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Leases and the Conceptual Framework

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Abstract: *Applying IFRS 16 involves significant judgements and accounting policy elections that may impact the recognition of assets and liabilities, and their measurement. This report provides an overview of IFRS 16 and makes an comparison between IAS 17 and IFRS 16. The adoption of IFRS16 would influence the financial position of companies, which will be discussed in details in the report. Even though the issue of IFRS16 would affect the cash flow as well, this report would rarely focus on the part. Besides, the issue of IFRS16 also has impact on Chinese Accounting Standards (CAS21), which would be mentioned in the last part in the report.*

Keywords: *IFRS16; CAS21; Changes on Financial Position*

1. Introduction

This report introduces the information of IAS 17 and IFRS 16 in brief and makes a comparison between them. Comparisons are made from three aspects, which are accounting recognition, financial reports and related ratios, and financial position of companies. This report also addresses the effect of adopting IFRS 16 would have on readers of financial reports. Besides, the report discusses the effect that IFRS16 made on CAS 21. The last part is the conclusion, which is a summary of all the points mentioned in the content and gives the result that the change can lead to a better accounting quality.

2. Background

Allowing for the transparency of information about lease obligations becomes increasingly essential, the old accounting standard for leases, which is IAS 17, has been replaced by IFRS 16 in 2019. However, the adoption of the new accounting standard has significant effects on the accounting requirements and companies, especially for lessees who have leases with large amounts. Although lessors would find some familiar contents in the new lease standard, they are facing new challenges which cannot be foreseen. Besides, a new guidance on separating lease and non-lease components, sale and leaseback transactions and subleases is needed by lessors. On the other hand, it will also have some benefits for financial reports and improves the quality of accounting in New Zealand.

3. Discussion

IFRS 16 is the new accounting standard for leases which has replaced IAS 17 in 2019. People who refuse to accept the new rule mainly worry about the significant costs of implementing IFRS 16 and the financial positions of companies with a large quantity of material off-balance sheet leases will look worse[1]. However, after comparing the results of adopting with that of not adopting IFRS 16, we could find that the benefits of applying the new standard outweigh the downsides.

3.1 Changes in accounting recognition of leases

For lessees, under IAS 17, leases should be identified as finance leases, which are showed on the balance sheet, or operating leases, which will not be disclosed on the balance sheet[7]. Under IFRS 16, a lessee shall recognise a right of use asset and a lease liability[2]. Initial measurement and subsequent measurement of the right of use asset and the lease liability are revealed below. (see *Table 1*)

Specifically speaking, IFRS 16 removes the classification and requires that leases should be capitalised at present value unless the term of the lease is less than 12 months, or the costs of leases are small[11]. Besides, IFRS 16 emphasises the separation of services and leases in the contract. Specifically, lease contracts or lease component in the contract need to be reported on the balance sheet and vice versa.

As for the depreciation, which is known as amortisation, of the leased assets and interest on leased liabilities, IFRS 16 requires companies to record it in the income statement over the lease term.

The adoption of IFRS 16 will have few influences on lessors except for the enhancement of disclosure. Firstly, lessors still need to identify leases into finance or operating leases and account for them differently just as required in IAS 17[4]. On the other hand, additional information, such as the management of risks in leased assets, must be disclosed.

Adopting IFRS 16 can fix the problem that lack of transparency on financial data. Although under IAS 17, leases which are not reported on the balance sheet have been disclosed in notes, except for auditors, most people do not read notes to the financial statements. Thus, the application of IFRS 16 in the future can help analysts and investors, and especially individual investors have full pictures of the firms.

Table 1: Measurement of the right of use asset and the lease liability[5].

	Right of use asset	Lease liability
Initial measurement	a. The amount of the initial measurement of the lease liability. b. Any lease payment made at or before the commencement date, less any lease incentives received. c. Any initial direct costs incurred by the lessee. d. An estimate of costs to be incurred by the lessee in dismantling and removing the underlying asset to the condition required by the terms and conditions of the lease, unless those costs are incurred to produce inventories. The lessee incurs the obligation for those costs either at the commencement date or as a consequence of having used the underlying asset during a particular period.	a. Fixed payments less any lease incentives receivable. b. Variable lease payments that depend on an index or a rate, initially measured using the index or rate as at the commencement date. c. Amounts expected to be payable by the lessee under residual value guarantees. d. The exercise price of a purchase option if the lessee is reasonably certain to exercise that option. e. Payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.
Subsequent measurement	A lessee shall measure the right-of-use asset applying a cost model. The cost model should be applied by lessee who measure the right of use asset at cost, which means accumulated depreciation and accumulated impairment losses should be lessen, and adjustment should be made for any remeasurement of lease liability.	a. Increasing the carrying amount to reflect interest on the lease liability. b. Reducing the carrying amount to reflect the lease payments made. c. Remeasuring the carrying amount to reflect any reassessment or lease modifications, or to reflect revised in-substance fixed lease payments.

