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The Effect of Transition from IAS 17 to IFRS 16 — Based on the Case Study of Tesco

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Abstract

Leasing is an economic practice in which the lessor borrows a physical item for a certain fee. The lessee is given the right to use the item for a certain period of time. Leasing is an important source of financing for economic units and is of certain importance as an alternative to financing assets through purchase or borrowing. In 2016, the International Accounting Standards Board announced that starting from 2019, the measurement of leases will be changed from International Accounting Standards (IAS 17) to International Financial Report Standard (IFRS 16), which will terminate the off-balance sheet financing of the lessee by recognizing all leases in the lessee's budget. This paper analyzes the specific impact of IFRS 16 "leasing" in practice. The author summarizes the characteristics of IAS 17 and the problems existing in IAS 17. Following the application of the IFRS 16, subsequent measurement rule changes resulting from the change in the lease classification definition will result in significant changes in the company's financial statements. By analyzing the data changes in specific cases and the impact on user behavior, this paper verifies the correctness of previous theoretical research and analysis, and tests whether the new criteria will change as expected in practical application. The author chooses Tesco, Britain's largest retailer, as a sample company here to give a full picture of the problem. Specifically, this paper analyzes the retrospective restatement of Tesco's 2019 annual report and attempts to alert others to the actions the company has taken to address the adoption and relevance of IFRS 16.

Keywords: lease, IAS 17, IFRS 16, Tesco

1. Introduction

According to Čevizović, Mijoč (2019) and Silvana et al. (2020) for lessees, leasing is one of the preferred forms of financing for SMEs, as it is easily replaceable and requires minimal effort to obtain them. For the lessor, leasing operations are an efficient means of making efficient use of goods that are used over a long period of time on favourable trading terms (Violeta ISAI, 2006). The International Accounting Standards Board (IASB) have to set out detailed principles for the recognition, measurement, presentation and disclosure of leases. According to IASB (2019), in 2001 the IASB adopted IAS 17 leases, which had originally been issued in 1997. From 2001 to 2004, IAS 17 had been revised many times until January 2016 IASB issued IFRS 16, which would be effective for annual reporting periods beginning on or after 1 January 2019. Moreover, in May 2020, the board issued COVID-19 related rent concessions connected with IFRS 16 (IASB, 2022).

This paper will discuss the impact of the transition from IAS 17 to IFRS 16 on the way leasing activities are recorded and the usefulness of economic information by comparing theories and practice (using Tesco as a case). It begins with reviewing the role of IAS 17 and the rationale for its replacement, as well as the changes in the new policy. How the new model has been applied to Tesco and whether it validates the researchers' results in theory. For the managers, whether the implementation of the new standard will have an impact on the lease term portfolio strategy of, and for investors, whether this transition will facilitate their use of financial reporting information to help them make investment decisions. More than that, this thesis hopefully inspires other companies on how to make more efficient use of IFRS 16.

2. Literature Review

2.1 IAS 17-Features

The objective of IAS 17 is to prescribe, for lessees and lessors, the appropriate accounting policies and disclosures to apply in relation to finance and operating leases (IASB, 2005). At the beginning of the lease term, lessees shall recognize finance leases as assets and liabilities in their balance sheets at the lower of the fair value of the asset and the present value of the minimum lease payments, while operating lease payments are recognized as an expense on income statement (YUCEL, 2016).

2.2 IAS 17-Existing Issues

The implementation of the new principle is due to the fact that the previous ones had space for improvement, which means that IAS 17 were problematic or were not applicable to the current evolving accounting environment. Maglio, Rapone and Rey (2018) found that the line between finance and operating leases was difficult to define in a principled way. Under IAS 17, companies take advantage of financial accounting loopholes to structure lease transactions as operating leases, give managers opportunities to have incorrect behaviours and interfere with investor perceptions of disclosure. IAS 17 only required that all companies show finance leases on their balance sheets and not all assets and liabilities arising from leases (Muthupandian, 2009). Knowledgiate Team (2016) summarised two main issues in SOFP. The first one is obligations under non-cancellable leases are not recognised as liabilities for operating leases. The second one is assets used under operating leases are not shown in the statement of financial position, thereby inflating the return on assets.

