Accounting for the leases in accordance with the IFRS 16 and its impact on national accounting framework

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Abstract: *In highly capital demanding types of industries, the leasing is almost historically considered to be one of the principal sources for financing the acquisitions of PP&E. Surprisingly enough it has been overlooked by the accounting regulators for many years. From the point of view of IFRS, the first exposure draft dealing with leases was published in October 1980. Two years later, the final version of the IAS 17 has been issued. However, due to its rather comprising nature, IAS 17 became a target of dissatisfied users of financial statements. As a result of this discontent, a proposal for the new standard on leases have been added in to IASB agenda in 2006. After ten years of discussion, the standard (IFRS 16) have been completed in 2016, with effective date as of 1st of January 2016. The article is focused on the discussion of its main features and likely effects on Slovak IFRS adopters and users.*

Keywords: *leases, IFRS 16, leases*

JEL codes: M 41

1 Introduction

Due to its specific features, leasing have historically become of the main types of financing in many types of industries all over the world. Surprisingly enough, this fact has not been reflected in more than insignificant part of jurisdictions and all aspects of the lease transactions have been treated more or less as a menial provision of the services. While this approach is quite simple, straightforward and the cheap, it could contribute to conceal the true state of the financial affairs of the business. For example (Šlosárová and Bednárová, 2015) keeping the lease liabilities off the balance-sheet could greatly distort the ratios of liquidity or indebtedness. In addition, in certain jurisdictions, the lack of any appropriate regulation have resulted in recognition of expenses (and income) on the date of payments rather than of the date of the actual decrease of the companies´ wealth (Kubaščíková and Pakšiová, 2015) – clearly violating the accrual principle.

In order to cope with these problems on a world-wide level, *International Accounting Standards 17 (Leases)* have been issued by the International Accounting Standards Committee (IASC) in 1980. Though it has been amended several times and supplemented with three interpretations (SIC 15 in 1999, SIC 27 in 2001 and IFRS 4 in 2004), the result was not quite satisfactory. The reason was quite simple – in order to overcome the major opposition against the theoretically sound accounting rules, the IASC has adopted the two-tier approach. *First tier* of lease contracts has been considered as *operating leases*. Their accounting treatments were more or less following previous accounting rules (if any), except for the requirement to systematically recognize income and expenses throughout the period at which they have been incurred rather than previously applied practice of their recognition on the dates when the payments have been occurred. The *second tier* of contracts contains finance leases. In this case, upon the acquisition of the leased assets, the leassees have to recognize both the underlying asset and the related liability. However, as stated Parajka (2015), the distinction line between these two tiers were rather vague (which was a bit surprising, considering the totally different accounting treatment of both of them) and leads to limited adoption of this approach in national accounting regulations.

In practice, a proxy approaches simulating the application of the rules for the second tier for the data presented for the operating leases have been widely accepted and adopted as documented by Xu, Davidson and Cheong (2017). For example, the balance-sheets of the companies engaged in the operating leases have been adjusted by inclusion of assumed leased assets and liabilities computed initially as the product of the lease payments and coefficient. In order to resolve related problems the project of the new accounting treatment for the leases have been approved by the IASB in 2006. However, it took almost 11 years to complete it, with at least one significant change of its underlying paradigm.

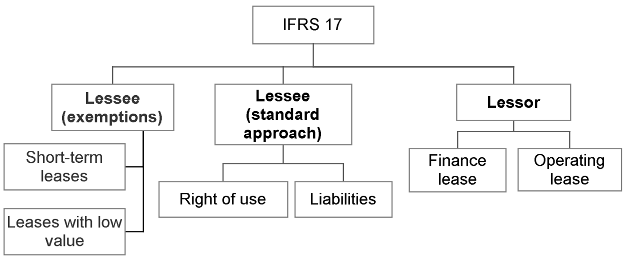
2 Methodology and Data

The new standard for leases, IFRS 16 (IASB, 2018), has been approved by the International Accountingg Standards Board in 2016, with its compulsory effective date being 1st of January 2019 (alas, there are some exception for the entities which are not using calendar year as their accounting period). As a result, there are no empirical data available. In order to cope with such inherent limitations, for the purpose of this paper we have adopted normative approach by which assess the provisions of the new IFRS 16 with the previous accounting treatment as applied by the former standard, IAS 17. While some authors have analyse the expected quantitative impact of the standard on financial ratios (Arrozio et al 2016, Moralez-Daz and Zamora-Ramirez, 2018) we have focus our attention on underlying changes which serve as an example of good practice and could be reflected in national accounting regulations in various countries, including, but not limited to, Slovakia.

3 Results and Discussion

Even though the change of the accounting practice introduced by the new standard seems to be quite difficult to assess, its main features could be captured effectively and quite fast (Figure 1).

