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SABAH

# **Comparison of new International Financial Leasing Standard (IFRS 16) to old International Accounting Standard of Leasing (IAS 17)**

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## **Abstract**

The objective of this paper is to research about rationale for new International Financial Leasing Standard (IFRS 16 Leases) which defines accounting policies related to recognition, measurement, presentation of leases in financial statements from the point of view of both lessees and lessors by contrasting with the previous leasing standard - IAS 17 and examine the impact of differences between IFRS 16 and IAS 17 on the financial statements.

In this context; this examination brings up that IFRS 16 prompts the revealing of all rent transactions from tenant's outlook like a financial lease, unlike IAS 17 which mentions classification of leases as either financial or operating lease. Hence, this approach is believed that it improves transparency and accuracy in financial disclosures of companies in such manner that they will represent the profitability, liquidity, solvency and money streams of the lessees and lessors.

*“The new Standard will provide much-needed transparency on companies’ - IASB chairman, Hans Hoogervorst (2016)*

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## **Introduction**

Need of enterprises to make new investments in order to produce more and compete with other companies in international markets and maintain their existence is inevitable. However, it is not always possible for the enterprises to finance their investments that require large cash outflow from equity capital. In this case, by eliminating the risks and costs of owning assets, they refer to an alternative financing method of leasing in order to obtain the right of using of assets.

The concept of off-balance sheet financing is to provide financing to companies in order to maintain their core operations, without affecting their assets and liabilities balances. There are two main objectives of the off-balance sheet financing process. The first one is to make the financial statements appear stronger than actually they are to the investors and lenders, and the other is to obtain a tax advantage.

Especially due to the off-balance sheet financing transactions that occurred after the accounting scandals in the US financial markets, financial information presented in the financial statements of a company has been revealed not to be sufficient enough to reflect the financial situation of the company. The application of the operating lease method to benefit from the off-balance sheet financing method is of great importance in terms of the reliability of the financial statements.

According to previous guidance in IAS 17, leases are classified according to the risk and benefit of the ownership of the leased asset in the lessor company or the lessee company. The mentioned risks are the changes that may occur in the rate of return due to technological wear or loss due to idle capacity and changes in economic conditions. The benefits can be considered as expected income that can be generated as a result of the increase in value thanks to the use of asset in a profitable manner through useful life of asset or the expectation that the asset will be converted to cash at the end of its useful life.

Under the guidance in IAS 17, most of leasing transactions are classified as operating leases and are not reported in the lessee's balance sheet. Since the off-balance sheet operating leases have a significant influence on the reported assets and liabilities, this situation is quite likely to mislead users of such external financial statements of companies while making crucial decisions.

Whereas, when the assets and liabilities arising from the leasing transactions are presented in the financial statements of a company that should be, this fact prevents the leasing transactions from being the off-balance sheet financing instrument and meets the principle of fair presentation. In order to fulfill the requirements of this principle, both the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) have worked on a new accounting standard that will transfer all leasing transactions to the balance sheet. As a result of this study, IASB published the IFRS 16 Leases Standard in January 2016, which will replace the IAS 17 standard in early 2019 with the early implementation option.

According to IAS 17, a company could make changes to its rental portfolio and sell the assets it has, and then rent them back from the balance sheet. Thus, company could achieve decrease in its assets and financial debts. Different from IAS 17, IFRS 16 will continue to present the rights to use an asset and financial debts as financial asset and liability, even in the sale and leaseback transactions. Therefore, it is expected that the sale and leaseback transactions will decrease thanks to new leasing standard.

Under specific guidance of new leasing standard, leasing transactions need to be reflected in financial reports under a single roof, regardless of the extent of the risks and rewards of ownership. Hereby, it will be ensured that investors and analysts are better informed about the amount, timing and cash flow uncertainties arising from the leasing transactions and that the companies can be compared with each other

more easily and effectively. It should be noted that, IFRS 16 does not modify accounting treatment for services. Despite the fact that leases and services are usually linked in contracts, reporting of sums related to services on the balance sheet is not mandatory.

Changes in the recognition and reporting rules is expected to result in significant changes in the financial statements of companies such as assets, long-term liabilities, equity, EBITDA and EBIT. Therefore, financial indicators calculated by using these financial statement items will also be subject to changes.

This paper consists of five chapters. In the second chapter, the literature review is included. In the third chapter, objective of new International Financial Leasing Standard and rationale for IFRS 16 are explained. In the fourth section of thesis, the guidelines of the new standard relating to the initial recognition, subsequent measurement, presentation and disclosure of financial statements are discussed in comparison with the former IAS 17 from the tenant perspective. In the last section, the provisions of the IFRS 16 are examined by comparing with the previous IAS 17 from the point of view of lessor.

## **Chapter 1. Literature review**

The first accounting standard on leasing in the world is FAS 13 which is developed by FASB and adopted in 1976 in the United States (Beattie 1998). Separation of leasing transactions as finance and operating lease and recognition of right to using of asset and commitment generated from finance lease in the assets and liabilities side of the balance sheet by the lessee respectively, and presentation of operating leases in the income statement actually stems from this standard. Then, International



Accounting Standards Committee founded in 1972 IAS 17 Leasing Transactions The standard was published in 1982.

A number of studies have been conducted in recent years in order to analyse the transition of IAS 17 to IFRS 16 and its possible impacts on financial statements. The studies are aimed at finding out whether there is significant effect of recognizing operating leases as right of use assets and lease liabilities in the balance sheet of the companies. In some of the investigations, it has been concluded that the information contained in the disclosure notes of the financial statements is not as effective as the information reported in the financial statements from the decision makers' standpoint. Furthermore, a large number of studies revealed that financial information on operating leases is as influential as financial leases in having effect on financial ratios and thereby, investors and other stakeholders' decision-making processes.

In practice, some companies took the advantage of the application of IAS 17 on classification of leasing transactions as either operating or finance leases, and deliberately made changes in the terms of the contract which allowed them to classify leasing transactions as operating leases and hence, manipulated financial ratios (Imhoff, Lipe and Wright, 1991). Such facts proposed an item for the agenda in terms of importance of revising the leasing standard.

The IASB and FASB signed the Norwalk Transaction in 2002 in order to develop quality and compatible financial reporting standards (FASB, 2002). The Board initiated a project in July 2006 with an aim of producing a common standard on the accounting treatment of the lease transactions.

At the beginning, the Board agreed on making the accounting treatment for the lessor and the lessee separately, then changed its decision and developed the standard from

the lessee's standpoint in July 2008. Exposure draft on the standard was published in March 2009 (FASB, 2009).

A research on 91 companies from the largest 200 companies of the Fortune 500 list which was conducted in 2009 with the purpose of evaluating the effects of the related draft, revealed that the capitalization of operating leases would have an impact on the financial indicators of the companies and that the new standard would increase the transparency and consistency of the financial statements of the companies (Grossman 2010).

A survey was conducted among top executives working in the accounting department of 284 companies in order to determine the possible effects of the draft version of standard published by IASB and FASB in August 2010. In the study, 68% of the participants stated that it would affect the debt-to-equity ratio, 44% of them stated that it would affect the current debt contracts, 40% of them mentioned that it would affect the short term rent agreements, and 25% of them stated that it would prompt lessees to buy assets rather than renting (Deloitte, 2011). In another study conducted with the aim of examining the impact of this draft on operating leases by investigating the reports of UPS and FedEx, (Duke 2012), it has been found that the significant amount of debt was recognized only in the disclosure notes of the financial statements, whereas in the case that the operating leases are incorporated into the financial statements, the ratio of debt to equity ratio, return on assets, interest coverage ratio and retained earnings would decrease.

In a survey of companies operating in Albania conducted to analyse the influence of the draft text published by the IASB and FASB in August 2010, it is observed that 88.89% of the surveyed companies recognized leasing transactions as operating leases, and only 11.11% of them capitalized such transactions as finance lease. As a result of the study, it is determined that the companies will be able to present more

balanced financial statements, their financial ratios will be affected significantly, the debt structure will change, the administrative burden will increase and new information technology systems will be required, all thanks to the transition to new leasing standard (Bashi and Molla, 2013).

In the study conducted in the fast-food sector in Hong Kong in order to determine the effects of transition on two companies, it was judged that the capitalization of operating leases significantly affected the financial ratios (Tai, 2013).

As a result of a research conducted to study the possible effects of the capitalization of leasing on the financial indicators and the approximate failure rate in the companies operating in five different sectors in South Africa, it is concluded that leverage ratios and estimated failure indicators will be highly affected by capitalization of operational leases (Dillon, 2014).

In another study to evaluate the principles set under new standard, the effects of IFRS 16 on the market value of the companies and the attitudes of investors to these effects were examined through case analysis. According to the findings obtained in the study, it is concluded that the change will not have a notable influence on investors decisions, whereas it has been concluded that the sectors which prefer the operating leasing method will be more affected than other sectors (Sandblom and Strandberg, 2015).

As a conclusion of Effects Analysis of 1.145 company for leasing transactions performed by IASB, it has been determined that capitalisation of operating leases in the financial statements is expected to highly impact the airline, retail, travel and leisure, transportation, telecommunications, energy, media, distribution, information technology and health sectors (IASB Leasing Standard, Effects Analysis, January 2016).

## **Chapter 2. Objective and scope of IFRS 16 and rationale for new leasing standard, accounting for transition**

### **a) Objective of IFRS 16**

New International Financial Leasing Standard sets out the guidelines for the initial recognition, presentation and disclosure, subsequent measurement of leasing transactions in financial statements. The target of new standard is to make sure that both of tenants and lessors give relevant and transparent information in a way that faithfully represents leasing transactions. This data plays a role of source for utilisers of financial statements to evaluate the impact that leases have on the statement of financial position, income statement and statement of cash flow of a company. IFRS 16 stipulates companies to consider the terms and conditions of lease agreements and all related circumstances, and to implement the standard consistently to agreements with similar features and in similar conditions.

### **b) Scope of IFRS 16**

New leasing standard applies to all lease contracts, including right-of-use assets leasing in a sublease, aside from:

- (a) Leases to investigate for or utilise oil, natural gas, minerals and comparative non-regenerative resources;
- (b) Leases of biological assets inside the extent of IAS 41 (*Agriculture*) – held by a tenant;
- (c) Service concession settlements inside the extent of *Service Concession Arrangements* - International Financial Reporting Interpretations Committee (IFRIC) 12;

- (d) Intellectual property licenses endowed by a lessor inside the extent of IFRS 15;
- (e) Rights at the disposal of a tenant under licensing settlements inside the extent of IAS 38 (*Intangible Assets*) - for example movie films, video recordings, patents and copyrights.

