

LEASE ACCOUNTING UNDER IFRS 16 AND IAS 17 – A COMPARATIVE APPROACH

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Abstract: In January 2016 the International Accounting Standard Board (IASB) issued the International Financial Reporting Standard (IFRS) 16 Leases, this being the final step in accomplishing the goal of bringing most leases on-balance sheet for lessees. Whereas, under the provisions of International Accounting Standard (IAS) 17 Leases, a lessee had to make a distinction between a finance lease (on balance sheet) and an operating lease (off balance sheet), the new accounting model requires the lessee to recognise almost all lease contracts on the balance sheet (with optional exemptions for certain short-term leases and leases of low-value assets). The aim of this paper is to discuss some of the major differences between IFRS 16 and IAS 17 and to point out the effects of the new accounting model on a company's financial statements.

Key words: lease accounting, IFRS 16 Leases, IAS 17 Leases.

JEL Classification: M41.

1. Introduction

International Financial Reporting Standard (IFRS) 16 *Leases* is the new standard that replaces International Accounting Standard (IAS) 17 *Leases*. IFRS 16 is effective from 1 January 2019 and it was issued as part of the IASB's joint project with the Financial Accounting Standards Board (FASB), the US national standard-setter. As a response to the concerns regarding the lack of transparency of information about lease obligations, the IASB and the FASB initiated a project to improve the accounting for leases.

Both IASB and FASB agreed that a lessee obtains an asset and also a liability at the beginning of a lease. Applying lease accounting requirements based on IAS 17, most leasing transactions were not reported on a company's balance sheet, and therefore these assets and liabilities were not recognised on the balance sheet. According to IASB, listed companies using IFRS or US GAAP disclosed almost US\$3 trillion of off balance sheet lease commitments in 2014 [1].

IFRS 16 was issued to address the criticism of IAS 17, concerning especially the fact that many leases are off balance sheet, being difficult for users to get an accurate view of a company's lease assets and liabilities, and also to estimate the amount of off balance sheet obligations.

That is why the absence of information about leases on the balance sheet meant that investors and analysts did not have a complete picture of the financial position of a company, and were unable to properly compare companies that borrow to buy assets with those that lease assets, without making adjustments.

2. Literature review

From 2016 until now, there have been published several on-line guides for the implementation of IFRS 16, some of which being mentioned below.

PricewaterhouseCoopers published in March 2016 a detailed guide for implementing IFRS 16 (PricewaterhouseCoopers, 2016). In May 2016 Ernst & Young published an overview of IFRS 16 that describes the key principles of the standard and the impact of its adoption (Ernst & Young, 2016).

In June 2016, Deloitte published a guide that is intended to assist the preparers and users of financial statements to understand the impact of IFRS 16 Leases (Deloitte, 2016).

KPMG's publication regarding transition options to IFRS 16 provides an overview of the transition options and expedients and how they would affect a company's financial statements (KPMG, 2016).

We also note other implementation guides, published by BDO (BDO, 2016a) or Grant Thornton (2016).

All these guides contain the requirements of IFRS 16, accompanied by interpretations and examples to give clarity to those requirements, and pointers regarding practical issues that are likely to arise.

In Romania, the aspects concerning the new leasing accounting treatment are discussed in few articles. For example, Mutulescu A. (2016) reviewed the new requirements of IFRS 16 and focused on the important issues regarding the accounting model for the lessees and lessors. Sacarin, M. (2017) discussed the major differences between IFRS 16 and IAS 17, providing an illustrative example that points out the effects of applying IFRS 16 on a company's financial statements.

3. Key differences between IFRS 16 and IAS 17

In this article the key differences between IFRS 16 and IAS 17 relating to leases are examined. The article is focused on the following aspects: definition of a lease; classification of leases; initial and subsequent measurement (lessees); effects on the financial statements (lessees).

3.1. Definition of a lease

According to IFRS 16, a lease is 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. This definition is more focused on who controls the right-of-use asset, linking with IFRS 15 *Revenue from Contracts with Customers*. Non-lease components are still excluded, but lease components need to be reported on.

The lessee accounting model in IFRS 16 reflects the economics of a lease because, at the commencement date, a lessee obtains the right to use an underlying asset for a period of time, and the lessor has delivered that right by making the asset available for use by the lessee.

According to IAS 17, a lease is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time. The definition is focused on whether lessee or lessor carries the risk and reward. Both lease and non-lease components are accounted off balance sheet.

As a potential impact, we note that lessees are required to identify and separate non-lease components (i.e., services components such as maintenance) to ensure only the necessary ones are accounted for on balance sheet, therefore non-lease components may receive an increased focus in negotiation phases and their separation from a lease is more important. However, IFRS 16 does permit an accounting policy election (the practical expedient), whereby lessees can recognise the lease and non-lease component as a 'single lease component' on the balance sheet. If lessees choose to utilise this election, this would effect in increasing the lease obligations stated on balance sheet.

