IFRS 16 & IAS 17 DIFFERENCES

Financial Reporting I

21 MAYIS 2019

Mouad LAMFICHEKH

Abstract:

In this article I will be discussing the global key differences between IFRS 16 and IAS 17 relating to leases. The article is focused on the following aspects: definition of a lease; classification of leases; initial and subsequent measurement (lessees); effects on the financial statements (lessees).

Introduction:

International accounting standards are Standards for the preparation and presentation of financial statements created by the International Accounting Standards Committee (IASC). They were first written in 1973, and stopped when the International Accounting Standards Board (IASB) took over their creation in 2001.

The international Accounting standards broad (IASB) is an independent, private sector body that develops and approves international financial reporting standards (IFRSs). The IASB operates under the oversight of the IFRS foundation. The IASB was founded in 2001 to replace the international Accounting Standards Committee (IASC). Under the IFRS Foundation Constitution, the IASB has complete responsibility for all technical matters of the IFRS Foundation including discretion in developing and purchasing its technical agenda. The preparation and issuing of IFRSs and exposure drafts, following the due process stipulated by the constitution and also the approval and issuing of interpretations developed by the IFRS Interpretations Committee.

In this context International FinancialReporting Standards (IFRS) was issued by the (IASB) to set common rules so that financial statements can be consistent, transparent and comparable around the world. They specify how companies must maintain and report their accounts, defining types of transactions and other events with financial impact. IFRS were established to create a common accounting language, so that businesses and their financial statements can be consistent and reliable from company to company and country to country.

Having an international standard is especially important for large companies that have subsidiaries in different countries. Adopting a single set of world-wide standards will simplify accounting procedures by allowing a company to use one reporting language throughout. A single standard will also provide investors and auditors with a cohesive view of finances. Accordingto the Americaninstitute of certified public accountants (NY 10036-8775) over 120 nations and reporting jurisdictions permit or require IFRS for domestic listed companies, although approximately 90 countries have fully conformed with IFRS as promulgated by the IASB and include a statement acknowledging such conformity in audit reports.

International financial reporting standards (IFRS) 16:

IFRS 16 became effective for annual reporting periods on the first January 2019 to replace International Accounting Standard (IAS) 17. and it was issued as part of the IASB's joint project with the Financial Accounting Standards Board (FASB), the US national standard-setter. As a response to the concerns regarding the lack of transparency of information about lease obligations, the IASB and the FASB initiated a project to improve the accounting for leases. They both agreed on the point that a lessee obtains an asset and in the same time a liability at the beginning of the lease. The problem is that while applying lease accounting requirements based on IAS 17, most of the leasing the transactions were not reported on a company's balance sheet. According to IASB, listed companies using IFRS or US GAAP (which have similar vision on this point) disclosed almost US$3 trillion of off balance sheet lease commitments in 2014.

In January 2016 IFRS 16 was issued to address the criticism of IAS 17, concerning especially the fact that many leases are off balance sheet, being difficult for users to get an accurate view of a company's lease assets and liabilities, by reporting the information that faithfully represents lease transactions and provides a basis for users of financial statements to assess the amount, the timing and uncertainty of cash flows arising from leases. To achieve this objective, the lessee should recognize the assets and liabilities arising from a lease.

A lessee measures right-of-use assets similarly to other non-financial assets (such as property, plant and equipment) and lease liabilities similarly to other financial liabilities. As a consequence, a lessee recognizes depreciation of the right-of-use asset and interest on the lease liability. The depreciation would usually be on a straight-line basis. In the statement of cash flows, a lessee separates the total amount of cash paid into principal (presented within financing activities) and interest (presented within either operating or financing activities) in accordance with IAS 7.

Assets and liabilities arising from a lease are initially measured on a present value basis. The measurement includes non-cancellable lease payments (including inflation-linked payments), and also includes payments to be made in optional periods if the lessee is reasonably certain to exercise an option to extend the lease, or not to exercise an option to terminate the lease. The initial lease asset equals the lease liability in most cases.

