

Reporting Lease Contracts According to IFRS 16: Case of Romanian Entities

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Abstract

In 2016, a new accounting standard on leases was issued and it is effective since 2019. According to IFRS 16 "Leases", the classification of lease contracts as finance or operating leases is eliminated; significant changes could emerge for the lessee.

Our study examines the effect of the new accounting model for lease provided by IFRS 16 in case of Romanian entities listed on Bucharest Stock Exchange. We analyzed the financial statements prepared for 2019. The main objectives are to analyze the changes in the balance sheet and the profit or loss account subsequent to the application of IFRS 16 and to measure the conformity with the requirements of this standard.

The results show that the new rules regarding lease accounting do not bring significant changes on the financial statements of the lessee. We also find that, on average, Romanian listed entities present a low level of compliance with IFRS 16.

Key words: IFRS 16 "Leases"; Romanian listed entities; Bucharest Stock Exchange (BSE); right-of-use asset; disclosure index

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1. Introduction

Globalization and financialization of the economies created the premises for the development and implementation of a set of accounting standards, designed to allow the presentation of the financial information in a world-wide accepted and understandable business language. This set of accounting standards, known as IFRS (International Financial Reporting Standards), are issued by the International Accounting Standards Board (IASB) since 1973 and gained, in time, more and more legitimacy. Nowadays, according to IASB, nearly all of the analyzed jurisdictions (156 of the 166) support the application of these accounting standards (IFRS Foundation, 2018). At the European Union level, IFRS are mandatory for the preparation of financial statements of all entities whose securities are traded on an EU regulated market.

The accounting standards endeavor to keep up with the changes in the way business are running. In the field of lease accounting and disclosures, recent debates question the effectiveness, the ethics and consistency of the old accounting model in relation with the international conceptual framework and the objective of financial reporting.

Until 2016, two types of leases must be segregated according to the substance over form principle, which means "representation of the substance of an economic phenomenon instead of representation of its legal form only" (IFRS Framework, 2.12). Finance leases are capitalized as assets and liabilities in the balance sheet (which is called Statement of financial position, according to IAS 1), while operating leases only result in the recognition of an expense in the profit or loss account (or Statement of comprehensive income, according to IAS 1) prepared by the lessee. There is a hairline distinction between financial lease and operating lease; a lease contract is recognized as financial lease if it "transfers substantially all risks and rewards incident to ownership" to the lessee

(IAS 17.4). All the others lease contracts are classified as operating lease.

The new standard on leases, IFRS 16, was issued in 2016 and is effective since 1 January 2019. Significant changes were introduced for the lessee, along with the elimination of the classification of lease contracts as finance or operating leases. According to the new regulation, with very few allowed exceptions, all leases must be capitalized and presented in the balance sheet. A right-of-use asset and a lease liability are recognized in the balance sheet of the lessee. In the profit or loss account, two types of expenses are disclosed: an operating expense, represented by the depreciation of the right-of-use asset, and a financial expense, related to the interest.

In Romania, entities listed on BSE took the step towards the application of the new standard on leases, IFRS 16, since 1 January 2019. The financial statements for 2019, available in early 2020, present the effect of the first application of IFRS 16, allow the analysis of the degree of changes in the balance sheet and the profit or loss account and of the conformity with the requirements of IFRS 16.

The objective of our research is twofold. First, we measure the impact of the adoption of IFRS 16 on the financial position and performance of Romanian listed entities and compare the results against the objectives set out by the IASB. Second, we analyze the degree of compliance with the requirements from the standard on leases and measure the disclosure index achieved by Romanian listed entities. The analysis is made only from the perspective of the lessee.

We consider that this topic is useful for investors and other stakeholders, allowing them to understand the effects of the first-time application of the new accounting model for lease on the financial statements of Romanian listed entities. For the members of the accounting profession in Romania, our research could provide a useful picture on how listed entities manage to go through the process of applying the new requirements regarding leases and on the accounting policies they decided to choose. Since Romanian accounting regulation, applicable for unlisted entities, provides the same definitions for assets and liabilities as the IFRS Framework and lists the substance over form principle among the ten general financial reporting principles, we dare to say that we are not far from the moment when the Romanian accounting regulating body (The Ministry of Finance) analyses the opportunity of a change in the accounting and reporting of leases, in line with the international standard.

