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FAC014 **IFRS 16 LEASES – A SIGNIFICANT CHANGE FOR LESSEES OR "MUCH ADO ABOUT NOTHING"?**

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ABSTRACT:

The new international accounting standard on leases, International Financial Reporting Standard (IFRS) number 16 (IFRS 16), effective from 1 January 2019, will cause most lease arrangements to be accounted for on the face of the balance sheet (also referred to as the face of the statement of financial position) of lessees. Former operating leases (leases not accounted for on the balance sheet) will be capitalised by recognizing a right-of-use (ROU) asset and a corresponding lease liability. As a result, the annual financial statements (AFS) of some lessees will differ materially in their qualitative and quantitative characteristics. This future change, particularly the need to recognise a lease liability on-balance sheet and the related (perhaps unintended) consequences thereof, has created a fair amount of anxiety amongst lessees. This paper explores whether these changes are fundamental or rather a case simply of alternate disclosure with no material change for lessees.

Key words:
IFRS 16, lease accounting, lessee, on-balance sheet, unintended consequence.

INTRODUCTION

Leasing is an economic transaction that has been used since the early 1900's and formed one of the fundamental pillars of the related accounting transactions (Miller and Upton, 1976).

The concept of leasing makes economic sense (Werden, 2005). When an entity requires the use of an asset or a resource, the entity need not be forced into purchasing the asset outright, but rather gaining right to use the asset for a particular period in exchange for a payment. This would have potential working capital advantages too and serves as a mechanism for an entity to manage, potentially, its cash flows more efficiently.

Since September 1982, lease accounting governed by International Accounting Standards (IAS) 17 (International Accounting Standards Board (IASB), 2015) required both lessors (the legal owner of the asset), and the lessee (the party making payments) to distinguish between whether the lease was an operating or a finance lease (Branswijck et al., 2011).

The accounting standard did not focus primarily on what an operating lease is, but rather defined an operating lease as a lease other than a finance lease.

The standard then went into a significant amount of detail giving examples of what indicators could suggest the existence of a finance lease. The more prominent indicators were as follows:

1. The lease transfers ownership of the asset to the lessee by the end of the lease term.
2. The lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than fair value at the date the option becomes exercisable that, at the inception of the lease, it is reasonably certain that the option will be exercised.
3. The lease term is for the major part of the economic life of the asset, even if title is not transferred.
4. At the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset.
5. The leased assets are of a specialised nature such that only the lessee can use them without major modifications being made (IASB, 2015, para 10).

The rationale being that if one could not reasonably conclude that the lease transaction was a finance lease, it was by default an operating lease.

While the distinguishing characteristics as described above were not inherently controversial, the difference between the accounting thereof was very material.

A finance lease was defined as a lease whereby the significant risks and rewards of ownership had passed from the lessor to the lessee (IASB, 2015, para 4). Thus, from an accounting perspective, the lessee would recognise a leased asset on its balance sheet, as well as a corresponding liability. The leased asset would be accounted for using the same principles as that of an owned asset requiring only separate disclosure from that of owned assets. A depreciation charge would be allocated against the carrying value of that asset resulting in a decrease to net profit. The corresponding lease liability would be reduced by payments made against it and increased by interest charged on it, also resulting in a decrease to net profit.

Finance lease accounting was sometimes referred to as accounting for the substance of the transaction, rather than its legal form (Baker and Hayes, 2004). The legal form being a pure rental agreement; whereas the substance of the transaction was the financing of the asset by way of an interest-bearing loan. This concept was widely understood and accepted (Lantto and Sahlström, 2009).

By inference, the operating lease was accounted for in a completely different way. Since it was defined as a lease that is not a finance lease, the substance of the transaction was the antithesis of the above and hence rather took the form of a pure rental agreement. Thus no leased asset was raised, and consequently no corresponding liability. The theory was quite simple, since no risks and rewards had deemed to pass to the lessee, no asset was deemed necessary to raise, and if no asset was raised, then no corresponding liability could be raised either (Imhoff Jr et al., 1991).

To this end, for an operating lease, the only related disclosure the AFS would contain was the effect that the lease had on the income statement, being either a lease rental expense from the lessee's perspective or a lease rental income from the lessor's. An interesting update to IAS 17 transpired in 2005 where the IASB introduced a requirement to straight-line the lease income and lease expense in the case of an operating lease. This resulted in effectively an average lease income or lease expense being disclosed in the AFS (Mey, 2016).

As a result of this, the impact on the balance sheet was limited to the potential of having either a short-term asset or liability, resulting from the difference between the actual amount received or paid (cash flow) versus the amount of income or expense recognized in the income statement (accounting consequence). If indeed such a short-term asset or liability arose, a resultant deferred tax asset or liability would have been raised thereon.

The only other evidence of the operating lease transaction was disclosed in a note to the AFS. From the lessee's perspective this note was known as a lease commitment note. The disclosure requirements for this note were limited to showing the remaining payments that the lessee had contractually committed to, split between the present value of the commitment and the future finance charges that were at that point not yet accrued. While this was a disclosure requirement, it did not form part of the liabilities presented on the face of the balance sheet. Hence, the lease commitment note only provided information to the user - it did not agree to a specific liability balance or balances that were represented on the face of the balance sheet (refer to the section that discusses the additional consequences for lessees on adoption of IFRS 16 for further discussion).

