IFRS 16 – fundamentals unchanged, transparency boosted

Although Q1 EBITDA is likely to surprise positively at companies reporting under IFRS, our stance on the Redeye coverage universe is unchanged as fundamentals will be unaffected. Nonetheless, as the adoption of IFRS 16 will improve transparency and comparability, the new standard is potentially supportive for our bull cases.

IFRS 16 will require companies to cease off-balance sheet financial reporting for leases classified as operating. The consequence will be improved EBITDA, but higher indebtedness and lower EPS in the early years of a lease.

Office rentals will be booked as a liability with a corresponding asset on the balance sheet. Instead of a pure operating cost, the rent will now be captured in the depreciation and financial expenses line items. For companies with substantial lease contracts, such as those with major premise rentals, these changes are likely to be significant.

Below we illustrate the new standard's impact across the income statement.

Debt	↑
Asset	↑
Debt/Equity ratio	↑
Equity/Assets	↓
Asset Turnover	↓

Expense for rent	↓
Depreciation	↑
Interest (expense)	↑
EBITDA	↑
EPS (first year)	↓

Cash from operating activities	↑
Cash from financing activities	↓
Total cashflow	↔

Even so, these presentational changes should have no real impact on companies' underlying earnings, cash flow or financial risk. Accordingly, share prices should not respond to the 'fake news' – but investors should be ready to lighten positions in stocks where they have lower conviction in the event of any rally.

Lease accounting into the 21st century

IFRS 16 requires almost all lease agreements to be recognised in the balance sheet. As a result, office and store rentals will also now be found there.

"These new accounting requirements bring lease accounting into the 21st century, ending the guesswork involved when calculating a company's often-substantial lease obligation. The new standard will provide much-needed transparency on companies' lease assets and liabilities, meaning that off balance sheet lease financing is no longer lurking in the shadows. It will also improve comparability

between companies that lease and those that borrow to buy." Hans Hoogervorst, chairman of IASB.

The now superseded IAS 17 classified leasing agreements as either finance (on-balance) or operating (off-balance). IFRS 16 treats all lease agreements equally by recognising them in the balance sheet. This on-balance sheet accounting model is similar to the way finance leases were treated under IAS 17. The overall effect will be to make the accounting treatment similar to a situation where a company finances an investment with a loan.

Balance sheet impact

Balance sheets will now show a liability representing the obligation to make lease payments. They will also show an asset that is the 'right-of-use' of the underlying asset.

The new accounting treatment will raise the debt to equity ratio and reduce equity/assets. Asset turnover will decline too.

P&L impact

IFRS 16's main P&L impact compared to IAS 17 is lower rent expense and higher depreciation. This is a result of depreciating the 'right-of-use' asset over the lease term or its useful life instead of simply recognising the lease invoices in the P&L as rent. The new treatment will increase EBITDA since expenses are pushed further down in the P&L.

Financial expenses will also increase somewhat due to the recognition of interest on the new liability. Interest expense will decrease over time with the reduction of the lease liability, which means that the total lease expense will be front-loaded. The implication of this is that earnings per share will be lower in a lease portfolio's earlier years.

Cash flow statement impact

Total cash flow is unaffected by new accounting principles, of course. However, the new perspective on lease payments as payment of interest and repayment of the lease liability, instead of as an operating expense, has the effect of increasing cash flow from operating activities, while reducing cash flow from financing activities by a corresponding amount.

Measurement of the lease liability/asset

	Initial measurement	Subsequent measurement
Liability	Present value of the lease payments over the lease term	Similar to the effective interest method. The liability is reduced with the payments made and increased with the interest expense. The liability can also be increased by extensions of lease terms that were not previously included in the liability.
Asset	Initial measurement of the liability adjusted for lease pre-payments, incentives received, initial direct costs and the estimate of restoration, removal and dismantling costs.	Depreciation, impairment test, and impact of re-measurements of the liability, such as on term extensions not previously included.

Other factors to consider

- The lease term includes not only the non-cancellable period but also extensions that are reasonably certain. The amounts capitalised may be materially affected by companies' judgements of what is 'reasonably certain'. This judgement is made initially and then re-estimated only in special situations.
- Most leases are discounted at the entity's incremental borrowing rate, for a loan of similar term and with the underlying asset as security.
- Some components should be separated and excluded from the lease liability and asset (cleaning, insurance and tax, for example).
- Short-term leases (terms less than 12 months) may be excluded.
- Leases of assets of low value (USD 5,000) may be excluded.
- Variable lease payments that depend on usage, such as sales-based rents, are not included in the lease liability and asset
- Short-term lease payments, low-value asset lease payments and variable lease payments depending on usage continue to be recognised as expenses in the period when they arise. The annual expenses for each of these three types of lease payments are to be disclosed in the notes to the annual report.
- The amount of right-of-use assets and lease liabilities are either presented in the balance sheet or disclosed in the notes to the annual report.
- Companies can choose to either start using IFRS 16 from the beginning of 2019 without restating amounts for 2018 or to apply the standard retrospectively from the beginning of the first comparative period. Most companies will use the simplified method, meaning that amounts presented in the formal financial statements for 2018 and 2019 will not be comparable. Companies are free to provide comparable amounts in other parts of the financial report.
- Observable EV/EBITDA multiples will be affected – in different ways and to different extents for different companies. Peer analyses may indicate other conclusions than before.

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