Tănase, Alin Eliodor; Calotă, Traian Ovidiu; Oncioiu, Florin Răzvan

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The Impact of IFRS 16 on the Companies' Key Performance Indicators: Limits, Advantages and Drawbacks

Alin Eliodor Tănase[1], Traian Ovidiu Calotă[2], Florin Răzvan Oncioiu[3]

[1,2]Titu Maiorescu University, Romania, [1]E-mail: alineliodortanase@yahoo.com, [2]E-mail: traiancalota@yahoo.com
[3]Association of National Evaluators of Romania, [3]E-mail: oncioiu_florin@yahoo.com

Abstract *This article focuses on the impact of the new standard IFRS 16 Leases on the companies' key performance indicators. The magnitude of this impact could be said to change depending on the usage density of the lease in the companies and also depending on the sector they are in. The results show that future transactions may be influenced by IFRS 16 such as sale and leaseback, acquisitions and mergers, and lease vs. buying.*

Key words IFRS16, IAS 17, Operating Leases, Financial Leases

JEL Codes: M41

1. Introduction and literature review

IFRS 16 Leases standard sets out the principles for the recognition, measurement, presentation and disclosure of leases. It is effective beginning on or after January 1st, 2019 but earlier application is permitted for an entity as long as that entity also applies IFRS 15 Revenue from Contracts with Customers at or before the date of initial application of IFRS 16. This standard supersedes IAS 17 Leases, IFRIC 4 Determining whether an Arrangement contains a Lease, SIC-15 Operating Leases—Incentives, and SIC-27 Evaluating the Substance of Transactions Involving the Legal Form of a Lease. For a long time, the leases standards attracted the attention of both theoreticians and that of the practitioners.

An important statement of Durocher (2008) is that the impact of the reflection of the operating leases belonging to 100 companies having the highest revenue in 2002 and 2003 and whose securities have been traded in Canadian stock market on the balance sheet on the financial indicators under certain assumptions (interest rate, total life cycle of the lease/consumed life cycle/remaining life cycle and tax rate). Branswijck *et al.* (2011) have stated that the most important change is the elimination of the distinction between financial lease and operating lease in the draft study conducted by IASB and FASB published in 2010. They have determined that the liability/equity ratio, return on asset and current ratio are negatively affected. In addition; they have detected that these impacts occurring in the financial ratios show differences between the sectors.

By extension, Bohušová (2015) reiterates the idea that the changes to be made on IAS17 shall have important effects on the financial statements and financial ratios. In the study conducted by Öztürk and Serçemeli (2016), they aimed to indicate that the primary difference between the standard IFRS 16 and IAS 17 is the state of the fact that all lease transactions are reported as a financial lease transaction by the lessee regardless of whether the leasing is finance lease or operating lease and the fact that the disclosures of financial statements have been developed in a way that they shall reflect the cash flows, the financial performance and the financial position of the lessee or the lessor. In other words, IFRS 16 shall cause to the termination of the distinction between operating and financial lease, capitalization of the lease contract and the finalization of the unrecorded financing for long-term leases.

2. New perspectives on evaluation and presentation the leasing under IFRS 16

IFRS 16 defines lease as being a *contract* (or a *part* of a *contract*) that conveys the *right* to use / control an *asset* for a period of time in exchange for *consideration* [IFRS 16:9]. The exact definition contains the term *identified asset*.

On the other hand, IFRS 16, paragraph 18, requires an entity to determine the lease term as being the non-cancellable period for which a lessee has the right to use the asset (underlying asset) together with:

1. periods covered by an option to extend the lease if the lessee is *reasonably certain* to exercise that option; and
2. periods covered by an option to terminate the lease if the lessee is *reasonably certain* not to exercise that option.

Assessing of *reasonably certain* must be done based on all facts or circumstances creating economic incentive to exercise, such as:

1. contractual terms/conditions for optional periods compared with market rates;
2. significant leasehold improvements undertaken;
3. significant leasehold improvements expected to be undertaken;
4. costs relating to termination of lease/signing of new replacement lease;
5. importance of underlying asset to lessee's operations; and
6. conditionality associated with exercising the option (IFRS 16, Appendix B, Application guide, B37).

In this context we can analyze some of the terms, such as:

a) *identified asset* - the asset mentioned in the contract must be specifically identified. This means that, if the supplier has *substantive right* to substitute this asset, there is no identified asset.