Effectively then, operating leases were accounted for off-balance sheet. In 2016, somewhat of a bombshell was dropped in the world of lease accounting that would radically change the way leases would be accounted for and disclosed by the lessee. The IASB repealed IAS 17 and replaced it with a new accounting standard for leases, IFRS 16. No more would lessees be allowed to use the indicators outlined above as a reference and select whether leases were

finance or operating. No more would lessees be given the option of recording leases off-balance sheet.

IFRS 16 requires all leases to be recorded as finance leases from the lessee's perspective. All lessees are required to recognise an asset known as a ROU asset, with a corresponding liability on their balance sheets. The liability is measured as the present value of the future lease payments discounted at the rate applicable to the contract applying the effective interest rate method. This would imply a dramatic change to key ratios determined with reference to the amounts presented in the AFS of lessees. Users of the AFS may not fully understand the reasons for these changes. It may also require a change to information technology (IT) systems to accommodate capitalised lease accounting. IT and accounting staff may need to be retrained. IFRS 16, much ado about nothing?

The purpose of this study is to identify the various consequences of the new lease accounting standard, in particular for lessees, whether intended by the IASB or not, and to explore the possible impact thereof. The research questions to be addressed are 'What are the main consequences of the new leases standard for lessees?' and 'What impact will they have on the preparers and users of AFS?' The value of this study is that it focuses on a current topic, being the future of lessee accounting. It highlights some of the main consequences for lessees and provides an opinion as to whether the resultant impact on lessees will be fundamental or not.

THEORETICAL FRAMEWORK: UNINTENDED CONSEQUENCES OF REGULATORY DEVELOPMENTS

There is a vast amount of literature that provides examples of regulatory developments having unintended consequences. For example (Vakkur et al., 2010) examine the impact of the Sarbanes Oxley Act (2002) (SOX) which was intended to improve the control environment at organisations and promote greater certainty in capital markets (Maroun, 2012). Related literature suggests that SOX has resulted in an inflexible environment focusing on rules-based rather than conceptual compliance based and has inadvertently resulted in a decrease in the value of firms (Maroun, 2012).

In examining a financial reporting environment, the introduction of monitoring bodies that are aimed at ensuring certain quality reporting levels does not always result in an improved quality of reporting (Maroun, 2015).

In the case of the SOX, the inflexible rules-based approach followed by SOX, coupled with sanctions for non-compliance, has led to a decline in the value of firms. Similarly, the introduction of quality inspections by the Public Company Accounting Oversight Board (PCAOB) aimed at improving the quality of external audit (PCAOB, 2007) has had unintended consequences for the quality of corporate reporting. Each case highlights how reforms, 'not well informed by and well-grounded' in 'professional practice and the wide array of factors' influencing and shaping regulatory domains 'run the risk of producing unintended and potentially dysfunctional consequences' (Humphrey et al., 2011, p. 443), (Segal and Maroun, 2014)

In a taxation context, laws and regulations implemented by authorities to eliminate anti-avoidance transfer pricing schemes have often been unsuccessful and have instead added increased complexity and costs to the tax system both locally and internationally (Stiglingh, 2011). The unintended result of these increased taxation compliance implementations is an increased administrative responsibility on the taxpayer, which is often a smaller business without the sufficient resources and capability to manage the increased financial expenditure (Maroun, 2015).

Reflecting on auditing-specific areas, a further example is that the quality reviews by the Public Company Accounting Oversight Board (PCAOB) which is designed to improve the reliability and standards of external audits has resulted in unintended consequences for the quality of audit reporting (Maroun et al., 2014). This has occurred through the increased time taken to complete the audit of financial statements and, as a result, preliminary results have been released by companies prior to the actual audit work being completed and this has resulted in a decrease in the dependability of these preliminary results (Segal and Maroun, 2014). (Humphrey et al., 2011) has also noted that even though there are increased regulations continually being implemented in the audit profession there is minimal actual effect on the quality of the audit being performed (Parker et al., 2008), (Power, 1994). What has resulted is that the increased attempts at regulating the non-audit services performed, partner rotation and audit reporting requirements have not always resulted in the desired effects that were expected (Maroun, 2015).

The situations highlighted above reflect how legislation and changes which have not been well grounded in professional practice 'run the risk of producing unintended and potentially dysfunctional consequences' (Humphrey et al., 2011). The aim of this literature review is not to provide a complete analysis of the problematic aspects of the introduction of new auditing legislation. What is important to appreciate is that rarely are proposed regulatory developments free from unintended consequences (Segal and Maroun, 2014).

This study used a content analysis of IFRS 16 itself, the comment letters received by the IASB whilst drafting the new standard, the IASB's own analysis of the effects of IFRS 16 and prior academic literature on lease accounting to explore the impact of the new standard. Further information was gathered by attending the 2016 Panel discussion on the new leases standard at the South African Institute of Chartered Accountants (SAICA).

THE INHERENT WEAKNESSES OF THE LESSEE ACCOUNTING PRESCRIBED BY IAS 17

Sir David Tweedie, a former member of the IASB, delivered a historical speech in Australia in August 2002, in which he told the audience that he could guarantee that most of them had never flown on an aircraft that was shown on the airline's balance sheet. He described the lease accounting requirements of IAS 17 (and those applicable in the United States of America, the United Kingdom and Australia at that time) as "[…] perfectly harmonized worldwide […] but absolutely useless." (Beckman, 2016).