2.3 IFRS 16-Capitalisation

According to Bunea-Bontas (2017), the key differences between IFRS 16 and IAS 17 are the definition, classification and measurement way of leases. IFRS 16 removes the classification of leases and records operating and finance leases under one heading, ‘leases’. The present value of the lease payments is shown as a right-of-use asset along with PPE and the lease is capitalised. In addition to this, IFRS 16 changes the nature of the costs associated with leases by replacing straight-line operating lease costs for leases to which IAS 17 is applied with depreciation charges on the leased asset (included in operating costs) and interest charges on the leased liability (included in finance costs) (IASB, 2016).

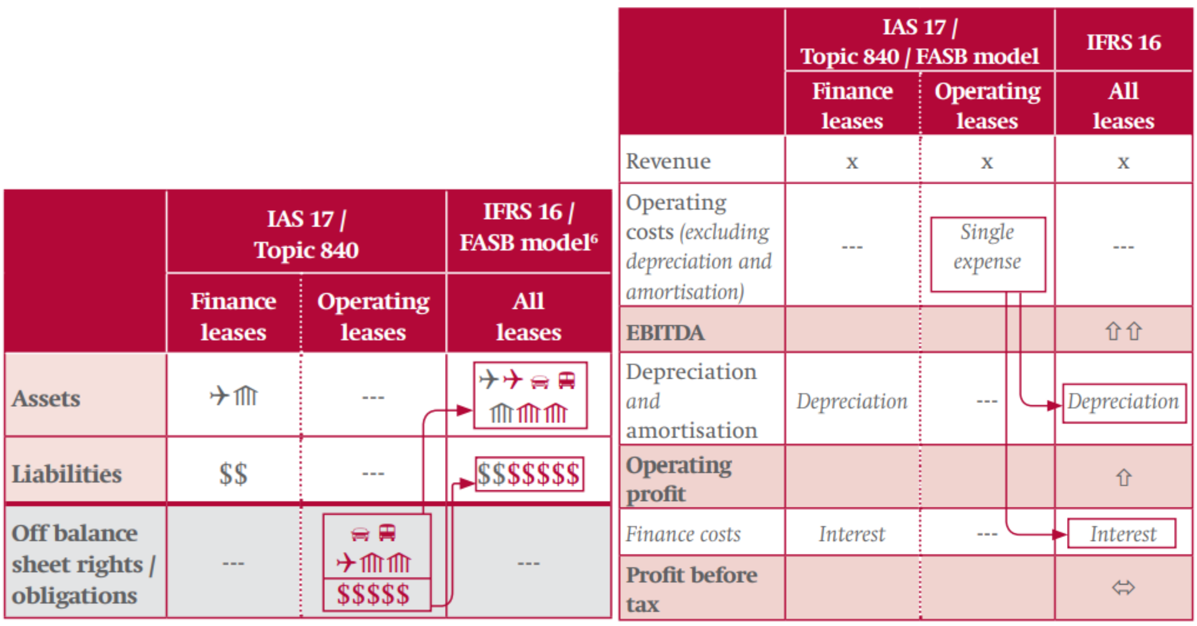

Figure 1. (IASB, 2019)

3. Methodology

This paper mainly relies on the data from TESCO which is as a case study to explore the impact of changing from IAS 7 to IFRS 16 in SOFP. Considering the retailer industry would be the most heavily impacted industry (Stancheva-Todorova, 2019; Marshall & Andrew, 2016), the new model will not have a significant impact on the majority of companies with limited use of operating leases (Mariusz Karwowski, 2018), and larger companies would be affected more deeply than companies which have a lower market valuation (Pardo & Giner, 2018; Singh, 2012), this paper applied data from TESCO — British largest supermarket group (TESCO, 2022) — to do the research.

