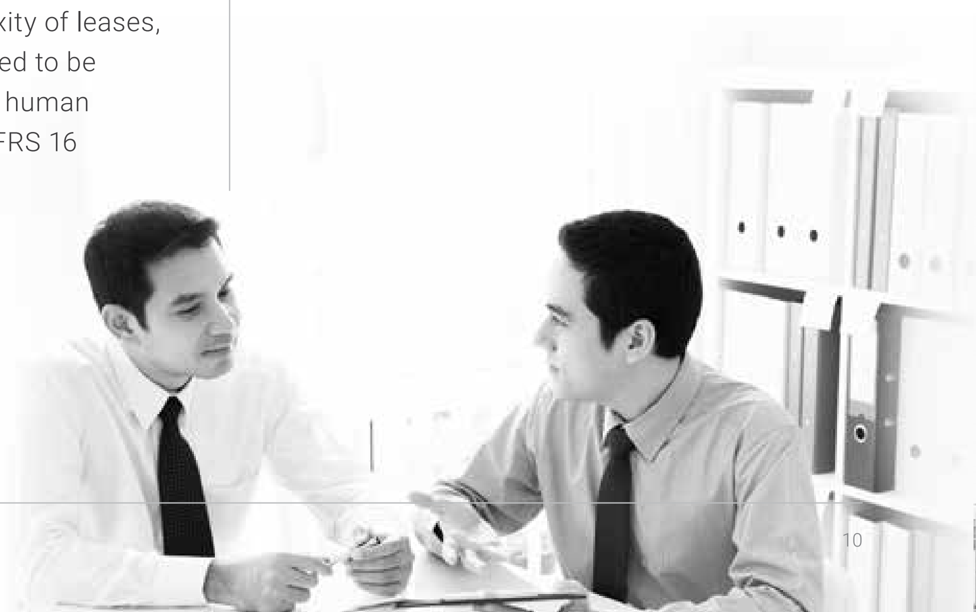
We recommend firms appoint people with the requisite skillset to examine vendor contracts in detail. They should determine whether such agreements meet the definition of a lease under IFRS 16 and if so, whether they have lease components that will require them to be brought, in whole or in part, onto the balance sheet. Again, the outcome of the analysis may change the way such service contracts are structured and negotiated.

Systems and software:

In many cases companies will have systems capable of catering to IFRS 16 data requirements. Software vendors have developed modules capable of performing the necessary calculations at the press of a button.

However, this software can be expensive and difficult to integrate with other functions or systems. A system that captures data from a lease agreement; enters it into enterprise resource planning (ERP) systems for vendor management purposes; and ensures it flows through to accounting enables a much more holistic approach to lease management and reporting than one that automates IFRS 16 accounting alone.

That said, such a system may be an ambitious investment for a company with simple leasing arrangements. The quantity and complexity of leases, costs, and availability of resources all need to be considered in deciding on the balance of human and technological resources applied to IFRS 16 compliance.



TREASURY

A substantial part of the IFRS 16 burden will fall on the treasury function, which may need to reallocate resources and revise policies as a result. The main pressure points will include:

Discount rates:

The treasury department is likely to face demands to produce estimates of the discount rates or discuss these rates with lenders. Before, many organisations' discount rates were considered only on an entity-wide level. Now, more resources and close coordination with accounting and operational functions will be needed to determine discount rates for individual leases. These rates will also need to withstand possible scrutiny from analysts and external auditors.

Foreign exchange (FX):

We have seen cases where lessees with many leases across various markets denominated in different currencies - such as airlines - realised only upon examining their leasing arrangements in detail that IFRS 16 would cause additional volatility in the P&L through FX gains or losses. This has potential consequences for companies' hedging strategies, and will need to be managed carefully by treasury and factored into planning.

Loan covenants:

As IFRS 16 will typically result in companies appearing more indebted, the standard may challenge the covenants made with lenders. As with compensation, some companies and their banks are managing this by accounting for loan purposes on a Frozen GAAP basis, but this will only defer the issue until a loan has to be renewed or renegotiated.

As IFRS 16 takes hold, a sudden surge in debt levels could have consequences for a company's credit rating. While there is a view that major ratings agencies had already effectively been factoring leases (previously off the books but disclosed in financials) into their calculations, some firms may face an uneasy transition period before the practical impact of the new standard on lending arrangements becomes clear.

Close cooperation and transparency in communication with lenders will be key to managing this transition successfully - and in many enterprises, treasury will need to lead the charge.

TRANSITION ACCOUNTING: THE IMPORTANCE OF AN INFORMED CHOICE

IFRS 16 presents organisations with a choice of two basic transition approaches, both of which must be consistently applied to all leases: full retrospective, in which the new standard is applied retrospectively to all comparative periods with the financials for these periods, restated as if IFRS 16 had always been in effect; and modified retrospective, in which the impact is booked from 1 January 2019 (or whenever the initial application date is for the company), and past financials are not restated.