His speech highlighted the inherent weaknesses of IAS 17, specifically the operating lease accounting model as it applied to lessees. Why would an airline company not recognize arguably its most significant operating assets (i.e. its aircrafts) on its balance sheet? The answer is that most airlines finance their aircrafts via lease arrangements. Instead of purchasing aircrafts outright, airlines typically enter into long-term lease arrangements with aircraft manufacturers. These leased aircrafts have remained off-balance sheet where the arrangement was classified as an operating lease using the indicators in IAS 17. Sir David Tweedie did not believe that the resultant disclosure in the AFS was useful to the users thereof. The users would not see any aircraft assets on the balance sheet, nor would they see any liabilities for future lease payments.

His speech also alluded to another weakness of IAS 17, being the opportunity to structure lease arrangements in order to keep the leased assets and the corresponding liabilities off-balance sheet. A well-known issue was that lessees frequently structured contracts for leased assets, in situations where they enjoyed benefits similar to outright ownership, in a way that kept both the leased assets and related liabilities off their books. This method of accounting created off-balance sheet financing and was called operating lease accounting (Frecka, 2008).

Operating lease accounting was achieved by ensuring that some or all of the finance lease indicators within IAS 17 were not met. This was possible because as the name suggests, the standard contained indicators, not absolute criteria, which would lead one to classify a lease as a finance lease. For example, one of the indicators of a finance lease was that ownership of the asset would transfer to the lessee by the end of the lease term. Lease arrangements could be structured to ensure that legal ownership remained with the lessor. From the lessee's perspective, this would generally not pose an issue since they were enjoying the right of use of the asset during the lease term anyway. However, this type of structuring undermined the objective of IAS 17 which was to classify leases as either operating or finance leases depending on the substance of the arrangement rather than the legal form (IASB, 2015, para 10).

Subsequently it became apparent that the other IASB members also had concerns over the lessee accounting model as they embarked on a project to overhaul IAS 17. This ultimately resulted in the new standard for lease accounting, IFRS 16, being published in January 2016.

In the introduction to IFRS 16, the IASB provides reasons for issuing the new standard. It notes how the previous lease accounting model was criticised for failing to meet the needs of users of financial statements because it did not always provide a faithful representation of leasing transactions. In particular, it did not require lessees to recognise assets and liabilities arising from operating leases (IASB, 2016c, Introduction, para 5). The IASB explains that the new approach to lease accounting requires a lessee to recognise (account for) assets and liabilities for the rights and obligations created by leases. The IASB believes this approach will result in a more faithful representation of a lessee's assets and liabilities (IASB, 2016c, Introduction, para 6).

Under IFRS 16, lessees will not classify their lease arrangements as either operating or finance leases. Instead, all leases will be treated as finance leases (excluding short-term leases and leases of low value items). At the inception of a lease arrangement, the lessee will recognize a ROU asset and a corresponding lease liability on its balance sheet (IASB, 2016c, Introduction, para 10). The ROU asset will subsequently be treated like any other owned asset – as the economic benefits embodied in it are consumed, it will be depreciated. Similarly, the liability will be treated like a long-term loan. The loan will grow with interest charges and will reduce each time a lease payment is made.

ADDITIONAL CONSEQUENCES FOR LESSEES ON ADOPTION OF IFRS 16

Whilst the IASB will achieve its goal of requiring lessees to recognise a ROU asset and a corresponding lease liability on their balance sheets for most long-term lessees (IASB, 2016c, Introduction, para 6), the additional, perhaps unintended, consequences may detract from its achievement. Even before the new standard was released, many organisations and professionals expressed their concerns over the proposed changes. In this regard, the IASB received over 600 comment letters in response to the Lease Exposure Draft (ED) it published in May 2013. The ED preceded IFRS 16 and it set out the IASB's proposed changes to lease accounting. Although the final lease accounting standard is somewhat different to what the IASB proposed in the ED, the fundamental principle of lessees recognizing leases on-balance sheet remains unchanged.

One of the significant concerns raised in response to the ED was that of cost versus benefit. Many respondents questioned whether the perceived benefits of the new lease accounting would really exceed the costs of implementing it (IASB and FASB, 2013). Lessees may incur significant costs when they transition from the old accounting standard, IAS 17, to the new accounting standard. This is discussed in more detail below.

SAICA gathered feedback on the ED from various Chartered Accountants. One of the concerns noted related specifically to the banking industry; banks were particularly concerned with the impact the new lease accounting would have on the regulatory requirements of banks (SAICA, 2013).

Banks are heavily regulated due to the nature of their business (Levine, 2004). A key service that banks offer is the safe-keeping of customers' money. By keeping cash on hand, customers are at risk of loss, for example due to theft. With banks, customers don't need to keep large amounts of cash on hand; transactions can be handled with cheques, debit cards or credit cards, instead. When a bank takes a deposit from a customer, it becomes a debtor of the customer. This is because the customer can generally withdraw all or part of the cash deposited at any time. However, due to the nature of the business that banks conduct, a bank's position is somewhat different to that of a normal debtor. The cash deposited into a bank account becomes the property of the bank and bank has a right to use the money as it likes. The bank is not bound to inform the customer the manner of utilisation of the cash deposited by him. For example, the bank may use the cash to provide a loan to another customer or to pay its own

expenses. The bank also does not give any security to the customer as a normal debtor would. For these and other reasons, it is necessary to regulate the activities of banks.

