Volume **XIV**/2020 ISSN 2344-102X
Issue (XXIV) / **October** 2020 ISSN-L 2344-102X

EFFECTS OF THE IMPLEMENTATION OF IFRS 16 ON FINANCIAL STATEMENTS

Professor PhD Veronica GROSU
Stefan cel Mare University of Suceava, 720229, Romania
veronica.grosu@usm.ro

Abstract
The purpose of this paper is to analyze the effects of the implementation of IFRS 16 leasing on the financial statements of reporting entities, given that the International Accounting Standard IFRS 16 eliminates the difference between operational leasing and financial leasing by unifying the accounting treatment of the user who, in both cases, records now the right of use and related debts.

Key words: *IFRS 16, financial statements, operational leasing, financial leasing, contract*

JEL Classification: *M41*

I. INTRODUCTION

It is well known that leasing is an alternative to financing through long-term loans and with guaranteed guarantees, practically generating two problems that need to be solved, such as indebtedness and the cost of financing those operations. In these conditions, it is natural that leasing, as a source of financing, be included in the category of attracted or foreign capital.

The introduction of the new IFRS 16 standard requires the application of treatments according to which:

- the assets from the balance sheet will indicate the value of the leased asset;
- in the case of rents, the current value must be recognized in the balance sheet liability;
- the amortization rate of the right of use will be indicated in the profit and loss account depending on the duration of the leasing contract, and if this period is longer, for the entire useful life of the right of use.

International Financial Reporting Standard (IFRS) 16 Leasing is the new standard that replaces the International Accounting Standard (IAS) 17 Leasing. IFRS 16 is effective January 1, 2019 and was issued as part of the IASB's joint project with the Financial Accounting Standards Board (FASB), which sets US international standards. In response to concerns about the lack of transparency of information on leasing obligations, the IASB and the FASB have initiated a project to improve the accounting of leases. IFRS 16 has been issued to address the criticism of IAS 17, in particular that many leases are recorded in off-balance sheet accounts, making it difficult for users to obtain an accurate picture of leased assets and liabilities of a company and also assess the amount of off-balance sheet liabilities. This is why the lack of information on leases in the balance sheet meant that investors and analysts did not have a complete picture of a company's financial position and could not compare companies that lend to buy assets with those that rent assets, without making adjustments.

In other words, it is very important to remember the so-called *Right of use of ROU* or the right to use the leased asset, an element considered essential in distinguishing a lease from a simple service contract. In fact, in the new standard, the distinction between operational leasing and financial leasing is completely resolved by introducing a new interpretation of the difference between the leasing contract and the service contract (Fisco e Tasse, 2019).

IFRS 16 will apply to all leases, with two exceptions: the first is given by the fact that the contractual term is less than 12 months, the second depends instead on the low value of the asset; if the tenant is in a situation of exemption, he will have to account exclusively for the rents paid and provide the corresponding information in the explanatory notes.

For example, the financial statements for 2019, the first statements prepared in accordance with the new requirements of IFRS 16, allowed the assessment of the positive or negative effects of the adoption of this new standard, which changed in a structural way the accounting of leasing, had or did not have a positive effect. For example, special attention must be paid to the fact that the new rules in IFRS 16 have had (Fisco e Tasse, 2019):

- a strong impact on the financial indicators of the balance sheet;
- on the risk of reducing the comparability of the information contained in the financial statements

According to the new standard, the lease confirms that the lessee has the right to use the asset, and in return

Volume **XIV**/2020 ISSN 2344-102X
Issue (XXIV) / **October** 2020 ISSN-L 2344-102X

he must pay a series of periodic installments to the lessor, the owner of the asset. The lessor can be both the asset manufacturer and an independent leasing company. If the lessor is represented by an independent leasing company, it involves the purchase of the asset from a manufacturer. In this way, the lessor makes the purchased asset available to the lessee and the lease begins to take effect. The use of an asset may be effected by a lease. As long as the lessee has the right to purchase the asset, the purchase and lease of the asset are two different financial arrangements.