A tenant voluntarily can apply new leasing standard to lease arrangements of intangible assets other than those depicted in (e) above. Furthermore, under IFRS 16, there are some optional exemptions which help to reduce burden on lessees to apply new standard. These optional exemptions enable to tenants choosing not to apply recognition requirements to short term lease arrangements and lease arrangements of low value assets.

### **c) Rationale for new leasing standard**

According to principles set out in IAS 17, if the leasing transaction is classified as a finance lease, the lessee should report the assets and liabilities arising from this transaction in the statement of financial position, whereas if the lease agreement is classified as an operating lease, the assets and liabilities arising from this transaction are not reflected in the statement of financial position (IASB 2016a). In this context, The IASB has three main rationales when it comes to the adoption of IFRS 16 and these are expressed as follows in the Decision of the Standard (IASB 2016b).

**1.** When the assets and liabilities arising from operating leases are not included in the entity's financial statements according to old International Accounting Standard of Leasing, the principle of transparency has not been fulfilled. Hereby, for the users of the financial statements, the required information could not be provided. Operating lease transactions should be considered as a financing and borrowing

instrument. However, in this situation lessor could not see the lessee's debt burden explicitly, and resorted to various estimation methods.

2. Despite the fact that financial leasing transactions are reflected in the statement of financial position, operational leasing transactions cannot be reflected on the statement of financial position under specific guidelines of IAS 17, and due to this situation the concept of comparability has been damaged. In order to ensure comparability, restructuring of financial statement items to reflect operational leasing transactions has been brought to the agenda.

3. Under IAS 17, disclosure on exposure of the lessor to the credit risk and asset risk derived from the leasing transaction is not sufficiently emphasized.

In this article, abovementioned rationales of the IFRS 16 standard are taken into consideration and the effects of the presentation of operating leases in the Statement of Financial Position on liquidity and financial structure are examined.

**Table 1: Example to illustrate the extent of off-balance sheet lease commitments**

<b>Retailer</b>	<b>Country</b>	<b>Off balance sheet leases (discounted)</b>	<b>On balance sheet debt</b>	<b>Off balance sheet leases as a multiple of on balance sheet debt</b>
<b>Circuit City</b>	US	\$3,293M	\$50M	65.86
<b>Woolworths</b>	UK	£1,602M	£147M	10.90
<b>Clinton Cards</b>	UK	£525M	£58M	9.05
<b>HMV</b>	UK	£809M	£115M	7.03
<b>Borders</b>	US	\$2,152M	\$379M	5.68

(Source: *Effect analysis report IFRS 16, IASB, 2016*)

**Table 2: Comparison of present value of future instalments for off-balance sheet rents to total assets**

<b>Industry sector</b>	<b>Number of companies</b>	<b>Total assets (in millions of US\$)</b>	<b>Present value of future payments for off balance sheet leases (<i>estimate</i>) (in millions of US\$)</b>	<b>Present value of future payments for off balance sheet leases/total assets</b>
<b>Retailers</b>	204	2,019,958	431,473	21.4%
<b>Airlines</b>	50	526,763	119,384	22.7%
<b>Travel and leisure</b>	69	403,524	83,491	20.7%
<b>Transport</b>	51	585,964	68,175	11.6%
<b>Energy</b>	99	5,192,938	287,858	5.5%
<b>Media</b>	48	1,020,317	55,764	5.5%
<b>Telecommunications</b>	56	2,847,063	172,644	6.1%
<b>Distributors</b>	26	581,503	25,092	4.3%
<b>IT</b>	58	1,911,316	56,806	3%
<b>Healthcare</b>	55	1,894,933	54,365	2.9%
<b>Others</b>	306	13,959,223	306,735	2.2%
<b>Total</b>	<b>1022</b>	<b>30,943,502</b>	<b>1,661,787</b>	<b>5.4%</b>

(Source: *Effect analysis report IFRS 16, IASB, 2016*)

*“Too often, an entity’s reported leverage understates reality and new leasing standard will improve computations of default risk.” – Papa Vincent, director of financial reporting system for Chartered Financial Analysts (2016)*

#### **d) Accounting for transition**

The new leasing standard has two application options for transition accounting - fully retrospective and cumulative effect or the modified retrospective approaches. The fully retrospective method is applied according to IAS 8 and implies that previous accounting periods should be adjusted for as per IFRS 16 guidance. Under this approach, companies need to make adjustment to the equity at the beginning of the earliest comparative information presented. Unlike retrospective method, the cumulative effect approach does not require restatement of comparative information. At the date of first application of the new leasing standard, lessees will recognize the cumulative effect of initial implementation and make an adjustment to opening balance of equity account as of 01/01/2019.

Steps in transition accounting for tenants with lease arrangements previously reported as operating leases are as following:

- Recognition of a lease liability, estimated at the present value of remaining lease reimbursements, discounted using the tenant’s incremental borrowing rate at date of initial application.
- There are two alternatives for measuring the value of the right-of-use asset on transition date (on a rent-by-rent basis): first option is measuring the asset assuming if new leasing standard had been implemented since the commencement date of a rent contract using discount rate based on tenant’s incremental borrowing rate at the initial application date; second option is



recognising the value of the asset at an amount equivalent to the rent obligation, adjusted by the sum of prepaid or accrued rent payments recognised immediately before initial application date, if any.

While implementing the modified retrospective approach tenants are allowed on a rent-by-rent basis to carry out the following practical expedients:

- apply a unique discount rate to leases' portfolio with reasonably similar characteristics;
- adjust the asset on transition by the sum of any recognized onerous lease provision previously, as an option to undertaking an impairment review;
- perform a stated exemption for recognition and measurement of leases with maturity date of equal or less than 12 months of the initial application date and take into account those leases as short-term leases;
- use the benefit of hindsight in performing the new leasing standard, for instance, in defining the lease term if a lease contract includes alternatives of extending or terminating the lease; and
- exclude initial direct expenses in the estimation of the right-of-use asset.

Steps in transition accounting for lessors with lease arrangements previously reported as finance leases are as following:

- The book value of the right-of-use asset and the rent obligation at the initial application date will be the book value of the rent asset and liability preceding that date estimated applying IAS 17.
- Carry out subsequent accounting in compliance with the requirements of new leasing standard.

## **Chapter 3. Advantages of transition to IFRS 16 and costs related to transition to IFRS 16**

### **a) Advantages of transition to IFRS 16**

It is anticipated that recognition of operating leases in the financial statements by using the new standard will enhance provision of more reliable information about the financial situation of the company. By means of this, potential investors and financial analysts will be able to assess the firm's financial position better. Thanks to the application of new leasing standard, the need to adjust the amounts arising from operating leases reported off-balance sheet will be eliminated. Additionally, the fact that in the correction procedures, the persons who make the correction erroneously in order to make the company seem better than in reality in the eyes of investors and other stakeholders, will be beside the point in the new standard application. Once Capital Markets Advisory Committee which is investor advisory body to International Accounting Standards Board stated that “while expert investors consider disclosure-only solution as an acceptable way when using financial statements for their decision-making processes, it might not be useful for the others who want to get necessary information on a clear way from the financial statements” (IFRS 16 Effect analysis report, 2016).

It is expected that assessment of firms' assets and liabilities arising from all leasing transactions in the same method, and consideration of only the rights and obligations arising from the leasing process will have a positive effect on the comparability of accounting information. In cases where the leasing transaction is similar to the margin buying of an economic asset (for example, leasing of an asset over its useful life), there will be no difference between the two methods in the financial statements. However, in cases where the leasing transaction differs from the margin buying of

underlying asset (shorter than the useful life of the asset), the new standard practices will reflect the difference in the financial statements (IASB, Effects Analysis Report, 2016).

*“The stock market effect of new standard is going to be minimal as analysts already capitalize leases,” says Stephen Furlong - airline analyst at Davy Research (2016).*

#### **b) Costs related to transition to IFRS 16**

It can be stated that the new standard application will not result in any cost burden on the companies who enters financial leasing operations only. However, operating leases are expected to be subject to some costs within the scope of the new standard application. Whereas, the companies who reported their operating leases according to principles of previous leasing standard will need to make changes in accounting systems in order to be able to apply new standard principles and to organize training programs for their employees due to implementation of new standard practices. The fact that there is a discount rate currently used by companies for recognition of finance leases does not constitute an additional cost element to the mentioned companies, unlike the situation is the opposite for the firms that involve in operational lease arrangements. While the discount rate is not required for operating leases under the previous standard, this requirement is subject to the new leasing standard. Furthermore, the introduction of the new standard may require some firms to reassess the obligations of existing leases in order to reflect modifications to lease payments regarding to inflation. This situation is also expected to be an additional cost factor for firms (IASB, 2016).

Survey conducted in Sweden in order to examine the effects of the draft text published by IASB and FASB in August 2010 also gave insights about expectations of companies on upcoming costs caused by application of new leasing standard.

Survey has been conducted among SMEs working in Sweden and they were asked about open-ended questions, and it has been found out that, the awareness of the companies about the relevant changes was not sufficient. The companies, whose awareness is considered adequate, have expressed their opinion that the new standard should not be implemented on the grounds that it will increase the administrative workload and require complex calculations. As a result, it is determined that the companies that implement operational leasing transactions will be affected by transition to new leasing standard (Adil Ali and Djarv, 2015).

There are also costs that are expected to decrease thanks to the implementation of the new standard practice. For example, companies that undertake both finance and operating lease arrangements no longer need to classify their leasing transactions into two groups. Additionally, under IFRS 16, there are optional exemptions which mentions that reporting of leasing transactions with the maturity of equal or less than 12 months, as of the date of application of the new standard and low-value asset leases (for example, personal computers) on the balance sheet according to new leasing standard is not mandatory. However, in such cases, the old standard provisions must be applied for the lease transactions. The fact that firms with the mentioned conditions do not need to make changes in the scope of the new standard application can be expressed as a cost reducing effect especially for SMEs. Moreover, the fact that the comparative information is not required to be restated again in the initial period (cumulative effect approach) when the new standard comes into force is aimed at reducing the costs.

*"FASB continued its endeavors to develop its new lease standard, issuing minor amendments, sixteen targeted alterations, and a proposal to decrease costs and make implementation simpler for lessors" (Journal of Accountancy, 2018)*

*“Maybe 25% of entities have gotten begun or even made a decision on which system they will utilize to make the change. The lack of implementation suggests there is still a long way to compliance for many large tenants, since each will have to carry out new lease accounting systems, controls and policies.” - Michael Keeler, CEO, LeaseAccelerator (2018)*

## **Chapter 4. Comparison of IAS 17 and IFRS 16 in terms of lessee accounting**

Comparison of IAS 17 and IFRS 16 in terms of lessee accounting is performed in terms of initial recognition, subsequent measurement, and presentation in the financial statements and disclosures notes under four headings in this chapter.