Definition of lease according to IFRS 16:

According to IFRS 16, a lease is a contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration. This definition is more focused on who controls the right-of-use asset. At first sight, the definition looks straightforward. But, in practice, it can be challenging to assess whether a contract conveys the right to use an asset or is, instead, a contract for a service that is provided using the asset.

For example, an entity might want to transport a specified quantity of goods, in accordance with a stated timetable, for a period of five years from A to B by rail. To achieve this, it could either rent a number of rail cars or it could contract to buy the transport service from a freight carrier. In both cases, the goods will arrive at B – but the accounting might be quite different!

The lessee accounting model in IFRS 16 reflects the economics of a lease because, at the commencement date, a lessee obtains the right to use an underlying asset for a period of time, and the lessor has delivered that right by making the asset available for use by the lessee.

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

IFRS 16 states that a contract contains a lease if:

- there is an identified asset; and
- the contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration.

Definition of a lease according to IAS 17:

IAS 17 sets out the required accounting treatments and disclosures for finance and operating leases by both lessors and lessees. IAS 17 classifies leases into two types:

- Financial lease: if the lease transfers substantially all the risks and rewards incidental to ownership; and
- Operating lease: if the lease does not transfer substantially all the risks and rewards incidental to ownership.

anyways whether a lease is a finance lease or an operating lease depends on the asset of the transaction rather than the form of the contract. Examples of situations that may indicate that a lease should be classified as a finance lease include:

- ownership of the asset transfer to the lessee at the end of the lease term;

- the lease term covers substantially all of the asset's economic life;

- the lessee will have the option to purchase the asset outright at below expected fair value or extend the lease term at below market rent; and

- the present value of the minimum lease payments amounts to substantially all of the fair value of the asset.

When a lease includes both land and buildings elements, each element should be assessed and classified separately as a finance or an operating lease. In making this assessment an important consideration is that land normally has an indefinite economic life.

Difference in Classification of leases between IFRS 16 and IAS 17:

Under IFRS 16, from a lessee's perspective, once an arrangement meets the definition of a lease, they are all recognized in the same manner, except for practical exceptions for short-term leases and low-value leases. The distinction between operating and finance leases remains in IFRS 16 only from the perspective of lessors.

According to IAS 17, leases are classified at the inception of a lease as a finance lease or an operating lease, based on whether or not substantially all the risks and rewards incidental to ownership are transferred. A finance lease is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset.

According to IFRS 16, no distinction is made between finance and operating leases from the perspective of lessees. IFRS 16 provides an option to lessees with short-term leases to account for them as operating leases, as they were accounted for under IAS 17 that is off balance sheet. Same option is provided also for leases where the underlying asset is of low-value. Short-term leases are those that as of the commencement date, have a term of 12 months or less, after considering reasonably certain lease options for extensions and terminations. This election must be applied consistently by class of underlying asset. Examples of low-value assets include tablets and personal computers, small items of office furniture and telephones. This election can be applied on a lease-by-lease basis.

Initial and subsequent measurement (lessees)

IAS 17 requires recognition of an asset and an assumption of an obligation (to pay future lease payments) based on the lesser of either the present value of the minimum lease payments or the fair value of the leased asset. Subsequent to initial recognition, the asset is amortized over the period of expected use/useful life on a basis that is consistent with the lessee's depreciation policy for other similar assets. Lease payments are allocated between a finance charge and a reduction of the outstanding liability.

If practicable, an entity is required to use the interest rate implicit in the lease as the discount rate in calculating the present value of the minimum lease payments. If not practicable, the lessee's incremental borrowing rate may be used.

Minimum lease payments, from the perspective of the lessee, are the payments over the lease term that the lessee is or can be required to make, excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor, along with any amounts guaranteed by the lessee.

Under IFRS 16 finance leases do not exist from the perspective of lessees. All leases (with limited exception) are recorded on balance sheet, similar to finance lease treatment under IAS 17.

Lessees are required to initially recognize a lease liability for the obligation to make lease payments and a right-of-use asset for the right to use the underlying asset for the lease term. The lease liability is measured at the present value of the lease payments to be made over the lease terms. The lease payments are discounted using the interest rate implicit in the lease, unless it is not readily determinable, in which case the lessee may use the incremental rate of borrowing.