In practice, we know that there are two types of leasing: financial leasing and operational leasing, hence the accounting problems generated.

II. AN OVERVIEW OF THE LEASING MARKET IN EUROPE

According to data provided by ASSILEA (2019) in 2018, a phase of gradual slowdown in economic growth for the euro area has begun, spread across all major EU countries. In Italy, for example, in 2019, due to a domestic and international context of extreme uncertainty, it experienced a period of weakness caused mainly by the worsening of domestic demand, which was affected by a slow growth in investment. The long-term leasing and rental sector strengthened the dynamics of previous years in 2019, although on less important volumes, closing with 27.9 billion euros. Regarding the various forms of contract, it was mainly leasing with no option to purchase in its dual form of operational leasing instrument and long-term leasing to support the dynamics of the sector.

According to preliminary data published by Leaseurope, the European Leasing Federation (2020), on leasing in Europe in 2019, it was found that the leasing market in Europe in 2019 continued to grow, although at a slower pace than in the previous year. The volumes of the total stipulated contracts increased by + 3.1% compared to 2018, reaching a total of 357.1 billion euros. Over 95.7% of the new European volumes involved the securities sectors, which in 2019 reached 341,569 million euros (+ 2.9% compared to last year). At the same time, real estate leasing registered an increase of 6.9%, with over 15,533 million euros of new contracts. For example, in 2016, the new leasing volume reached a value of 333.7 billion euros, granted by companies represented through Leaseurope members (2017).

The United Kingdom recorded the largest leasing market in 2016, with a volume of 73.8 billion euros, followed by Germany (55.0 billion euros) and France (47.8 billion euros). Leasing entered the third year of solid recovery, a widespread activity, and almost half of these markets registered a double-digit increase. In particular, Russia, Ukraine and Greece have shown increases in leasing volumes, thus returning after several years of low levels.

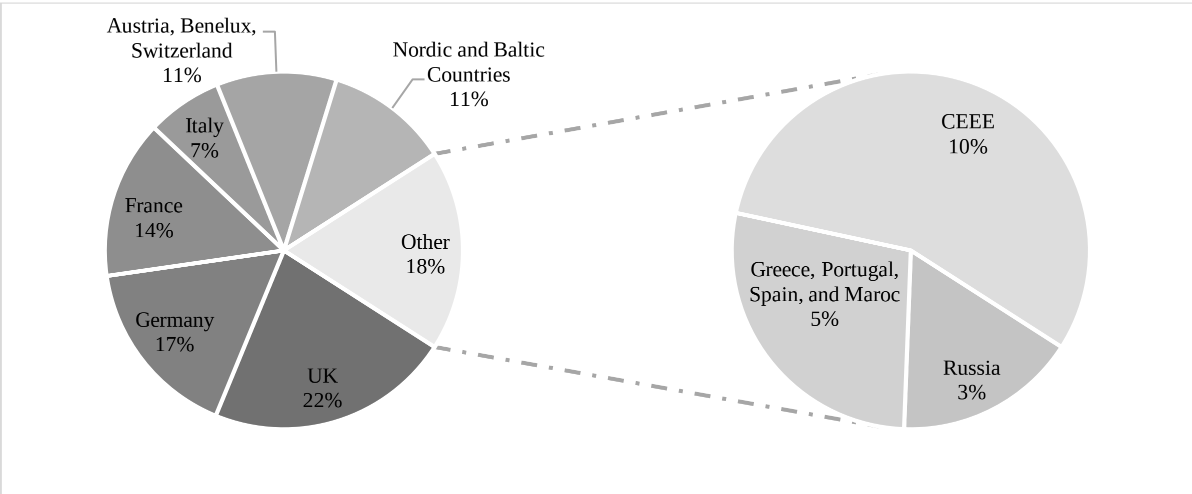

Figure 1 – Leasing value in Europe in 2016 (in billions of euros)
Source: Leaseurope, Key facts and figures, 2016