### **4.1. Comparison of IAS 17 and IFRS 16 in terms of initial recognition by lessee**

Under this heading, there are 3 subheadings in which initial recognition is discussed in terms of under IAS 17, then IFRS 16, and finally key points differing these two standards are summarized.

#### **4.1.1. Initial recognition and measurement under IAS 17**

##### **a) Finance leases**

A lessee classifies lease arrangement as a finance lease if there is transfer of substantially all the risks and benefits accidental to ownership according to specific

guidance under previous leasing standard. There are situations that would normally result in lease arrangements being reported as a finance lease:

- (a) the rent transfers proprietorship of the underlying asset to the tenant until the end of the rent term;
- (b) the tenant has the option to buy the asset at a value that is anticipated to be lower enough than the fair value at mentioned option date becomes exercisable for asset to be sensibly sure, at the commencement of the lease, that this option will be worked out;
- (c) the rent term covers the vital part of economic life of underlying asset regardless of whether title is transferred or not;
- (d) at the commencement of the rent the present value of minimum rent payments equals to at least considerably the fair value of the subject matter; and
- (e) the leased resources are of such a specific nature that only the tenant is able to use them without significant modifications.

According to IAS 17, rent classification has to be made at the commencement of the lease term. By chance, if the tenant and the lessor negotiate on altering the terms and conditions of a lease, besides than by renewing the rent contract, in a way that might be resulted in a dissimilar characterization of the rent, if the altered terms had been effective at the beginning of the lease, the updated agreement is taken into consideration as the new agreement over its life. In any case, alterations in estimates (such as, changes in the economic life or the residual value), or alterations in circumstances (for instance, default by the tenant), do not offer need to a new characterization of a rent for accounting treatment purposes.

According to IAS 17, at the beginning of the rent term, tenants had to account for finance leases as assets and obligations in their financial statements at sums equal to the leased property's fair value, if lower, the present value of minimal rent payments,

each identified at the commencement of the lease term. The discount rate used in calculation of the present value of minimal rent payments is the interest rate implied in the lease contract, if any; if this is not the case, the tenant's incremental borrowing rate had to be used. Any initial direct expenses of the tenant are added to the value recognised as an asset.

Transactions and other circumstances are recognised and represented in accordance with substance over form concept and rather than with legal form. Despite the fact that the legal form of the rent agreement is that the tenant may not secure any legal title to mentioned leased asset, in terms of finance leases the substance and financial reality are that the tenant gets the economic benefits from the use of the mentioned asset for the vital part of economic life in exchange for going into a commitment to pay for that privilege a sum approximating, at the beginning of the lease term, the fair value of mentioned asset and the related financial charges.

If such lease arrangements are not presented in the tenant's statement of financial position, asset and obligation balances of a company are understated, hence, distorting financial ratios.

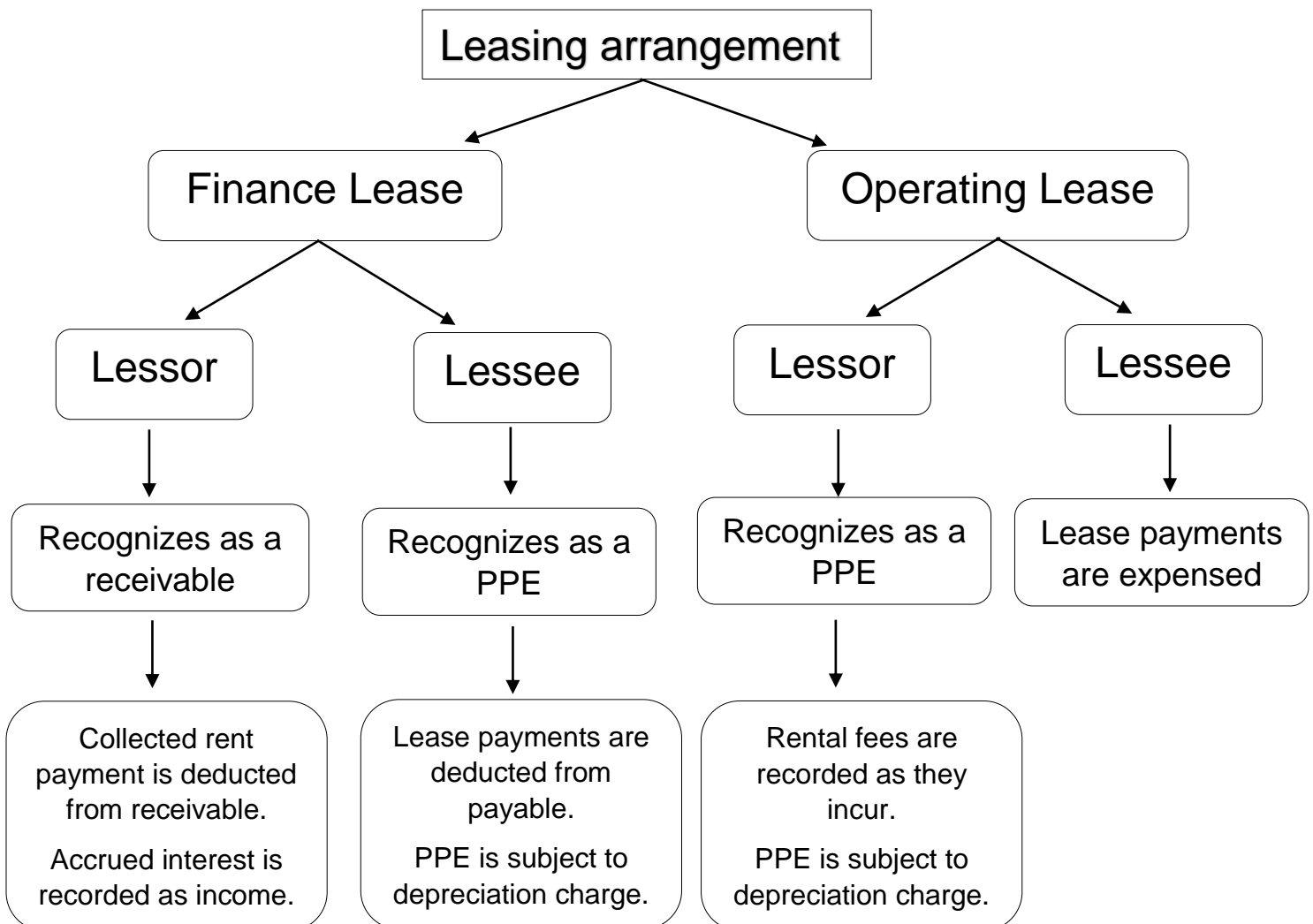
Therefore, according to principles set out under IAS 17, it is allowed for the finance lease at the beginning of the lease arrangement term, to be reflected in the tenant's balance sheet as assets and liabilities to pay future rent payments at the same sums but except for initial direct expenses of the tenant that are added to amount of the recognised asset.

It is not suitable for the obligations for leased resources to be reflected in the financial statements as a reduction from the rented assets. If for the appearance of obligations in the balance sheet a distinction is made between current and non-current liabilities, the similar differentiation is made for rent liabilities.

Initial direct expenses are often incurred regarding to specific rent activities, for instance, negotiating and securing rent arrangements. The expenses identified as entirely attributable to activities carried out by the tenant for a finance lease are added to the sum recognised as an asset.

## b) Operating leases

As stipulated in IAS 17, for operating leases, rent payments is recognized as an expense by applying the straight-line method. However, if the lease payments are structured in such a way to be increased according to the expected general inflation, the straight-line method is not used and the lease payments adjusted for each period in connection with inflation are accounted as expense (Demir and Bahadır, 2012).





As shown in the chart above, finance lease and operating lease are different in terms of the accounting policies applied by the lessee and the lessor.

In finance lease, the lessor recognizes the rent as receivable and deducts the rent income earned from the receivable and recognizes it as interest income. The lessee recognizes the rent amount as an asset and deducts the lease payments made in relation to the lease from the payable. The lessee also charges depreciation to the underlying asset. Whereas, in the operating lease method, the lessor recognizes the rental value as an asset and records the rent payments collected as income. At the same time, the lessor is the party that applies the depreciation charge to the asset. In this method, the lessee is the party that records the rent payments as expenses.

#### **4.1.2. Initial recognition and measurement under IFRS 16**

New leasing standard specifies a lease as a contract, or portion of a contract, that transfers the **right of using an asset** (the mentioned asset) for a certain period of time in trade for consideration. At first appearance, the definition may look straightforward. Whereas, in practice, it can be challenging to determine whether a contract transfers the right of using an asset or is, instead, an agreement for a service that is provided utilizing the asset.

For instance, an entity wants to transport a predetermined amount of goods, in accordance with an indicated timetable, for a period of four years from X to Y by rail. To succeed this, it could either lease rail cars or it could negotiate to purchase the transport service from a cargo carrier. In both situations, the goods will reach up Y – but the accounting treatment might be different enough!

Right now, many entities that have contracts which incorporate both a service and an operating lease, do not classify the operating lease component. The reason is that the

accounting treatment for a service/supply arrangement and an operating lease is the same (The cause is that the lessee does not recognize operating lease on the Statement of Financial Position instead, expense is recognized in income statement on a straight-line basis over the lease term). As stipulated in the new standard, the treatment of mentioned two components will be different. A tenant may decide as a practical expedient by group of leased asset not to isolate non-lease components (services) from rent components. If the tenant decides to perform this exemption each rent component and any related non-rent component is accounted for as single rent component. Thus, the service component will either be isolated or the entire lease arrangement will be accounted for as a lease.

Leases are different from service contracts: a lease provides a customer with the title to control the use of underlying asset; whereas, in a service contract, the supplier retains control.

IFRS 16 performs a control method to the identification of lease, differentiating between service arrangements and leases based on whether contract includes an identified asset which is controlled by customers. Hence, the new leasing standard stipulates that a contract includes a lease if:

- contract defines an **identified asset**; and
- the contract transfers the **right of controlling the use of mentioned identified asset** for a time period in trade for consideration.

#### **a) What an identified asset means?**

An arrangement only includes a lease if an identified asset is in existence. This concept is in line with the concept of the ‘specified asset’ stipulated in IFRIC 4 which is superseded by IFRS 16.

An asset is generally identified in an explicitly specified way in a contract. In any case, an asset might be identified in an implicitly specified way when the asset is made accessible for utilisation by the customer.

Let's give examples to the identified asset specified in different conditions in the contract:

*Example 1: Implicitly specified asset*

Client A enters into a four year agreement with Supplier B in order to get right to use a truck specifically designed for Client A. The truck is planned to ship materials used in production process of Client A and is not appropriate for utilisation by other clients. The truck is not specified in an explicit way in the contract, but Supplier B possesses only one truck that is suitable for Client A's use. If the truck does not work appropriately, the contract requires Supplier B to replace or repair the truck. Presume that Supplier A does not own a substantive substitution right.

