

A New Lease of Life



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Sue Lloyd, a member of the International Accounting Standards Board® (the Board), discusses the changes to lessee accounting introduced by IFRS 16 *Leases*. The new requirements are a response to concerns expressed by investors and others about the lack of information about leasing transactions when companies applied previous accounting requirements.

Sir David Tweedie, the Board's previous chairman, is famously known for saying that one day he would like to fly on an airplane that actually appears on the airline's balance sheet. Well, get ready David—because your wish is about to come true! At long last the Board has changed the requirements for lease accounting. The new Standard, IFRS 16, supersedes the requirements in IAS 17 *Leases*. Companies are required to apply the new requirements from **1 January 2019**.¹

In this *Investor Perspectives* article, we discuss some of the key changes to financial statements that investors will see when companies apply the new lessee accounting requirements in IFRS 16. We also provide context for the new requirements by comparing them to former IFRS requirements and the future US GAAP requirements, including an illustrative example.²



IFRS 16 changes lessee accounting substantially. It will reduce the need for investors to make adjustments, by providing a richer set of information than was available when companies applied IAS 17, providing further insight into a company's operations and funding.

Why change lease accounting?

For many years we have been told that lease accounting does not meet investors' needs. Because the accounting applying IAS 17 depended on whether the lease qualified as an operating lease or a finance lease in the financial statements of lessees, some leases would end up on balance sheet while most would result only in rent expense in the income statement and no balance sheet items. As a result, over 85 per cent of all leases are estimated to be off balance sheet today. Investors would then often adjust the financial statements to recognise estimated assets and liabilities arising from off balance sheet leases, and would also often adjust EBIT or EBIDTA and interest. To address this issue we have substantially changed lessee accounting.

1 A company can choose to apply IFRS 16 before 1 January 2019 if it also applies the new revenue Standard IFRS 15 *Revenue from Contracts with Customers*.
2 US GAAP requirements for leases will also change. In this document we use 'US GAAP model' to refer to the decisions of the Financial Accounting Standards Board (FASB), the body responsible for setting Generally Accepted Accounting Principles in the United States (US GAAP), as at 31 December 2015.

What will change?

IFRS 16 eliminates the classification of leases as either operating or finance for lessees and, instead, introduces a single lessee accounting model. This model reflects that leases result in a company obtaining the right to use an asset (referred to in this article as the 'lease asset') at the start of the lease and, because most lease payments are made over time, also obtaining financing. As a result, the new Standard requires lessees to account for all of their leases in a manner similar to how finance leases were treated applying IAS 17.³ Applying IFRS 16, a lessee will:

- (a) recognise lease assets (as a separate line item or together with property, plant and equipment) and lease liabilities in the balance sheet;⁴
- (b) recognise depreciation of lease assets and interest on lease liabilities in the income statement; and
- (c) present the amount of cash paid for the principal portion of the lease liability within financing activities, and the amount paid for the interest portion within either operating or financing activities, in the cash flow statement.

What does this mean for investors?

From a practical perspective, there are a few important points that investors should bear in mind as they digest the implications of this change.

① Some sectors will be more affected than others:

some sectors that use off balance sheet leases extensively (for example, airlines, retailers, travel and leisure) will be affected more significantly by this change than other sectors. In addition, even within industries, some companies use off balance sheet leases more extensively than others and, thus, will be more affected.

② **Balance sheets will get bigger:** bringing these assets and liabilities onto the balance sheet means that companies with material off balance sheet leases will report higher assets and financial liabilities than they currently do.

We believe that the lessee accounting model in IFRS 16 is easy to understand. A lessee recognises assets and financial liabilities relating to its leases, and corresponding amounts of depreciation and interest. This will reduce complexity in financial statements. It will also allow comparisons to be made between those companies who lease assets and those who borrow to buy assets.

At a high level, this means that investors no longer have to estimate the assets and liabilities resulting from off balance sheet leases when, for example, calculating return on capital employed and leverage ratios. The new accounting will result in more information about leases both on the balance sheet and in improved note disclosures. It will also provide a more accurate reflection of the economics of leases in the financial statements.

In this article we provide you with information to help you understand the effects of the new lease requirements on companies' financial statements in preparation for the implementation of IFRS 16.

For more detailed information, see our

[Effects Analysis of IFRS 16](#).

What about lessors?

There is little change for lessors. Applying IFRS 16, a lessor continues to classify its leases as operating leases or finance leases and to account for those two types of leases differently. This is because we were told that the lessor accounting model in IAS 17 is not 'broken' and that the cost of making any substantial changes to lessor accounting would outweigh the benefits at the moment. Nonetheless, IFRS 16 requires lessors to provide enhanced disclosures about their risk exposure, particularly to residual value risk.