Identified asset can be specified explicitly (e.g. serial number) in the contract or implicitly specified at the time that the asset is made available for use by the customer (IFRS 16, Appendix B, Application guide, B9). The right to substitute the assets may be considered as being substantive as long as the supplier has *practical ability* to substitute and it would also *benefit economically* from this substituting.

Practical ability exists when supplier has right to substitute asset (this means that customer has no power to stop this substitution) and alternative assets are readily available or could be sourced within a reasonable period of time (IFRS 16, Appendix B, Application guide, B14).

There are also situations when the right or obligation may exist but it is not *substantive* such as: assets is not working properly and it is substitute; assets is substitute caused by technical upgrade; substitution rights that can only be exercised on or after a particular date or at the occurrence of a future event (IFRS 16, Appendix B, Application guide, B15-18).

Also, if lessee cannot readily determine whether right is substantive, than it must consider that right is not substantive.

b) *right to use or control* - it must be interpreted as being the *right to obtain* substantially all the benefits from use of mentioned above asset, throughout the period of use, and the *right to direct* use of mentioned above asset, throughout the period of use (IFRS 16, Appendix B, Application guide, B9).

The economic benefits from use of an asset include:

- its primary output and by-products;
- payments from third parties relating directly or indirectly to use of asset.

Customer has the right to direct the use through period of use when if it has the right to direct how and for what purpose the asset is used. Likewise a customer has the right to direct the use of the asset when the relevant decisions are predetermined and customer has the right to operate the asset throughout period of use or the customer designed the asset in such a way that predetermines how and for what purpose the asset will be used (IFRS 16, Appendix B, Application guide, B24).

When the right to direct the use through period of use is analyzed it must take in consideration also the potential *protective rights* included in the contract by the supplier. Generally these protective rights (e.g. limit where or when the customer can use the asset) do not prevent the customer from having right to direct the use (IFRS 16, Appendix B, Application guide, B30). IFRS 16 provide a flowchart scheme that may help companies for assessing the contract if it's a lease or if it contains a lease (IFRS 16, Appendix B, Application guide, B31).

Based on the figure 1 let analyze these two examples and establish if the contract contains or not a lease.

Example no. 1

Entity ABC, as customer, signed a contract with a forwarder. The contract provides customer with exclusive use of 5 trucks of particular specification for four years. ABC has the power to established when, where and what goods will be transported under the local law regarding safety regulations on transport. Supplier has the obligation to substitute any of the trucks with a similar one if and only if there are necessary repairs or periodically revisions.

Analyze:

- There is an identified asset.
- The customer has the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use.
- The customer has the right to direct how and for what purpose the asset is used throughout the period of use.

So, the contract is a lease.