Fixed payments for lease elements, less any lease incentives receivable over the lease term:

+ Certain variable payments linked to an index/rate based on level of index/rate at commencement
+ Residual value guarantee: amounts expected to be payable under residual value guarantees
+ Purchase options / Termination costs: exercise price of a purchase option if the lessee is reasonably certain to exercise that option or termination penalties if lease term reflects exercise of termination option.
+ Payments made previously, as lease payments made to lessor at commencement date or before that date

⇨ **LEASE LIABILITY**

The right-of-use asset is initially measured at the amount of the lease liability, adjusted for lease prepayments, lease incentives received, the lessee's initial direct costs for example commissions, and an estimate of restoration, removal and dismantling costs.

LEASE LIABILITY = the initial amount:

+ initial direct costs
+ costs of removal or cost to restore, as the estimated cost of removing and or restoring leased asset
+ payments made previously
- lease incentives received

⇨ **Right-of-use asset**

In subsequent periods, the right-of-use asset is depreciated and accounted for similarly to a purchased asset, following either the cost or revaluation model under IAS 16 Property, Plant and Equipment. The method chosen must be consistent within major classes of assets. Right-of-use asset is subject to impairment testing under IAS 36 Impairment of Assets.

The lease liability is accounted for similarly to a financial liability. Accordingly, the lease liability is accounted for under the effective interest method. Lease payments are allocated between interest expense and a reduction of the lease obligation.

For lessees that depreciate the right-of-use asset on a straight-line basis, the aggregate of interest expense on the lease liability and depreciation of the right-of-use asset generally results in higher total periodic expense in the earlier periods of a lease. Lessees measure the lease liability upon the occurrence of certain events (e.g., change in the lease term, change in variable rents based on an index or rate), which is generally recognized as an adjustment to the right-of-use asset.

Exampleofthe lessee accounting:

On 1.1.20X1 an entity enters into a three-year lease of industrial equipments. The rentals are CU20,000 payable at the end of each year. The applicable discount rate is 6%. The initial measurement of the right-of-use asset and lease liability is CU53,46:

$$= \frac{20{,}000}{1+0.06}+\frac{20{,}000}{(1+0.06)^2}+\frac{20{,}000}{(1+0.06)^3}=\text{5[illegible]}$$

The table below summarizes the cash flow and income statement and the balance sheet assuming straight line depreciation over three years:

Table no. 1. Cash flows and Profit and Loss Account of the lessee

Cash flows and Income Statement	1.1.20X1 CU	20X1 CU	20X2 CU	20X3 CU	Total CU
Lease payments	-	20,000	20,000	20,000	**60,000**
Depreciation expense	-	17,820	17,820	17,820	**53,460**
Interest expense*	-	3,208	2,200	1,132	**6,540**
Total expense	-	21,028	20,020	18,952	**60,000**

*Interest expense = Lease liability x 6%

Table no. 2. Balance Sheet of the lessee

Balance sheet	1.1.20X1 CU	20X1 CU	20X2 CU	20X3 CU
Right-of-use asset	53,460	35,640	17,820	-
Lease liability (see below)	53,460	36,668	18,868	-

Table no. 3. Calculation of the lease liability

		1.1.20X1 CU	20X1 CU	20X2 CU	20X3 CU
•	Fixed payments for lease elements	53,460	53,460	53,460	53,460
+	Certain variable payments	0	3,208	5,408	6,540
-	Payments made previously	0	20,000	40,000	60,000
=	**Lease liability**	**53,460**	**36,668**	**18,868**	**0**

The accounting entry on initial recognition:

	Debit (CU)	Credit (CU)
Right-of-use asset	53,460	
Lease liability		53,460

The subsequent accounting entry in 20X1 (Year 1):

	Debit (CU)	Credit (CU)
Depreciation expense	17,820	
Interest expense	3,208	
Lease liability	16,792	
Cash		20,000
Right-of-use asset		17,820

The accounting entries in 20X2 and 20X3 continue in the same pattern.

