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IFRS 16 “Leases” – consequences on the financial statements and financial indicators

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Abstract

In January 2016, the International Accounting Standards Board (IASB) issued IFRS 16 “Leases”, which will replace the current standard IAS 17 “Leases”. IFRS 16, whose application is mandatory for financial years beginning on or after January 2019, sets out new rules for the recognition and measurement of leases, leading to a change of value for the elements recognized in the financial statements, as well as for the financial indicators calculated based on these. The purpose of this article is to present, based on a comparative analysis of IFRS 16 and IAS 17, the main consequences that the application of IFRS 16 will arise, in respect of the financial statements and the financial indicators determined based on the information provided by these.

Keywords: *IFRS 16 “Leases”, lessee, consequences, financial statements, financial indicators, IAS 17 “Leases”.*

JEL Classification: *M41*

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Introduction

One of the objectives of IASB (International Accounting Standards Board) is to make certain that, in order to take useful decisions, current and potential investors are provided with high quality, transparent and comparable information, through the financial statements (IFRS Foundation, 2013). According to this purpose, IASB issued in January 2016 the standard IFRS 16 "Leases", which sets out new rules for the lease[1] recognition, measurement (valuation) and disclosure in the financial statements. The application of this standard, which will replace the current IAS 17 "Leases"[2], issued in 1997 (IASB, 2015), is mandatory for periods beginning on or after January 1, 2019. The application before that date is allowed, but only if IFRS 15 "Revenues from Contracts with Customers" is also applied. In the European Union, it is expected that IFRS 16 "Leases" will be endorsed by the EFRAG in 2017 (EFRAG, 2016).

Though leasing is an important funding source for many companies, IASB estimated that, in 2014, 85% of the lease commitments of companies applying IFRS and USGAAP, i.e. 3,3 trillion dollars, were not disclosed in their balance sheets (IASB, 2016a). An explanation for this would be that both the currently applicable IAS 17, and the similar US standard[3], allow the classification of the lease contracts in finance lease (whose associated assets and liabilities are disclosed by the lessee in the statement of financial position), and operating lease (for which the lessee discloses information only in the notes).

The existence of the two models laid down by IAS 17 has been criticized over the years, as it doesn't allow the disclosure in the statement of financial position of a complete picture of:

- The assets that are controlled and used in performing the activities; and
- The liabilities associated to lease contracts that, economically speaking, can't be avoided.

As a consequence, the information provided by the statement of financial position, the statement of comprehensive income and the statement of cash flows are not sufficient for investors and analysts, in making decisions. In order to assure the comparability between entities, but also in order to determine the debt ratio and the employed capital, they currently adjust elements from the statement of financial position with information referring to the operating lease, found in the notes. This generates additional costs, as well as the overestimation of the indebtedness as, unlike liabilities associated to the finance lease, that are disclosed in the statement of financial position at a discounted value, the liabilities associated to the operating lease are presented in the notes at a non-discounted value.

With the application of IFRS 16, the IASB expects to eliminate these transparency and comparability deficiencies. The solution promoted by the IASB (2016b) for eliminating the off balance-sheet funding is to cease making a difference between the finance lease and the operating lease and to disclose in the lessee's (customer's) statement of financial position all leasing contracts, with some exceptions. As a consequence, many of the rights and obligations meeting the definition of assets and liabilities, as prescribed by the Conceptual Framework, but which are currently not recognized, will be disclosed in the statement of financial position. Under these circumstances, the quality of the information provided to investors will improve, and these will be able to perform more complete analyses of the financial position and performance of the entities.