4. Case Study of TESCO

4.1 Consequences of Changing Recording Method

4.1.1 Theoretic Research

According to Stancheva-Todorova (2019) and Tumpach et al. (2021), the mandatory recognition of IFRS 16 of off-balance sheet assets and liabilities arising from operating leases in the statement of the financial position lead increase in their balance sheet lease assets (right-of-use assets) and financial liabilities. In the income statement, there will be an increase in EBITDA and an increase in finance costs (Francesca, Alberto & Ogliari Matteo, 2018). Although in the income statement the entry for "operating expenses" is changed to "depreciation and interest", this does not change the total, which means that it does not affect the profit for the year (Olivo et al., 2022).

The changes in the way of recording lead to changes in the data, and Selcuk and Nevzat (2019) argue that many financial ratios change significantly as a result. Specifically, Díaz, Ramírez (2018) and Belesis et al. (2021) support that this would have a systematic impact on leverage and quick ratios. Leverage measures deteriorated significantly (Ireneusz, Bartosz & Marek, 2022). Giner, Merello & Pardo (2019) confirm that debt maturity, liquidity and return on assets will fall and leverage and return on equity will rise in 2019, but that these figures will not change materially after 2019.

Moreover, according Olivo et al. (2022.), Eidy et al. (2021) and Raoli (2021), company value, capital structure, economic performance and market reactions will also receive the impact of the new model.

4.1.2 Adoption in Tesco 2019 Annual Report

In balance sheet, IFRS 16 increases the right of use assets about £7.7 billion (part of these is included previously in PP&E). New lease liabilities are about £10.5 billion, which include some finance lease liabilities previously included in borrowings. The £36 million increase of borrowings in current liabilities is because of the discounted operating lease commitments. However, the net assets have changes from £14,8 billion to £13.5 billion. In income statement, the operating profit/loss increase £496 million. And the decrease of £ 57 million of profit/loss before tax is affected by four factors, rental charge, additional depreciation, additional net interest charge and other net gains/loss. The restated figures show an increase in assets and liabilities as experts had predicted.

After calculating financial ratios of Tesco, the direction of change in these ratios is largely in line with the findings of previous studies, with current ratios falling and operating profit ratios rising. Increases in L/E ratio and L/A ratio mean higher profitability and higher risk of loss for investors. However, the size of the impact of the new model varies from the size of the share of leasing in the business strategy. Beyond this, current ratios are affected by other factors. In Tesco (retail), consumers usually buy products with cash or credit cards and supply agreements often exist with suppliers increasing interest-free debt, which means that money is received quickly and paid slowly. Its current ratio is lower than other sectors. After taking into account the characteristics of the industry, the new model calculation for leasing will have some impact on the financial ratios, but the impact is not as significant as one might expect.

Table 1. The impact on Tesco's financial ratios

Ratios	Before restated	After restated	Change%
Current ratio	0.61	0.60	-2.28%
L/E ratio	2.30	3.22	39.64%
L/A ratio	0.70	0.76	9.39%
Operating profit ratio	3.37%	4.14%	22.85%

Because depreciation on the right of use asset is calculated on a straight-line basis, lease interest is higher at the beginning and decreases over time. It dilutes earnings per share (EPS) in the earlier lease term and increases EPS towards the end of the lease.

