

EVALUATION OF THE APPLICABILITY OF INTERNATIONAL FINANCIAL REPORTING STANDARD 16 (LEASES) ON FINANCIAL PERFORMANCE OF COMPANIES IN NIGERIAN

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Abstract

This study evaluates the applicability of adopting International Financial Reporting Standard 16 (Leases) and its possible effect on the financial performance of Nigerian companies. The study which employed the use of empirical literature to draw its conclusion found out that IFRS 16 adoption would go a long way in improving the financial performance of companies in Nigeria. It also found out that ROA and CR may look unfavourable in a short run but in a long run all financial performance indicators may improve. Therefore, the research recommends that firms should apply the improvement on the standard requiring capitalisation of all types of leases as result suggests that performance is improved through capitalisation of leases, also small firms are stimulated to finance their assets through lease financing because size does not dissuade them from realising the benefit of adopting the new standard.

Keywords: IFRS 16, Capitalisation, Financial performance, Operating lease, Finance lease, JEL Classification: M41

Introduction

In August 2010 the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) published for public comment joint proposals to improve the reporting of lease contracts. The proposals are one of the main projects included in the boards Memorandum of Understanding. The proposals, if adopted, will greatly improve the financial reporting information available to investors about the financial effects of lease contracts (IFRS, 2010). The accounting under existing requirements depends

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on the lease being classified as operating or finance. Classification as an operating lease results in the lessee not recording any assets or liabilities in the statement of financial position under either IFRS or US GAAPs. The proposals would result in a consistent approach to lease accounting for both lessees and lessors a right-of-use approach. This approach would result in all leases being included in the statement of financial position, thus providing complete and useful information to investors and other users of financial statements.

Moreover, in January 2016 the outcome of the exposure draft issued emerged and the International Accounting Standards Board (IASB) published a new standard, IFRS 16 (Leases). The new standard brings most leases on-balance sheet for lessees under a single model, disregarding the discrepancy between operating and finance leases. Lessor accounting, however, remains largely unchanged and the difference between operating and finance leases is retained. IFRS 16 displaces IAS 17 (Leases) and related explanations and is operational for periods beginning on or after 1 January 2019.

Leasing is an alternative means of financing plant, equipment and business vehicles. It is a contract between an owner of equipment (the lessor) and another party (the lessee) giving the lessee possession and use of a specific asset in return for payment of specific rentals over an agreed period (Kurfi, 2005). The lessee may or may not be entitled to acquire title to the goods through the exercise of an option to purchase, usually at the end of the lease term. The lessor's role is to finance the acquisition of equipment required by the lessee who will have selected the goods and dealt directly with the supplier in determining their performance attributes and suitability (Salam, 2013). International Financial Reporting Standard 16 (IFRS 16) defines a lease as a contract that conveys to the customer ('lessee') the right to use an asset for a period of time in exchange for consideration. A company assesses whether a contract contains a lease on the basis of whether the customer has the right to control the use of an identified asset for a period of time. The requirements relating to the definition of a lease in IFRS 16 have been changed somewhat from those in International Accounting Standard (IAS) 17 in response to feedback received. However, those changes are not expected to affect conclusions about whether contracts contain a lease for the vast majority of contracts (a lease applying IAS 17 is generally expected to be a lease applying IFRS 16).

The IASB has concluded that the benefits of IFRS 16 outweigh the costs. IFRS 16 will result in a more faithful representation of a company's assets and liabilities and greater transparency about the company's financial leverage and capital employed. This is expected to reduce the need (i) for investors and analysts to make adjustments to amounts reported on a lessee's balance sheet

and income statement and (ii) for companies to provide ‘non-GAAP’ information about leases and secondly it will improve comparability between companies that lease assets and companies that borrow to buy assets. A company will more accurately measure assets and liabilities arising from leases applying IFRS 16 as compared to the estimates made by only more sophisticated investors and analysts when companies applied IAS 17. IFRS 16 is expected to facilitate better capital allocation by enabling better credit and investment decision-making by both investors and companies.

However, the significance of the implementation costs depends on the size of a company’s lease portfolio, the terms and conditions of its leases and the systems already in place to account for leases applying IAS 17. The IASB expects that companies with material off-balance sheet leases will incur costs to (a) set up systems and processes, including educating staff; (b) determine the discount rates used to measure lease assets and lease liabilities on a present value basis; and (c) communicate changes to reported information to external parties. Once a company has updated its systems to provide the information required by IFRS 16, the IASB expects costs to be only marginally higher compared to those incurred when applying IAS 17. The data required to apply IFRS 16 is similar to that needed to apply IAS 17, with the exception of discount rates that are required for all leases when applying IFRS 16.