This single recognition model of the rights of use and the obligations associated to lease contracts generated, over the elaboration of IFRS 16, different controversies on the complexity and the relationship between the generated benefits and the involved costs (Raymond Chabot Grant Thornton, 2016). In order to mitigate these controversies, IFRS 16 leaves it to the lessee whether or not to disclose in the statement of financial position leases with a period of less than one year, as well as those with a low value of the support assets[4]. Besides this simplification option, referring to the two types of

[1] We use the term "leasing", but the scope of the standard mustn't be limited to lease contracts, i.e. contracts between an entity and a non-bank financial company, whose business operating area is the leasing activity. According to IFRS 16, lease contracts are those contracts that convey "the right to control the use of an asset for a period of time, in exchange for consideration" (IFRS 16.9). As a consequence, the standard can refer to contracts with a different legal form, but a similar economic substance, like rental agreements, concessions of goods etc.

[2] This standard replaced IAS 17 "Leases", issued in September 1982.

[3] Financial Accounting Standards Board (FASB), Topic 840 Leases.

[4] Though not specified in the standard, the standard's basis for conclusions specifies that IASB referred to contracts whose value is lower than 5.000 USD.

lease contracts, all other lease contracts will have to be disclosed in the statement of financial position.

The application of IFRS 16 will mainly have consequences at the lessee, as this will be bound to recognize assets and liabilities that are currently not disclosed. On the other hand, IFRS 16 doesn't come with any significant changes for the lessor, compared to IAS 17, as the current rules for the classification and recognition of the lease contracts by the lessor are mainly maintained. The application of IFRS 16 will not have the same effects in all sectors. Its impact will however be significant in trade entities, as well as in the air and waterborne transport, that currently use high value goods, acquired based on operating leases.

In this context, we consider that it is to the best interest of such entities to perform, as soon as possible, an analysis of the consequences that the application of this standard will have on the information provided by the financial statements, as well as on the main financial indicators.

1. Consequences of applying IFRS 16 "Leases" on the financial statements

1.1. Consequences on the assets, the liabilities and the equity

As specified above, IFRS 16 requires that entities recognize in the statement of financial position the right to use the assets and the obligations associated to all lease contracts, except for leases with a period of less than one year and those whose support assets have a low value. As a consequence, the application of IFRS 16 will generate a significant increase of the assets and liabilities for entities with current operating leases of significant values.

Table no. 1. The recognition of the items in the statement of financial position

Items	IAS 17		IFRS 16 (all leasing contracts)
	Finance lease	Operating lease	
Assets recognized in the balance sheet	Yes	No	Assets recognized in the statement of financial position (balance-sheet)
Liabilities recognized in the balance sheet	Yes	No	Liabilities recognized in the statement of financial position (balance-sheet)
Rights and obligations off balance-sheet	No	Yes	No

If, with the application of IFRS 16, the assets and the liabilities of the entities increase, the earnings and implicitly the equity can increase or decrease. Yet, IASB expects that the influence of IFRS 16 will be not significant for most companies. However, apparently most affected will be air transportation and retail companies (IASB, 2006c). The effect of applying IFRS 16 on the equity will be influenced by several factors like, for instance: the period of the contract, the payment deadlines, the effective interest rate of the contract or the marginal debt ratio, the lease portfolio, the amortisation of the right to use the asset etc. Nevertheless, should an analysis of each single contract be performed, it is certain that, for the entire period, the consequences on the equity of applying IFRS 16 are identical to the consequences of IAS 17.

1.2. Consequences on the profit or loss of the period

Over the entire period of a lease, the value of the expenses recognized according to IFRS 16 will be the same as the value of the expenses accounted for according to IAS 17, in case of the operating lease. Yet, for every reporting period, the nature and the value of the expenses will be different. The application of IAS 17 involves the usually straight-line recognition of operating rental expenses, while under IFRS 16 the entity will recognize operating expenses with the amortisation of the right to use the asset, as well as finance costs (interest expenses), whose total value will be different between reporting periods, depending on the period of the contract, the amortisation of the right to use the asset, the payment deadlines and the implicit interest rate or the marginal interest rate. Yet, as a general rule, when the right to use the asset is amortised on a straight-line basis, the total expenses of the lease contract decrease over time as, in their turn, the interest expenses decrease while payments are being made.