*Analysis:* The truck is an identified asset. Despite of the truck is not specified in the contract in an explicit way (for instance, by serial number), it is specified in an implicit manner, because Supplier B must utilise it to accomplish the contract.

*Example 2: Identified asset – implicitly specified when the asset is made accessible for utilisation by the client*

Client A enters into a four year contract with Supplier B for the use of an equipment. The specification of mentioned equipment is described in the contract (brand, capacity, options, etc.). At the origination date of the contract the equipment is not yet built.

*Analysis:* The equipment is considered as an identified asset. Despite the fact that the equipment cannot be determined at origination date of the contract, it is obvious that it will be identifiable at the beginning of the lease term. The equipment is identified

in an implicitly specified way when it is made accessible for utilisation by the client (i.e. at the beginning date of a lease).

A capability portion of the asset is considered as identified asset if that is physically distinguishable (for instance, a floor of a construction). A capacity or other part of mentioned asset that is not physically distinguishable (for instance, a capability portion of the fibre optic cable) is not an identified asset, unless it constitutes substantially all of the capability of the asset and thus provides the client with the privilege to acquire substantially all the economic benefits regarding to use of an asset.

*Example 3: Identified asset – physically distinct part of a larger asset*

Client A enters into an 11-year agreement with Supplier B for the privilege to use four fibres inside a fibre optic cable between Florida and London. The contract specifies four of the cable's 20 fibres for utilisation by Client A. The four fibres are dedicated exclusively to Client A's data for the length of the agreement term. Presume that Supplier B does not own a substantive substitution right.

*Analysis:* The four fibres are identified assets as they are physically distinguishable and specified in an explicit manner in the contract.

*Example 4: Identified asset – capacity portion of the asset*

*Situation A:*

Client A enters into a four-year agreement with Supplier B for the privilege to deliver oil from Country X to Country Y through Supplier B's pipeline. The contract states that Client A will have the title to use 94% of the capacity of pipeline in the duration of the arrangement.

*Analysis:* The capacity part of the pipeline is considered as an identified asset. Though 94% of the pipeline's capacity is not physically distinguishable from the

remaining capacity of mentioned pipeline, it constitutes substantially all the capacity of the whole pipeline and hence provides Client A with the title to acquire substantially all the economic benefits from utilisation of the pipeline.

*Situation B:*

Presume the same circumstances as in Situation A, with the exception of that Client A has the title to use 65% of the capacity of the pipeline through the term of the contract.

*Analysis:* The capacity part of the pipeline is not considered as an identified asset as 65% of the pipeline's capacity is less than significantly all of the capacity of mentioned pipeline. Client A does not own the right to acquire substantially all the economic benefits from utilisation of the pipeline.

Nevertheless if an asset is determined, a customer does not own the right to utilise a specified asset if, at origination date of the arrangement, a supplier possesses the **substantive right to substitute** underlying asset through the period of use (the full period of time that the asset is utilised to accomplish a contract with a client, including the total of non-consecutive periods of time, if any). A supplier's title to substitute an asset is substantial when both of the conditions below are satisfied:

- the provider has the realistic ability to replace alternative assets through the period of utilisation (for instance, the client cannot preclude the supplier from replacing an asset and alternate assets are effortlessly available to the provider or may be sourced by supplier within a suitable period of time); and
- the supplier would get advantage economically from the practice of its privilege to replace the asset (the economic benefits related with replacing the asset are anticipated to exceed the expenses associated with replacing the asset).

The IASB stated that abovementioned conditions are intended to distinguish between substitution rights that end up a provider controlling the utilisation of an asset, instead of the client, and rights which do not alter the nature or characteristics of the contract.

If the supplier has a title or a commitment to replace the asset on or after either a specific date or the happening of a specified event, the provider's substitution right is not substantial because the provider does not have the viable ability to replace alternative assets through the period of use.

An entity's estimation of whether a provider's substitution right is substantial is based on realities and circumstances at origination date of the contract. At origination date of the contract, an entity should not take into account future events which are not likely to happen. IFRS 16 demonstrates the following examples of conditions that, at origination date of the arrangement, are not likely to happen and, hence, are excluded from the estimation of whether a provider's substitution right is substantial through the period of use:

- an agreement by the future client to pay an over market rate for utilisation of the asset;
- the introduction of modern technology that is not considerably developed at the origination date of the contract;
- a substantive difference between the client's use of underlying asset, or the operation of the asset, and the utilisation or operation considered likely at the origination date of the contract; and
- a substantive difference between the market value of the asset throughout the period of utilisation, and the market value considered likely at the origination date of the contract.

The requirement that the substitution right must bring advantage to the supplier economically for being substantive is a modern concept. In many circumstances, it

will be obvious that the supplier will not get advantage from the work out of the substitution right thanks to the expenses associated with replacing an asset. If an asset is situated in the customer's properties or elsewhere, the expenses associated with replacement are usually higher than when situated in the supplier's properties, and so, are more likely to outweigh the benefits related with replacing the asset. However, merely because a provider concludes that the expense of substitution is not considerable does not mean that it would get financial benefit from the right of replacement.

IFRS 16 further elaborates that a client should assume that a supplier's replacement right is not substantial when the customer cannot effortlessly determine whether the provider owns a substantive substitution right.

**b) When contract transfers the right of controlling the use of mentioned identified asset?**

A contract transfers the right of controlling the use of the identified asset if the client has both the right to acquire **considerably all the economic benefits from use** of the underlying asset and the **right to coordinate the use of an identified asset** through the period of use.

A customer can acquire economic benefits from utilisation of an asset in a direct or indirect way, such as by utilising, holding or sub-leasing underlying asset. The financial benefits from utilisation of an asset encompass its primary output and by-products (together with potential cash flows generated from these things), and other financial benefits from using mentioned asset that could be realized from a commercial arrangement with a third party.

‘Substantially all’ term is not specified in IFRS 16. However, companies might consider the term likewise to how it is utilized in IAS 17 within the context of classification of leases. Economic benefits originated from construction or proprietorship of the identified asset (for instance, tax benefits associated with excess tax depreciation) are not considered as financial benefits generated from the utilisation of the asset. As a result, they are not taken into account when assessing whether a client has the right to acquire substantially all of the financial advantages. When assessing the title to acquire substantially all of the financial benefits from use of an identified asset, an entity take into consideration the economic benefits that arisen from use of underlying asset within the defined scope of a customer’s title to use the asset. For instance:

- (a) if a contract restricts the use of a car to only one specific territory during the term of use, an entity take into consideration only the financial benefits from utilisation of the car within that location, and not beyond;
- (b) if a contract defines that a client can drive a car only up to a specific number of miles through the period of utilisation, an entity takes into account only the financial benefits from use of the car for the allowed mileage, and not beyond.

If a contract commands a customer to pay the provider or another party a part of the cash flows generated from utilisation of an asset as fee, those reimbursements paid as fee are considered to be portion of the financial benefits that the client obtains from utilisation of the asset. For instance, if the client is required to pay the provider a percentage of income from use of retail place as fee for that use, that requirement does not restrict the client from having the title to obtain considerably all the economic benefits from utilisation of the retail place. The reason is that the cash flows derived from those sales are taken into consideration to be financial benefits



that the client obtains from utilisation of the retail place, a portion of which he then pays to the provider as fee for the right to utilise that place.

A client has **the right to coordinate the use of the identified asset** through the period of utilisation when either:

- the client has the right to coordinate how and for what reason the asset is utilized through the period of utilisation; or
- the related decisions about how and for what reason an asset is utilized are predetermined; and
  - the client either has the privilege to operate mentioned asset, or to coordinate others to function the asset in a way that it decides, through the period of utilisation, without the provider having the right to alter those operating guidelines; or
  - the client designed underlying asset, or specific attributes of the asset in a manner that predetermines for what reason and how underlying asset will be utilized through the period of utilisation.

Decision-making rights are considered as relevant when they influence the financial benefits to be stem from the utilisation of the asset. The new standard gives several illustrations of related decision-making rights:

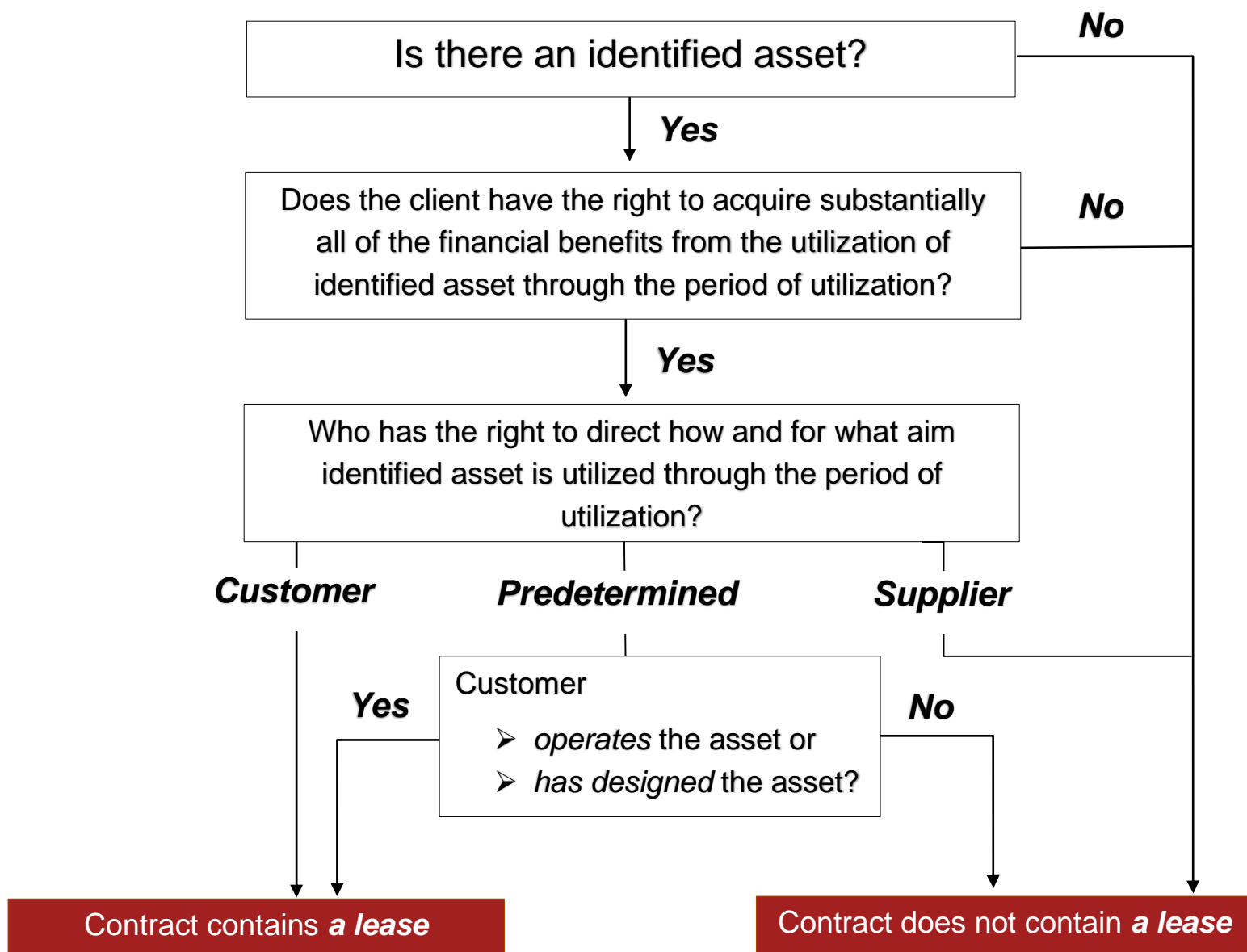
- Right to alter *what* type of product is manufactured.
- Right to alter *when* the product is manufactured.
- Right to alter *where* the product is manufactured.
- Right to alter *how much* of the product is manufactured.