Nigeria is Africa’s largest economy that been driven by oil and gas industry. Samaila (2014) stated that oil and gas industry is one of the vital industries in the world, largely because of its strategic role in every economy and the world at large. The distinctive features that characterised the industry are derived from the nature of crude oil, its operations and commercial arrangements. Total crude oil and condensate production for the year 2015 were 773,458,592 barrels giving a daily average of 2.12 mmb/pd. This is lower than the previous years by 3.14%. In the gas sector, a total of 2,929.85 Billion Standard Cubic Feet (BSCF) of Natural Gas production was reported. This shows an increase of 13.18% when compared with 2014 production. Of the quantity produced, 2,588.48 BSCF (88.35%) was utilised, while 341.37 BSCF (11.65%) was flared (Nigerian National Petroleum Corporation [NNPC], 2015).

Additionally, Nigeria has been a member of the Organisation of Petroleum Exporting Countries (OPEC) since 1971. According to International Monetary Fund (IMF, 2016), The Nigerian economy is facing substantial challenges. While the non-oil sector accounts for 90 percent of GDP, the oil sector plays a central role in the economy. Lower oil prices have significantly affected the fiscal and external accounts, decimating government revenues to just 7.8 percent of GDP and resulting in the doubling of the general government deficit to about 3.7 percent of GDP in 2015. Exports dropped about 40 percent

in 2015, pushing the current account from a surplus of 0.2 percent of GDP to a deficit projected at 2.4 percent of GDP. With foreign portfolio inflows slowing significantly, reserves fell to \$28.3 billion at end of 2015.

According to ELAN (2015) statistics show an impressive 27.39 percent growth in leasing activities. The volume of outstanding leases grew from N869 billion in 2014 to N1.1 trillion in 2015, and this was based on the developmental attributes of leasing which make it attractive during a boom or recession, as is currently the case. Several studies have been conducted on leasing and financial performance both in Nigeria and abroad, but the fact suggests that there is no significant empirical study in the literature on the effect of adopting the new standard on leasing (IFRS 16) on the financial performance of the business. In Nigeria researches on lease capitalisation are also very insignificant to talk of the new IFRS 16 “leases”. To the best of researchers know it is only a research by Bello and Sabo (2016) examined lease capitalisation and profitability. So, the evidence with regard to lease capitalisation and financial performance is scarce in the Nigeria. There are numbers of research conducted on the impact of adopting IFRS by the business world over but research on the adoption of the new standard on the lease is left out in the literature. Therefore this study will serve as a pioneering effort to evaluate the applicability of implementing the new IFRS 16 on the financial performance of companies in Nigeria.

Review of empirical studies

To get an insight of lease capitalisation impact on profitability, several studies have been conducted up to till date. But the fact suggests that most of the research has been conducted in foreign countries. There is no significant empirical study in the literature on lease capitalisation and financial performance of companies in Nigeria. It is only a research by Bello and Sabo (2016) examined lease capitalisation and profitability. So, the evidence with regard to lease capitalisation and profitability is scarce in the Nigerian economy. Therefore this study will serve as an extension of Bello and Sabo (2016) to examine the impact of implementing the new IFRS 16 on the financial performance of Nigerian oil marketing companies for the period 2005 to 2014.

Bello and Sabo (2016) examined the impact of operating lease capitalisation on the profitability of Nigerian oil and gas companies. The study revealed that operating lease capitalisation has a significant impact on profitability listed oil and gas companies in Nigeria. Moreover, Dillon (2014) examined the impact of operating lease capitalisation on key financial statement ratios and failure prediction indicators of South African companies listed on JSE. The research results confirm that capitalisation of operating lease commitments has a significant impact on both key financial statement ratios and Altman’s failure

prediction models for the South African companies studied, more especially leverage and other debt related ratios.

Similarly, Opperman (2013) assesses the impact of operating lease capitalisation on financial statements of listed companies in JSE. The study revealed that all ratios and other indicators evaluated showed an increase, except for the ROA indicator, which decreased by 2.14%. The most significant impacts were found on D/E ratio and EBITDA, which showed an increase of 12.54% and 11.76% respectively. The debt ratio (D/A) showed a moderate increase of 5.22%. PBT, which showed an increase of 3.02% and EPS, which showed an increase of around 3.6, were the least impacted by the operating lease capitalisation except for the impact on ROA, which is negative.

In addition, De Villiers & Middleberg (2013) determine the impact of operating lease capitalisation on the financial statements and the resulting financial ratios of the JSE Top 40 companies. The study revealed that the capitalising of long-term operating leases will have a significant effect on the key financial ratios that are used to interpret a company's financial performance. Furthermore, Gates (2013) examine and discuss whether the result of the lease capitalisation had a material effect on the financial position of companies. The research found out that EBITDA and ROA are positively affected while CR is negatively affected.