Leaseurope's analysis by country and by type of asset (See Figure 1) also shows that Germany and the Nordic and Baltic countries have seen a dramatic increase in real estate leasing (68% and 97% respectively). Russia, on the other hand, is marked by a drastic reduction in real estate leasing (-32%). The most common leasing contracts are in the field of vehicles, and the highest percentage is registered in Russia (31%) and Italy (28%). According to the chart below, it can be seen that the equipment and machinery purchased through leasing register significant increases, because the economic agents have come to the conclusion that it is much more profitable and

Volume **XIV**/2020 ISSN 2344-102X
Issue (XXIV) / **October** 2020 ISSN-L 2344-102X

advantageous to purchase the equipment necessary to carry out the company's activity due to the fact that it does not require an immediate and very large amount of available resources, thus managing to ensure the continuity of its activity without resorting to other types of financing.

Globally, there has been a decline in leasing operations in 2019 due to a number of closely related factors, such as the escalation of nationalist and protectionist policies, fueled by new US tariffs, and the existence of a framework of strong policy uncertainty. and trade management with foreign countries, but also a general cyclical weakening of global industrial activity (ASSILEA, 2019).

Today, everyone is concerned about how to recover from a period of economic crisis, although not long in duration but with unpredictable effects such as those of the current pandemic, so that the proposed solutions materialize in positive values, with higher growth rates. chosen for investments and industrial orders. Confirming the close connection with investments, leasing proves to be one of the protagonists of this recovery.

According to the data and trends recorded in recent years, there are some aspects that have always characterized the leasing product and its role in the production and economy sector and, at the same time, we note that unlike the profound changes that have affected it in the last twenty For years, however, leasing has remained one of the preferred sources of financing for companies.

III. FINANCIAL AND OPERATIONAL LEASING IN ACCORDANCE WITH IFRS 16

Leasing operators continue to find small and medium-sized enterprises in the sector as their main customer. This type of transaction is essentially a lending operation. Represents a financing contract by which a financial company acquires, on behalf of an enterprise, an asset that is necessary for its activity, thus obtaining income. A typical financial leasing contract involves three categories of subjects (Sostero & Zanatta, 2016: 8): the supplier of the good, in most cases the companies that produce capital goods or construction companies are considered; the leasing company, or lessor, refers to an investment company, most often belonging to a banking group; the user of the good, or lessee, is practically the subject who manifests the need to use the good of the leasing contract for carrying out the activity, but does not have immediate liquidity available for direct purchase, or disposing, but prefers to use it for other purposes.

The logic behind the stipulation of a financial leasing contract is divided into a series of phases. First, the tenant contacts the supplier to identify the good he needs and to define the characteristics and the purchase price. It is not excluded that the goods are produced in accordance with the technical specifications requested by the user. Once this initial negotiation has been completed, the user addresses the leasing company, requesting the purchase of the asset. The leasing company clearly performs all appropriate assessments, both in terms of the tenant's solvency and the comfort of the transaction. If the result is positive, it will proceed to purchase the asset from the manufacturer and enter into the lease agreement with the user. The contract must contain in essence: the characteristics useful for the correct identification of the asset, all economic conditions intended to regulate the relationship between value and expiration of taxes, the possible redemption price at which, at the end of the contract period and if deemed appropriate, the user can buy the rights on the property, interest due in case of late payment, any additional guarantees. Nothing prevents the parties from freely accepting additional clauses, including, for example, service components, such as the maintenance of the leased asset (Albanese & Zeroli, 2011: 33).

The essential points of the operation, summarized in Figure 4 are therefore: the acquisition of ownership of the asset by the leasing company, which then leases it to the user. The latter is required to pay periodic fees, including a fee as consideration for the right to use the asset and an interest rate. At the end of the term, the user can exercise the option to purchase the asset through a redemption price. Financial leasing is also called capital leasing. The leased asset is new and the lessor purchases it from the manufacturer or distributor, but not from the user-lessee. Financial leasing has the following characteristics: it does not offer insurance and maintenance services to the tenant; is fully depreciated; the lessee has the right to renew the contract at the expiration of the existing one; the contract cannot be canceled, so the tenant must make all payments or there will be a risk of bankruptcy.