Nevertheless, there are a few rights that are not considered when assessing which party has the pertinent decision-making rights, such as *protective rights*. In many circumstances, a supplier might restrict the use of underlying asset by a client in order

to defend its personnel or to guarantee compliance with pertinent laws and regulations (for instance, a client who has leased a ship is restricted from sailing the cruise into waters where probability of piracy or transportation of hazardous materials is high). Such protective privileges do not influence the evaluation of which party to lease contract owns the right to coordinate the utilisation of the identified asset.

Requiring a client to have the privilege to direct the utilisation of the identified asset is an alteration from IFRIC 4. An arrangement may have satisfied IFRIC 4's control criteria if, for instance, the customer acquired substantially all of the end product of a mentioned asset and fulfilled certain price-per-unit-of-output criteria in spite of the client did not have the privilege to direct the utilisation of the underlying asset as studied by IFRS 16. Under new leasing standard, such arrangements will no longer be taken into account as leases.

The flowchart below sums up the analysis to be performed to assess **whether a contract incorporates a lease:**



### c) Identifying and classifying lease and non-lease elements of a contract

A company accounts for each rent component inside a contract as a rent separately from non-rent components of the arrangement, unless the company (tenants only) employs the practical expedient (e.g. as a practical expedient, tenant may elect, by group of identified asset, not to sort out non-lease elements from lease elements, and instead recognize each lease element and any related non-lease elements as a single lease element).

The title to use an identified asset is a separate rent component if both:

(a) The tenant can benefit from utilization of the identified asset either solely or together with other assets that are readily accessible to the tenant. Readily accessible resources are services or goods which are sold or leased on an individual basis (by the tenant or other suppliers) or assets that the tenant has already acquired (from the lessor or other transactions); and

(b) The identified asset is neither strongly dependent on, nor strongly interrelated with, other mentioned assets in the contract. For instance, the fact that a tenant could decide not to rent the mentioned asset without considerably affecting its privileges to use other mentioned assets in the contract might imply that the identified asset is not strongly dependent on, or strongly interrelated with, other mentioned assets.

If one of or both of abovementioned criteria are not satisfied, the right to utilize multiple assets is taken into account as a single rent component.

A contract may encompass a sum payable by the tenant for activities and expenses that do not transmit goods or services to the tenant. For instance, a lessor may encompass within the total sum payable costs for administrative issues, or other expenses it incurs related with the rent, that do not transmit goods or services to the tenant. Such commitment do not give cause to a separate element of the contract, but are taken into consideration to be portion of the total consideration allocated to the individually identified elements of the contract.

#### **d) Measurement and recognition exemptions**

Under the new leasing standard, lessees will no longer perform classification between finance lease arrangements and operating lease arrangements (off balance sheet). Whereas, the standard stipulates two recognition and measurement

exemptions. These exemptions are non-mandatory and they only related to tenants. If one of these immunities is applied, the rents are accounted for in a manner that is **alike** to current **operating lease bookkeeping** (that is, payments are accounted for on a straight-line basis or another basis that is considered more illustrative of the model of the tenant's benefit):

- **Short-term rents:** Short-term leases are specified as leases with a rent term of twelve months or less. The rent term also encompasses periods covered by an alternative to lengthen or an alternative to cease if the tenant is reasonably determined to exercise the lengthening option or not employ the ceasing option. A rent that includes a purchase opportunity is not considered as a short-term lease. If a tenant elects this immunity, it has to be performed *by class* of mentioned asset. If a company applies the short-term rent exemption it will treat any following modification or alteration in lease term as ending up a new rent. The short-term rent accounting treatment election is aimed to reduce the expenses and complexity of implementing IFRS 16. Once a tenant establishes a policy for the group of underlying assets, all upcoming short-term rents for that class are commanded to be recognized in line with the tenant's policy. A tenant assesses any potential alteration in its bookkeeping policy in pursuance of IAS 8. Let's give an example and analyse whether in following conditions the lessee should account for the lease as a short-term lease arrangement.

*Example:*

A tenant enters into a lease arrangement with a ten-month non-cancellable term with an opportunity to lengthen the rent for three months. The rent does not include a purchase opportunity. At the rent commencement date, the tenant concludes that exercise of the lengthening option is reasonably assured as the

monthly rent payments during period of the extension are considerably below than market rates.

*Analysis:* The lease arrangement term is higher than 12 months and it is considered as 13 months. As a result, the tenant may not recognize the rent as a short-term lease.

- **Leases of low value underlying assets:** The standard does not specifies the term of ‘low value’, but clarifies that the Board mentions assets at an amount of USD 5,000 or less when they are new. Examples of such assets are office furniture or personal computers. For some assets (e.g. assets that are highly interconnected with, other identified assets), the exemption is not appropriate.

The selection can be carried out on a *rent-by-rent* basis. It is vital to note that the examination does not take into consideration whether low-value resources in aggregate are substantial. Therefore, although the aggregate value of the resources subject to the exemption may be substantial the exemption is still present.

IFRS 16 also clarifies that both a tenant and a lessor can implement the standard to **portfolio** of rents with alike characteristics if the company reasonably anticipates that the resultant effect is not significantly different from implementing the standard on a rent-by-rent basis.

#### **e) Initial recognition and measurement**

Under the new leasing standard, lessees are required to recognize a **right-of-use asset** and a related **lease liability** for nearly all rent contracts. This is based upon the guideline that, in economic conditions, a rent contract is the acquirement of a right to utilize an identified asset with the buying price paid in installments.

The impact of this method is a significant increase in the value of recognized financial obligation and assets for companies that have entered into material lease contracts that are presently classified as operating rents.

**The lease obligation** is initially accounted for *at the commencement date* (the date on which the lease giver makes mentioned asset available for usage by a tenant) and evaluated at an amount equivalent to the present value of the rent payments during the rent term that are not still paid; **the right-of-use asset** is at first recognized *at the commencement date* and measured *at cost*, including the sum of the initial evaluation of the lease obligation, plus any rent payments made to the lease giver at or before the date of commencement less any rent incentives obtained, the initial assessment of *restoration expenses* and any *primary direct expenses* incurred by the tenant. The provision for the refurbishment costs is accounted for as a separate obligation.

Right-of-use asset	Lease liability
<b><i>Lease Liability</i></b>	<b><i>Lease Payments</i></b>
<i>Lease payments made before or at commencement date</i>	<b><i>Discount rate</i></b>
<i>Restoration costs</i>	<i>Provision</i>
<i>Initial direct costs</i>	

## **Lease payments**

Lease payments are instalments made by a tenant to a lessor associated with the right to utilize an identified asset during the rent term, including the following:

- (a) Fixed instalments (including in-substance fixed instalments), less any rent incentives;
- (b) Variable lease instalments that depend on a rate or an index;
- (c) The exercise rate of a buying option if the tenant is reasonably assured to exercise that opportunity; and
- (d) Instalments of penalties for ceasing the lease, if the rent term reflects the tenant exercising an option to cease the lease.

For the tenant, lease instalments also embody amounts anticipated to be payable by tenant under *residual value guarantees*. As the Board stated, it is assumed that a residual value warranty could be paraphrased as an obligation to transfer money based upon variability in the market value for the identified asset and is alike to variable rent payments based on a rate or an index. Rent payments do not encompass payments allocated to non-lease elements of a contract, unless the tenant elects to combine non-lease elements with a rent component and to recognize them as a single rent element.

A rent agreement with a lessor may include *incentives* for the tenant to sign the lease contract, such as an advance cash payment to the tenant, payment of expenses for the tenant (such as moving costs) or the undertaking by the lessor of the tenant's pre-existing rent with a third participant. For tenants, lease incentives received at or before the rent commencement date decrease the initial measurement of the tenant's right-of-use asset and the tenant's lease liability.



IFRS 16 differentiates between three types of **contingent instalments**, depending on the underlying factor and the likelihood that they actually conclude in instalments:

(a) Variable rent payments based on **a rate or an index**: Variable rent payments based on a rate or an index (for instance, linked to a benchmark interest rate, or a consumer price index) are component of the lease obligation. From the standpoint of the tenant, these payments are unavoidable, as any uncertainty associated only with the measurement of the obligation but not to its presence. Variable rent payments based on a rate or an index are initially evaluated using the rate or the index at the date of commencement (instead of forward rates or indices). This implies that a company does not predict future changes of the rate/index; these alterations are taken into consideration whenever lease instalments change.

(b) Variable rent payments based **upon any other factor**: Variable rent payments not based upon a rate or an index are not component of the lease obligation. These embody payments related to a tenant's performance stemmed from the mentioned asset, such as instalments of a specified portion of sales derived from a retail store or based upon the output of a wind farm. Likewise payments related to the utilization of the mentioned asset are exempted from the rent liability, such as instalments if the tenant exceeds a determined mileage. Such instalments are recognized in profit or loss statement at the time in which the occasion or condition that stimulates those payments happens.

(c) **In-substance fixed instalments**: Lease instalments that, in form, include variability, but, fundamentally, are fixed are considered as a component of the lease liability. IFRS 16 states that a rent payment is in-substance fixed when there is no real variability (for instance, where instalments must be made if underlying asset is verified to be able of operating, or where instalments must be made only when an occasion happens that has no real possibility of not happening). Moreover, the

existence of an option for the tenant within a rent agreement can also end in an in-substance fixed instalment. If, for instance, the tenant has the option either to lengthen the lease period or to buy the underlying asset, the minimum cash outflow (either the discounted rent payments through the lengthening period or the discounted buying price) stands for an in-substance fixed payment. That is to say, the company cannot dispute that neither the lengthening option nor the buying option will be exercised.

