The Transition from IAS 17 to IFRS 16 and Its Impact on the Usefulness of Financial Information

Yifan Chen
Chengdu University of Technology, Chengdu 610059, China.

Abstract: In January 2016, the International Accounting Standards Board issued a new standard for lease accounting: International Financial Reporting Starndard (IFRS) 16. The new principle of IFRS 16 brings essential changes against the previous standard IAS 17 including canceling the classification of operating lease and finance lease and requiring to capitalize every lease-related activity on financial statements. Since lease accounts for a large proportion of business transactions of many enterprises, the essay evaluates the impact of lease standard switch from IAS 17 to IFRS 16 by adopting two methodologies of literature review and case study. There are three issues analyzed, first, the major differences in definition, classification and measurement aspects. Second, the change of financial statements and specific financial ratios based on the annual report in 2022 of Tesco. Third, the usefulness of financial information under IFRS 16 from the perspective of auditor, investor, analyst and lessee respectively.
Keywords: IFRS 16; IAS 17; Leases; Transition of Lease Standard

1. Introduction

Under the impact of booming development of technology, enterprises find hard to possess high-value assets mainly due to the uncertainty of equipment replacement (Sbaih et al., 2023). Besides, along with the trend of market economy, newly-established companies prefer to make leasing contract to acquire assets for operating use at the very beginning stage (Kryatova et al., 2021). Based on the two situations, companies would like to rent long-term assets because it conforms to the technological development and brings benefit to the entity without high expenditure on purchasing.

According to previous accounting principle IAS 17, firstly, leases should be classified as either operating lease or finance lease. Secondly, some leases were not required to be recorded in financial reports, therefore the balance sheet did not present leasing assets and obligations precisely. Those provisions made users of financial statements difficult to analyze the overall performance of the company and make comparisons (BUNEA-BONTAȘ, 2019).

Since 1 January 2019, IFRS 16 has become effective and replaced IAS 17, aiming to increase the transparency of leasing information of financial reports by requiring to capitalize leasing transactions on balance sheet and canceled the classification of operating and finance leases, bringing significant influences to accounting treatment of lessees particularly.

The essay mainly talks about the transition from IAS 17 to IFRS 16 and the improvement of financial information with the following structure. The literature review introduces the main idea of key academic supporting sources of this essay and then the methodology part explains the two applied methodologies and their validity. In the third stage, there are three issues discussed in the critical analyse. First, the major transition from IAS 17 to IFRS 16. Second, the specific changes on financial statements exerted by the change of leasing accounting principle. Last but not least, the evaluation of the usefulness of IFRS 16 from different perspectives including auditor, investor, analysts and lessee. Finally, the conclusion summaries the results discussed in critical analysis and pointed out the limitations and corresponding suggestions for further research.

2. Literature review

The essay adopts several journal articles to support the discussion and analyze.

Sbaih, et al. (2023) talks about the importance of leases of companies, the new accounting treatment of IFRS 16 and the changes of financial ratios. Silvana, Valerio and Federico (2020) also analyses the impact of financial statements and ratios under the new rule, they mentions the difference between lessees and lessors as well. Segal and Genevieve (2019) goes deep in the specific focus of IFRS 16 and IAS 17 respectively. Kryatova, et al. (2021) states the drawbacks of IAS 17. Combining the sources together, the essay can discuss the transition and the improvement of financial information effectively.

3. Methodology

In order to clarify the issue and solve the research goal, the essay adopts methodologies of both literature review and case study. The sources of literature review are academic journal articles chosen firstly from authoritative websites such as Springer and EBSCO. Then the further selection keeps articles that acquire scientific and reliable methods like deduction and empirical analysis through data sets. The essay also uses financial statements of of Tesco as cases. Tesco, a distinguished retailer in the UK, obtaining considerable operating leasing activities, adopts IFRS 16 and has an accurate disclosure of accounting information, which enhances the veracity of following analysis.