With respect to IFRS 16, this standard defines a lease as a contract that transfers the right to the end user to use a particular asset for a certain period of time in exchange for compensation. What is now gaining in importance is the right to control the use of the good and is what companies need to evaluate in every contract. All contracts covered by this definition, with the exception of short-term leases and those relating to a low-value asset, will now be registered and processed in accordance with the financial method.

It is further emphasized that, with regard to intangible assets, companies may choose autonomously whether to treat them in accordance with the new one or to maintain the accounting method already in force. Considering that the only accounting method, the financial one, wants to give more importance to the substance of the contract than to its form. The prevalence of the substance over the form is among the postulates of the balance sheet and stipulates that operations and events must be detected in accordance with the substance and their economic reality and not only in accordance with the legal form. The current standard, IFRS 16, does not radically

Volume **XIV**/2020 ISSN 2344-102X
Issue (XXIV) / **October** 2020 ISSN-L 2344-102X

change the accounting for finance leases in IAS 17. The most important difference relates to the treatment of residual value guarantees provided by a lessee to a lessor. This is because IFRS 16 requires the company to recognize only amounts that are expected to be paid below the residual value of collateral, rather than the maximum amount secured under IAS 17 (IASB, 2016).

Leases that transfer substantially all the risks and rewards of ownership of the leased asset to the lessee are also referred to as finance leases in IFRS 16.

If a contract includes parts, such as services, that are not required by IFRS 16, the lessee must separate the different parts, if possible, so that it can explain what can be defined as leasing in accordance with the new provisions. It is added that, for the lessor, IFRS 16 maintains the distinction between operating leasing and financial leasing, requiring only that more information be provided in the notes, which does not lead to large accounting differences. If the transaction is classified as a finance lease because all the risks and rewards associated with owning the asset are transferred to the lessee, the lessor must recognize an asset in its financial statement for the leased asset, qualifying it as credit for an amount equal to the net investment. from the leasing contract (Guersent, 2017: 26). The net investment is calculated as the current value (discounted at the default leasing rate) of the sum of all payments due to the lessor and the unsecured residual value of the asset (Europe Economics, 2017: 36). So far, IFRS 16 remains almost the same as that required by IAS 17, however, the new standard also refers to the exact specification of user fees that must be included in the calculation of the net investment:

- payments from the fixed amount, without deducting any incentives in favor of the tenant;
- variable payments whose value depends on the performance of an index or a rate;
- any residual value of the asset covered by the guarantee by the lessee;
- the exercise price of the purchase option (which is provided in the contract), if it is reasonably certain that the lessee will exercise it;
- any penalties due in the event of early termination of the lease, if the duration of the transaction is so long that it is reasonable for the tenant to release it before maturity.

In fact, these are the same amounts that the lessee uses to calculate the value of the lease debt, so that there is an exact symmetry between the amount recorded as a loan by the lessor and a debt from the lessee (EFRAG Secretariat paper, 2016: 1–3).

Owners who are at the same time producers or traders of leased assets (and therefore not financial leasing companies who merely purchase the good from the supplier and lease it to the user) must apply the specific provisions set out in the new standard (but these are not new, as they are also present in IAS 17), due to their dual position as supplier and concessionaire.

In general, manufacturers and traders offer customers the opportunity to choose between buying or renting the property directly. The choice of financial leasing generates income (or loss) equivalent to the income generated by the direct sale of the asset under normal market conditions.

It often happens that the manufacturer-lessor applies a fictitiously low interest rate to attract customers. This involves recognizing an "inflated" amount of total transaction revenue at the original date (because payments are discounted at a lower rate than the market average). For this reason, the standard stipulates that the lessee producer must counterbalance the effect of using an artificially low rate by reducing the profit from the sale to the value that would be applied at the actual market rate. Any costs incurred in concluding the finance lease must be recognized as a component of negative income in the income statement per year: this type of cost, if incurred by a lessor who is also a producer or trader of the underlying asset, is not included in the category of initial direct costs and should therefore not be taken into account when calculating the initial net investment.