If instalments are initially arranged as variable rent payments related to the use of the identified asset but the variability is removed later, those instalments become in-substance fixed instalments when the variability is removed. IAS 17 does not embody any specific rule on in-substance fixed payments. Nevertheless, the Board believes that present practice already pursues this approach.

### **Discount rate**

The tenant uses as the rate of discount the **interest rate inferential in the lease contract** - this is the interest rate that produces the present value of lease instalments and the unguaranteed residue value to equal the sum total of the fair cash value of identified asset and any primary direct expenses of the lessor. Identifying the interest rate inferential in the rent is a key judgment that can considerably impact a company's financial statements.

If the rate cannot be effortlessly determined, the tenant should instead refer its **incremental rate of borrowing**.

The incremental rate of borrowing is determined as the interest rate that a tenant would have to pay in order to borrow, over a like term and with a like security, the funds essential to obtain an asset at equivalent value to the right-of-use asset's cost in a like economic environment.

### **Restoration costs**

In many circumstances, the tenant is obliged to give back the underlying to the lease giver in a specific term or to restore the place on which the mentioned asset has been situated. To reflect this commitment, the lessee recognizes a provision in line with *IAS 37*. The initial carrying value of the provision (the initial assessment of costs to be exposed) should be embodied in the primary measurement of the right-of-use assets. This conform to the accounting treatment for restoration expenses in *IAS 16*. Any subsequent alteration in the assessment of the provision, caused by a revised estimation of anticipated restoration costs, is recognized as an adjustment of a right-of-use asset as stipulated in *IFRIC 1*.

### **Initial direct costs**

The standard describes initial direct cost as incremental cost that would not has been incurred if a rent had not been acquired, except for expenses incurred by a producer or dealer lessor related to a finance lease. All initial direct expenses are included in the primary measurement of the right-of-use assets. Due to the change in the definition of initial direct costs under *IFRS 16*, initial direct costs of the lessor will now eliminate expenses incurred not depending on whether the lease is acquired (for instance, certain legal advice).

### **4.1.3. Conclusion of comparative analysis on initial recognition and measurement**

*IFRS 16* and *IAS 17* standards are compared in terms of the initial recognition and measurement by the lessee and the following differences are identified:

1. Enterprises applying the *IAS 17* standard while initially recognizing the leasing transaction, firstly, they had to determine whether the transaction satisfies criteria set

under IAS 17 to be classified as a finance lease or not. Whereas, according to the new leasing standard, the need for implementation of abovementioned step in initial recognition process is resolved. Therefore, all leasing transactions in terms of the lessee accounting will be accounted for as a financial lease under IFRS 16.

**2.** Under IAS 17, the cost to be reflected in the statement of financial position in the initial recognition associated with financial lease has to be determined as of the beginning of the lease agreement and is equal to the lower of the fair value or present value of future rent payments. Whereas, under IFRS 16, the amount to be reflected in the initial recognition of both assets and liabilities in the statement of financial position, the underlying asset will be measured based upon the present value of the future rent payments that have not yet been paid by the tenant at the date of commencement. According to this provision, different from IAS 17, the determination of fair value in leasing transactions is no longer a criterion under IFRS 16. Thus, the determination of the present value requires the reduction of future lease payments to their present value within a certain discount rate and its determination is easier than determining the fair value (Ciesielski & Weirich 2010).

**3.** The discount rate that should be known under IAS 17 and IFRS 16 in order to calculate the present value of future rent payments is the interest rate implicit in the lease contract and if it cannot be determined, the tenant's incremental borrowing interest rate is taken into consideration. In this context, while comparing the definition of both ratios, it is defined that the definition of interest rate implicit in the lease contract is the same in both standards, on the other hand, it is determined that the definition of the incremental borrowing interest of the lessee changes in IFRS 16. In this context, according to IAS 17, an alternative borrowing interest rate of the lessee is described as the interest rate that the lessee must pay in a similar lease arrangement. But if such a rate cannot be determined, the interest rate that may be

incurred by the lessee within the framework of similar maturities and collaterals related to the amount to be borrowed for the purchase of the leased asset at the inception date of the lease can also be used. However, under IFRS 16, the lessee's alternative borrowing interest rate is resolved from the contingent option approach. From now on, the alternative interest rate of the lessee is limited to the interest rate that the lessee is committed to pay in exchange for indebtedness within the framework of similar conditions and collaterals in order to acquire an asset of similar value to the right-of-use-assets in an analogue economic environment.

**4.** According to the new standard, the right-of-use assets must be initially recorded at cost. However, in this respect, there is no explicit provision under IAS 17 that such assets will be recorded at cost initially.

**5.** Another issue brought by IFRS 16 is that short-term leasing transactions and that the leasing transactions of low-value assets are not required to be reflected in the balance sheet. In this context, short term leases is defined as the leasing transaction in which the leasing period covers one year or less from the date when the asset subject to the lease is made accessible to the tenant. Tablet computers, personal computers, office furniture and telephones can be considered as examples for low-value assets.

## **Chapter 4.2. Comparison of IAS 17 and IFRS 16 in terms of subsequent measurement by lessee**

Under this heading, there are 3 subheadings in which subsequent measurement is discussed in terms of under IAS 17, then IFRS 16, and finally key points differing these two standards are summarized.

## **Chapter 4.2.1. Subsequent measurement under IAS 17**

### **a) Finance leases**

Minimum rent payments will be allocated between the fund charge and the decrease in the outstanding liability. The fund charge will be apportioned to each period through the lease term with the intention of producing a constant periodic interest rate on the residual balance of the obligation. Contingent leases will be charged as costs when they are incurred.

Practically, in allocating the fund charge to periods through the lease term, a tenant may use some manner of approximation to ease the calculation.

A finance rent gives cause for depreciation expense for depreciable resources and finance cost for each bookkeeping period. The policy for depreciation of depreciable leased assets will be in harmony with that for depreciable properties that are possessed, and the depreciation recognised will be calculated in line with IAS 16 and IAS 38 standards. If there is no rational certainty that the tenant will obtain proprietorship until the end of the rent term, the asset will be depreciated in full over the shorter of rent term and its life of use.

The sum of the amortisation expense for the underlying asset and the finance cost for the period is hardly the same as the rent payments payable for certain period, and therefore, it is inappropriate merely to recognise the rent payments payable as a cost. Hence, the asset and the associated liability are less likely to be in the same amount after the commencement date of the rent term.

To identify whether a mentioned asset has become impaired, a company applies IAS 36.

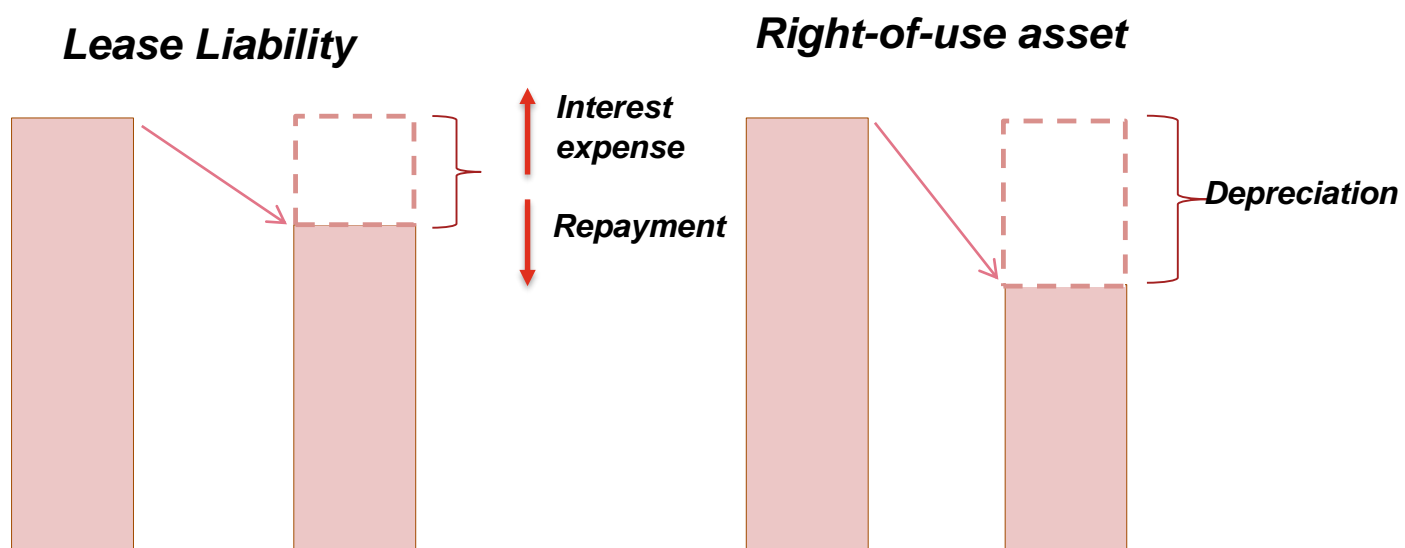
## b) Operating leases

According to IAS 17, for operating leases, rent instalments is recognized as an expense by performing the straight-line method. Nevertheless, if the lease instalments are structured in such a way to be increased according to the anticipated general inflation, the straight-line method is not used and the lease instalments adjusted for each period in connection with inflation are accounted as expense.

### Chapter 4.2.2. Subsequent measurement under IFRS 16

The **lease liability** is evaluated in subsequent periods applying the effective interest rate approach. The **right-of-use asset** is amortized in line with the provisions in IAS 16 which will end in a depreciation on the straight-line basis or any other systematic basis which is more characteristic of the model in which the company expects to use the right-of-use asset. The tenant must also apply the impairment provisions in IAS 36, to the right-of-use asset.

The carrying amount of a right-of-use asset and the rent liability will not further be equal in following periods. The carrying value of the right-of-use asset will, generally, be below the carrying value of the rent liability.



After the date of the commencement, a tenant measures the lease obligation by:

- (a) Increasing the carrying value to demonstrate interest on the lease obligation;
- (b) Reducing the carrying value to demonstrate the lease instalments made; and
- (c) Remeasuring the carrying value to demonstrate any reassessment or rent modifications specified, or to demonstrate revised in-substance fixed lease instalments.

Interest on the lease obligation in each period through the lease term is the sum that produces a constant periodic interest rate on the remaining amount of the lease obligation.