Two transition options

Transition approaches	Full retrospective	Modified retrospective
Principle	Apply IFRS 16 for all financial periods presented as if it has always been in place since original lease inception date i.e. retrospective	Apply IFRS 16 from 1 January 2019 (for calendar year-ends) i.e. cumulative catch-up. In addition, there are two measurement options available for the right-of-use assets that can be applied on a lease-by-lease basis.
Restatement of comparative information required in financial year 2019 financials?	Yes – both current year and comparatives financials prepared under IFRS 16	No – only current year financials prepared under IFRS 16
Date of retained earnings adjustment	1 January 2018 (for calendar year-ends)	1 January 2019 (for calendar year-ends)
Optional practical expedients available?	No	Yes
Disclosure requirements	Line-by-line comparison disclosure	Additional transition date disclosures required
Comparability of financial information	Higher	Lower
Costs involved	Higher	Lower

Both approaches carry advantages and disadvantages. The full retrospective approach is clearly a more complex and resource-intensive undertaking, but provides a better basis for comparability. The decision on which approach to employ must be evaluated across several key factors, including:

The corporate trajectory:

For firms planning an initial public offering or marketing to potential investors, the full retrospective approach will be virtually mandatory as sponsors and potential investors will demand the comparability it provides. For listed entities aiming to provide comparable financial information without the pain of applying a full retrospective approach, the use of 'pro-formas' in earnings releases and management discussion and analysis materials may prove an attractive alternative.

Availability of information:

In some cases, historical lease data is widely dispersed, poorly maintained, unavailable or otherwise inaccessible, making the full retrospective option less realistic.

We recommend companies conduct a thorough consultation with stakeholders and a comprehensive inventory count of lease-related data before making a final decision on which method is preferred and whether the data is of sufficient quantity and quality to support their chosen approach.

It is also important that key stakeholders are involved in the decision-making process and the impact of the standard is communicated to them as early as possible. In smaller firms finance may handle most aspects of leasing and the choice can perhaps be made by just one or two people. However, in larger companies with regional or international operations, board members and senior management, real estate, treasury and even IT teams will all likely need to be consulted.

CHARTING A WAY FORWARD

The main thing enterprises should keep in mind is that in choosing a transition option and overall IFRS 16 implementation, there is no 'one size fits all' approach. A course of action should be determined based on the structure and situation of the organisation.

IFRS 16's deep balance sheet and strategic implications argue for the development of a proactive framework for compliance. This should draw on the input and involvement of senior management and multiple business units, from real estate to treasury and IT.

Depending on the company's plans, external stakeholders from lenders to potential investors may need to be communicated with and consulted. Such stakeholders should be reached early, and regularly.

Companies must acknowledge that they may lack the time or resources to tackle IFRS 16 while attending to 'business as usual,' especially if their leasing arrangements are complex. Engaging an external partner with experience guiding enterprises through IFRS 16 modelling and data management processes can ease a substantial burden, especially during the intensive transition period.

Firms that operate across the region or internationally will also benefit from working with a partner with expertise on the ground in multiple markets and an understanding of how local practices will affect the application of IFRS 16 to businesses across various jurisdictions.

Expertise on local tax regimes is helpful since in some jurisdictions IFRS 16 may have flow-on tax impacts that need to be assessed and factored into decision-making. In Australia, for example, interest expense deductions are limited under the thin capitalisation rules. This means some companies whose interest expenses surge as a result of IFRS 16 could face deductions being denied.

Overall, despite the complexities, companies and their stakeholders alike stand to gain from the increased transparency IFRS 16 brings. Formulating an implementation strategy that factors in the effect of the standard beyond the books, and supporting that strategy with the right resources and partnerships, will position the enterprise to benefit from IFRS 16 and minimise the pain of transition.

HOW WE CAN HELP

At TMF Group, our goal is to keep you compliant with local tax and accounting obligations through the entire corporate lifecycle, from redefining internal functions to rapid expansion in new markets. Whether you need help with statutory bookkeeping, consolidated account preparation or international management reporting, we can manage your accounting processes across any jurisdiction without any conflict of interest. On IFRS 16, we are here to help you with:

1
Transition assessment and compliance

Our global team of in-house experts in over 80 jurisdictions can assess your current and past reporting for IFRS 16 compliance and offer direct and indirect tax compliance support in liaison with relevant authorities for registration, returns, calculations and recovery.

2
Accounting and Reporting

We can help maintain your books and records in accordance with IFRS 16 accounting standards in multicurrency formats and meeting relevant accounting policies used for management reports (including IFRS 16, local GAAP).

Get in touch

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