Table no. 2. The recognition of the items in the profit or loss account

Items	IAS 17		IFRS 16
	Finance lease	Operating lease	
Revenues	X	X	X
Operating expenses (including amortisation expenses, but other than depreciation and amortisation expenses)	-	Yes	-
EBITDA			Increases
Depreciation and amortisation expenses	Yes		Yes
Operating income	-		Increases
Finance costs (interest expenses)	Yes		Yes
Income before tax			For each reporting period, it increases or decreases, depending on the period of the contract, the amortisation of the right to use the asset, the payment deadlines and the implicit interest rate or the marginal interest rate

1.3. Consequences on the cash flows

The application of IFRS 16 will have no impact on the cash outflows, however the structure of the flows in the statement of cash flows will be changed. In this line, the net cash flow generated by operating activities increases while, by the same amount, the cash flow of the financing activities decreases.

Table no. 3. The recognition of the items in the cash flow statement

Items	IAS 17		IFRS 16 (all leases)
	Finance lease	Operating lease	
Cash flows generated by operating activities	The fraction of the paid amount recognized as interest[1]	The entire amount paid	The fraction of the paid amount recognized as interest
Cash flows generated by investing activities	-	-	-
Cash flows generated by financing activities	The fraction of the paid amount representing principal repayment		The fraction of the paid amount representing principal repayment
Net cash flows		**-**	**Net cash flows remain unchanged**

1.4. Case study

On 01.01.N, the ALFA company rents a new building from the BETA company. The fair value of the building amounts to 1.500.000, and its period of use is estimated to 50 years. The period of the rental agreement is of 5 years. The annual rent of 12.000 lei is paid at the beginning of each year. The implicit rate of the lease contract can't be determined, hence a discount rate of 7% is used. At the ALFA company, the right to use the building is amortised on a straight-line basis, over the period of the contract.

[1] According to IAS 7 „Statement of Cash Flows", it can be included in the cash flows of the financing activities

IAS 17 „Leases”

Under the provisions of IAS 17, the presented rental agreement is an operating lease. Hence, the right to use the asset and the obligations of the rental agreement are not disclosed in the statement of financial position. Yet, the notes need to present the total amount of the payments generated by the contract, as well as a breakdown of the payments for the next periods: up to a year and between one and five years (IAS 17.35).

IFRS 16 „Leases”

With the application of IFRS 16, the presented rental agreement must be disclosed in the statement of financial position. Hence, the lessee recognises the right to use an asset, as well as an associated liability. The right to use the asset and the liability are measured at the discounted value (VA) of the payments generated by the contract, amounting to 52.647 lei. After the initial recognition, the right to use the asset is amortised over the entire period of the contract, whereas the annual amortisation amounts to 10.529 lei (52.647 lei/5 years), and the paid amounts are separated in principal repayment and financial expense.

VA = 12.000 + 12.000/(1 + 0,07) + 12.000/$(1+0{,}07)^2$+12.000/$(1+0{,}07)^3$+12.000/$(1+0{,}07)^4$= 52.647 lei

The comparative analysis of the consequences of the two accounting treatments on the assets, liabilities, equity, earnings and cash flows, illustrated in Tables 4, 5, 6, 7, 8 and 9, shows that the application of IFRS 16 leads to:

- The increase of the assets and liabilities of the ALFA company;
- the decrease of the earnings in the first years of the lease contract; however, over the total period of the lease contract, the earnings are identical with the ones disclosed under IAS 17;
- The decrease of the equity in the first years of the leasing contract; however, over the total period of the leasing contract, the result is identical with the one disclosed under IAS 17;
- The change of the cash flow structure, with no change of the total net cash flow amount.