In the same vein, Branswijck & Longueville (2011) investigated the financial impact of adoption of lease capitalisation on listed companies in Belgium and Netherlands for the year 2008. The research found out that D/E ratio is positively affected; ROA and EBITDA do not change while CR is negatively signed. Furthermore, Bostwick, Fahnestock & O'keefe (2011) examined the effect of lease capitalisation on key measures of financial performance for five (5) major U.S. corporations. The study established that operating lease capitalisation has a positive impact on major financial performance indicators of major U.S. corporations.

Additionally, PwC (2010) carried out a study to assess the impact of operating lease capitalisation on the financial statements and key financial ratios of sampled 125 listed telecom companies from 32 countries. The study identifies the minimum impact of capitalising the operating lease commitments disclosed in the published financial statements. In view of the proposed inclusion of likely lease renewals, contingent rentals and residual value obligations the eventual impact may be much greater and may also impact the amounts currently recognised for finance leases. EBITDA will increase as a result of the replacement of operating lease expense by depreciation and interest expense. For 22% of the telecom companies, the increase in EBITDA

is expected to be between 10% and 25%, for 13%, more than 25%. From a balance sheet perspective, the debt to equity ratio is an important ratio for many companies. Based on the study it was concluded that the ratio is expected to increase by more than 10% for more than 50% of the telecom companies and more than 25% for at least 25% of these companies. The combined effect of increasing debt and interest expenses, combined with an increase in EBITDA on a telecom company's EBITDA/interest ratio, is uncertain. For 28% of the companies in the study, the combined impact is positive. For 45%, however, the impact is more than 5% negative, for 18% of these, the impact is more than 20%.

Similarly, Mulford, Turner & Singh (2007) examined the relationship between lease capitalisation, financial agreements and EBITDA. The study revealed that after capitalisation of operating leases EBITDA will look more favourable. Moreover, Lipe (2001) investigate the lease accounting research and the G4+1 proposal to lease accounting. The study found out that EBITDA is positively affected by implementing the proposal of capitalising the operating leases.

However, CFO (2012) assesses the impact of the new lease accounting standard. The study revealed that EBITDA, ROA and D/E ratio are negatively affected but the negative impact on EBITDA was found to be temporary while CR was positively impacted. In the same vein, Tang and Fiedler (2010) investigated the implications of lease capitalisation to financial ratios in the context of lease accounting. The result of the study established that, after lease capitalisation, the figures looked less favourable, return on assets (ROA) became lower; the debt ratio became higher and also Companies that relied primarily on leasing appeared to be in a more favourable financial position prior to lease capitalisation. Once the leases were capitalised, they were generally in a less favourable financial position than the companies which purchase the assets. Moreover, Shea (2009) evaluated the impact of changes in the lease rules of lease accounting on earnings, debt covenants, compensation arrangements and earn-out agreements. The study found out that EBITDA increases due to capitalisation while the income statement, in general, is negatively affected in early years but positively signed in later years.

Fulbier, Silva and Pferdehirt (2008) examine the impact of lease capitalisation on financial ratios of listed German companies for two years (2003 and 2004). The study sampled 90 companies belonging to the three major German indices DAX 30, MDAX, and SDAX. They collected data from consolidated financial statements for the years (2003 and 2004) and examine the capitalisation impact on key financial ratios. The result of the study shows a material

capitalisation impact for a considerable number of companies, especially for the fashion and

Research Model

Changes in financial ratios occur primarily in assets and liability relations, but it was observed that minor effects on the profitability ratios and market multiples often used for valuation purposes. Since these effects may indicate higher operating and financial risk as well as tightened debt covenants, the new approach may provide management with incentives to dampen its impact. In contrast, the impact on valuation and compensation (and their respective incentives) seems low, due to small changes in profitability ratios and valuation multiples. In addition, Mulford and Gram (2007) examined the effects of lease capitalisation in the financial statements on key measures of performance and financial position. The research discovered that lease capitalisation does not have a significant impact on ROA and ROE.

Based on the nature of results obtained from researchers so far discussed, the prediction of the impact of IFRS 16 adoption on financial performance is, therefore, ambiguous. But it is clear that capitalising operating lease will increase the total assets of the business. The expenses aspect of the financial statement can also be increased with depreciation; however, the decrease may also arise as a result of removing the interest on operating leases. Therefore, unless if an increase in profit is more than proportionate to an increase in the total assets as a result of operating lease capitalisation ROA and CR may decrease while ROE and EBITDA may increase. It's therefore eminent to note that operating lease capitalisation may increase financial performance of the business in a long run.