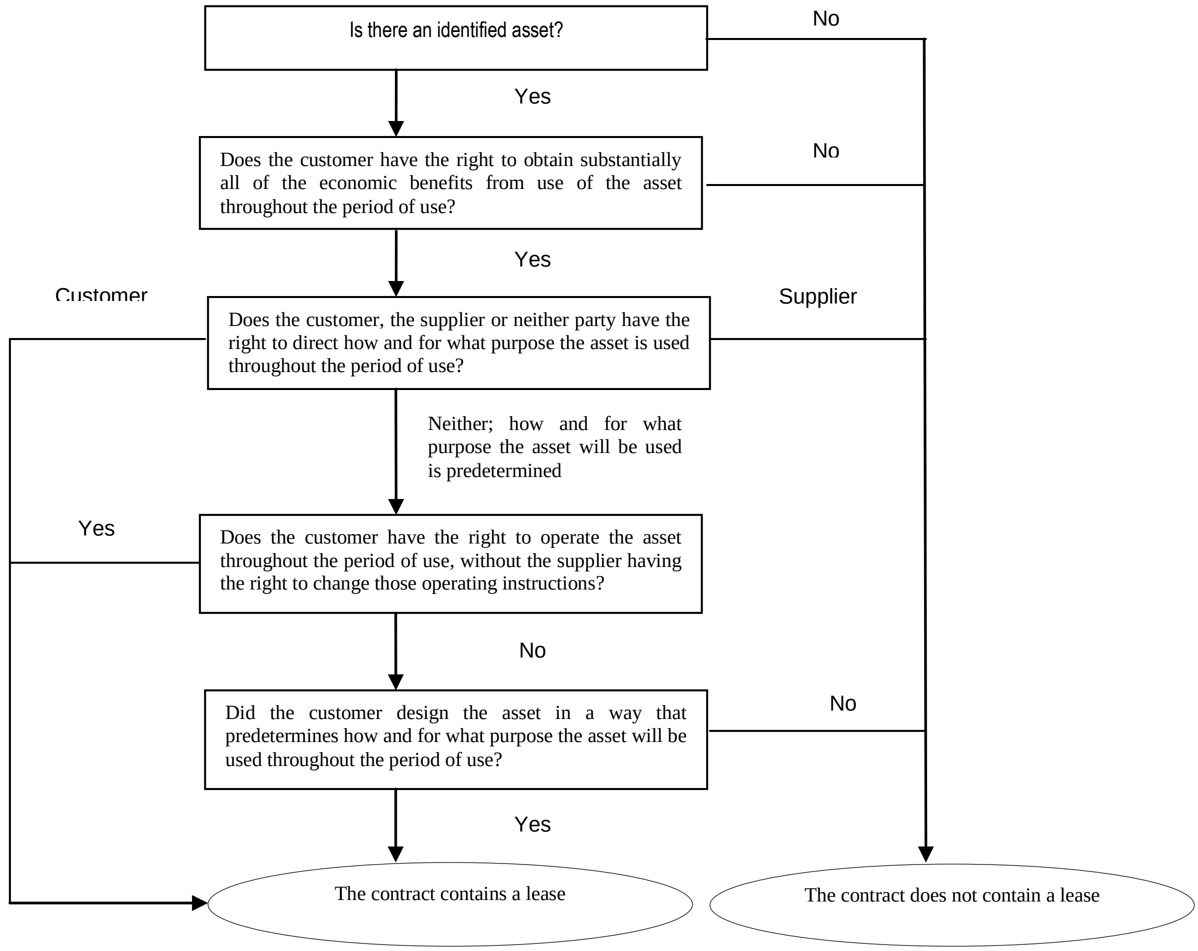

Figure 1. ”*The contract contains a lease*” and ”*The contract does not contain a lease*”

Example no. 2

Entity ABC, as customer, signed a contract with a forwarder. The contract obliges the forwarder to transport a specific quantity of specific goods, using a specific truck according to a predefined schedule for four years. Forwarder has a large fleet that can be used to transport the specified goods.

Analyze:

- There is not an identified asset. Actually the supplier has substantive substitution right.
- The customer has not the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use.
- The customer has not the right to direct how and for what purpose the asset is used throughout the period of use.

So, the contract doesn't contain a lease.

3. Results and discussions

The new standard is set to impact lessees more than lessors, since the accounting remains substantially the same for lessors.

Accounting by lessees suffered significant changes while lessor accounting remains basically similar with the previous requirements from old IAS 17 *Leases.* Main idea is: *all the leases* – finance or operating lease - are presented *on financial position* (balance sheet). At the commencement date – in financial position (balance sheet) - a lessee shall recognize both an asset (*Right-of-use asset*) and a liability (*Lease liability*) (IFRS 16: 22). *Right-of-use asset* shall be measured at *cost* at the commencement date (IFRS 16: 23). *Leasing liability* shall be measured at *present value of unpaid lease payments* at the commencement date. Also the lease payments should be discounted using the interest rate implicit in the lease. Sometimes the interest rate implicit in the lease can't be readily determined and, in this case, the lessee's incremental borrowing rate must be used (IFRS 16: 26).

The *lease payments* that are not paid at the commencement date shall be computed by adding the following items (IFRS 16: 27):

Table 1. Components and conditions of lease

Components	Conditions
(+) Fixed payments	including in-substance fixed payments
(-) Lease incentives receivable	any lease incentive received must be eliminated
(+) Variable lease payments	if depend on an index or a rate
(+) Residual value guarantees	Expected payments under guarantees
(+) Exercise price of a purchase option	if the lessee is reasonably certain to exercise the option
(+) Penalties for terminating	if the lease term reflects termination

In *income statement (profit and loss)* for all types of leases the lessee shall include in separate lines:

1. amortization expense (the right – of – use asset is generally amortized on a straight –line basis);

2. interest expense;

3. variable lease payments not included in the measurement of the lease liability in the period in which the event or condition that triggers those payments occurs.