Convergence with US GAAP

The Board worked jointly with the US national standard-setter, the FASB, to improve lease accounting. The FASB expects to publish its new lease requirements in early 2016. The Board and the FASB have reached the same conclusions in many areas of lease accounting. However, different conclusions on lessee accounting were reached for some leases with respect to the recognition of expenses and the reporting of cash flows.

3 IFRS 16 includes two exemptions from recognising assets and liabilities for (a) short-term leases (ie leases of 12 months or less) and (b) leases of low-value items (such as personal computers).

4 These are initially measured at the present value of unavoidable lease payments. Note that these are not the underlying leased assets but the assets arising from the lease contracts.

The table below provides an overview of the lessee accounting requirements in IFRS 16, showing the similarities and differences between IFRS 16 and the forthcoming US GAAP model. For lessor accounting, like IFRS 16, US GAAP will be essentially unchanged.

		IFRS 16	US GAAP model ⁵	
			Former ON balance sheet leases	Former OFF balance sheet leases
Balance sheet				
1	Recognition	All leases on balance sheet	✓	✓
		Exemption for short-term leases	✓	✓
		Exemption for leases of low-value assets	✓	—
2	Measurement	Lease liabilities on a discounted basis	✓ ⁶	✓ ⁶
		Initial lease asset = lease liability	✓	✓
3		Depreciation of lease assets	Typically straight-line	Typically increasing ⁷
4 5	Presentation	Lease liabilities	IAS 1 ⁸	Separate presentation (from former off balance sheet leases)
		Lease assets	PPE or own line item ⁹	Separate presentation (from former on balance sheet leases)
Income statement				
6		Operating costs	Depreciation	Depreciation
		Finance costs	Interest	Interest
Cash flow statement				
7		Operating activities	Interest ¹⁰	Interest
		Financing activities	Principal	Principal

5 For leases already reported on the balance sheet applying previous lease accounting requirements (ie finance/capital leases), the US GAAP model requires a lessee to account for them as for IFRS 16. For leases not reported on the balance sheet applying previous lease accounting requirements (ie operating leases), the US GAAP model requires a lessee to (a) recognise lease assets and liabilities (measuring lease liabilities as for IFRS 16), (b) recognise a single lease expense typically on a straight-line basis over the lease term and (c) present total cash paid within operating activities.

6 Lease liabilities are measured in the same way applying IFRS 16 and the US GAAP model, except that inflation-linked payments are reassessed when those payments change applying IFRS 16, but are not when applying the US GAAP model.

7 Lease assets are measured at an amount that achieves the recognition of a single lease expense typically on a straight-line basis.

8 IAS 1 *Presentation of Financial Statements* requires a company to present financial liabilities separately from other liabilities. In addition, IAS 1 requires a company to present additional line items (for example, lease liabilities) when such presentation is relevant to understand the company's financial position.

9 Lease assets are presented on the balance sheet either (a) together with owned property, plant and equipment (PPE) or (b) as their own line item(s) if that presentation is relevant to understand the company's financial position.

10 Applying IFRS Standards, interest payments can be presented within operating, investing or financing activities.

Balance sheet

1 Recognition on the balance sheet

IFRS 16 requires a lessee to recognise assets and liabilities arising from all leases on the balance sheet. This is the most significant change to lease accounting introduced by IFRS 16. This change brings financial reporting closer to portraying how most investors consulted view the underlying economics of off balance sheet leases.

Are there any exemptions?

Yes. In response to concerns expressed about cost and complexity (and, in particular, the costs to apply the requirements to large volumes of ‘small’ items), IFRS 16 does not require a lessee to recognise assets and liabilities for (a) leases of 12 months or less (short-term leases), and (b) leases of low-value items (such as personal computers and office furniture or other items with a value of less than US\$5,000). If the exemption is applied, then basically the old ‘operating lease accounting’ is applied, so rent expense is recognised in the income statement.

2 Measurement of lease liabilities

Leases can provide lessees with flexibility. For example, leases often include extension options or break clauses, and can include payments that vary based on sales or the use of an asset.

IFRS 16 requires a lessee to measure lease liabilities at the present value of future lease payments. However, to reflect the flexibility obtained by a lessee and to reduce complexity, lease liabilities include only economically unavoidable payments. In addition, there is a simplified approach to deal with variability in payments.¹¹

3 Measurement of lease assets

A lessee measures lease assets initially at the same amount as lease liabilities, including costs directly related to obtaining the lease. Lease assets are then depreciated in a similar way to other assets such as property, plant and equipment. This is expected to often result in a straight-line depreciation charge over the lease term.