4. Critical analyze

4.1 The transition from IAS 17 to IFRS 16

4.1.1 Definition of a lease

According to IAS 17, a lease is a contract or an agreement between lessor and lessee, which conveys the right to use an assets during a period of time and related with series of payments. Under this definition, a finance lease is defined as a lease that transfer all the risks and rewards to the owner of the asset, and operating lease is regarded as the exception of finance lease. It can be seen that IAS 17 emphasizes the risk and reward of the asset (BUNEA-BONTAȘ, 2019).

IFRS 16 defines a lease as the “a contract … that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration" (IFRS 16, 2019). This new principal emphasizes the right to use the asset instead of identifying who carries risks and rewards (BUNEA-BONTAȘ, 2019).

4.1.2 Classification of leases

IAS 17 classifies leases as finance lease and operating lease. If a lease transfers the risk and reward along with the ownership form lessor to lessee, then the lease is identified as finance lease. And operating lease is recognized as non-finance lease with no transition of risk and reward.

IFRS 16 makes a significant change by canceling the classification and treating all leases as finance leases as lessee.

Removing the classification simplifies the identifying procedure, since lessors may have different classification of a certain lease based on the use of the asset and their personal understanding (BUNEA-BONTAȘ, 2019). IFRS 16 greatly mitigates the subjectivity and increases the efficiency of accounting.

4.1.3 Accounting treatment

IAS 17 only capitalizes finance lease, whereas operating lease is directly measured by the total leasing expense through straight-line method.

However, IFRS 16 requires lessee to recognize all leases with present value of right-of use assets and lease liabilities on balance sheet, except for 1) lease of 12 month or less and 2) low-value asset. The implementation of IFRS 16 brings huge impact to lessee while the accounting work of lessors seems basically unchanged (Morales-Díaz and Zamora-Ramírez, 2018, Kryatova et al., 2021 and Sbaih et al., 2023). The essay will present the changes reflected in financial statements from lessee's perspective.

4.2 Changes of financial statements

The adoption of IFRS 16 significantly influences the accounting work of retail sectors (Morales-Díaz and Zamora-Ramírez, 2018) as the industry obtains massive leasing transactions primarily for renting house property where the outlets located (Segal and Naik, 2019). Tesco is one of the top three retail companies in the world and adopts IFRS 16 for leases. Therefore, the essay chooses the annual report 2022 of Tesco as a case to analyse the specific changes brought by IFRS 16.

4.2.1 Financial statements

	Notes	26 February 2022 £m	27 February 2021[a] £m	29 February 2020[a] £m
Non-current assets				
Goodwill and other intangible assets	10	5,360	5,393	6,078
Property, plant and equipment	11	17,060	16,945	19,157
Right of use assets	12	5,720	5,951	6,874
Investment property	13	22	19	26
Investments in joint ventures and associates	14	86	178	307
Other investments[b]	16	1,253	763	866
Trade and other receivables	18	159	170	166
Loans and advances to customers and banks	19	3,141	3,309	4,171
Reinsurance assets	23	184	–	–
Post-employment benefit surplus	30	3,150	–	–
Derivative financial instruments	25	942	1,425	1,083
Deferred tax assets	6	85	552	449
		37,162	**34,705**	**39,177**

Figure 1: Balance Sheet - Non-current Assets

		12,189	**10,807**	**13,893**
Current liabilities				
Trade and other payables	21	(9,181)	(8,399)	(8,922)
Borrowings	24	(725)	(1,080)	(2,219)
Lease liabilities	12	(547)	(575)	(598)
Derivative financial instruments	25	(26)	(81)	(61)
Customer deposits and deposits from banks	27	(4,729)	(5,321)	(6,377)
Insurance contract provisions	23	(623)	–	–
Current tax liabilities		(11)	(79)	(324)
Provisions	28	(283)	(186)	(155)
		(16,125)	**(15,721)**	**(18,656)**
Liabilities of the disposal group classified as held for sale	7	(14)	(276)	–
Net current liabilities		**(3,950)**	**(5,190)**	**(4,763)**
Non-current liabilities				
Trade and other payables	21	(53)	(109)	(170)
Borrowings	24	(6,674)	(6,188)	(6,005)
Lease liabilities	12	(7,411)	(7,827)	(8,968)
Derivative financial instruments	25	(357)	(926)	(887)
Customer deposits and deposits from banks	27	(1,650)	(1,017)	(1,830)
Insurance contract provisions	23	(27)	–	–
Post-employment benefit deficit	30	(303)	(1,222)	(3,085)
Deferred tax liabilities	6	(910)	(48)	(40)
Provisions	28	(183)	(119)	(137)

Figure 2: Balance Sheet - Liabilities

According to the part of balance sheet, the lease assets are recognized as right-of-use assets under non-current asset. Lease liabilities contains both current liabilities and non-current liabilities.