3.2 Changes in financial ratios and reports

Adopting IFRS 16, the company who has material off-balance sheet leases will increase the amount of lease asset and financial liabilities, and reduce the equity on the balance sheet. The influence on the income statement would be growing EBITDA, operating profit, and financial costs, profit before tax will not change. As for cash flow, the total cash flow amount will stay the same while the cash from operating activities will rise and cash from financing activities will drop. As a result, related financial ratios will change as well. The table reveals the influence on related ratios. (see *Table 2*)

Table 2: Influence on financial ratios[3].

Metric	What it measures	Expected effect of IFRS 16
Operating cash flow	Profitability	Increase
Net cash flow	Profitability and liquidity	No change
Gearing	Long-term solvency	Increase
Current ratio	Liquidity	Decrease
Asset turnover	Profitability	Decrease
EBIT/ Operating profit	Profitability	Increase
EBITDA	Profitability	Increase

The changes of listed financial ratios encourage the investors to make adjustments to their investment decisions. The disclosure of the financial information would make investors and analysts know the real

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situation of the firm, for example, a greater transparency of financial gearing and capital employed can encourage investors better to evaluate the performance of the company[6]. Not only can the users of financial reports benefit from the new standard, but also the companies. IFRS 16 enables firms to measure their financial position precisely and then, a more level playing field can be created[4]. Moreover, IFRS 16 requires corporations to recognise leased assets and liabilities, which means companies must identify how they can finance and operate their businesses more efficiently. Companies are expected to make their financial information to be aligned with management information for leases by applying IFRS 16.

3.3 Influences on the companies

As the discussion above indicates, the financial reports and related financial ratios will change if IFRS 16 is adopted. Not only will investors and analysts be affected, but the firms will also be impacted, for example, the cost of borrowing. This is because corporations with material off-balance sheet leases are expected to report higher financial liabilities and higher assets under applying IFRS 16. Whereas the profitability will be better because under IFRS 16, EBITDA does not include expenses related to leases and EBIT does not include interest on leased liabilities[10]. The tables below indicate the changes in financial liabilities and profits in specific areas. (see *Table 3* and *Table 4*)

Table 3: Percentage of off-balance sheet leases for firms from different industries.

	The amount of long-term financial liabilities (in millions of USD)		Long-term financial liabilities to equity ratio	
Industry sector	Reported on the balance sheet (IAS 17)	Reported on the balance sheet (IFRS 16)	Reported on the balance sheet (IAS 17)	Reported on the balance sheet (IFRS 16)
Airlines	114,818	234,202	123%	251%
Retailers	378,698	810,171	48%	103%
Travel and leisure	135,423	218,914	118%	191%
Transport	124,107	192,282	54%	84%
Telecommunications	808,574	981,218	79%	96%
Energy	1.017,236	1,305,094	42%	54%
Media	340,330	396,094	102%	119%
Distributions	174,509	199,601	91%	104%
Information technology	280,487	337,293	31%	37%
Healthcare	437,284	491,649	58%	65%
Others	2,629,476	2,936,211	64%	71%
Total	6,440,942	8,102,729	59%	74%

Table 4: The effect of IFRS 16 on EBITDA, EBIT and profit margin on different industries.

	EBITDA		EBIT / Total revenue		Increase in profit margin % before interest and tax (%)
Industry sector	IAS 17	IFRS 16	IAS 17	IFRS 16	
Airlines	51,624	73,849	6.33%	7.69%	1.36
Retailers	270,403	347,716	6.01%	6.66%	0.65
Travel and leisure	50.299	63,279	11.80%	13.15%	1.35
Transport	71,177	87,580	10.00%	10.70%	0.70
Telecommunications	399,328	434,452	13.18%	13.80%	0.62
Energy	688,370	745,273	8.11%	8.42%	0.31
Media	118,156	128,959	17.70%	18.29%	0.59
Distributions	29,350	35,047	3.70%	3.94%	0.59
Information technology	298,655	312,392	18.28%	18.50%	0.22
Healthcare	254,616	265,181	15.41%	15.63%	0.22
Others	1,162,512	1,228,643	10.63%	10.83%	0.20
Total	3,394,490	3,722,371	10.19%	10.58%	0.39

The costs of borrowing changes are likely to result from the availability of more accurate information on lease liabilities. Although the increase in borrowing costs is not good for the companies, it is good for lenders since they can be better informed about a company's credit risk, and then they can reasonably measure the risks of the loan. In other words, it means that changes to the cost of borrowing as the consequence of the lender's improved decision-making can also reveal the improved transparency on a firm's financial gearing[8].