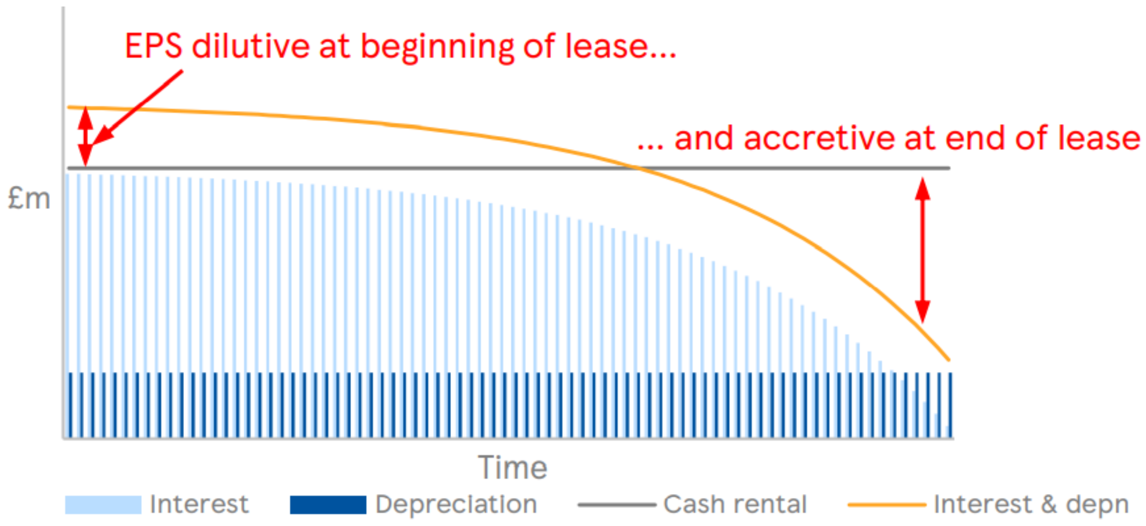

Figure 2. 20 years lease with fixed annual rentals (Tesco, 2019)

4.2 Effects to Users

4.2.1 Theoretic Research

According to Tănase et.al (2018) and Singh (2012), for managers of companies, IFRS 16 may affect future transaction decisions and the setting of executive compensation contracts, but business fundamentals will not change as a result. For investors, the new rules may change estimates of the cost of debt, the weighted average cost of capital and the valuation of a business, which may affect whether to continue to invest (Камбурова & Лиляна, 2019). According to Kints, Spoor (2019), Maglio et al. (2018) and Saxena (2015) for lessees, combining two types stifle any attempt to hide lease liabilities off-balance sheet. Moreover, the accounting treatment under the new rules reduces the cost of comparing different investments (Pardo & Giner, 2018).

However, the results of calculating two identical leases for two businesses may differ significantly because of the subjective nature of many aspects of the new rules. (Maiona, 2017) The implementation of IFRS 16 has increased the level of financing frictions, resulting in a reduction in the value of companies using high levels of operating leases, which deceases the value of future investment. (Jin, 2022)

4.2.2 The Analysis of Tesco

For the managers, this paper predicts that the changes in financial information resulting from the implementation of the IFRS 16 would have an impact on the strategy of lease portfolio. Due to the first effective implementation of the new principle starts in FY2020 (Tesco, 2020), Tesco's annual reports for 2017-2021 are selected for analysis in this paper (retrospective restatement in 2019). The percentage of leases which are greater than one year but less than five years decreases and the percentage of leases greater than 5 years increases. Changes in the percentage may be related to the implementation of the new policy, but they are also influenced by other factors, such as the calculation way, the COVID-19, etc. By comparing the previous data and restated data in 2019, it can be seen that even if the actual leasing acts occurring are the same, the situation of the percentage of each kind of contract will be different because of the diverse recording methods. Moreover, the variation is large, all charge above 14%. Therefore, this paper cannot define the original prediction that the IFRS 16 has a significant impact on the shape of lease term portfolio.