Table no. 4. The breakdown of the paid amounts in principal repayment and interest

Date	Paid amount	Discount rate (%)	Principal repayment	Interest	Unsettled liability
01.01.N	0	7	0	0	52,647
01.01.N	12,000	7	12,000	0	40,647
01.01.N+1	12,000	7	9,155	2,845	31,492
01.01.N+2	12,000	7	9,796	2,204	21,697
01.01.N+3	12,000	7	10,481	1,519	11,217
01.01.N+4	12,000	7	11,215	785	0

Table no. 5. Comparative presentation of the consequences on the value of the assets and liabilities

Date	IFRS 16			IAS 17		
	Assets	Liabilities	Rights and obligations off balance-sheet	Assets	Liabilities	Rights and obligations off balance-sheet
31.12.N	42,118	40,647	0	0	0	48,000
31.12.N+1	31,589	31,492	0	0	0	36,000
31.12.N+2	21,060	21,697	0	0	0	24,000
31.12.N+3	10,531	11,217	0	0	0	12,000
31.12.N+4	0	0	0	0	0	0

Table no. 6. Comparative presentation of the consequences on the profit or loss

Item	31.12.N		31.12.N+1		31.12.N+2		31.12.N+3		31.12.N+4	
	IFRS 16	IAS 17	IFRS 16	IAS 17	IFRS 16	IAS 17	IFRS 16	IAS 17	IFRS 16	IAS 17
Income	X	X	X	X	X	X	X	X	X	X
Rental expenses	0	12,000	0	12,000	0	12,000	0	12,000	0	12,000
EBITDA	X	X-12,000	X	X-12,000	X	X-12,000	X	X-12,000	X	X-12,000
Amortisaton expenses	10,529	0	10,529	0	10,529	0	10,529	0	10,531	0
Operating profit/loss	X-10,529	X-12,000	X-10,529	X-12,000	X-10,529	X-12,000	X-10,529	X-12,000	X-10,531	X-12,000
Financing costs	2,845	0	2,204	0	1,519	0	785	0	0	0
Profit/loss before tax	X-13,374	X-12,000	X-12,733	X-12,000	X-12,048	X-12,000	11,314	X-12,000	X-10,531	X-12,000

Table no. 7. Comparative presentation of the consequences on the equity

Date	IFRS 16	IAS 17	Consequence of applying IFRS 16 on the equity
31.12.N	(13,374)	(12,000)	(1,374)
31.12.N+1	(12,733)	(12,000)	(733)
31.12.N+2	(12,048)	(12,000)	(48)
31.12.N+3	(11,314)	(12,000)	+686
31.12.N+4	(10,531)	(12,000)	+1,469
TOTAL	(60,000)	(60,000)	0

Table no. 8. Comparative presentation of the consequences on the cash flows (the paid interest is classified into the operating cash flow)

Item	N		N+1		N+2		N+3		N+4	
	IFRS 16	IAS 17	IFRS 16	IAS 17	IFRS 16	IAS 17	IFRS 16	IAS 17	IFRS 16	IAS 17
Cash flows generated by the operating activities		(12,000)	(2,845)	(12,000)	(2,204)	(12,000)	(1,519)	(12,000)	(785)	(12,000)
Cash flows generated by the investing activities										
Cash flows generated by the financing activities	(12,000)		(9,155)		(9,796)		(10,481)		(11,215)	
Net cash flows	(12,000)	(12,000)	(12,000)	(12,000)	(12,000)	(12,000)	(12,000)	(12,000)	(12,000)	(12,000)

Table no. 9. Comparative presentation of the consequences on the cash flows (the paid interest is classified into the financing cash flow)

Item	N		N+1		N+2		N+3		N+4	
	IFRS 16	IAS 17	IFRS 16	IAS 17	IFRS 16	IAS 17	IFRS 16	IAS 17	IFRS 16	IAS 17
Cash flows generated by the operating activities		(12,000)		(12,000)		(12,000)		(12,000)		(12,000)
Cash flows generated by the investing activities										
Cash flows generated by the financing activities	(12,000)		(12,000)		(12,000)		(12,000)		(12,000)	
Net cash flows	**(12,000)**	**(12,000)**	**(12,000)**	**(12,000)**	**(12,000)**	**(12,000)**	**(12,000)**	**(12,000)**	**(12,000)**	**(12,000)**

2. The consequences of applying IFRS 16 on the financial indicators

The future recognition in the balance sheet of the current operating lease contracts will have significant consequences on several financial indicators. In this line, some of these indicators will improve with the application of IFRS 16, while others will change for the worse (IASB, 2016c). IFRS 16 will have on financial indicators the consequences presented in **Table no. 10**.