In this example rentals over the three years are CU 20,000 every year. Under IAS 17 assuming this is an operating lease (according to the classification of IAS 17), the annual expense would be CU20.000. Under IFRS 16 the total expense over the three years is also CU60,000 but this is 'front-loaded', that is the expense is higher in the early years. This results from recognizing interest at a constant rate of return on the outstanding liability.

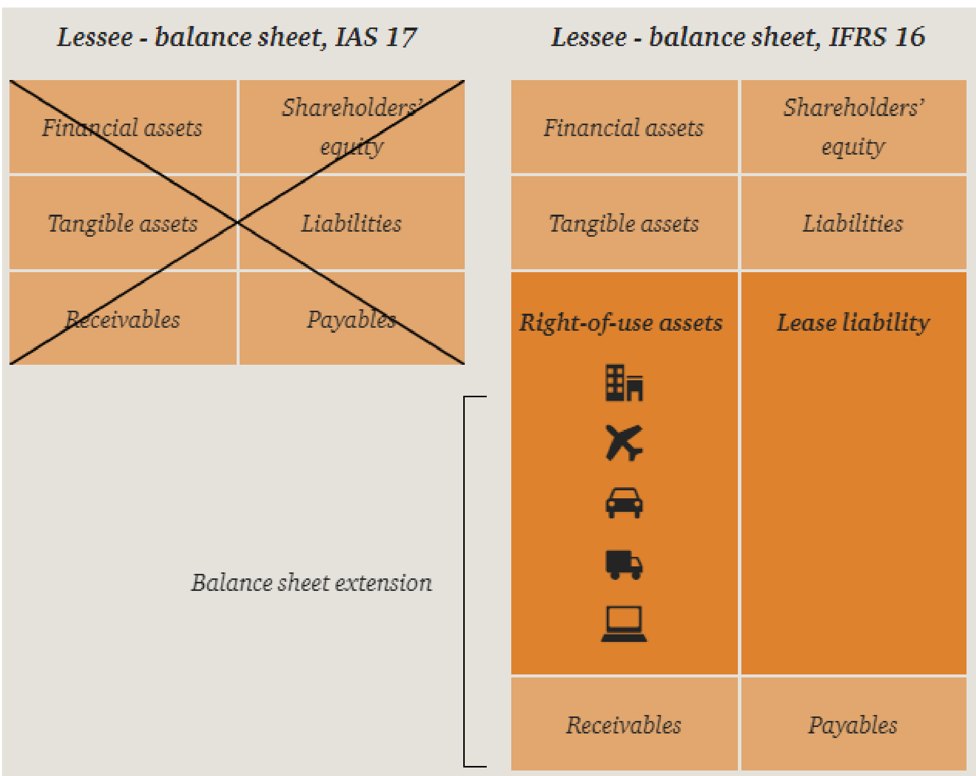
IFRS 16 and IAS17 Leases difference in financial statements:

Differences in the balance sheet:

As a result of the elimination of classification of leases as either operating leases or finance leases for lessee by IFRS 16, all leases are treated in similar way to finance leases as it used to be applying the IAS 17. Therefore, Leases are 'capitalized' by recognizing the present value of the lease payments and showing them either as lease assets (right-of-use assets) or together with property, plant and equipment. If lease payments are made over time, a company also recognizes a financial liability representing its obligation to make future lease payments.

In another way under IFRS 16 leases have to be recognized on the balance sheet in form of right-of-use asset and lease liability. This expands the balance sheet. Lessees that currently hold only operating leases will have to recognize the rights of use for leased assets such as property, aircraft, vehicles, moving equipment and IT…

The following figure (1) represents the standard all leases appear on the balance sheet



Exemption:

IFRS 16 does not require a lessee to recognize assets and liabilities for short-term leases, any leases of 12 months or less and leases of low-value assets for example, a lease of a personal computer.