From a South African regulatory perspective, banks are required to comply with Basel III. Basel III is a comprehensive set of measures, developed by the Basel Committee on Banking Supervision, to strengthen the regulation, supervision and risk management of the banking sector. Basel III imposes certain capital and liquidity requirements on banks aimed at improving a bank's ability to absorb shocks arising from financial and economic stress (Bank of International Settlements (BIS), 2017). One of these requirements is the liquidity coverage ratio which requires banks to have sufficient high-quality liquid assets to withstand a 30-day stressed funding scenario (BIS, 2017). Where a bank is a lessee, although it will recognize both an asset and liability in respect of the lease on its balance sheet, the impact on the liquidity coverage ratio is potentially detrimental. Since ROU assets will be long-term in nature, they are expected to be categorised under Basel III as other assets as opposed to liquid assets. The corresponding lease liabilities will increase the bank's total liabilities, resulting in a reserving requirement of 2.5% of the balance, as well as a liquid asset requirement of 5% of the balance (SAICA, 2013). In summary, the recognition of additional lease liabilities on-balance sheet will require banks to have additional liquid assets on-balance sheet, however, the ROU assets will not count as liquid assets. The result of additional debt on-balance sheet without the corresponding increase in liquid assets will place more pressure on the bank's ratios. It is doubtful that this was the intention of the standard, but never the less the result is an unintended consequence.

The new lease accounting standard may also have other consequences for lessees, each of which is discussed in more detail below.

Key financial ratios may be affected

Lessees with a significant number of long-term leases, and specifically lessees who historically classified those leases as operating leases under IAS 17, will see an impact on some of their key financial ratios.

Financial ratios are generally determined by reference to the amounts published in an entity's annual financial statements (AFS). For example, a financial ratio may be determined taking an entity's assets, liabilities, equity or a combination of these amounts into consideration. Other financial ratios may take an entity's income or expense amounts into consideration. Entities that use IFRS as the framework for accounting, will comply with the principles of IFRS (including IFRS 16 when it is effective) in determining the amounts that are presented in their AFS. As such, the changes to lessee accounting will impact certain financial ratios of lessees. This is a concern to many lessees as financial ratios are used by various stakeholders to measure an entity's performance, future prospects and even its credit worthiness. Stakeholders ultimately use these financial ratios to assist them in making decisions regarding an entity, for example, whether to invest in the entity or whether to lend money to the entity.

There is a significant amount of literature related to the impact on financial ratios. This is partly because the IASB officially started its project to develop a new approach to lessee accounting as early as 2006. The IASB embarked on this project jointly with the Financial Accounting Standards Board (FASB) which the accounting standard setter in the United States of America. In addition, literature prior to 2006 exists where the impact of lessees classifying their leases as either operating or financing leases is analysed. Several studies have been conducted to evaluate the potential impact of including operating leases on the balance sheet by recognizing an asset and a liability – similar to the approach under IFRS 16.

Another sector, for which the effect of the new standard may have a significant effect, is that of the retail sector. (Goodacre, 2003) conducted a study of 102 United Kingdom (UK) retail companies. It is common practice for retail companies to enter into property lease arrangements for their retail outlets. This is typically because retailers don't have the finance available to buy each and every property where their outlets are situated. Under the accounting standards adopted by the 102 companies at the time, the majority of their property leases were classified as operating leases. As such, no related assets or liabilities were recognised on their balance sheets for the leased properties. The study applied the constructive capitalization method (CC method) to estimate the effect of recognizing assets and liabilities on-balance sheet for all property leases classified as operating leases. This method is widely used (by analysts for example) to capitalize off-balance sheet debt, such as operating leases, onto the balance sheet. The CC method (Imhoff Jr et al., 1991; Imhoff Jr et al., 1997) consists of incorporating in the balance sheet the present value of the discounted future payments derived from operating lease contracts. After applying the CC method, the study provided evidence of a significant impact on key financial ratios including gearing, profit margin, return on assets (ROA), return on equity (ROE), interest coverage and asset turnover ratios.

Mulford and Gram (Mulford and Gram, 2007) focused on retail companies in the United States of America (US). The CC method was also applied to 19 US companies and found evidence of an increase in Earnings before interest, tax, depreciation and amortization (EBITDA) and a decrease in ROA and ROE. However, as explained elsewhere in this paper, the earnings after depreciation and interest would most likely decrease substantially due to the depreciation charged against the ROU asset as well as interest raised on the finance lease liability; both of which would not have existed under IAS 17.

More recently, (Chambers et al., 2015) analysed the potential impact of the accounting proposed in the ED on the financial ratios of lessees. They found that the initial recognition of leased assets and liabilities on the balance sheet will not only increase assets and liabilities but will also increase debt ratios, EBITDA, and interest expense while decreasing net income. The article goes on to discuss how the change in such ratios could have a ripple effect on stakeholders such as lenders and employees.