In accordance with IFRS 16, from the lessee's perspective, once an arrangement meets the definition of a lease, they are all recognized in the same way, minus the practical exceptions for short-term leases and low-value leases. The distinction between operating and financial leases remains in IFRS 16 only from the perspective of lessors. According to IFRS 16, no distinction is made between financial and operating leases from the perspective of tenants. IFRS 16 provides an option to lessees with short-term leases that account for them as operating leases because they have been accounted for in accordance with IAS 17, which is off-balance sheet. The same option is provided for leases where the underlying asset is of lesser value. A short-term lease is one that, at the start date, has a term of 12 months or less, after considering reasonable leasing options for extensions and terminations. These choices must be applied consistently across asset classes. Examples of low-value assets include tablets and personal computers, small office furniture, and telephones. These choices can be applied on the basis of a lease agreement (Bunea-Bontaș, 2017: 78–84).

IV. EFFECTS OF THE IMPLEMENTATION OF IFRS 16 ON FINANCIAL STATEMENTS

The effects on the balance sheet are as follows: the increase in leasing assets, the increase in financial liabilities and the decrease in equity. For companies that have recognized off-balance sheet leasing in accounts, it is expected that IFRS 16 will lead to an increase in leasing assets and financial liabilities. The accounting amount of leasing assets will decrease faster than the accounting amount of leasing liabilities. This will lead to a reduction

Volume **XIV**/2020 ISSN 2344-102X
Issue (XXIV) / **October** 2020 ISSN-L 2344-102X

in capital compared to IAS 17. The effects on the Profit and Loss Account are: increase in profit before interest, taxes, depreciation and amortization, increase in operating profit and financing costs and constant profit before tax. For off-balance sheet companies, IFRS 16 is expected to generate a higher pre-interest profit (e.g. operating profit) compared to amounts reported in accordance with IAS 17. This is because if a company applies IFRS 16, it has a default interest on lease payments for previous off-balance sheet leases as part of financing costs. Instead, in accordance with IAS 17, all off-balance sheet leasing expense is included as part of operating expenses.

The effects on the cash flow statement are as follows: cash from operating activities increases, cash from financing activities decreases, but cash flow remains constant. IFRS 16 is expected to reduce cash outflows from operating activities, with a corresponding increase in cash to finance outflows, compared to IAS 17. This is because, in accordance with IAS 17, companies present cash outflows in off-balance sheet leases as operating activities. In contrast, through the application of IFRS 16, main repayments on all leases are included in financing activities. IFRS 16 is significantly different from these requirements for tenants. With limited exceptions, all leases are recorded in the balance sheet and result in the recognition of an asset and a liability. Therefore, the new standard will affect the balance sheet and also the related ratios, such as the debt/equity ratio. In addition, IFRS 16 will affect the income statement, as an entity must now recognize the interest expense on the lease and the amortization of the right to use the asset. Accordingly, for leases previously classified as operating leases, the total amount of expenses at the beginning of the lease term will be greater than that provided for in IAS 17.

In the case of cash flows, lease payments related to contracts that were previously classified as operating leases are no longer presented in full as an operating cash flow. Only the part of the payments that reflects the interest on the leasing debt can be presented as an operating cash flow. Cash payments for the main part of the leasing debt are classified in financing activities. From the lessor's perspective, IFRS 16 is substantially unchanged from IAS 17. When the annual financial statements are prepared, the users of the goods (which have been leased both financially and operationally), inventory and present to the leasing company the list of assets obtained on the basis of leasing contracts. Under the heading "Explanatory notes to the annual financial statements", the contracting parties that have performed leasing and leaseback transactions are obliged to reflect in these notes the information regarding the transactions carried out.

V. CONCLUSIONS

According to IFRS 16, from the lessee's perspective, once an arrangement meets the definition of a lease, they are all recognized in the same way, but without the practical exceptions for short-term leases and low-value leases. The distinction between operating and financial leases remains in IFRS 16 only from the perspective of lessors. According to IAS 17, from the lessee's perspective, leases are classified as operating or financial leases. Operating leases are off-balance sheet and lease payments are recognized as an expense during that contract. Financial leases are those that transfer substantially all the risks and rewards of ownership to the lessee and are recognized in the balance sheet with an appropriate financial asset and liability.