The image below shows a perfect example of the balance sheet of Microsoft in which they chose to adopt IFRS 16 in 2017, two years ahead of time. Where we can notice They added "Operating lease right-of-use assets" line to the total current assets, and also an 'operating lease liabilities' line to the total current liabilities which represent the total amount of operating lease the company has committed to pay discounted to its present value

BALANCE SHEETS

(In millions)

June 30,	2018	2017
Assets		
Current assets:		
Cash and cash equivalents	$ 11,946	$ 7,663
Short-term investments	121,822	125,318
Total cash, cash equivalents, and short-term investments	133,768	132,981
Accounts receivable, net of allowance for doubtful accounts of **$377** and $345	26,481	22,431
Inventories	2,662	2,181
Other	6,751	5,103
Total current assets	169,662	162,696
Property and equipment, net of accumulated depreciation of **$29,223** and $24,179	29,460	23,734
Operating lease right-of-use assets	6,686	6,555
Equity and other investments	1,862	6,023
Goodwill	35,683	35,122
Intangible assets, net	8,053	10,106
Other long-term assets	7,442	6,076
Total assets	$ 258,848	$ 250,312
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	$ 8,617	$ 7,390
Short-term debt	0	9,072
Current portion of long-term debt	3,998	1,049
Accrued compensation	6,103	5,819
Short-term income taxes	2,121	718
Short-term unearned revenue	28,905	24,013
Other	8,744	7,684
Total current liabilities	58,488	55,745
Long-term debt	72,242	76,073
Long-term income taxes	30,265	13,485
Long-term unearned revenue	3,815	2,643
Deferred income taxes	541	5,734
Operating lease liabilities	5,568	5,372
Other long-term liabilities	5,211	3,549
Total liabilities	176,130	162,601
Commitments and contingencies		
Stockholders' equity:		
Common stock and paid-in capital – shares authorized 24,000; outstanding **7,677** and 7,708	71,223	69,315
Retained earnings	13,682	17,769
Accumulated other comprehensive income (loss)	(2,187)	627
Total stockholders' equity	82,718	87,711
Total liabilities and stockholders' equity	$ 258,848	$ 250,312

Differences in income statement:

For companies with material off balance sheet leases, IFRS 16 changes the nature of expenses related to those leases. IFRS 16 replaces the straight-line operating lease expense for those leases applying IAS 17 with a depreciation charge for the lease asset (included within operating costs) and an interest expense on the lease liability (included within finance costs).

This change aligns the lease expense treatment for all leases. Although the depreciation charge is typically even, the interest expense reduces over the life of the lease as lease payments are made. This results in a reducing total expense as an individual lease matures. The difference in the expense profile between IFRS 16 and IAS 17 is expected to be insignificant for many companies holding a portfolio of leases that start and end in different reporting periods.

The income statement treatment applying IFRS 16 for former off balance sheet leases also differs from the treatment applying the FASB model for those leases. This is because the FASB model is designed so that expenses related to those leases are reported typically on a straight-line basis and are included within operating costs.

Thus IFRS 16 effects the income statement by increasing the earnings before interest, taxes, depreciation, and amortization (EBITDA) and it also increase operating profit and finance costs and constant profit before tax. For companies that have material off balance sheet leases, IFRS 16 is expected to result in higher profit before interest for example: operating profit compared to the amounts reported applying IAS 17. By cause of applying IFRS 16 a company presents the implicit interest in lease payments for former off balance sheet leases as part of finance costs. In contrast, under IAS 17, the entire expense related to off balance sheet leases is included as part of operating expenses.

Difference in cash flow statement:

The aim of IFRS 16 is to reduce operating cash outflows, with a corresponding increase in financing cash outflows, compared to the amounts reported applying IAS 17. This is because, applying IAS 17, companies presented cash outflows on former off balance sheet leases as operating activities. In contrast, applying IFRS 16, principal repayments on all lease liabilities are included within financing activities. Interest can also be included within financing activities applying IFRS 16.

Under IAS 17, lease payments related to operating leases were included in cash flows from operating activities. Except for rent-free periods or cut-off effects, rental expense in EBIT (earnings before interest and taxes) was perfectly equal to the amount of rent paid. Now under IFRS 16 the repayment of the lease liability (fixed rent) is now a cash outflow from financing activities.

