

Changes New Leases Standard IFRS 16 Has Brought and Evaluation of Its Possible Effects on Financial Reports and Financial Ratios of Corporations

Rabia AKTAŞ

Manisa Celal Bayar University
Faculty of Economics and Administrative
Sciences

Manisa, Turkey

orcid.org/0000-0002-7006-5235

rabia.aktas@cbu.edu.tr

Sibel KARĞIN

Manisa Celal Bayar University
Faculty of Economics and Administrative
Sciences

Manisa, Turkey

orcid.org/0000-0001-6955-398X

sibel.kargin@cbu.edu.tr

Nuray DEMİREL ARICI

Manisa Celal Bayar University
Faculty of Economics and Administrative Sciences

Manisa, Turkey

orcid.org/0000-0002-0504-426X

nuray.demirel@cbu.edu.tr

Extensive Summary

Introduction

Leasing is one of the major sources of financing for businesses. Existing national (the Tax Act) and international regulations (IAS 17 – Leases) classify leases as “finance leases” and “operating leases” and report accordingly. According to IAS 17, finance leases are reported as assets and liabilities on the balance sheet of the lessee and the interest and the depreciation allocated to the asset are reported on the comprehensive income statement at the end of the accounting period. Operating leases, on the other hand, are reported as lease expenses on the comprehensive income statement and not reported on the balance sheet.

This approach has been criticized for many years by related parties. Criticisms focus on the fact that two economically similar transactions are reported differently and this prevents financial statements to provide better information. Taking these criticisms into account, IASB (International Accounting Standards Board) has issued a new lease standard (IFRS 16 – Leases) in January 2016. The New Standard removes the “finance leases” – “operating leases” classification and determines a single model for the lessee. According to this model, the lessee will report all leases as assets and liabilities on its balance sheet.

It is expected that the New Standard will affect the financial statements in the sectors that use mainly high-value tangible assets such as buildings, land, vehicles and equipment and that choose to acquire these assets by leasing. With the introduction of the new standard, businesses that use operating leases in high amounts and keep them off the balance sheets before will experience a major increase in assets and liabilities, decrease in equity, and deterioration in some financial ratios associated with them.

Studies have shown that operating leases are used all over the world as an important financing instrument in acquiring assets and that capitalizing these transactions will lead to significant effects on the leverage ratios and on the financial risks of the enterprises (Edwards and Goodacre, 1998; Bennett and Bradbury, 2003; Fülbier, Lirio Silva and Pferdehirt, 2008; Gritta and Lippman, 2010; Grossman and Grossman, 2010; Singh, 2011; Seay and Woods, 2011; Beattie, Tang and Fiedler, 2011; Tai, 2013; Şenyiğit, 2014; Wong and Joshi, 2015).

In this study, how IFRS 16 would affect financial statements and certain financial ratios has been investigated. First, the issue has been illustrated through a hypothetical business in comparison with IAS 17. Then, using financial statements of a public airline company and a public retail company, possible effects of the new standard on financial statements and financial ratios have been determined.

Reporting of a Lease Transaction According to IAS 17 and IFRS 16

The difference between IAS 17 and IFRS 16 can be illustrated by the following example. A store chain selling household appliances rents a store for five years in a big shopping mall. The lease contract will commence on January 1st, 2018. Annual rent payments will be 65.000 TL (Turkish Liras). According to the contract, rent payments include 5.000 TL per year for the services (cleaning, security, maintenance-repair, etc.) provided by the shopping center. The interest rate is 10%.

First of all, it is necessary to classify the leasing transaction according to IAS 17. Since the contract is an operating lease taking into consideration that the contractor has not transferred the significant risks and benefits of ownership of the leased asset to the tenant, it is simple and easy to account the transaction. No measurement or accounting entry will be made at the beginning of the contract. At the end of each year, the lease expense will be reported in the comprehensive profit / loss table. Also, it is not necessary to separate the portion covering the service fees from the rent payment.

Table 1: Effects of the Operating Leases to the Financial Statements of the Lessee by IAS 17

	Jan. 1, 18	Dec. 31, 18	Dec. 31, 19	Dec. 31, 20	Dec. 31, 21	Dec. 31, 22	
	0	1	2	3	4	5	Total
Cash Outflows (Payments)	65.000	65.000	65.000	65.000	65.000		325.000
Lease Expenses		65.000	65.000	65.000	65.000	65.000	325.000

On the other hand, there is no need to classify the leasing transaction according to IFRS 16. However, service fees included in the payment must be separated.