Following the release of IFRS 16, the IASB itself released a document entitled "Effects Analysis, IFRS 16 *Leases*". In this document, the IASB describes the likely costs and benefits of IFRS 16, including the effect on key financial statement amounts and ratios of lessees. The IASB

mentions that it gained insight on the likely effects through its consultation with various stakeholders throughout the project on leases. What this illustrates is that the full impact of the new lease accounting standard was not known at the start of the project. There was a clear goal – for lease assets and liabilities to be recognised on the balance sheets of lessees – but the additional consequences became clearer over the project period. The Effects Analysis notes that for leases previously classified as operating leases, the IASB expects significant changes in some financial ratios (IASB, 2016a). This was further discussed by one IASB member, Darrel Scott, at the SAICA Panel Discussion held in August 2016. It can be noted, that the changes below are to an extent speculative as the standard is in its infancy and has not yet been tested practically due to the fact that entities have not yet produced a set of annual financial statements under IFRS 16. The changes expected by the IASB include those summarised in Table I below:

Table I: Changes to financial amounts and ratios

A	B	C	D
Financial amount/ratio	**What it measures**	**Common method of calculation**	**Expected effect of IFRS 16**
Leverage	Solvency	Liabilities/Equity	Increase (Note 1)
Asset turnover	Profitability	Sales/Assets	Decrease (Note 2)
Interest expense	Profitability	Not applicable	Increase (Note 3)
Depreciation expense	Profitability	Not applicable	Increase (Note 4)
Rent expense	Profitability	Not applicable	Decrease (Note 5)
EBITDA[58]	Profitability	Refer name	Increase (Note 6)
EBITDAR[59]	Profitability	Refer name	No Change (Note 7)

Notes:
Column A lists amounts presented in a lessee's AFS that may change as a result of IFRS 16. This column also lists financial ratios that are calculated using the AFS amounts that may be impacted. Column B explains what the amounts/financial ratios in Column A are typically indicative of when analysing the status of a lessee. Column C explains how the amounts/financial ratios are commonly calculated by users of the AFS. Column D indicates how the IASB expects the amounts/financial ratios to change. The notes below provide explanations of why the amounts/financial ratio are expected to change or not to change.
Note 1: Liabilities will increase due to the recognition of additional lease liabilities. Generally, there will be no initial impact on equity because while the lease liabilities cause equity to decrease, the lease assets will cause equity to increase.
Note 2: Sales (or revenue) will not be impacted. Assets will increase due to the recognition of lease assets.
Note 3: The additional lease liabilities will give rise to an increased interest expense. The lease liabilities will be measured using the amortised cost basis of accounting which takes the time value of money into account. The initial lease liability will increase over the lease term with interest and decrease as lease payments are made by the lessee.
Note 4: The additional ROU assets will give rise to an increased depreciation expense. The ROU assets will be treated in the same manner as owned assets in that they will be consumed/ depreciated as they are used. The consumption of the economic benefits embodied in the ROU assets will be recognised within depreciation expense.
Note 5: Rental expense will no longer be recognised in respect of most long-term leases. Instead, lessees will recognize interest expense on the lease liabilities and depreciation on the ROU assets.
Note 6: Under the old IAS 17 lease accounting, this ratio would have been determined taking rental expense for all operating leases into account. This means the EBITDA would have been reduced by the rental expense recognised. Under the new IFRS 16 accounting, this ratio will increase since no rental expenses will be recognised for long-term leases.
Note 7: There will be no change to this ratio because all lease-related expenses (i.e. interest expense, depreciation and rent expense) are excluded from the financial ratio.

[58] Earnings before interest, tax, depreciation and amortisation
[59] Earnings before interest, tax, depreciation, amortisation and rent expense

As previously mentioned, financial ratios are used by various stakeholders to assist in their decision-making. It is therefore not surprising that lessees are concerned about the impact the new accounting standard will have on their reported financial statements amounts and resulting ratios. The following paragraphs explore how the decisions of lenders and analysts may be impacted.

Lenders

Lenders, such as banks, expose themselves to risk when they lend money to customers. A significant risk is credit risk which is the risk that a customer may not be able to repay the loan (IASB, 2016b, Appendix A) and that the lender may lose the principal of the loan and/or the interest associated with it. Credit risk arises because customers expect to use future cash flows to pay current debts. The generation of future cash flows, however, cannot be guaranteed. It's almost never possible to ensure that customers will definitely have the funds to repay their debts. Lenders charge customers interest on the principal amount of the loan, not only as compensation for the time value of money, but also as compensation for the credit risk assumed (Altamuro et al., 2014).

Interest represents the income that lenders earn on loans issued. To this end, lenders, like any other entities operating a business for profit, seek to maximize the income they earn from issuing loans. As such, they will charge a customer a higher interest rate if they believe the customer exposes them to a higher credit risk. Similarly, a customer with a lower credit risk will be charged a lower interest rate.

The assessment of credit risk is understandably a critical part of a lender's business model. Where a credit rating agency has already published a credit rating for a customer, the lender can use this as a reference for credit risk. Where a credit rating is not publically available for a customer, the lender often assesses credit risk by analyzing the AFS of the customer. The lender scrutinizes the nature and amounts of the entity's assets, liabilities, income and expenses. It also computes various financial ratios as part of its analysis, for example the leverage ratio. Depending on the results of the analysis, the lender will decide whether to lend to the entity or not. If the lender does decide to lend, it will determine the interest rate that appropriately manages the entity's exposure to credit risk.