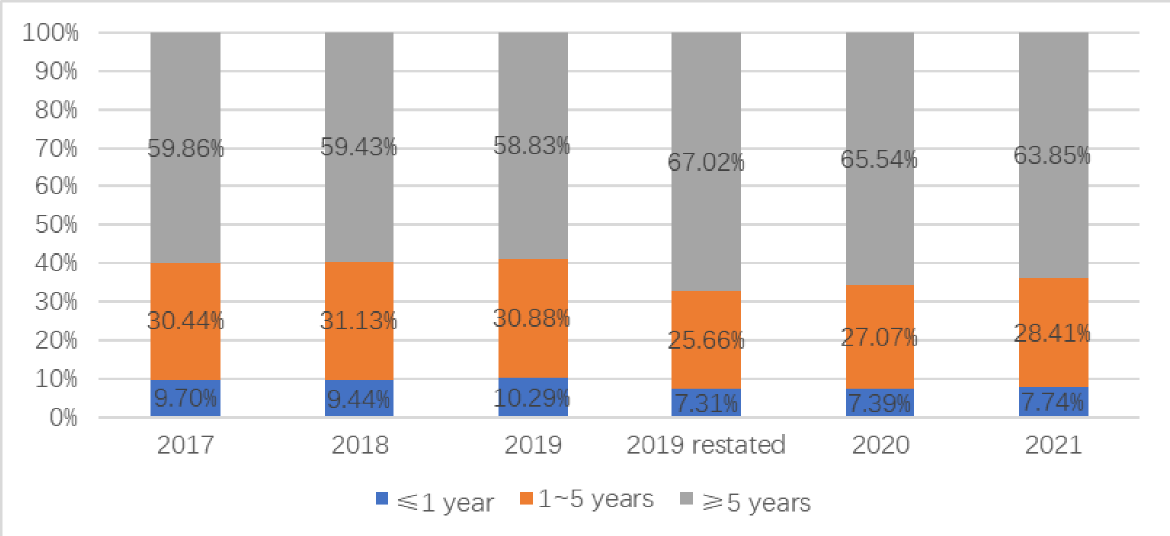

Figure 3. 2017-2021 Maturity analysis – contractual undiscounted lease payments-lease labilities

Investors look at annual reports to help them decide whether to continue with their investments. After comparing Tesco's annual reports from 2017-2021, it is found that there are some changes in the headings (Appendix E & F). The new disclosure approach provides more detailed disclosure in two identities instead of the old approach where only approximate operating leases were disclosed and where lessor economic leases were not disclosed. The second subtitle is categorised by identities assist readers quickly locating the part they want to know about (as a lessor or a lessee). For investors who want to understand the leasing section of Tesco, the data is more detailed and facilitates a grasp of the leasing situation. However, the greater figures disclosed, the higher level of expertise required, which means that it makes investors who do not have an abundant economic knowledge to understand connotations more difficultly. It can be seen that the usefulness of the financial information in the lease section is directly linked to the professional quality of the reader.

5. Conclusion

IFRS 16 was adopted by the IASB to provide greater uniformity in lease accounting standards and to improve the transparency of lease information, thereby providing a better analytical role for users of financial information. In this paper, the features and differences of the new model are discussed by comparing them with IAS 17. Tesco is selected to analyse the actual practice of its financial statements applying IFRS 16 to test whether it is in line with academic theoretical research. However, as only one company has been selected as a case study for analysis in this paper, the focus is on comparing the 2019 annual report before and after the restatement mixed with the last five years of annual report disclosure, as well as external influential factors (COVID-19). Therefore, the current conclusions may not be applicable to future years and different companies in different sectors. But since the retail sector, where Tesco is located, is relatively more affected by the new model, this case can be used as a reference for other companies to help them make expedients of passing through the policy transition period and how to better run their companies. In the future, companies from different industries and more data should be selected for analysis to gain further insight into the application of IFRS 16.