3.2. Classification of leases

Under IFRS 16, from a lessee's perspective, once an arrangement meets the definition of a lease, they are all recognised in the same manner, except for practical exceptions for short-term leases and low-value leases. The distinction between operating and finance leases remains in IFRS 16 only from the perspective of lessors.

According to IAS 17, leases are classified at the inception of a lease as a finance lease or an operating lease, based on whether or not substantially all the risks and rewards incidental to ownership are transferred. A finance lease is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset.

According to IFRS 16, no distinction is made between finance and operating leases from the perspective of lessees. IFRS 16 provides an option to lessees with short-term leases to account for them as operating leases, as they were accounted for under IAS 17 that is off balance sheet. Same option is provided also for leases where the underlying asset is of low-value. Short-term leases are those that as of the commencement date, have a term of 12 months or less, after considering reasonably certain lease options for extensions and terminations. This election must be applied consistently by class of underlying asset. Examples of low-value assets include tablets and personal computers, small items of office furniture and telephones. This election can be applied on a lease-by-lease basis.

3.3. Initial and subsequent measurement (lessees)

IAS 17 requires recognition of an asset and an assumption of an obligation (to pay future lease payments) based on the lesser of either the present value of the minimum lease payments or the fair value of the leased asset. Subsequent to initial recognition, the asset is amortized over the period of expected use/useful life on a basis that is consistent with the lessee's depreciation policy for other similar assets. Lease payments are allocated between a finance charge and a reduction of the outstanding liability.

If practicable, an entity is required to use the interest rate implicit in the lease as the discount rate in calculating the present value of the minimum lease payments. If not practicable, the lessee's incremental borrowing rate may be used.

Minimum lease payments, from the perspective of the lessee, are the payments over the lease term that the lessee is or can be required to make, excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor, along with any amounts guaranteed by the lessee.

Under IFRS 16 finance leases do not exist from the perspective of lessees. All leases (with limited exception) are recorded on balance sheet, similar to finance lease treatment under IAS 17.

Lessees are required to initially recognise a lease liability for the obligation to make lease payments and a right-of-use asset for the right to use the underlying asset for the lease term. The lease liability is measured at the present value of the lease payments to be made over the lease term (see below). The lease payments are discounted using the interest rate implicit in the lease, unless it is not readily determinable, in which case the lessee may use the incremental rate of borrowing.

- *Fixed payments* for lease elements, less any lease incentives receivable over the lease term
- + *Certain variable payments* linked to an index/rate based on level of index/rate at commencement
- + *Residual value guarantee*: amounts expected to be payable under residual value guarantees
- + *Purchase options / Termination costs*: exercise price of a purchase option if the lessee is reasonably certain to exercise that option or termination penalties if lease term reflects exercise of a termination option
- *Payments made previously*, as lease payments made to lessor at or before commencement date
- = **Lease liability**

The right-of-use asset is initially measured at the amount of the lease liability, adjusted for lease prepayments, lease incentives received, the lessee's initial direct costs (e.g., commissions) and an estimate of restoration, removal and dismantling costs (see below).

- *Lease liability* - the initial amount
- + *Initial direct costs*

- + *Costs of removal / Costs to restore*, as the estimated cost of removing and/or restoring leased asset
- + *Payments made previously*
- *Lease incentives received*
- = **Right-of-use asset**

In subsequent periods, the right-of-use asset is depreciated and accounted for similarly to a purchased asset, following either the cost or revaluation model under IAS 16 *Property, Plant and Equipment*. The method chosen must be consistent within major classes of assets. Right-of-use asset is subject to impairment testing under IAS 36 *Impairment of Assets*.

The lease liability is accounted for similarly to a financial liability. Accordingly, the lease liability is accounted for under the effective interest method. Lease payments are allocated between interest expense and a reduction of the lease obligation.

For lessees that depreciate the right-of-use asset on a straight-line basis, the aggregate of interest expense on the lease liability and depreciation of the right-of-use asset generally results in higher total periodic expense in the earlier periods of a lease. Lessees measure the lease liability upon the occurrence of certain events (e.g., change in the lease term, change in variable rents based on an index or rate), which is generally recognised as an adjustment to the right-of-use asset.

Example – Lessee accounting

On 1.1.20X1 an entity enters into a three-year lease of industrial equipments. The rentals are CU20,000 payable at the end of each year. The applicable discount rate is 6%.