Under IAS 17, the AFS of two entities (lessees) that had similar lease arrangements could look very different. This was because the lessees may have classified their lease arrangements differently depending on their individual analyses of the lease indicators. The lessee that classified its leases as operating leases (lessee A) would have no assets or liabilities associated with the leases on its balance sheet. Its income statement would show the rental expense incurred during the year. On the other hand, the lessee that classified its leases as finance leases (lessee B) would have recognised lease assets and liabilities on its balance sheet. Its income statement would show depreciation of the leased asset and interest expense on the loan. A practical illustration is provided in the table below:

Table II: Illustration of lessee accounting under IAS 17	
Scenario: • Leased asset: Machinery • Lease term: 4 years • Lease payments: R5 000 payable annually in arrears • Effective interest rate charged by lessor: 10% per annum **Assume:** • Lessor A classifies the lease as an operating lease • Lessor B classifies the lease as a finance lease	
Lessee A: Operating lease accounting	**Lessee B: Finance lease accounting**
Balance sheet (at inception of lease) • Nil effect	***Balance sheet (at inception of lease)*** • Finance lease asset: R15 849[60] • Finance lease liability: (R15 849)
Income statement (at inception of lease) • Nil effect	***Income statement (at inception of lease)*** • Nil effect
Balance sheet (at end of year 1 of lease) • Nil effect	***Balance sheet (at end of year 1 of lease)*** • Finance lease asset: R11 887[61] • Finance lease liability: R12 434[62]
Lessee A: Operating lease accounting	**Lessee B: Finance lease accounting**
Income statement (at end of year 1 of lease) • Rental expense: R5 000[63]	***Income statement (at end of year 1 of lease)*** • Depreciation expense: R3 962[64] • Interest expense: R1 585[65]

[60] The initial finance lease asset and liability is calculated as the present value of the annual lease payments using the effective interest rate
[61] The finance lease asset is depreciated over the 4 year lease term. After 1 year of depreciation, the carrying amount is reduced to R11 887.
[62] The finance lease liability is measured on an amortised cost basis. Interest at 10% is added to the initial liability and the payment of R5 000 is subtracted from the liability.
[63] A lease/rental expense is recognised on a straight-line basis over the 4 year lease term. In this scenario the annual lease payments are equal so there is no need to straight-line the payments.
[64] Depreciation on the finance lease asset is calculated at R15 849 / 4 years.
[65] Interest on the finance lease liability is calculated at R15 849 x 10%.

If a lender concentrated solely on the balance sheet and income statement of the two lessees' AFSs, the lender could conclude that lessee A had a more favourable leverage ratio. With no lease liabilities on-balance sheet and no interest expense in the income statement, the lender may assess the credit risk of lessee A to be lower than that of lessee B. This is despite the fact that the two lessees had the same lease payment commitments. This school of thought contributed to the structuring of lease arrangements by lessees in order to keep the leased assets and the corresponding liabilities off-balance sheet.

This paper suggests that the 'on-balance sheet' accounting requirements may dilute the importance of the decision as to whether an asset shall be leased or rather purchased, as the newly required 'on-balance sheet' reporting will reduce the previous disclosure discrepencies. It is noted, however, that the *buy versus lease argument* spreads significantly further than an accounting decision, for example, the entity's cash flows and capital commitments will need to be scrutinized. None the less; the closer aligned reporting requirements of the new standard may allow a more strategic decision to be made by an entity as to how it finances its capital expenditure with potentially less emphasis on the now narrowed financial statement differences.

The elimination of operating lease accounting has many lessees concerned about a negative impact on their financial statement amounts and ratios (IASB and FASB, 2013). There is a concern that when lessees are required to apply IFRS 16 and capitalise their previous operating leases on-balance sheet for the first time, lenders will see them in a different light. If lenders assess these lessees to be less credit worthy, they may be less inclined to provide new loans. They may also impose a higher interest rate on existing or future debt.

Is this concern founded? It could be from the assumption that lenders don't consider an entity's off-balance sheet debt when assessing credit risk. Previously, where the lease liabilities were not recognised on-balance sheet, lessees were required to disclose the total future lease payments they were committed to paying in a note to the AFS (IASB, 2015, para 35). A lender could get a more holistic view of an entity's obligations by considering both the on and off-balance sheet lease obligations. A lender that followed this approach would not favour a lessee with operating leases over a lessee with finance leases.

The IASB's response to this concern is that IFRS 16 represents a change only to accounting. According to the IASB, IFRS 16 will provide more transparent information about a company's existing financial commitments, but it will not change those commitments - stated differently, the company is still the same company, and thus still in the same financial position after the implementation of IFRS 16 as it was when it applied IAS 17. This is despite the balance sheet being materially different to that which it was before. In addition, information received by the IASB indicates that most sophisticated users of financial statements (including credit rating agencies and lenders) already estimate the effect of off-balance sheet leases on financial leverage, particularly when a company has a significant amount of off-balance sheet operating leases (IASB, 2016a). (Altamuro et al., 2014) performed research which also provides evidence in this respect. The evidence suggests that lenders set interest rates based in part on credit ratings when published credit ratings are available. Because the credit rating agencies adjust for off-balance sheet leases, the interest rates charged on loans granted to credit-rated borrowers are not expected to change

as a result of the implementation of IFRS 16. This finding suggests that perhaps the costs that will be incurred to convert the accounting to IFRS 16 may be simply a cost, with no benefit attached, because the information was already disclosed in the commitment note required by IAS 17. Thus the authors feel that this cost then may be an additional unintended consequence.