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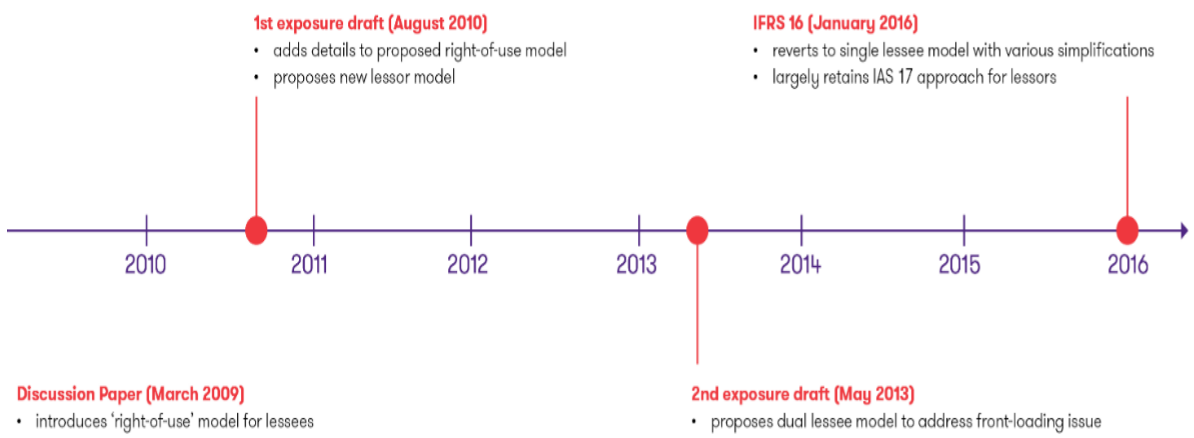
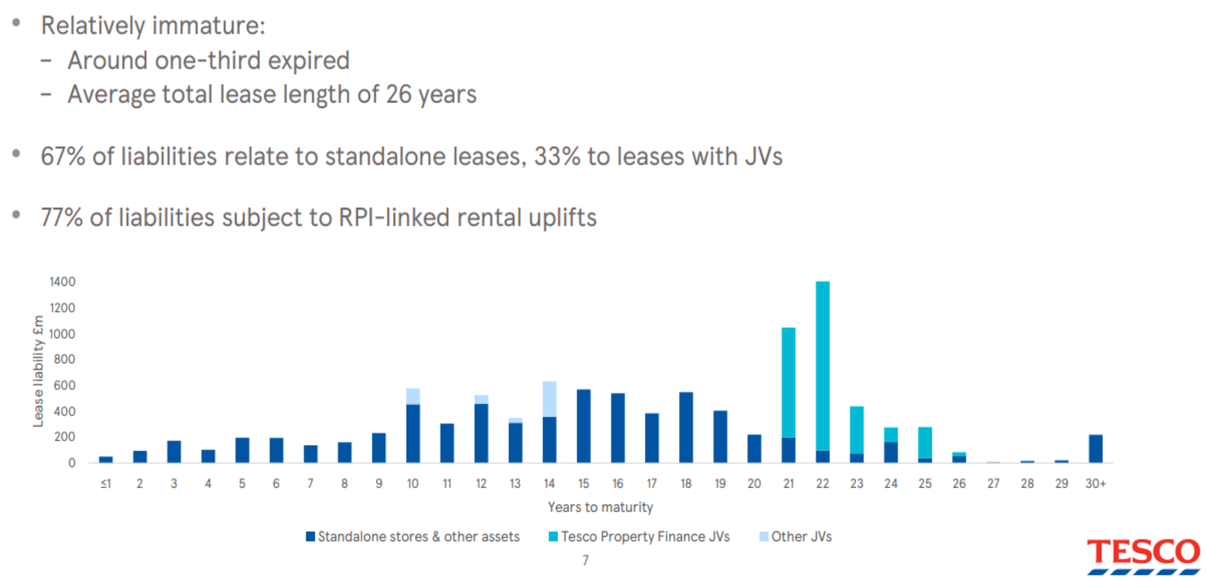
Appendix