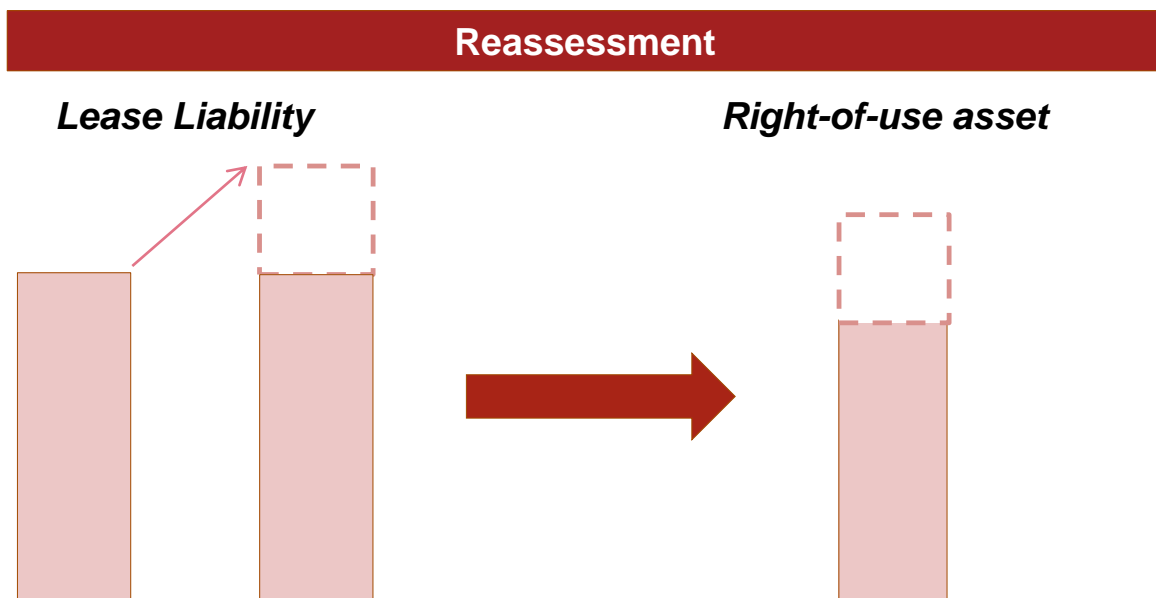
As actual rent payments can differ considerably from rent payments incorporated in a rent liability on initial recognition, the new standard specifies when the rent liability should be reassessed. It is vital to note that a revaluation only occurs if the variation in cash flows is derived from contractual terms that have been component of the contract since the date of inception. The requirements for **revaluation** are summed up below:



<b>Component of the lease liability</b>	<b>Reassessment</b>
Lease term and related extension or termination payments	When? – If there an alteration in the rent term. How? – Reflect the updated payments using an updated discount rate
Exercise price of a purchase option	When? – If a considerable change affects whether the tenant is reasonably assured to exercise an option.  How? – Reflect the updated payments using an updated discount rate
Amounts expected to be due under a residual value warranty	When? – If there is an alteration in the amount anticipated to be due.  How? – Include the updated residual payment using the unrevised discount rate.
Variable lease instalment based on an index or a rate	When? – If the alteration in the rate/index results in the alteration in cash flows.  How? – Demonstrate the revised payments dependent on the rate/index at the point of time when the changed cash flows be effective for the remainder of the lease term using the unrevised discount rate.

Apart from this, the lease obligation will be remeasured if instalments initially structured as variable instalments become in-substance fixed lease instalments because the variability is removed at some point after the date of commencement. Any remeasurement of the rent liability results in a reciprocal adjustment of a right-of-use asset. If the carrying value of the right-of-use asset has yet already been reduced to nil, the remaining revaluation is recognized in profit or loss statement.

### ***Reassessment of a lease liability***



The right-of-use asset is remeasured if the carrying value of the provision for refurbishment costs has revised due to a revised assessment of expected expenses. In that case, the variation in the carrying value of the right-of-use asset has to be equal to the variation in the carrying value of the provision. If an adjustment result in an addition a company will consider whether this indicates that the new carrying value of the right-of-use asset might not be recoverable in full.

Apart from the cost method applied in initial recognition and measurement stage, IFRS 16 embodies two alternative measurement methods that can impact evaluation for some right-of-use assets:

- A right-of-use asset *has to* be subsequently measured in line with the fair value method in **IAS 40** if it meets the investment property definition and the tenant has chosen the fair value method stipulated in IAS 40.
- A right-of-use asset *can* be subsequently evaluated at the revalued amount in line with **IAS 16** if it pertains to a class of PPE and the tenant applies the revaluation method to all assets within that class.

### **Chapter 4.2.3. Conclusion of comparative analysis on subsequent measurement**

IFRS 16 and IAS 17 standards are compared in terms of the subsequent measurement by the lessee and the following differences are identified:

1. Under guidance of IAS 17, it is not explicitly stated that on the basis of which method (cost model or revaluation model) right-of-use assets will be measured in the subsequent periods. Only the references made to IAS 16 and IAS 38 at the point of amortization allocation, point out that the assets subject to the lease arrangements will be measured based on the cost model.

Whereas, under specific guidance of IFRS 16, it is stated that the main method to revalue right-of-use assets in subsequent periods is the cost model, unless otherwise stated.

The cost model in IFRS 16 is parallel with the cost model in IAS 16 and IAS 38. But, it differs due to the nature of lease arrangements. Namely, the right-of-use assets are

reassessed at cost, less accumulated depreciation and any accumulated impairment losses, and (b) the restated cost of the financial leasing liabilities.

2. As mentioned above, the cost model is the main method for remeasurement of the right-of-use assets after initial recognition. Whereas, IFRS 16 has an accounting policy different from IAS 17. This accounting policy is the revaluation model within the context of IAS 16. In this regard, the right-of-use assets can also be accounted for by the revaluation method, if the right-of-use assets is within the scope of class of the assets which remeasured based on revaluation method under IAS 16. But it should be noted that this is an optional application.

3. Under specific guidance of IFRS 16, there is specific and detailed provision related to subsequent measurement of lease liabilities which mentions reflection of the interest charges, any change in structure of payments which were components of initially recognized lease liability and lease payments on the carrying amount of lease liability.

### **Chapter 4.3. Comparison of IAS 17 and IFRS 16 in terms of presentation in Financial Statements by lessee**

In IFRS 16, special provisions are introduced with respect to the reporting of leases in the financial statements. In this context, IFRS 16 sets out how to report leasing transactions in the statement of financial position, statement of profit or loss and other comprehensive income and the statement of cash flows. Hence, under this heading differences between IAS 17 and IFRS 16 are remarked in terms of presentation of lease transactions in financial statements separately.

### **Chapter 4.3.1. Comparison in terms of presentation in the Statement of Financial Position**

According to IAS 17, finance leases must be recognized as an asset and a liability in the statement of financial position. Apart from this, no additional explanation has been made regarding to the presentation of the operating leases on the statement of financial position.

Whereas, according to IFRS 16, the reporting of the leasing transactions in the statement of financial position is regulated separately in terms of both right-of-use assets and liabilities arising from those leasing transactions. In respect to the regulation, the leasing transactions will be reported as follows.

**a. Right-of-use assets** are presented in the statement of financial position and disclosure notes separately from other assets. If they not presented in this manner, the entity has to report both the right-of-use assets and other assets owned by an entity which performs the same function within the same financial statement line item and disclose that financial statement line item which embodies right-of-use assets.

**b. Lease liabilities** arising from leasing transactions is presented separately from other liabilities in the statement of financial position and disclosure notes. If they are not presented separately, the entity discloses which financial line items embodies those lease liabilities in the statement of financial position.

#### **Presentation of lease liabilities arising from the leasing transactions**

IFRS 16 has adopted the principle of measuring the lease liabilities arising from leasing transaction with the present value of the future lease instalments. However, in order to reflect the flexibility of the tenant in terms of lease payments and to reduce confusion, the obligations cover only the economically compulsory payments. Under

the new leasing standard, there is a simplified approach in order to overcome changes in lease payments which form components of lease liabilities. Hence, liabilities arising from the leasing transactions include in-substance fixed payments to be made by the lessee and other discretionary payments, and do not include variable rent payments related to other factors rather than on the basis of rate/index, such as related to usage or disposal of leased assets.

### **Presentation of right-of-use assets arising from leasing transactions**

The companies which involve in leasing transactions, will initially record the right-of-use assets at the same amount with the lease liabilities arising from the leasing transaction and then add the initial direct costs for the leasing operation. Subsequently, assets arising from the leasing will be depreciated on a straight-line basis over the period of the lease.

Another point that should be mentioned in this section is that the right-of-use assets entitled to investment property status will continue to be classified as investment property. This issue is an ongoing application since IAS 17.

Due to the fact that the tenants were performing off-balance sheet leasing transactions, the most important impact of the new standard is the increase in the assets and liabilities arising from leasing transactions. Therefore, it is most likely that there will be significant changes in the financial ratios calculated from the tenant's assets and liabilities.

In general, the carrying value of the assets resulting from the leasing transaction decreases more quickly than the book value of the lease liabilities. This situation will lead to a decrease in the shareholders' equity reported by the companies with material operating lease balances when compared with the situation when IAS 17 was applied. However, the effect of the leasing arrangements on the equity that the lessee reports depends on the lessee's leverage, the lease terms, the equity capital ratio of the

liabilities arising from the leasing transaction and how the tenant provides the financing of the company's activities.

*“Capitalizing operating leases will add an estimated \$2 trillion which is 11 per cent more reported debt to the balance sheets of US-based organizations and could result in a permanent decrease of \$96bn in equity of US organizations.” - Equipment Leasing and Finance Foundation in the US (2016)*

### **Chapter 4.3.2. Comparison in terms of presentation in the Statement of Profit or Loss and other comprehensive income**

Under guidance of IAS 17, as only the finance lease arrangements are accounted for as the assets and the lease liabilities in the statement of financial position, the interest expenses on lease liabilities and depreciation charge on these assets are recognized as expenses. Whereas, in terms of operational leases, accrued lease instalments are reported directly under operating expenses in the income statement.

According to the new leasing standard, since all leasing transactions will be recorded as a finance lease, regardless of the type of the lease, depreciation will be calculated for all leased assets. In addition, the interest expenses to be incurred for the realization of the lease installments in the future will be recorded as expense.

It is expected that new standard will lead to an increase in the profit before interest and tax amount of entities with significant operating lease balances. Because, under guidance of IAS 17, a tenant who records the costs related to the operating leases in the income statement as part of the operating expense, will no longer recognize rent expense in this manner, but according to the new standard, they will account for interest and amortization expense. As a result of the change, there will be a significant change in the EBITDA figure.