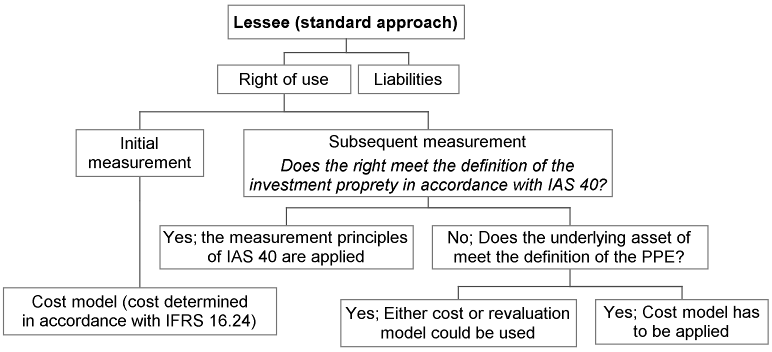
Figure 1 The main features of the IFRS 17



In accordance with the provisions of the IFRS 17, the lessors retain the principally same accounting approach as adopted by the IAS 17. Consequently, they continue to account for leases either as the finance or operating leases, based on the distinction criteria. The main change is on the side of the leassees. Under the provisions of IAS 17, the leassees were eligible to account for operating leases (provided that the lease have not meet the definition of the finance leases) as if they have no assets under their control and no related liabilities for the period of the contract lease. Consequently, part of the assets and liabilities have been kept off the balance-sheet. In accordance with the IFRS 17, this approach could be chosen by the leassees only in two cases – if the lease is short-term (under 12 month) or if the underlying asset is considered to be low value (no threshold, however, is explicitly stated). All other leases have to be accounted for by leassees in a standard way, which is quite similar (but not the same) as a former accounting treatment of the finance lease. However, there are some interesting differences (Figure 2).

Under the former requirements of the IAS 17, the leassees have to recognize underlying asset of the finance lease contract in accordance with the nature of such assets. For example, leased cars, airplanes, machine computers were recognized by leassess in their balance-sheets as a part of property, plant and equipment (PP&E). In addition, the underlying assets of the lease have to be initially measured at the lower of a) present value of the b) minimum lease payments or fair value (Juhászová et al., 2014).

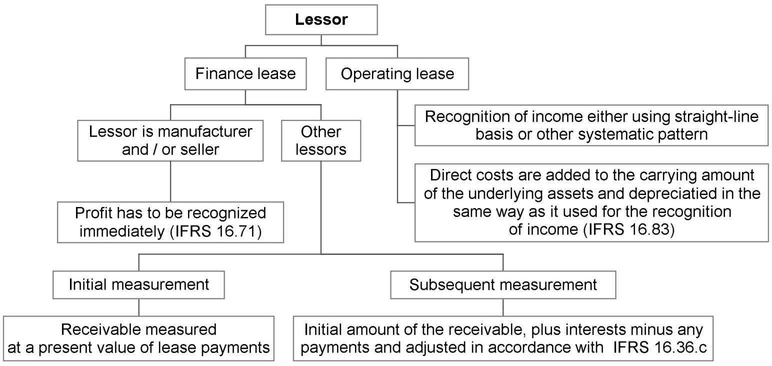
Figure 2 Standard approach for accounting for leases by the leassees (IFRS 17)



In order to determine the initial cost of the right of use of the underlying asset of the lease in accordance with the requirements of the IFRS 16, the leassee would have to establish the initial carrying amount of the related liability first. Upon the commence of the lease, the carrying amount of the liability is deemed to be equal to present value of the sum of *fixed lease payments*, *variable lease payments*, *amounts expected to be payable by the lessee under residual value guarantees*, *exercise price of a purchase option* (if any) and *payments of penalties for terminating the lease*, if the lease term reflects the lessee exercising an option to terminate the lease. Though the IAS 17 has called also for the estimation of the present value of the asset with reference to the lease payments, there was no explicit reference to variable payments (though definition of the minimum lease payments have take into account any amounts guaranteed by the lessee or by a party related to the lessee). The *right of use* is *initially measured* at the amount equal to the sum of initial estimate of the lease liability, plus lease payments made at or before the commencement date, initial direct costs incurred by the lessee and costs to be incurred by the lessee in dismantling and removing the underlying asset (similarly to requirements of the IAS 16.16.c) and less any lease incentives received. Subsequently (and, alas to a certain degree, surprisingly) the right of assets is deemed to be depreciated in the same manner as would be depreciated the underlying asset of the lease.

There is no substantial change in the patter of recognition of assets and income for the lessors between IAS 17 and IFRS 16 (see Figure 3).

Figure 3 Accounting for leases by the lessors (IFRS 17)



Conclusions

The changes in accounting treatment of leases brought up by the standard IFRS 16 could be considered as challenging. However, the major change is enhancement of the scope of the requirements of IFRS for finance lease to almost all leassees. In addition, IFRS could be considered to be more rigid than IAS 17 and provide less backdoors and makeshift reporting opportunities. In addition, because of its inherent logic, it could be applied in national accounting regulations framework at least as the source of inspiration. From the point of view of the users and prepares of the financial statements this step (if approved) could increase the quality of accounting data and confidence of the stakeholders in them, while decreasing the cost of capital (because of less risk of the bad decision) in the same time.

Acknowledgments

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