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IFRS 16 not only affects the cost of financing, but it also enables companies to measure their financial position precisely, and then, a more level playing field can be created. Moreover, IFRS 16 requires corporations to recognise leased assets and liabilities, which means companies must identify how they can finance and operate their businesses more efficiently. Companies are expected to make their financial information to be aligned with management information for leases by applying IFRS 16[9].

Apart from the discussions above, IFRS 16 can also have an impact on a company's cash flow. This is because companies will now have to make lease payments on a regular basis, rather than just when they renew or acquire new leases. This can put a strain on a company's cash flow, especially if it has a large number of leases. Investors can be affected due to the issue of IFRS16 as well, since the companies will now be reporting different amounts of debt and expenses on their financial statements.

3.4 Influences on CAS 21

To be consistent with the IFRS16, the Ministry of Finance of China released the new accounting standard regarding lease, which is CAS21 on 7th December, 2018. Significant changes on financial statements, especially for lessees who have substantial operating leases, would be seen due to the issue of the new CAS21.

Considering that the operating leases and finance leases would no longer be differentiated, which means both of them would be recognised in the balance sheets of relevant lessees. Then, there would be significant growth in total assets and liabilities in the balance sheet. These changes may have influence on the lease negotiation, the lessor's operation is likely to be affected as a result. The new CAS21 optimised the principles to distinguish leases from services. New lease standard defines the contents of the "identified assets" and the "right to control", which is used to determine the scenarios where lease accounting can be applied. Due to the publishment of the new CAS21, the lessee does not need to separate the operating lease from the finance lease, and right of use assets and lease liabilities on all leases should be recognised in the balance sheet. It is noteworthy that short term leases and asset leases with low value that are subject to simplified accounting treatment should be excluded. Besides, interest expenses, accrued depreciation and impairment loss ought to be recognised as well. More guidance on lessor accounting can also be found in the new lease standard, which requires more focus on the substance of the transaction instead of the form of contract. Moreover, detailed explanations on the accounting treatment regarding finance lease and disclosure criteria when manufacturer and dealer become the lessor are mentioned in the new CAS21.

The standard offers the lessee with numerous options for transitional accounting treatment since the potential influence of the new CAS21 is notable and widespread. A firm may choose nor to revalue whether a contract which already existed is a lease of includes a lease on the first day when the new CAS21 is carried out. On the contrary, if the company selects to revalue the lease that is already existed, the retained earnings should be adjusted at the beginning of the year when the new lease standard carried out for the first time, while financial information in the comparative period will not be adjusted. Leases, that will be completed in 12 months after the first day of application of the new CAS21, may be defined as short term lease when companies who choose to adopt the method. Otherwise, the company needs to adjust the previous financial information by following the new lease standard.

For a lessee who has operation leases, total assets and total liabilities will both grow up because of the application of the new CAS21. Specifically speaking, the right of use assets and lease liabilities should be disclosed in the balance sheet according to the new CAS21, which may lead to a significant effect on a large number of financial indicators, especially for industries that heavily adopt the current operating lease model. Moreover, adopting the new lease standard will also have impact on the income statement of lessees since interest expenses will be classified as financial expenses. As a result, big changes will happen on EBITA and EBIT as same as the impact caused by the adoption of IFRS16, which has been discussed above in table 4. Also, total expense recognised in the income statement will be front-loaded, meaning that the total expense for the first few periods after the inception of the lease will be larger than the amount that would have been reported under the old standard[12]. Last but not the least, deferred tax would exist due to the distinction between lease expense and lease payment. For lessees, the lease payments will not always be disclosed under cash outflows that relates to operating activities. The repayment of the principal and interest of lease liability will be recognised as cash outflows that relates to financing activities. When it comes to the assessment of the lease term, significant judgement is involved in determining whether the option o renew or terminate lease will be exercised.

On the other hand, CAS21 is different from IFRS 16 in several aspects. Due to the specific circumstances of Chinese mainland, the land use rights are classified as intangible assets, thus not subject

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to CAS21. Under IFRS, however, the land use rights are regarded as property, plant, and equipment and are subject to IFRS16. Secondly, in IFRS16, lessee should adopt the principle of investment property in certain circumstances, which cannot be found in the new CAS21. Therefore, under the new CAS21, all right of use assets owned by the lessee should be subsequently measured under the cost mode of the fixed assets standards.

4. Conclusion

Adopting IFRS 16 will lead to changes in lease recognition and financial reports, which will subsequently influence the financing of the firm. The first two effects mainly encourage investors and analysts to have a better understanding of the financial position of the enterprise and then they can make a wiser investment decision. The third influence is about lenders, such as banks or other financial companies, and corporations themselves. The more transparent information being disclosed in the financial reports will help lenders measure the company's repayment capacity. Similarly, firms with the precise assessment of their financial performance will enable them to focus on the efficiency in operating and financing, especially for those with a lot of leased assets and liabilities. After analysing all the factors, we could conclude that accepting IFRS 16 will improve the accounting quality in New Zealand.

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