Table no. 10. IFRS 16's consequences on financial indicators

Indicator	Significance	Ratio	Consequence of applyingIFRS 16	Explanation
Debt ratio	Long term solvability	Debt/Equity	Increase	The increase is due to the increased liabilities
Current liquidity ratio	Liquidity	Current assets/Current liabilities	Decrease	Current liabilities increase, while current assets remain unchanged
Total assets turnover	Profitability	Sales/Total assets	Decrease	The decrease is due to the recognition of new assets
EBITDA to interest coverage ratio	Long term solvability	EBITDA/Interest expenses	Contingent on other factors	Both EBITDA, and the interest expenses will increase. The increase is contingent on the characteristics of the lease portfolio
EBIT	Profitability	Earnings before interest and taxes	Increase	The expense with the amortisation of the right to use the asset will be lower than the expenses that are currently recognized with the operating lease

Indicator	Significance	Ratio	Consequence of applyingIFRS 16	Explanation
EBITDA	Profitability	Earnings before interest, taxes, depreciation and amortisation	Increase	It is no longer influenced by expenses that are currently recognised for the operating lease.
Net earnings for the year (profit or loss)	Profitability	Income – Expenses	Contingent on other factors	It is contingent on the characteristics of the lease contracts and the tax regulations
Earnings per share	Profitability	Net earnings/Number of issued shares	Contingent on other factors	It is contingent on the effects on the earnings for the year
Return on invested capital	Profitability	EBIT/(Equity + finance debt)	Contingent on other factors	Both EBIT and the finance debt will increase. The evolution of this indicator is contingent on the characteristics of the lease contracts.
Return on equity (ROE)	Profitability	Net earnings for the year/Equity	Contingent on other factors	It is contingent on the effect on profit or loss, which in its turn is influenced by the characteristics of the lease contracts
Net cash flows generated by operating activities	Profitability	Paid interest is not included in operating activities	Increase	The entire payment made (principal repayment and interest) is presented within financing activities
Net cash flows generated by operating activities	Profitability	Paid interest is not included in operating activities	Increase	Paid interest is lower than the payment made for the operating lease.
Total net cash flows	Profitability and liquidity	Difference between the inflows and outflows generated by the operating, financing and investing activities	No consequence	The payments made will be the same as the current ones.

3. Conclusions

Unlike the current IAS 17, IFRS 16 will no longer differentiate between finance and operating lease, at the lessee. More, all lease contracts will be recognized in the statement of financial position. At the lessee, this treatment will lead to changes of the information disclosed in the financial statements. In this line, the value of the assets and the liabilities disclosed in the statement of financial position will increase. In addition, the profit or loss of the period will no longer be distributed on a straight-line basis, as it is currently the case for operating leases. The expense associated to the lease contracts, consisting in the amortisation of the right of use and the finance cost, will differ between the reporting periods, depending on the period of the contract, the amortisation of the right to use the asset, the payment deadlines and the implicit interest rate or the marginal interest rate. Though the total net cash flow will not be influenced, the statement of cash flows will show a higher operating cash flow, while the net cash flow generated by financing activities will decrease by the same amount. A change of the amounts disclosed in the financial statement will implicitly result in a change of the financial indicators determined based on these. Hence, the debt ratio, the current liquidity and the total assets turnover will decrease, while the profitability indicators EBITDA and EBIT will increase. As for the influence on the net earnings, this will depend on the period of the contract, the payment deadlines, the effective interest rate of the contract or the marginal debt ratio, the lease contract portfolio, the amortisation of the right to use the asset etc.

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