Analysts

There are two main types of analysts, namely equity analysts and credit analysts. An equity analyst does research and analysis on companies to determine the merits and demerits of investing in the shares thereof. A credit analyst assesses and evaluates the credit risk of companies. A primary source of information for analysts is the AFS that companies publish. Analysts use the AFS to calculate specific financial ratios which inform their views on the companies.

Some lessees have also raised concerns about how they will be viewed by analysts when they are required to capitalize their previous operating leases on-balance sheet. For example, if an equity analyst is particularly interested in the asset turnover ratio of companies and sees that this ratio decreases significantly for a company on adoption of IFRS 16, will that analyst discourage potential investors from investing in the shares of said company? Similarly, if a credit analyst focuses on the leverage ratio of companies when assessing credit risk, and sees that this ratio increases for a company on adoption of IFRS 16, will that analyst discourage potential lenders from providing finance to that company?

In this regard, in a SAICA Panel Discussion on IFRS 16 held during August 2016 in Johannesburg, David Smith (Equity analyst, RMB Morgan Stanley) provided his views on the impact the new accounting by lessees will have on analysts. He explained how he, and other analysts, typically needed to make adjustments to the information reported in the AFS of lessees that had significant operating leases under IAS 17. These adjustments were necessary in order to fairly compare companies that purchased assets outright to other companies that chose to lease similar assets via operating lease arrangements. Analysts would use the information in the notes to the AFS regarding future lease payments to estimate the unrecognized assets and liabilities arising from operating leases. A common technique to estimate the lease asset and liability was to calculate the present value of the future lease payments. However, this was not always possible because of the limited information provided in some companies' AFS. David Smith's feedback highlights that sophisticated analysts were already aware that lessees with operating leases had off-balance sheet debt that needed to be considered before the lessee could be critically analysed and compared to lessees with finance leases. It highlights the challenges that analysts faced when AFS did not provide the information they needed to make meaningful adjustments to the amounts. This point also highlights that the disclosure for these commitments were already in place, and that perhaps just some upgrading of this note disclosure could have assisted analysts in this regard without the need for a radical transformation in the accounting standard.

The need for these specific adjustments will fall away when IFRS 16 is applied because all lessees will be required to recognize assets and liabilities for leases on-balance sheet. It seems therefore that the job of an analyst may become easier in the future. Furthermore,

lessees may not be viewed any differently by analysts when they capitalize leases for the first time.

Costs to implement IFRS 16 may exceed the benefits

Some lessees feel that the cost of transitioning from IAS 17 to IFRS 16 will exceed the benefits. As can be seen from the above paragraph, it would have been far easier and cheaper to perhaps upgrade the commitment note disclosure under IAS 17 as a mechanism of assisting analysts. The IASB believes the implementation of IFRS 16 will result in a more faithful representation of a lessee's assets and liabilities (IASB, 2016c, Introduction, para 6) which will ultimately benefit the users of the AFS. While this may be true, lessees with a large number of operating leases will need to dedicate considerable time and energy to the implementation. This will result in additional costs for these lessees.

In order to capitalize existing operating leases on to their balance sheets, lessees will need to analyse the terms of each lease contract. This will require lessees to gather and organize all existing lease contracts which could prove challenging where the contracts are not in an electronic form – hard copies may have been lost or misplaced over time. For large international companies, hard copies may also be held in different locations around the world.

Many respondents to the ED and the IASB itself anticipates that IT systems will need to be upgraded or newly set up to store the lease contract data and to assist with the accounting required by IFRS 16 (IASB, 2016a). Furthermore, costs will be incurred to train staff to use the IT systems as well as to understand the requirements of the new accounting standard.

Whilst it seems that the incurrence of costs is unavoidable, will the costs of implementing IFRS 16 really exceed the benefits? The task of gathering and organising existing operating lease contracts may be a time consuming exercise but the proposed changes to lessee accounting have been in the public domain since the ED of 2013. Even if lessees chose not to react until the final accounting standard was published, lessees will have approximately three years to prepare for IFRS 16 as the standard was published in January 2016 with an effective date of 1 January 2019. If lessees use this time effectively, costs could be minimized. For example, instead of hiring additional staff to perform this labour-intensive exercise at the nth hour, existing staff could comfortably perform the exercise over a three year period. Furthermore, the conversion of hard copy lease contracts into electronic copies will have other long-term benefits. Lessees will be able to access information regarding any contract at the touch of a button, resulting in efficiencies.

Lessees with some existing finance leases may be able to use their existing IT systems as a starting point for accounting for their operating leases in accordance with IFRS 16. This is because IFRS 16 effectively treats all leases as finance leases. For lessees that don't have existing finance leases, many of them might already have IT systems in place to manage and track leases, which should help to mitigate the costs of implementing IFRS 16. These lessees would have been collating certain information to meet the lease payment commitment disclosure requirements of IAS 17.