2. Literature review

From an old, vulnerable lease accounting model...

According to IAS 17, the lessee capitalized a lease contract according to the substance over form principle, only when it transfers all the risks and benefits to the lessee. Nobes (2005) states that a better approach for the segregation between the two types of lease contracts is to use the concepts of assets and liabilities defined by IFRS Framework.

Firms with significant amounts of goods used in the terms of lease contracts take advantages from classifying the leases as operating leases; as a consequence, significant liabilities are not reported in the balance sheet and the corresponding ratios for solvability, liquidity are improved.

According to an estimation published in 2016, over 85 per cent of all leases were off balance sheet. As a result, investors faced a significant burden, having to recalculate important ratios, after the adjustment made on the balance sheet in order to reconsider the assets and liabilities (Lloyd, 2016).

Frecka (2007) questions the ethicality of intentionally structuring lease contracts to avoid disclosing asset and liability amounts.

... to a new, perfectible solution

The dream of David Tweedie, the former chairman of IASB, that "one day he would like to fly on an airplane that actually appears on the airline's balance sheet" came true with the issuance and adoption of the new standard on lease, IFRS 16.

The new standard brings significant changes in lease accounting for the lessee. The lessee will no longer be required to determine whether a lease contract represents a finance lease or an operating lease. All leases are required to be recognized in the balance sheet, by means of a right-of-use asset and a liability corresponding to the obligation to make payments to the lessor. Two exceptions from this rule are provided for by IFRS 16, related to short-term leases and leases for which the underlying asset is of low value. IFRS 16 is in force beginning with 1 January 2019.

IFRS 16 solves the problem of possible different treatment of similar lease arrangements between entities, reduces the field for opportunistic choices made by managers, brings the information about leases in the balance sheet of the lessee, being easier to interpret by analysts.

However, the new lease standard also has its critics. First, some argue that there will be a lack of symmetry between the accounting of the lessee and the lessor. Bunea (2017) presents the opinions expressed by auditors, academics and EFRAG, stating that "both the lessee and the lessor should apply a single accounting model based on the right-to-use asset theory". From the preparers' perspective, the same author suggests that they are "willing to accept conceptually unsubstantiated solutions" if costs savings occur.

Second, some preparers do not agree with the right-of-use model, since they believe that in many cases the objective of a lease contract is not to purchase the asset, but to achieve operating flexibility.

Third, large entities consider that a single model is not suitable since the economic substance of the contract may vary.

Kabir and Rahman (2018) analyzed the provisions of IFRS 16 in relation with the Conceptual Framework. They find that, instead of relying on relevance and faithful representation, IASB used a notion outside the Framework to justify some lease accounting requirement, the consistency with other IFRSs.

The expected effects of the application of IFRS 16

In the European Union, since 2005, the application of the IFRSs is compulsory for the preparation of consolidated financial statements of all listed entities. The new standard on leases must be implemented by European companies starting with 2019.

According to IASB, the major benefits of IFRS 16 are improved quality and comparability of financial reporting.

Analyzing the anticipated effects of IFRS 16, Bunea (2017) find that there are no significant differences on financial statements or on costs associated with the implementation; however, "different perceptions" are perceived among different stakeholders.

Segal and Naik (2019) believe that the new assets and liabilities reported in accordance with IFRS 16 significantly change to key ratios of the lessee. Still, the transition to IFRS 16 has no effect on the cash flows and on the economic perspective of the business.

A research comprised of European companies finds that the change of assets and liabilities after adopting IFRS 16 ranges from zero to 84% for assets and 160% for liabilities. The authors also find that the most affected sectors are food and retail, hotels and transportation, while the least affected ones are banks and insurance, real estate, household and personal products (Morales-Diaz and Zamora-Ramirez, 2018).

Giner and Pardo (2018) find that investors read the information available in the notes regarding operating leases and use it in establishing market prices, in case of retailing firms.