Compared with IAS 17, the adoption of IFRS 16 increases the right-of-use assets (Figure 1) and lease liabilities (Figure 2) because it allocates all off-sheet lease assets and liabilities. Moreover, a decrease of equity will likely appear because the carrying value of right-of-use asset reduces faster than that of lease liability, which is different from the scenario under IAS 17.

	Notes	52 weeks 2022 £m	52 weeks 2021[a] £m
Cash flows generated from/(used in) operating activities			
Operating profit/(loss) of continuing operations		**2,560**	**1,547**
Operating profit/(loss) of discontinued operations		**(51)**	**5,482**
Depreciation and amortisation		1,718	1,764
(Profit)/loss arising on sale of property, plant and equipment, investment property, intangible assets, assets classified as held for sale and early termination of leases		(123)	(23)
(Profit)/loss arising on sale of joint ventures and associates		(25)	–
(Profit)/loss arising on sale of subsidiaries	7	23	(5,197)
Transaction costs associated with sale of subsidiaries		–	6
Net impairment loss/(reversal) on property, plant and equipment, right of use assets, intangible assets and investment property	15	115	(89)
Impairment of goodwill	15	–	295

Figure 3: Statement of Cash Flow - operating activities

Cash flows generated from/(used in) financing activities			
Own shares purchased for cancellation	31	(278)	–
Own shares purchased for share schemes	29	(144)	(66)
Repayment of capital element of obligations under leases		(577)	(621)
Increase in borrowings		394	1,098
Repayment of borrowings		(775)	(1,814)
Cash inflows from derivative financial instruments[b]		798	1,696
Cash outflows from derivative financial instruments[b]		(921)	(2,276)
Dividends paid to equity owners	8	(731)	(5,858)
Net cash generated from/(used in) financing activities		**(2,234)**	**(7,841)**

Figure 4: Statement of Cash Flow - financing activities

Other segment information

52 weeks ended 26 February 2022	UK & ROI £m	Central Europe £m	Tesco Bank £m	Total continuing operations £m	Discontinued operations £m	Total £m
Capital expenditure (including acquisitions through business combinations):						
Property, plant and equipment[a][b]	1,485	89	14	1,588	–	1,588
Goodwill and other intangible assets[c]	186	10	71	267	–	267
Depreciation and amortisation:						
Property, plant and equipment	(792)	(90)	(11)	(893)	–	(893)
Right of use assets	(500)	(35)	(2)	(537)	–	(537)
Investment property	(1)	–	–	(1)	–	(1)
Other intangible assets	(224)	(11)	(52)	(287)	–	(287)
Impairment						
(Loss)/reversal on financial assets	10	(1)	30	39	–	39

(a) Includes £584m related to obtaining control of The Tesco Sarum Limited Partnership (2021: £310m related to obtaining control of The Tesco Property (No. 2) Limited Partnership). Refer to Note 34 for further details.
(b) Includes £1m (2021: £12m) of property, plant and equipment acquired through business combinations.
(c) Includes £38m (2021: £5m) of goodwill and other intangible assets acquired through business combinations.

Figure 5: Other Segment Information - depreciation and amortization

The statement of cash flow shows there are 3 items related to leasing activities. Cash flows generated from operating activities (Figure 3) includes the depreciation and amortization and profit or loss related to leases. Figure 5 presents the accounts under "depreciation and amortization" in detail, so it is clear that the depreciation and amortization of right-of-use assets is recorded. Besides, cash flows generated from financing activities (Figure 5) also contains lease cash flows which is recorded as "Repayment of capital element of obligations under leases".