If it's the case the lessee should apply IAS 36 *Impairment of assets* to establish whether right – of –use asset is impaired. If right – of –use asset is impaired an impairment loss must be recognized in income statement.

The classification of a lease as being either an operating lease or a finance lease is important – under IFRS 16 – only for lessor. In other words a lessor must classify, based on risks and rewards, each of its leases as either an operating lease or a finance lease. The classification must be done at the inception date based on substance over form principle (substance of the transaction is taking into consideration rather than the form of the contract). Subsequently the classification is reassessed only if there is a lease modification. The definitions of finance and operating lease are similar with the requirements from IAS 17, *Leases* as follow:

1. if a lease *transfers* substantially all the risks and rewards incidental to ownership of an underlying asset than this lease is a finance one;

2. if a lease *does not transfers* substantially all the risks and rewards incidental to ownership of an underlying asset than this lease is an operating one. (IFRS 16:62)

A lessor shall recognize – at the commencement date - all assets held under *finance leases* in its statement of financial position (balance sheet). The assets are presented as receivables at the amounts equal to the *net investments in the lease*. The lessor will recognize in its *income statement* finance income over the finance lease term. The pattern used must reflect the constant periodic rate of return on the lessor's net investment in the lease. The lessor will recognize in its *income statement* lease payments from *operating leases* as income. The recognition is done on either a straight-line basis or another systematic basis if it's more representatives (IFRS 16:81).

4. Conclusions

Implementation of the new lease accounting standard has the potential to fundamentally change financial, operational and strategic decision-making in the context of operating lease arrangements, particularly for lessees that have a significant exposure to property and large value leases.

However, not all the leases are in the scope of this standard. There are some exceptions, according to IFRS 16:3, such as biological assets within the scope of IAS 41, service concession arrangements within the scope of IFRIC 12, lease to explore for or use non-regenerative resources, rights held by lessees under certain licensing agreements (for these see IFRS 15), other intangible assets based on policy choice of lessees.

Based on the results it can summarize the impact of IFRS 16 over financial position (balance sheet), income statement (profit and loss) and cash flow statements, especially for lessee, as presented in the below table:

Table 2. Assets and liabilities of lease

Financial position	***Assets***	***Liabilities***
	Increase	Increase
Income statement	*Depreciation & Interest expense*	*Lease expense*
	Increase	*Decrease*
Cash flows statement	*Cash from operating activities*	*Cash from finance activities*
	Increase	*Decrease*

Cash payments for principal portions should be presented as cash flow from financial activities. Cash payments for interest portion should be presented according the entity's policy under IAS 7 Statement of Cash flows. Payments for short – term lease or payment for low-value assets should be presented as cash flows from operating activities. Also within cash flow from operating activities must be presented the variable lease payments not included- at the commencement date - in the measurement of the lease liability.

The main key financial indicators from income statements will be influenced as follow:

Table 3. The impact of key financial indicators

Key financial indicator	**Impact (Increase/Decrease)**
EBIT (Earnings Before Interest &Tax)	Increase
EBITDA (Earnings Before Interest, Tax, Depreciation and Amortization)	Increase
EBITDAR (Earnings Before Interest, Tax, Depreciation, Amortization, and Rent Costs)	No impact
EPS (Earnings per share)	Increase/ Decrease

Others important key financial indicators are redefined such as: ROE (Return on equity), ROCE (Return on capital employed), current ratio, assets turnover, net income, ICR (interest cover ratio). The new requirements eliminate nearly all off balance sheet accounting for lessees and redefine many commonly used financial metrics such as the gearing ratio and EBITDA. This will increase comparability, but may also affect covenants, credit ratings, borrowing costs and your stakeholders' perception of you.

In conclusion, the standard impacts different arrangements of an entity, such as tax arrangements, hedging arrangements, supply arrangements, financial arrangements and covenants. Consequently, the date of initial application is the first day of the annual reporting period in which a lessee first applies the requirements of the new leases standard. At the date of initial application of the new leases standard, lessees recognize the cumulative effect of initial application as an adjustment to the opening balance of equity as of 1st January 2019. Also future transactions may be influenced by IFRS 16 such as sale and leaseback, acquisitions and mergers, and lease vs. buying.

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