Based on the literature reviewed so far the study proposed the following model presented in Equations (1) and (2) below. The dependent variable (financial performance is proxied by profitability and liquidity) of the two Equations are defined by earnings before interest, tax, depreciation and amortisation (EBITDA), Return on Asset (ROA), Return on Equity (ROE) and the Current ratio (CR). These measures are considered to be the most effective way of assessing the financial performance of businesses (Rehman, 2013; Kelly, Khayum & price, 2013, Helfert, 2011; D'Amato, 2010; Radut & Biclesanu, 2008; Alan, 2008). On the other hand the natural logarithm of the sum of the operating lease and finance leases amounted to the independent variable for the study, size (measured by natural logarithm of total assets) after adding operating leases is added to the model as a control variable, such control is essential because the bigger the company, the larger the expected lease asset volume will be (Malik, Saeed, Ahmed & Javed, 2012) and debt (measured by debt ratio) is also added to the model as another control variable as used by Deloof, Lagaert and Verschuere (2007); Yan, (2006) and Beattie,

Goodacre and Thomson (2000) where a negative relationship between debt and leasing was found while Malik, Saeed, Ahmed and Javed (2012); Einfeldt and Rampini (2009) and Tsay (2003) established a complementary relationship between leasing and debt.

For the purpose of this study the following linear regression equations are used as adopted with modification from the researches by Orabi (2014); Malik, Saeed, Ahmed & Javed (2012):

$$\text{EBITDA} = \alpha + \beta_1 \text{LFac}_{it} + \beta_2 \text{SZac}_{it} + \beta_3 \text{DT}_{it} + e_{it} \dots\dots\dots (1)$$

Where:

EBITDA = Earnings Before Interest, Tax, Depreciation and Amortisation

LFac = Capitalised lease (natural logarithm of (finance + operating lease))

SZac = Size after capitalisation (Natural log of (Total assets + operating lease))

DT = Debt (Total debt to Total assets)

α = the constant

β = the coefficient

e = Random error term

$$\text{ROA} = \alpha + \beta_1 \text{LFac}_{it} + \beta_2 \text{SZac}_{it} + \beta_3 \text{DT}_{it} + e_{it} \dots\dots\dots (2)$$

Where:

ROA = Return on Assets

LFac = Capitalised lease (natural log of (finance + operating lease))

SZac = Size after capitalisation (Natural log of (Total assets + operating lease))

DT = Debt (Total debt to Total assets)

α = the constant

β = the coefficient

e = Random error term

$$\text{ROA} = \alpha + \beta_1 \text{LFac}_{it} + \beta_2 \text{SZac}_{it} + \beta_3 \text{DT}_{it} + e_{it} \dots\dots\dots (3)$$

Where:

ROA = Return on Equity

LFac = Capitalised lease (natural log of (finance + operating lease))

SZac = Size after capitalisation (Natural log of (Total assets + operating lease))

DT = Debt (Total debt to Total assets)

α = the constant

β = the coefficient

e = Random error term

$$\text{CR} = \alpha + \beta_1 \text{LFac}_{it} + \beta_2 \text{SZac}_{it} + \beta_3 \text{DT}_{it} + e_{it} \dots\dots\dots (4)$$

Where:

CR = Current ratio (Current Asset/Current Liabilities)

LFac = Capitalised lease (natural logarithm of (finance + operating lease))

SZac = Size after capitalisation (Natural log of (Total assets + operating lease))

DT = Debt (Total debt to Total assets)

α = the constant

β = the coefficient

e = Random error term

Conclusion and recommendation

The study found out that that adoption of IFRS 16 has a significant influence on the financial performance companies. Therefore, capitalising all operating leases will improve the financial performance of businesses. Evidence suggests a positive relationship between lease capitalisation, liquidity and profitability which suggested that capitalisation of all type of leases could improve financial performance.

The study recommends that firms should adopt the new standard requiring lessees to capitalise all leases that have tenure of more than 12 months as evidence suggests that value is added through capitalisation of operating lease. It also recommends that small firms should engage in leasing as an alternative means of financing their assets since the study revealed that size of the firm and capitalised lease have a negative relationship.

It further recommends that, to validate the above conclusions data should be collected from annual reports and accounts of companies and such data be analysed empirically. To achieve this, operating leases should be added to total assets, interest charge on operating lease be removed, depreciation to be added to total expenses to the tune of the operating lease so capitalised using the companies method of depreciation. Therefore, this study serves as an eye opener in regards adoption of the new standard on leases (IFRS 16) to academics and actors in both private and public sector that are involved in lease activities.

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