IFRS in Romania

Romanian listed entities apply the IFRSs since 2007 for consolidation purpose and since 2012 for the preparation of individual financial statements. The recent adoption of IFRS in Romania was of great interest for many researchers.

Neag (2014) analyzed the reconciliation of shareholders' equity and net income of the Romanian listed companies from the first individual financial statements presented in accordance with IFRS and concluded that the application of IFRS had a small effect on net income and shareholders' equity.

Păunescu (2015) documents the existence of tensions between accounting and taxation and contends that adapting the Fiscal Code to the needs of the companies that use the IFRSs could be a solution to solve these tensions.

In case of entities listed on BSE, Mașca (2015) found that sustainable companies are interested in conservatism more than others.

Takacs (2012) tested the value relevance of earnings in case of Romanian listed entities and found that IFRS adoption had a negative effect on accounting information from the market perspective.

Țurlea et al. (2019) analyzed the discretionary accruals estimated under the Romanian Accounting Regulations, as well as under the IFRSs and found that the auditor's type does not statistically influence the value of discretionary accruals either if they are estimated using IFRS or the Romanian regulation.

Petre, S. and Albu, N. (2020) investigated the institutional context in which companies' compliance with IFRS is created over time, by analyzing data reported by Romanian entities listed on Bucharest Stock Exchange during 2013-2017. They found that overall, the three surveyed companies display a low level of compliance, and, surprisingly, the level of compliance decreases over time.

The compliance with the requirements of certain IFRS was tested by Gîrbină and Bunea (2009) for IFRS 7, Gorgan and Gorgan (2014) for IAS 38, Ponce *et al.* (2016) for the comprehensive income.

Our research complements the knowledge about IFRS adoption in Romania and provides an insight on the effects of the first-time application of IFRS 16 in case of Romanian listed entities.

3. Research methodology

The sample includes all Romanian entities, listed on the Bucharest Stock Exchange (BSE). From the total number of 84 listed entities, we eliminated from the study the financial institutions, the international companies and the entities that, according to their financial statements, do not have ongoing leasing contracts. Thus, the final sample consists of 42 Romanian entities, as lessees, that presented for the first time the information about lease in accordance with IFRS 16.

Data was collected from the individual annual financial statements prepared for the year 2019, available on BSE website.

Our first objective is to measure the impact of the adoption of IFRS 16 on the financial position and performance of Romanian listed entities and compare the results against the objectives set out by the IASB.

The impact of IFRS 16 was estimated by means of the magnitude of lease engagements. In order to measure the impact on the financial position, we determined the share of the right-of-use asset in the total assets and the share of lease liabilities in the total amount of liabilities, as of 31 December 2019. The impact of lease accounting on the financial performance was calculated by means of the share of depreciation charge for right-of-use assets in the total operating expenses and the share of interest expense on lease liabilities in the total financial expenses, reported for 2019. A more appropriate approach would have been to identify the right-of-use asset, the lease liability and the interest expense that resulted from the reclassification of operating lease at the date of the transition to IFRS 16. However, only a small number of entities disclosed this type of information; accordingly, this in-depth analysis could not be performed.

The second objective is to analyze the degree of compliance with the requirements from the standard on leases and measure the disclosure index achieved by Romanian listed entities. We identified 20 items that must be disclosed in the financial statements, according to the requirements of IFRS 16. A content analysis of the components of the financial statements (balance sheet, profit and loss account, statement of cash flow and notes to the financial statements) of surveyed entities was performed, in order to identify the accounting policies and disclosures made in accordance with IFRS 16. We used the score "1" when the required information was disclosed and the score "0" was allocated when we didn't find the information in the financial statements. Some of the requirements were not applicable for certain entities. For example, only a small number of entities choose to apply the fair value model for investment properties or tangible assets and, consequently, the disclosure requirement about the fair value model of the right-of-use assets is not applicable. For these circumstances, the disclosure requirement was marked as "not applicable" and the maximum number

of items to be disclosed by that entity was recalculated in order to take into account only the total number of applicable items to be disclosed. The disclosure index applied in our research was computed for each entity as a ratio between the number of disclosed items and the number of items applicable to that entity. This research method was used by Gîrbină and Bunea (2009). The following computation relationship was used:

$$DI = \frac{\sum_{i=1}^m d_i}{\sum_{i=1}^n d_i}$$

where:

- DI – the disclosure index of the provisions from IFRS 16 in case of Romanian listed entities
- d – the score for each surveyed entity
- m – the number of items disclosed by an entity
- n – the maximum number of items applicable to that entity

It is preferable that the disclosure index has a value as close as possible to 1, which means a very high level of disclosure and proves great compliance with the requirements of IFRS 16.