In conclusion, the new standard aims to better reflect the real consequences of economic operations, but also to ensure the much-needed transparency regarding the assets and liabilities arising from companies' leases, and this means that off-balance sheet financing of contracts it ceases to be unrecognized. It is also expected that IFRS 16 will facilitate comparisons between financing companies and lending companies to purchase. Another important aspect is that the new standard is a review of how companies account for contracts and stipulates that all of these must be reported as assets and liabilities in the user's balance sheet.

REFERENCES

1. Albanese, M., Zeroli, A. (2011). Leasing e Factoring – quarta edizione Milano,FAG.
2. Associazione Italiana Leasing - ASSILEA. (2019). To Lease 2019 – I numeri del leasing e del noleggio 2018-2019. Retrieved July 29, 2020 from https://www.assilea.it/documentazioneAction.do?idDocumento=1041&metodo=download
3. Bunea-Bontaș, C. A. (2017), Lease accounting under IFRS 16 and IAS 17 – a comparative approach. Revista Economia Contemporană, 2, 78–84.
4. EFRAG Secretariat paper. (2016). IFRS 16 Leases: fieldwork on the definition of a lease, 1–3. Retrieved August 15, 2020 from http://www.efrag.org/Assets/Download?assetUrl=%2Fsites%2Fwebpublishing%2FSiteAssets%2FEFRAG%2520Secretariat%2520Paper%2520-%2520IFRS%252016%2520Leases%2520-%2520Fieldwork%2520on%2520Definition%2520of%2520a%2520Lease.pdf&AspxAutoDetectCookieSupport=1
5. Europe Economics. (2017). Ex ante Impact Assessment of IFRS 16, 36. Retrieved August 15, 2020 from http://www.efrag.org/Assets/Download?assetUrl=%2Fsites%2Fwebpublishing%2FSiteAssets%2FIFRS%252016%252-%2520Europe%2520Economics%2520%2520Ex%2520ante%2520Impact%2520Assessment%2520%2822%2520February%25202017%29.pdf
6. Fisco e Tasse (2019). Leasing: con il principio IFRS 16 si modificano gli indicatori di bilancio, Fisco e Tasse, Retrieved July 18, 2020 from https://www.fiscoetasse.com/rassegna-stampa/27704-leasing-con-il-principio-ifrs-16-si-modificano-gli-indicatori-di-bilancio.html

Volume **XIV**/2020 ISSN 2344-102X
Issue (XXIV) / **October** 2020 ISSN-L 2344-102X

7. Guersent, O. (2017). EFRAG's letter to the European Commission regarding endorsment of IFRS 16 Leases, 26. http://www.efrag.org/Assets/Download?assetUrl=%2Fsites%2Fwebpublishing%2FSiteAssets%2FEFRAG%2527s%2520Final%2520Endorsement%2520Advice%2520on%2520IFRS%252016.pdf
8. International Accounting Standards Board. (2016). Effects Analysis IFRS 16 Leases. Retrieved August 17, 2020 from https://www.ifrs.org/-/media/project/leases/ifrs/published-documents/ifrs16-effects-analysis.pdf
9. International Accounting Standards Board (IASB). International Financial Reporting Standard (IFRS).
10. Leaseurope. (2017). Key facts and figures 2016. Retrieved August 3, 2020 from http://www.leaseurope.org/uploads/documents/LeaseuropeFF_16.pdf
11. Leaseurope, la Federazione Europea del Leasing. (2020). Leasing: I numeri in Europa. Retrieved August 2, 2020 from https://leasenews.it/news/mercato/leasing-i-numeri-in-europa
12. Sostero, U., Zanatta, L. (2016). Tesi di Laurea La contabilizzazione del leasing secondo i principi contabili internazionali. La pubblicazione dell'IFRS 16 Leases, Venezia, 2015/2016, 8.