Table 2: Effects of the (Operating) Leases to the Financial Statements of the Lessee by IFRS 16

	Jan. 1, 18	Dec. 31, 18	Dec. 31, 19	Dec. 31, 20	Dec. 31, 21	Dec. 31, 22	
	0	1	2	3	4	5	Total
Cash Outflows (Servis Fees)	5.000	5.000	5.000	5.000	5.000		25.000
Cash Outflows (Lease Expenses)	60.000	60.000	60.000	60.000	60.000		300.000
Present Value of Lease Expenses	60.000	54.545	49.587	45.079	40.981		250.192
Liabilities Caused by Leasing	190.192	149.211	104.132	54.545			
Assets	250.192	200.154	150.116	100.078	50.040		
Interest Expenses		19.019	14.921	10.413	5.455		49.808
Depreciation Costs		50.038	50.038	50.038	50.038	50.038	250.190
General Management Costs		5.000	5.000	5.000	5.000	5.000	25.000
Effect on Profit / Loss		74.058	69.959	65.451	60.493	55.038	325.000
Lease Payments		60.000	60.000	60.000	60.000		
Principal Payments		40.981	45.079	49.587	54.545		
Interest Expenses		19.019	14.921	10.413	5.455		

Effects of IFRS 16 on the Financial Statements and Financial Ratios of a Company Operating in the BIST Transportation (Airline) Sector (PEGASUS) and a Company Operating in the BIST Retail Trade Sector (BIMEKS)

In this part of the study, consolidated 2015 Annual Reports of two companies and possible impacts on financial ratios if operating leases are reported in accordance with IFRS 16 have been evaluated. Selected companies are Pegasus Airlines Inc. operating in BIST Transportation Sector and BIMEKS Information Processing and Foreign Trade Inc. operating in BIST Retail Trade Sector. The reason for selecting an example from the transportation (especially air transportation) sector is the acquisition of aircraft by operating leases to a large extent. Similarly, our second example is selected from the Retail Trade Sector where operating leases are widely used for asset acquisitions. In this sector, especially stores are extensively obtained by the operating lease contracts. The calculations are made under certain assumptions, such as the current leasing transactions of the companies will continue similarly in the future.

If reported according to the new leasing standard, Pegasus would experience a decrease in net profit and an increase in operating profit due to the significant increase in interest expenses in 2015. Hence, profitability ratios calculated on net profit would decrease. Net Profit / Equity ratio would decrease to 6.61% from 7.70% and Net Profit /

Sales ratio would decrease to 2.72% from 3.21%. Interest coverage ratio would also decrease to 129% from 167%.

Liabilities of BIMEKS arising from operating leases are very high compared to its obligations arising from financial leasing. While the company accounts transactions arising from financial leases, the amount that stays out of the balance sheet is much higher (5.17 times in 2014 and 3.60 times in 2015). In 2015, the amount arising from the non-cancellable operating lease payments which will be paid in the following years and which stays out of the balance sheet is 164,851,204 TL since they are classified as operating leases according to IAS 17. It constitutes 21% of the total assets of BİMEKS (786,884,437 TL). Leaving a high portion of assets and liabilities off-balance sheets will affect the presented figures and financial ratios and mislead the user.

Summary

Leasing has emerged as an important source of financing in many sectors and studies take place in the literature on how to account for leasing contracts. The current lease standard IAS 17 classifies lease contracts as finance leases and operating leases for the lessee. According to this classification, essentially same kind of lease transactions are accounted differently due to certain components that contracts carry. The new Lease Standard IFRS 16 removes the “finance lease” – “operating lease” classification and it puts operational lease transactions on-balance sheets along with finance lease transactions. In this respect, it is aimed to largely eliminate criticism towards IAS 17. Especially due to the effects on the capital structure, a more accurate financial risk assessment could be possible for those who provide funds to the companies.

In this study, the difference between the current and the new standard in the accounting of the lease contracts and related liabilities has been explained. Then, Pegasus Inc. and BİMEKS Inc., which acquire assets extensively by operating leases have been examined in the lights of the data obtained from the 2015 financial statements.

The results show that there will be a significant increase in the debt ratios of corporations, especially for Pegasus, when reported according to IFRS 16. The impact on the profitability ratios of enterprises, which are already operating with low profitability ratios, is moderate. This moderate effect is positive for BİMEKS and negative for Pegasus for 2015. Financial statements of the firms in different sectors could be affected in different ways and levels from the new standard depending on the intensity of the lease contracts. For this reason, subsequent studies may focus on the assessment of sectoral effects and the reflection of these effects on financial statements throughout the operating lease period.