Statement of cash flows (€m)
Operating lease - variable rent paid
Operating lease - fixed rent paid
Net cash from operating activities
Net cash from investing activities
Repayment of the lease liability (principal + interest)
Net cash from financing activities
Change in cash

Only fixed rental payments are reclassified under financing activities.

No change in net cash flows.

In fact, we will have the same aggregate amount of cash outflows under both IAS 17 and IFRS 16. The phasing effect on profit creates a temporary disconnect between the income statement and statement of cash flows that reverses over the term of the lease.

IFRS 16's impact in investors' point of view:

The impact of this new accounting standard varies for different industries, and as one might expect, companies that need to maintain a significant portfolio of leases will feel the greatest impact.

The IFRS 16 change is one of the most significant accounting standard changes in years. While some may feel that this makes it difficult for investors to compare some widely-used financial metrics across time periods, the benefits that accompany this method are manifold and should be embraced

After all, most of the dirty work, such as restating of financials will be done by the companies' accounting departments, with investors simply on the receiving end of that data.

In summary, the table below presents how IFRS 16 will affect the financial metric or ratio:

Financial Metric/Ratio	**Impact of IFRS 16**
EBIT, EBITDA	Higher
Earnings	No change
Total Assets	Higher
Total Liabilities	Higher
Total Debt	Higher
Operating Cash Flow	Higher
Free Cash Flow	Higher
EV/EBIT, EV/EBITDA	Lower
Price/Earnings	No change
Debt/Equity, Debt/Capital	Higher
Interest Coverage Ratio	Lower
Return on Invested Capital	Higher
Price/Operating Cash Flow	Lower
Price/Free Cash Flow	Lower

Conclusion:

The lease is defined as a contract between two parties, the lessor and lessee, in which the lessor is the legal owner of the asset, the lessee obtain the right to use the asset for a determined period of time in return of rental payment.

The difference between IFRS 16 and IAS 17 in the definition is that IFRS 16 it definition focus basically in on who controls the right of use of the asset. In the other hand IAS 17 focus more on whether lessee or lessor carries the risk and rewards.

There is a difference in classification: under IFRS 16, in every case the lease argument meets with the definition of lease, they are recognized in the same manner. Except for short-term leases and low value leases, and this exception is remains only from the perspective of the leasers. Despite IAS 17 that two kind of lease; FINANCIAL lease which is the lease that transfers mainly all the risks and rewards related to ownership of the asset to the lessee; OPERATING lease is defined as being any lease other than financial, which means there is no transfer of risks or rewards to the lessee.

While concerning differences in the financial statements: under IAS 17 the lessee is not obligated to report assets and liabilities from operating leases on their balance sheet and they are instead referred to in the footnotes, this typically financial statement users an inaccurate account of the company's outstanding expenses.

IFRS 16 changes IAS 17 method by requiring a lessee to recognize arising right of use assets and lease liabilities on their balance sheet; on the liabilities side of the balance sheet, an 'operating lease liabilities' line item will be added to represent the total amount of operating leases a company has committed to paying, discounted to its present value. At the same time, a corresponding asset, commonly named 'operating lease right-of use asset' will be recorded on the asset side of the balance sheet. The value of the asset and the liability should be equal at the onset, but the two values can diverge over time due to the straight-line depreciation.

The table below summarizes the key differences between the standards:

	IAS 17	IFRS 16
Classification	Classification is based on who bears the risks and rewards of the assets under lease.	The classification is based on who has the 'Right-of use' of the asset.
Accounting	Only Finance leases are recognised as assets with operating leases being an expense only.	All leases are recognised as assets.
	Operating leases have less complex accounting treatment	All leases will be treated in the same way, potentially resulting in significantly greater volume and complexity of work in Finance teams. This will include calculation of balance sheet amounts for assets and financial liabilities, associated depreciation and amortisation as well as increased record keeping requirements.
	Lease and service contracts under an operating lease are generally not required for analysis as accounting treatment is probably accounted for in the same way (ie as an expense).	Service components of leases must be segregated from assets as the treatment will differ and the service element will not form part of the asset, but will remain an expense item. This may also require further complex calculation to split the elements.

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