A. The timeline of IFRS 16 (Grant Thornton, 2018)



B. Tesco lease portfolio (until 2019)



C. Restated balance sheet for 23 February 2019

Balance sheet restatement

	As at 23 February 2019			As at 24 February 2018		
	Reported £m	IFRS 16 impact £m	Restated £m	Reported[a] £m	IFRS 16 impact £m	Restated £m
Non-current assets						
Goodwill and other intangible assets	6,264	–	6,264	2,661	–	2,661
Property, plant and equipment	19,023	163	19,186	18,521	191	18,712
Right of use assets	–	7,713	7,713	–	7,527	7,527
Investment property	36	–	36	100	–	100
Investments in joint ventures and associates	704	(38)	666	689	(35)	654
Financial assets at fair value through other comprehensive income	979	–	979	860	–	860
Trade and other receivables	195	48	243	186	31	217
Loans and advances to customers and banks	7,868	–	7,868	6,885	–	6,885
Derivative financial instruments	1,178	–	1,178	1,117	–	1,117
Deferred tax assets	132	119	251	116	285	401
	36,379	**8,005**	**44,384**	**31,135**	**7,999**	**39,134**
Current assets						
Financial assets at fair value through other comprehensive income	67	–	67	68	–	68
Inventories	2,617	–	2,617	2,264	–	2,264
Trade and other receivables	1,640	(90)	1,550	1,504	(89)	1,415
Loans and advances to customers and banks	4,882	–	4,882	4,637	–	4,637
Derivative financial instruments	52	–	52	27	–	27
Current tax assets	6	–	6	12	–	12
Short-term investments	390	–	390	1,029	–	1,029
Cash and cash equivalents	2,916	–	2,916	4,059	–	4,059
	12,570	**(90)**	**12,480**	**13,600**	**(89)**	**13,511**
Non-current assets classified as held for sale	98	–	98	149	–	149
	12,668	**(90)**	**12,578**	**13,749**	**(89)**	**13,660**
Current liabilities						
Trade and other payables	(9,354)	223	(9,131)	(8,994)	221	(8,773)
Borrowings	(1,599)	36	(1,563)	(1,479)	12	(1,467)
Lease liability	–	(646)	(646)	–	(712)	(712)
Derivative financial instruments	(250)	–	(250)	(69)	–	(69)
Customer deposits and deposits from banks	(8,832)	–	(8,832)	(7,812)	–	(7,812)
Current tax liabilities	(325)	–	(325)	(335)	–	(335)
Provisions	(320)	94	(226)	(544)	128	(416)
	(20,680)	**(293)**	**(20,973)**	**(19,233)**	**(351)**	**(19,584)**
Net current liabilities	**(8,012)**	**(383)**	**(8,395)**	**(5,484)**	**(440)**	**(5,924)**
Non-current liabilities						
Trade and other payables	(384)	19	(365)	(364)	–	(364)
Borrowings	(5,673)	93	(5,580)	(7,142)	110	(7,032)
Lease liability	–	(9,859)	(9,859)	–	(9,560)	(9,560)
Derivative financial instruments	(389)	–	(389)	(594)	–	(594)
Customer deposits and deposits from banks	(3,296)	–	(3,296)	(2,972)	–	(2,972)
Post employment benefit obligations	(2,808)	–	(2,808)	(3,282)	–	(3,282)
Deferred tax liabilities	(236)	187	(49)	(96)	14	(82)
Provisions	(747)	600	(147)	(721)	592	(129)
	(13,533)	**(8,960)**	**(22,493)**	**(15,171)**	**(8,844)**	**(24,015)**
Net assets	**14,834**	**(1,338)**	**13,496**	**10,480**	**(1,285)**	**9,195**
Equity						
Share capital	490	–	490	410	–	410
Share premium	5,165	–	5,165	5,107	–	5,107
All other reserves	3,798	(21)	3,777	735	(18)	717
Retained earnings	5,405	(1,317)	4,088	4,250	(1,267)	2,983
Equity attributable to the owners of the parent	**14,858**	**(1,338)**	**13,520**	**10,502**	**(1,285)**	**9,217**
Non-controlling interests	(24)	–	(24)	(22)	–	(22)
Total equity	**14,834**	**(1,338)**	**13,496**	**10,480**	**(1,285)**	**9,195**
APMs						
Net debt[b]	(2,863)	(10,341)	(13,204)	(2,625)	(10,114)	(12,739)
Total indebtedness[c]	(12,200)	(3,342)	(15,542)	(12,284)	(3,183)	(15,467)

[a] After restating for the adoption of IFRS 15 'Revenue from Contracts with Customers'.