4. Results and findings

Table 1 summarizes the descriptive statistics regarding the impact of the new lease standard on the financial position and performance of Romanian listed entities.

Table no. 1 Descriptive statistics on the impact of IFRS 16 – entire sample

Indicator	The share of the right-of-use asset	The share of lease liabilities	The share of depreciation charge for right-of-use assets	The share of interest expense
Mean	0.032731	0.085400	0.018432	0.155823
Median	0.007050	0.036900	0.009800	0.074650
Standard Deviation	0.076465	0.156837	0.023404	0.229823
Minimum	0.000100	0.001900	0.000100	0.000100
Maximum	0.420100	0.846700	0.092000	0.874900
Count	32	33	28	26

Source: authors' own processing

Table 1 presents the figures for the entire sample. The mean of the right-of-use asset is very small and represents 3.27% of the total assets presented in the balance sheet. This result suggests that the first-time application of IFRS 16 has only a very small impact on the assets of the Romanian listed entities. However, a maximum share of 42.01% was recorded for an entity that activates in the transport and storage field. In line with the results obtained for the right-of-use asset, we found that the mean of the share of depreciation charge for right-of-use assets in the total operating expenses is also small 1.84% and the highest value 9.20% was obtained by an entity in the field of information and communications.

The share of lease liabilities in the total amount of liabilities presents a mean of 8.54% and shows that for Romanian listed entities the leases contracts are a significant means of financing. But, since for the most of the surveyed entities we could not identify information about the new lease liability emerging from reclassifying the operating lease, we are not able to interpret this result in relation with the lease accounting standard. The interest expense on lease liabilities is also significant and represents 15.58% of the financial expenses.

Overall, our results allow us to conclude that the new rules regarding lease accounting do not bring significant changes on the financial statements of the lessee.

Next, we present our findings by industry. Since the impact of IFRS 16 is presumed to be higher for certain sectors, we classified the surveyed entities into subgroups according to their main field of activity. We only took into account the sectors with data for three or more than three entities.

Accordingly, the analysis was performed on four subgroups: extractive industry (EI), manufacturing industry (MI), trade (T), transport and storage (T&S). The results are summarized in Table 2.

The sector most affected by the introduction of the new accounting standard on leases is transport and storage, where the right-of-use asset represents 10.87% of the total assets, the share of lease liabilities in total amount of liabilities is 31.19% and the interest expense has a share of 59.63% in total financial expenses. Significant impact of the introduction of IFRS 16 was also noticed in case of trade sector, where the share of the right-of-use asset in total assets is 5.76%, the share of lease liability in total liabilities is 16.30% and the share of interest expense in financial expenses is 23.89%. At the opposite pole is the extractive sector, the least affected by the introduction of the new provisions on lease accounting.

Table no. 2 Descriptive statistics on the impact of IFRS 16 by subgroups of industry

	Mean				Standard deviation				No. observations			
	EI	MI	T	T&S	EI	MI	T	T&S	E I	M I	T	T& S
<i>The share of the right-of-use asset</i>	0.0055	0.0178	0.0576	0.1087	0.0041	0.0263	0.0484	0.2077	4	14	3	4
<i>The share of lease liabilities</i>	0.0885	0.0332	0.1630	0.3119	0.1209	0.0460	0.1554	0.4632	4	16	3	3
<i>The share of depreciation charge for right-of-use assets</i>	0.0029	0.0107	0.0251	0.0241	0.0026	0.0075	0.0246	0.0366	3	12	3	4
<i>The share of interest expense</i>	0.1488	0.0494	0.2389	0.5963	0.1865	0.0728	0.1408	0.4158	4	12	3	3

Source: authors' own processing

According to IASB, some sectors (such as airlines, retailers, travel and leisure, transport, telecommunications, energy, distributors) are more affected than others by the application of the new rules for lease accounting. Also, IASB states that even within industries, some companies are more affected, depending on the extent to which they used off balance sheet leases (IFRS Foundation, 2016a and 2016b).