As for statement of cash flow, compared with IAS 17, IFRS 16 requires to record depreciation and amortization for rented assets, and the cash paid for leases should be separated into loss arising on leases and capital element.

There are no change reflected by income statement of Tesco in 2022.

4.2.2 Financial ratios

On account of the significant changes of IFRS 16, many important financial ratios that help analyze the overall performance of a company will change correspondingly.

First, current ratio will decrease. Current ratio = current assets / current liabilities. After adopting IFRS 16, current assets remain the same while current liabilities increase, so the current ratio will decrease (Deloitte, 2016 and Silvana, Valerio and Federico, 2020).

Second, assets turnover will decrease. Assets turn over = revenue / total asset. Assuming the sale revenue is unchanged, IFRS 16 increase assets on balance sheet, thus lower the figure of assets turn over (Deloitte, 2016 and Silvana, Valerio and Federico, 2020).

Third, EBITDA will increase. EBITDA is earnings before interest, taxes, depreciation, and amortization. The total profit will increase because the expense of operating lease is not recorded according to IFRS 16. Though depreciation and amortization will increase, they are not included when calculating EBITDA.

Forth, IFRS 16 has no obvious impact on ROA (Morales-Díaz and Zamora-Ramírez, 2018) and ROE according to the research (Sbaih et al., 2023).

4.3 Usefulness of financial information to different information users

After the transition of lease principal, the improvement and usefulness of financial information received different ideas from several perspectives such as auditor, investor, analyst and lessee.

While audit firms approve the impact of IFRS 16 to present operating leases on financial statements, they hold doubts on specific issues that may cause controversy when bookkeeping and have raised potential solutions to the problem such as adopting dual model to recognize lease expenses (Mellado and Parte, 2022).

Investor and analyst are both key roles when estimating the operating performance of an entity. Since the the assets and liabilities related to lease are actually all recorded on the balance sheet, the implementation of IFRS 16 allows investors to evaluate debt risks more accurately and analysts can directly grab figures from financial reports instead of solely making assumptions (Raoli, 2021). Meanwhile, investors can tell clearer differences between leasing activities and keeping assets from third parties, which would make leasing activities easier to be compared and facilitate investment choice making (Silvana, Valerio and Federico, 2020 and Raoli, 2021).

Despite the several changes on financial statements, lessees find the cost of complying IFRS 16 increases. Though IASB has allowed recognition exemptions for both short-term and low-value leases for reducing costs (Kabir and Rahman, 2018), updating information system to acquire more financial information of lease transactions still requires high costs (Raoli, 2021). Specifically, lessees need to analyze every lease contracts, which means lessees should gather all contracts and they may also face the missing problem (Segal and Naik, 2019). Therefore, IFRS 16 makes the large amount of initial capital expense necessary.

According to preceding paragraphs, not all people enjoy the benefit of IFRS 16, indicating that whether the financial information has been successfully improved need to be further discussed.

5. Conclusion and limitation

The essay discusses three issues about the change from IAS 17 to IFRS 16. First, the transition of accounting lease principal causes changes to three aspects: definition, classification and accounting treatment. Second, financial statements need to make adjustments and corresponding ratios would increase or decrease. Finally, the essay analyzes the usefulness of financial information with the implementation of IFRS 16 from different views .

Along with the transition of standard, the focus of the lease definition has transferred from the "risk and reward" to the "control of right to use". IFRS 16 also removes the classification of finance lease and operating lease, mitigating the difficulty identifying the category. What's more, IAS 17 does not capitalize any operating lease whereas IFRS 16 capitalizes all leases on balance sheet.

By analyzing financial statement of Tesco of 2022, IFRS 16 increases both assets and liabilities on balance sheet, and also records the depreciation and amortization of right-of -use assets. Moreover, the total cash paid for leases are separated into profit or loss and repayment of capital element.

Finally, the usefulness of financial information after adopting IFRS 16 remains controversial. Auditors find some specific bookkeeping methods are still immature, lessees face significant expenditure on improving information system while investors and analysts are helped to evaluate the company more accurately.

The essay has a limitation that the income statement of Tesco does not reflect adjustments consistent with IFRS 16. Further research can be done by enlarging the capacity of samples and concluding the common results.

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