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IFRS 16

With IFRS 16's new rules on lease accounting coming into force in January 2019, how will a company's key financial metrics change?

What is IFRS 16?

IFRS 16 was issued in January 2016 and introduced significant changes to the way leasing transactions are reported. It replaced IAS 17 in January 2019.

The new regulation on lease accounting applies to how companies report contractual agreements that require one party (the lessee) to pay the owner of an asset (the lessor) for using it.

A lessee is now required to recognise assets and liabilities arising from a lease transaction on its balance sheet. The regulation introduces a single lessee accounting model without differentiating between the operating and finance leases.

There are two major exemptions to IFRS 16. If the lease has a maximum term of 12 months or represents an asset worth up to $5,000 when new, then IFRS 16 does not apply. All other leases will be affected.

What is the difference between operating and finance leases?

There are two main types of lease: finance and operating. Before the introduction of IFRS 16, finance leases were treated like debt, whereas operating leases were treated similar to renting an asset.

Finance leases are characterised by a transfer of asset-ownership risks and rewards to the lessee. It is an agreement between the lessor and the lessee for most or all of the asset's expected life. The lessee is responsible for maintaining the asset and must repay the full cost of the asset as well as the interest to the lessor.

In turn, operating leases are rental agreements where the lessor retains most of the risks and rewards of ownership. The lessor is responsible for maintaining the asset and the lease period is typically much shorter than the expected economic life of the asset. Operating lease payments were previously recognised as part of the operating expenses of the lessee.

IFRS 16 now requires a lessee to recognise assets and liabilities on its balance sheet for all leases. Lease assets are measured similarly to other non-financial assets (such as PP&E) and lease liabilities similarly to other financial liabilities.

Assets and liabilities arising from a lease are initially measured on a present-value basis; in most cases the initial lease asset equals the lease liability. The immediate result of IFRS 16 for a lessee will be a richer balance sheet, but also a larger recorded debt position.

What does IFRS 16 mean for a company's key financial metrics?

The other major change IFRS 16 brings is on the income statement rather than the balance sheet. A lessee now has to recognise the depreciation of the right-of-use lease asset as well as interest on the lease liability. This may alter a number of financial ratios and metrics, especially for companies that previously used operating leases.

In particular, earnings before interest, tax, depreciation and amortisation (EBITDA) are likely to increase because operating lease payments that were previously recorded as operating expenses will now be reflected through the higher depreciation charge and interest payments on the P&L. However, the impact on the bottom line should be broadly neutral.

Gearing, commonly calculated as a ratio of interest liabilities to equity, may also increase due to the recognition of all leases as part of financial liabilities.

Operating cash flows may rise due to lease payments now being part of the interest expense rather than operating costs.

However, some metrics are likely to fall. For example, asset turnover (sales to total assets) is likely to decrease as leases will now be recognised as part of a company's total assets.

> 'In 2005, the US Securities and Exchange Commission (SEC) estimated that US public companies may have approximately US$1.25tn of off-balance sheet leases. Responding to concerns about the lack of transparency of information about lease obligations, the IASB and FASB initiated a project to improve the accounting for leases.'
> International Accounting Standards Board (IASB)

02/07/19

As a reporting standard, IFRS 16 does not directly affect a company's operations, just the way a company reports its financial assets and liabilities. That said, there are some potential real-life effects.

For one, the introduction of IFRS 16 may break certain loan covenants (financial conditions placed on borrowers), especially relating to EBITDA or net interest.

That said, we expect both EBITDA and net interest to increase but have a neutral impact on net debt/EBITDA ratios. Further, we note that certain provisions are usually in place to allow previous accounting rules to apply even after standards change.

IFRS 16 might also shift tax brackets in certain jurisdictions, depending on how local rules define thresholds and treat taxation on leases. There is also some potential for FX volatility, as some lease assets and liabilities in foreign currencies may have previously been unrecognised on the balance sheet.