Low value exemption may lead to a lack of comparability between lessees

In certain instances, and in terms of paragraph 5 of the IFRS 16, a lessee may elect not to recognize a ROU asset and lease liability for its leases. This exemption from the general requirements of IFRS 16 can be elected for:
(i) short-term leases (i.e. where the lease term is 12 months or less); and
(ii) leases for which the underlying asset is of low value when it is new.

The second exemption is commonly referred to as the low value exemption. Interestingly, IFRS 16 does not provide a threshold/amount for determining whether an asset has a low value. The standard provides examples of low value assets including a tablet, personal computer, telephone or a small item of furniture. In practice, lessees will have to apply their judgement as to whether they believe an asset that they lease is of low value or not. Importantly, however, the IASB expects all lessees, regardless of their size, nature or circumstances, to reach the same conclusion as to whether an item is low value or not. Based on this, a large listed company and small private company should reach the same conclusion. It therefore appears that entities should not take their own materiality levels into account when making their assessment (IASB, 2016c, Appendix B, para 4).

The low-value exemption intends to capture leases that are high in volume but low in value. The application of the exemption may mean that an entity that leases many low-value items may avoid the recognition of the related lease liabilities, even though, in aggregate, the liability would be material (KPMG IFRG Limited, 2016). While the low value exemption may come as a relief to some lessees, one of the IASB's own members disagreed with the inclusion of this exemption in the new standard. When IFRS 16 was published, it included a section entitled "Dissenting Opinion" which explained why Mr Wei-Gui Zhang voted against the publication of IFRS 16 (IASB, 2016c, Dissenting Opinion, para 1-9). Mr Zhang did not believe that leases of low value items should be treated differently from any other leases. If a lessee does not need to consider its own materiality levels when electing the exemption, a lessee could potentially have many leased assets off-balance sheet, even if in aggregate, the leased assets have a high value. The AFS of a lessee like this will not be comparable to those of a lessee with leases of high value assets, even if both lessees have similar future obligations for lease payments. Mr Zhang also noted that the low value exemption could create the same tension between leasing and buying low value assets that existed applying the requirements of IAS 17. He was concerned that entities that require material amounts of low value assets would be incentivised to lease those assets rather than buy them in order to achieve off-balance sheet accounting.

CONCLUSION

The future AFS of many lessees will look considerably different following the adoption of IFRS 16. Former operating leases will be capitalised resulting in the presentation of "new" assets and liabilities on the face of the balance sheet. The findings of this study suggest, however, that these assets and liabilities are not "new" at all. Operating lease arrangements have always given the lessee a right to use the underlying asset which embodied economic benefits. In other words, operating leases have always created an asset for the lessee. Similarly, operating leases have always created a liability for the lessee as they impose an obligation on the lessee to make payments to the lessor over the lease term. Effectively, lessees will be in the same economic position before and after the implementation IFRS 16.

Although the face of the balance sheet will change, the previous lease accounting standard, IAS 17, required lessees to disclose their future operating lease payment obligations in an explanatory note to the AFS. The findings show that sophisticated users of AFS, such as lenders, have historically used the information in this note to get a better understanding of a lessee's financial position. Other users, for example, analysts and investors, have also analysed the information in this note to better understand the lessee's profitability and to make independent assessments of the lessee's future prospects. Sophisticated users were making adjustments to the amounts presented on the face of the balance sheet as well as those presented on the face of the income statement in order to calculate many of the financial ratios used to analyse and compare different companies. This indicates that lessees may not be seen in a negative light just because certain off-balance sheet information will come on-balance sheet in the future. In fact, they are likely to be seen in the same way they always have been.

Inevitably, there will be costs of transitioning from the old accounting standard to the new one. However, these costs can be managed. Moreover, the costs can result in other lasting benefits. Lessees need to use their time effectively as they embark on the project to transition to IFRS 16. The earlier they start, the more cost-effective they can be. Lessees should consider how the new lease requirements can be incorporated into existing processes and systems. The capitalization of leases is not an entirely new concept – it is effectively finance lease accounting repackaged.

In conclusion, the results of the study suggest that IFRS 16 will not result in a fundamental change for lessees. The new standard will result in leased assets and the related liabilities shifting from the notes of the AFS to the face of the balance sheet. Much ado about nothing?

In reaching this conclusion, it must be noted that this study is not without limitations. Since IFRS 16 is effective only from 1 January 2019, the full impact on lessees cannot yet be known. As lessees embark on the task of transitioning from the old to the new leases standard, and ultimately when they start to publish their IFRS-compliant AFS, the full impact will become clearer. Furthermore, this study did not include a quantitative analysis of AFS prepared using IAS 17 in order to estimate the impact that IFRS 16 will have on amounts and ratios. Future research may expand on the study, for example, by performing a quantitative analysis on AFS prepared using IFRS 16 and comparing the restated amounts to those previously reported. Quantitative work can also be expanded by way of feedback from preparers as to whether the unintended consequences did in fact cause a material concern to preparers and what other obstacles were met along the way. An additional study can be undertaken analyzing the strategic virtues in an entity's decision as to whether capital expenditure should be incurred by way of owned or purchased assets versus by way of leased assets.

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