The results of our study are, to some extent, aligned with the anticipated estimates of the effects of IFRS 16 adoption made by the IASB. According to our results, in Romania the most affected sectors are transport and storage (T&S) and trade (T) and these fields are among those mentioned by the IASB in the project of effect analysis for IFRS 16. Also, within the same sector, Romanian listed entities show different impact of the adoption of IFRS 16. Thus, within the transport and storage sector, from the 4 analyzed entities, 3 present a share of the right-of-use asset below 1% and for 1 entity the share of the right-of-use asset in total assets is 42.01%. Within the trade sector, the share of the right-of-use asset and the share of lease liabilities present the minimum values 0.54%, respectively 0.70% and the maximum values 10.09% and 16.43%.

For our second objective, the degree of compliance with the requirements of IFRS 16 was measured by means of the disclosure index. The results for the disclosure index are presented in the table below, using the descriptive statistics.

Table no. 3 The disclosure index for IFRS 16 in case of Romanian listed entities

Disclosure index	Entire sample	Extractive industry	Manufacturing industry	Trade	Transport & Storage
Mean	0.455808	0.662088	0.431568	0.538462	0.419231
Median	0.461538	0.664835	0.461538	0.538462	0.461538
Standard Deviation	0.221273	0.166506	0.228256	0.076923	0.198763
Minimum	0.076923	0.461538	0.076923	0.461538	0.153846
Maximum	0.857143	0.857143	0.857143	0.615385	0.600000
Count	42	4	22	3	4

Source: authors' own processing

The results show that, on average, Romanian listed entities present a low level of compliance with the requirements provided by IFRS 16. For the entire sample, the mean of the scores obtained for the disclosure index is 0.455808 and is rather closer to 0, meaning a low conformity and disclosure. From the 42 entities included in our study, 22 record a disclosure index above the average. The statistics of the disclosure index calculated by industry indicate that extractive industry and trade are the sectors with the highest scores for the disclosure index.

The maximum disclosure index of 0.857143 was obtained by an entity from extractive industry and one from manufacturing industry. The lowest score of 0.076923 was registered by 4 companies: 1 from constructions field, 2 from manufacturing industry and 1 activating in hotels and restaurants.

We performed a ranking of the disclosure requirements that were met by most of the analyzed entities; the items most frequently disclosed were: the lease liabilities separately from other liabilities (36 entities), the right-of-use assets separately from other assets (33 entities), a maturity analysis of lease liabilities (32 entities). At the opposite side, none of the analyzed entities presented restrictions or covenants imposed by leases, only 2 entities disclosed the cash payments for the interest portion of the lease liability and a small number of entities presented the expense relating to leases of low-value assets (6 entities).

Our findings are not consistent with the expected benefits of IFRS 16 expressed by IASB, stating that "the new accounting will result in more information about leases both on the balance sheet and in improved note disclosures" (IFRS Foundation, 2016a). In case of Romanian listed entities, in the first year of the application of IFRS 16, the conformity with the requirements of this standard is less than satisfactory.

5. Conclusions

Our paper presents insights on the first application of the new accounting requirements in the field of lease contracts, provided by IFRS 16 "Leases", in case of Romanian entities listed on Bucharest Stock Exchange.

First, we analyzed the degree of changes in the balance sheet and the profit or loss account and find that, overall, the new rules regarding lease accounting do not bring significant changes on the financial statements of the lessee. Our analysis by industry show that the most affected sectors were transport and storage and trade. Our findings are consistent with the estimations made by IASB regarding the adoption of IFRS 16.

Second, we measured the conformity with the requirements of IFRS 16 and find that, on average, Romanian listed entities present a low level of compliance with the requirements of this standard.

We believe that this analysis could replicated in order to measure the application of IFRS 16 in subsequent years and improved findings for the disclosure index may result.

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