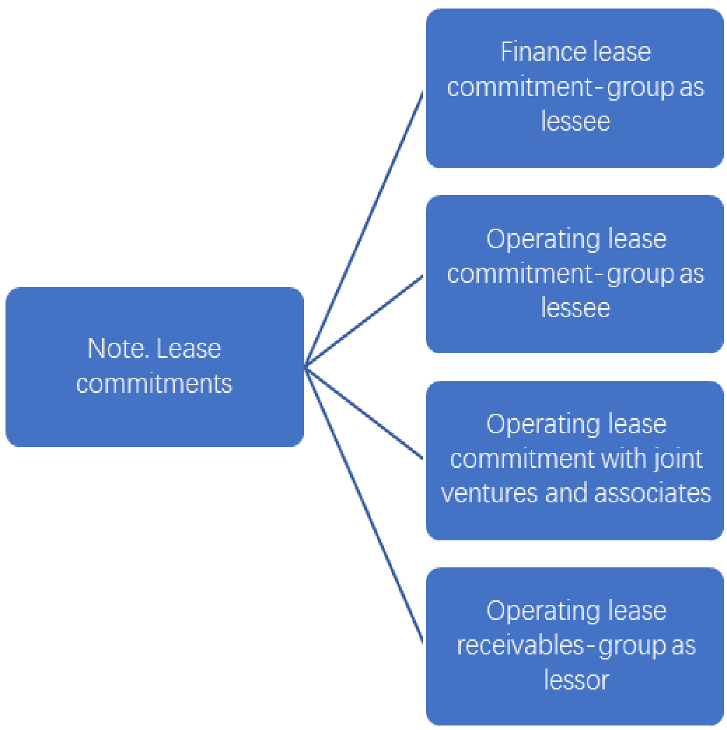
[b] Net debt comprises bank and other borrowings, lease liabilities, net derivative financial instruments, joint venture loans and other receivables/payables, offset by cash and cash equivalents and short-term investments. It excludes the net debt of Tesco Bank, which has lease liabilities of £35m (2018: £36m).

[c] Total indebtedness pre-IFRS 16 comprises Net debt plus the IAS 19 deficit in the pension schemes (net of associated deferred tax) plus the present value of future minimum lease payments under non-cancellable operating leases. Post-IFRS 16, lease liabilities are included in Net debt, replacing the present value of future minimum lease payments under non-cancellable operating leases.

D. Restated income statement for 23 February 2019

	52 weeks ended 23 February 2019 (reported)			IFRS 16 impact			52 weeks ended 23 February 2019 (restated)		
	Before exceptional items and amortisation of acquired intangibles £m	Exceptional items and amortisation of acquired intangibles £m	Total £m	Before exceptional items and amortisation of acquired intangibles £m	Exceptional items and amortisation of acquired intangibles £m	Total £m	Before exceptional items and amortisation of acquired intangibles £m	Exceptional items and amortisation of acquired intangibles £m	Total £m
Continuing operations									
Revenue	**63,911**	**–**	**63,911**	**–**	**–**	**–**	**63,911**	**–**	**63,911**
Cost of sales	(59,695)	(72)	(59,767)	394	95	489	(59,301)	23	(59,278)
Gross profit/(loss)	**4,216**	**(72)**	**4,144**	**394**	**95**	**489**	**4,610**	**23**	**4,633**
Administrative expenses	(1,989)	(86)	(2,075)	7	–	7	(1,982)	(86)	(2,068)
Profits/(losses) arising on property-related items	(21)	105	84	–	–	–	(21)	105	84
Operating profit/(loss)	**2,206**	**(53)**	**2,153**	**401**	**95**	**496**	**2,607**	**42**	**2,649**
Share of post-tax profits/(losses) of joint ventures and associates	24	11	35	(3)	–	(3)	21	11	32
Finance income	22	–	22	3	–	3	25	–	25
Finance costs	(536)	–	(536)	(553)	–	(553)	(1,089)	–	(1,089)
Profit/(loss) before tax	**1,716**	**(42)**	**1,674**	**(152)**	**95**	**(57)**	**1,564**	**53**	**1,617**
Taxation	(413)	59	(354)	16	(9)	7	(397)	50	(347)
Profit/(loss) for the year	**1,303**	**17**	**1,320**	**(136)**	**86**	**(50)**	**1,167**	**103**	**1,270**
Earnings/(losses) per share from continuing and discontinued operations									
Basic			13.65p			(0.52)p			13.13p
Diluted			13.55p			(0.51)p			13.04p
Earnings/(losses) per share from continuing operations									
Basic			13.65p			(0.52)p			13.13p
Diluted			13.55p			(0.51)p			13.04p
KPIs and APMs									
Operating margin			3.5%			0.6%			4.1%
Diluted adjusted EPS			15.40p			(1.39)p			14.01p

E. The structure of 'lease part' in 2017 & 2018 & 2019 annual report



F. The structure of 'lease part' in 2020 & 2021 annual report