The initial measurement of the right-of-use asset and lease liability is CU53,460:

$$= \frac{20,000}{1+0.06} + \frac{20,000}{(1+0.06)^2} + \frac{20,000}{(1+0.06)^3} = 53,460$$

The tables below summarise the Cash flows and Income Statement and the Balance Sheet (assuming straight-line depreciation over three years):

Table no. 1. Cash flows and Profit and Loss Account of the lessee

Cash flows and Income Statement	1.1.20X1 CU	20X1 CU	20X2 CU	20X3 CU	Total CU
Lease payments	-	20,000	20,000	20,000	60,000
Depreciation expense	-	17,820	17,820	17,820	53,460
Interest expense*	-	3,208	2,200	1,132	6,540
Total expense	-	21,028	20,020	18,952	60,000

*Interest expense = Lease liability x 6%

Table no. 2. Balance Sheet of the lessee

Balance sheet	1.1.20X1 CU	20X1 CU	20X2 CU	20X3 CU
Right-of-use asset	53,460	35,640	17,820	-
Lease liability (see below)	53,460	36,668	18,868	-

Table no. 3. Calculation of the lease liability

		1.1.20X1	20X1	20X2	20X3
		CU	CU	CU	CU
•	Fixed payments for lease elements	53,460	53,460	53,460	53,460
+	Certain variable payments	0	3,208	5,408	6,540
-	Payments made previously	0	20,000	40,000	60,000
=	Lease liability	53,460	36,668	18,868	0

The accounting entry on initial recognition:

	Debit (CU)	Credit (CU)
Right-of-use asset	53,460	
Lease liability		53,460

The subsequent accounting entry in 20X1 (Year 1):

	Debit (CU)	Credit (CU)
Depreciation expense	17,820	
Interest expense	3,208	
Lease liability	16,792	
Cash		20,000
Right-of-use asset		17,820

The accounting entries in 20X2 and 20X3 continue in the same pattern.

In this example rentals over the three years are CU20,000 every year. Under IAS 17, assuming this is an operating lease, the annual expense would be CU20,000. Under IFRS 16 the total expense over the three years is also CU60,000 but this is ‘front-loaded’, that is the expense is higher in the early years. This results from recognising interest at a constant rate of return on the outstanding liability.

3.4. Effects on the financial statements (lessees)

Effects on the balance sheet are the following: increasing lease assets, increasing financial liabilities and decreasing equity. For companies that have material off balance sheet leases, IFRS 16 is expected to result in an increase in lease assets and financial liabilities. The carrying amount of lease assets will reduce more quickly than the carrying amount of lease liabilities. This will result in a reduction in reported equity compared to IAS 17.

Effects on the income statement are as follows: increasing EBITDA (earnings before interest, taxes, depreciation, and amortization), increasing operating profit and finance costs and constant profit before tax. For companies that have material off balance sheet leases, IFRS 16 is expected to result in higher profit before interest (for example, operating profit) compared to the amounts reported applying IAS 17. This is because, applying IFRS 16, a company presents the implicit interest in lease payments for former off balance sheet leases as part of finance costs. In contrast, under IAS 17, the entire expense related to off balance sheet leases is included as part of operating expenses.

Effects on the cash flow statement are: increasing cash from operating activities, decreasing cash from financing activities, but constant total cash flow. IFRS 16 is expected to reduce operating cash outflows, with a corresponding increase in financing cash outflows, compared to the amounts reported applying IAS 17. This is because, under IAS 17, companies present cash outflows on off balance sheet leases as operating activities. In

contrast, applying IFRS 16, principal repayments on all lease liabilities are included within financing activities.

4. Conclusions

Based on IAS 17, from the perspective of the lessee, leases are classified as either operating or finance lease. Operating leases are off balance sheet and lease payments are recognized as an expense over the term of the lease. Finance leases are those that transfer substantially all the risks and rewards incidental to ownership of the asset to the lessee, and are recognized on balance sheet with a corresponding asset and financial liability.

IFRS 16 is significantly different than these requirements for lessees. With limited exceptions, all leases are on balance sheet and result in the recognition of an asset and a liability. Therefore, the new standard will affect balance sheet and also the related ratios such as the debt/equity ratio. Additionally, IFRS 16 will influence the income statement, because an entity now has to recognise interest expense on the lease liability and depreciation on the right-of-use asset. As a consequence, for lease contracts previously classified as operating leases the total amount of expenses at the beginning of the lease period will be higher than under IAS 17.

In the cash flow statement, lease payments related to contracts that have previously been classified as operating leases are no longer presented as operating cash flow in full. Only the part of the lease payments that reflects interest on the lease liability can be presented as an operating cash flow. Cash payments for the principal portion of the lease liability are classified within financing activities.

From the perspective of lessors, IFRS 16 is substantially unchanged from IAS 17.

Notes

[1] IASB, 2016. IFRS 16 – Project Summary and Feedback Statement, January 2016, pp. 3, available on-line at: http://www.ifrs.org/Current-Projects/IASB-Projects/Leases/Documents/IFRS_16_project-summary.pdf (accessed 7 March 2017)

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