**Table 3: Effect of the transition to IFRS 16 on the income statement figures**

Industry sector	EBITDA (in millions of US\$)		PBIT/Total revenue		Increase in profit margin excluding interest and tax (% points)
	Reported (IAS 17)	If all leases reported on balance sheet (IFRS 16)	Reported (IAS 17)	If all leases reported on balance sheet (IFRS 16)	
<b>Retailers</b>	270,403	<b>347,416</b>	6.01%	<b>6.66%</b>	0.65
<b>Airlines</b>	51,624	<b>73,849</b>	6.33%	<b>7.69%</b>	1.36
<b>Travel and leisure</b>	50,299	<b>63,279</b>	11.80%	<b>13.15%</b>	1.35
<b>Transport</b>	71,177	<b>87,580</b>	10.00%	<b>10.70%</b>	0.70
<b>Energy</b>	688,370	<b>745,273</b>	8.11%	<b>8.42%</b>	0.31
<b>Media</b>	118,156	<b>128,959</b>	17.70%	<b>18.29%</b>	0.59
<b>Telecommunications</b>	399,328	<b>434,452</b>	13.18%	<b>13.80%</b>	0.62
<b>Distributors</b>	29,350	<b>35,047</b>	3.70%	<b>3.94%</b>	0.24
<b>IT</b>	298,655	<b>312,392</b>	18.28%	<b>18.50%</b>	0.22
<b>Healthcare</b>	254,616	<b>265,181</b>	15.41%	<b>15.63%</b>	0.22
<b>Others</b>	1,162,512	<b>1,228,643</b>	10.63%	<b>10.83%</b>	0.20
<b>Total</b>	<b>3,394,490</b>	<b>3,722,371</b>	<b>10.19%</b>	<b>10.58%</b>	<b>0.39</b>

(Source: IFRS 16 Effect analysis report, IASB, 2016)



**Table 4: Effect of transition to IFRS 16 on profit margin (more detailed)**

Industry sector	Increase in profit margin excluding interest and tax (% points)					
	(by number of companies)					
	<0.2	0.2 – 0.5	0.5 - 1	1 - 5	5 - 10	>10
<b>Retailers</b>	4%	10%	25%	58%	3%	---
<b>Airlines</b>	---	8%	14%	72%	4%	2%
<b>Travel and leisure</b>	4%	6%	13%	62%	9%	6%
<b>Transport</b>	6%	18%	35%	33%	6%	2%
<b>Energy</b>	35%	25%	16%	21%	---	3%
<b>Media</b>	9%	25%	27%	29%	8%	2%
<b>Telecommunications</b>	14%	34%	21%	29%	2%	---
<b>Distributors</b>	19%	69%	---	12%	---	---
<b>IT</b>	24%	43%	14%	16%	3%	---
<b>Healthcare</b>	42%	15%	9%	23%	9%	2%
<b>Others</b>	44%	26%	16%	13%	1%	---
<b>Total</b>	<b>23%</b>	<b>22%</b>	<b>19%</b>	<b>32%</b>	<b>3%</b>	<b>1%</b>

*(Source: IFRS 16 Effect analysis report, IASB, 2016)*

### **Chapter 4.3.3. Comparison in terms of presentation in the Cash flow Statement**

Previous leasing standard does not specify how cash outflows related to leasing transactions should be reported in the cash flow statement. Whereas, IFRS 16 stipulates that the principal amount of the debts arising from leasing transactions has to be presented as a cash outflow from the financing activities (IASB, 2016). And interest payments have to be classified in accordance with other interest payments either as a cash outflow from the operating activities or as a cash outflow from the financing activities.

Expected impacts of IFRS 16 on the statement of cash flow are as following:

- Decrease in cash outflow from the operating activities,
- Increase in cash outflow from the financing activities,
- Total cash flow will not change.

Abovementioned expected impacts is due to the fact that according to IAS 17, the cash flow of the tenants' off-balance sheet leases is shown as the cash flows from the main activities. Unlike, IFRS 16 requires the principal payments of all lease liabilities to be included in the cash flows from financing transactions and interest portion of those liabilities can also be added to the cash flows from financing transactions or cash flows from operating transactions.

## **Chapter 4.4. Comparison of IAS 17 and IFRS 16 in terms of disclosure notes**

In this section, disclosure notes required by the lessee under guidance of IFRS 16 are discussed. In IFRS 16, disclosures notes are established in conjunction with the statement of financial position, the statement of profit or loss and the statement of cash flows (IASB 2016). Disclosures notes are prepared in a way to support the financial information regarding to financial position, financial performance and cash flow obtained from these three financial statements.

As a result of the comparison, it was determined that the disclosure notes required by the tenant have been found out to be considerably different from each other in terms of both standards. In this context, firstly the remaining similarities are discussed below:

- a. The net book value of each asset will be disclosed at the end of the reporting period.
- b. For the leased assets subject to the investment property status, the disclosure notes within the scope of IAS 40 will be prepared.

For material rents, like IAS 17, IFRS 16 stipulates that a company has to provide a breakdown of the costs related to rent in the disclosure notes to the financial statements. Different from IAS 17, an entity is also required to exhibit information about leased assets by group of asset being leased, and the total sum of rent cash outflows. Different from IAS 17, IFRS 16 relies on the provisions of IFRS 7 for the disclosure of a maturation analysis of rent liabilities. IFRS 7 stipulates that a company has to use judgement in identifying which time bands have to be disclosed to demonstrate useful information to analysts, investor and other stakeholders, whereas IAS 17 required time bands of less than 1 year, between 1 and 5years, and more than 5 years.

In the new disclosure notes, it has been observed that a more transparent approach regarding the leasing transactions has been carried out in order to provide the required financial information. Some of the new disclosure notes are described below (these disclosure notes are required to be prepared in tables according to IFRS 16) (IASB 2015).

- Disclosure of carrying value of each right-of-use asset held at the end of the reporting period,
- Additions to right-of-use assets within the period,
- Depreciation expense of each right-of-use asset for the period,
- Financial expense related to lease obligation,
- Total cash outflows resulted from leasing transactions,
- Presentation of a maturity distribution analysis table for liabilities arising from leasing transactions in line with IFRS 7 separately.

*“IFRS 16 will standardize the currently varied disclosure of leasing costs in footnotes” - Vincent Papa, director of financial reporting policy for Chartered Financial Analysts (2016)*

## **Chapter 5. Comparison of IAS 17 and IFRS 16 in terms of lessor accounting**

As a result of the comparison, it has been revealed that there is no significant difference between two standards in terms of lessor accounting policies. In terms of the lessor, the classification of leasing transactions as finance and operating leases

continues. Therefore, the lessor is obliged to determine the type of the lease in order to account for that leasing transaction.

The provisions for the determination of the type of lease under IFRS 16 are the same as the provisions of IAS 17 (IASB 2015).

In terms of finance leases, the lessor reflects the leased asset in accordance with IAS 17 as a financial leasing asset in the statement of financial position and recognize a receivable equivalent to net investment on leasing transaction. Net investment value is equal to the present value of future lease instalments discounted by the implied interest rate (IASB 2016). Thus, if the tenant records the future lease payments with their present value in the initial recognition, the lessor will simultaneously register future lease receivables with their present value in the initial recognition. At this point, IFRS 16 differs from IAS 17, because, according to IFRS 16, while the scope of the future lease payments has been redefined by the lessee due to recognizing all leasing transactions as a finance lease, reflection of the change made by the lessee also by the lessor to the finance lease came into question. Therefore, the scope of future lease receivables is determined as follows (IASB 2016).

- a.** In-substance fixed payments less any payable rental incentives,
- b.** Variable rent payments based on the rate or index measured at the date the asset is delivered to the tenant,
- c.** Residual value warranty provided by the tenant to the lessor (a third party that is not related to the lessee who is financially competent to fulfil the obligations under the guarantee or a third party that is not related to the lessor),
- d.** The exercise price of a buying option when the tenant is reasonably assured to work out the buying option,

e. Penalty payments related to ceasing of lease, if the rental period reflects the tenant's option to cease the lease.

There is a change in terms of **subleases** when compared to IAS 17, which worth mentioning. Under IAS 17, a **sublease** was recognized with regard to the underlying asset. Whereas, IFRS 16 now stipulates that the lessor has to evaluate the subleasing with regard to the right-of-use asset. The reason is that, characteristically, the fair value of an underlying asset is higher the fair value of a right-of-use asset, subleases are, currently, more likely to be separated as finance leases. Apart from this, since the lease giver of the subleasing is also the tenant with regard to the head lessor, it will however have to recognize an asset on its financial statement– as the right-of-use asset with regard to the head lessor (if the subleasing is recognized as an operating rent) or a rent receivable with regard to the subleasing (if the subleasing is recognized as a finance lease).

If the head lease is considered as a short-term rent, the sublease will be recognized as an operating lease.

A sublease that conclude in a finance leasing, an intermediate lessor is not allowed to offset the remaining rent liability and the rent receivable. The same thing is true for the rent income and rent expense regard to head lease and subleasing of the identical underlying asset.

Another differentiating point between IAS 17 and IFRS 16 in terms of lessor accounting is **modification of a lease** about which IAS 17 does not specify accounting treatment for modification of a lease. Whereas, IFRS 16 has specific guidance on this issue. IFRS 16 stipulates that modification of operating leases has to be accounted for as a separate lease arrangement by the lessor any accrued or prepaid rent payments are considered to be payments of new lease. Modification of finance leases are accounted for as a separate lease arrangement only if:

- The modification increases the lease's scope,
- The consideration for the rent increases by the sum in proportion with the stand-alone price for the increase in the scope any suitable adjustments to the price to demonstrate the terms of the particular contract.

It should be mentioned that this mirrors the provisions for the tenants.

If one of the abovementioned criteria is not satisfied, the lessor has to identify whether the modification would result in either a finance or an operating lease if it had been effective at inception date of the rent:

- If the rent would have been recognized as an operating rent, the lessor accounts for lease modification as a new rent (operating rent). The carrying value of the underlying asset which has to be accounted for is measured as the net investment in an original rent immediately before the rent modification.
- If the rent would have been recognized as a finance lease, the lessor recognized the modification in line with IFRS 9.

## **Conclusion**

Within the scope of this thesis, IFRS 16, which superseded previous leasing standard at the beginning of 2019, has been examined comparatively and the potential impact of the new standard on the company's financial statements has been discussed. The most important innovation that will enter into force with IFRS 16 is the recognition operating leases as right-of-use assets and liabilities in the statement of financial position, as they were only included in the disclosure notes of the financial statements according to IAS 17. Advantages of implementation of new leasing standards is believed to outweigh the costs related to the implementation. The new standard aims to ensure that both lessors and lessees provide relevant and transparent information in their financial statements in a manner which improves faithful representation of leasing transactions. Transition to the new standard is also helpful in improving comparability of financial information and eliminates the need for adjustments in the amounts derived from operating leases which are reported off-balance sheet by investors or analysts as they will be provided with sufficient information under IFRS 16.

On the other hand, certain costs are expected to be incurred by companies while implementing the new leasing standard which mainly include training of the staff about new standard, costs related to systems and processes in order to perform the new standard.

The sectors which are expected to be mostly affected by transition to IFRS 16 are airlines, retail, transportation, tourism and telecommunication and other sector companies with material operating lease balances.



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