Similarities and differences: IFRS Standards vs US GAAP

Recognition and measurement on the balance sheet

The Board and the FASB have reached the same conclusions on the following important aspects of lease accounting:

- (a) the definition of a lease;
- (b) the recognition of lease assets and liabilities; and
- (c) the measurement of lease liabilities.¹²

The same population of leases is brought onto the balance sheet by both IFRS 16 and the US GAAP model except that IFRS 16 allows leases of low-value assets to be exempt from recognition.¹³

As a result, the most significant effect of applying the new lease requirements—ie the increase in financial liabilities for lessees and the measurement of those liabilities—will be similar for most companies applying IFRS Standards and most companies applying US GAAP.

Differences arise between IFRS 16 and the US GAAP model for leases that were previously off balance sheet. Applying the US GAAP model, a lessee will generally depreciate lease assets more slowly in the earlier years of a lease than when implementing IFRS 16 (where, typically, the depreciation of lease assets is on a straight-line basis).

Accordingly, the Board expects the carrying amount of lease assets, as well as reported equity, to be higher when implementing the US GAAP model than when applying IFRS 16. However, these effects are not expected to be significant for most companies.

The example in the appendix to this article illustrates the expected effects for companies with significant off balance sheet leases.

¹¹ Lease liabilities include fixed payments (including inflation-linked payments), and only those optional payments that the lessee is reasonably certain to make. Lease liabilities exclude variable lease payments linked to sales or use.

¹² See footnote 6.

¹³ Because low-value asset leases are expected to not be material for most lessees, the Board does not expect any significant differences in the amounts recognised by companies applying IFRS Standards and companies applying US GAAP in this respect.

Effects on the balance sheet

- ↑ Lease assets
- ↑ Financial liabilities
- ↓ Equity

For companies that have material off balance sheet leases, IFRS 16 is expected to result in an increase in lease assets and financial liabilities.

The carrying amount of lease assets will typically reduce more quickly than the carrying amount of lease liabilities. This will result in a reduction in reported equity compared to IAS 17 for companies with material off balance sheet leases. This effect is not unique to leases. It is similar to the effect on reported equity that arises from financing the purchase of an asset, either through a former on balance sheet lease or through a loan.

Accordingly, there will be a change to key financial ratios derived from a lessee's assets and liabilities (for example, leverage and performance ratios).

The example in the appendix to this article illustrates this.

4 Presentation of lease liabilities

Lease liabilities are considered to be financial liabilities. IFRS 16 requires a lessee to disclose lease liabilities separately from other liabilities. Applying the requirements in IAS 1, a lessee is required to present lease liabilities as a separate line item, or together with other similar liabilities, in a manner that is relevant to understanding the lessee's financial position. A lessee will also split lease liabilities into current and non-current portions, based on the timing of payments.



Similarities and differences: IFRS Standards vs US GAAP

Presentation of lease liabilities

The Board and the FASB have both concluded that lease liabilities meet the definitions of financial liabilities in IFRS Standards and US GAAP.

Neither IFRS 16 nor the US GAAP model prescribes any particular presentation for lease liabilities, except that the US GAAP model requires a lessee to present lease liabilities relating to former on and off balance sheet leases in different line items. In contrast a lessee applying IFRS Standards will make this distinction (or a more relevant one) only if that is relevant to understanding its financial position.

5 Presentation of lease assets

IFRS 16 requires a lessee to present lease assets on the balance sheet either (a) together with owned property, plant and equipment (if not presented as a separate line item) or (b) as their own line item(s) if that is relevant to understanding the lessee's financial position.

Income statement

Investors should be aware that the lease accounting model will change what they see in the income statement. Applying the new model, the income statement will disaggregate the presentation of lease expenses for former off balance sheet leases (ie splitting the expense into two components) and in a manner that explicitly recognises the financing element inherent in leases. This will change the pattern of expense recognition on an individual lease.

6 Single lessee model

IFRS 16 requires a lessee to account for all leases recognised on the balance sheet in the same way. This is because all leases result in a lessee obtaining the right to use an asset at the start of the lease and (if payments are made over time) also obtaining financing. Consequently, IFRS 16 requires a lessee to recognise and present (a) depreciation of lease assets separately from (b) interest on lease liabilities.

Individual leases—for an individual former off balance sheet lease, IFRS 16 results in a different total expense recognition pattern compared to IAS 17. This is because interest expense is typically higher in the earlier years of a lease than in the later years. When combined with typically straight-line depreciation of lease assets, this results in a total lease-related expense (interest plus depreciation) that is higher than a straight-line lease expense during the first half of the lease term. The opposite is true in the second half of the lease term. Over the lease term, the total amount of expense recognised is the same.

Portfolio of leases—nonetheless, lessees typically hold portfolios of leases, which generally neutralises any significant effect on profit or loss when applying IFRS 16 compared to IAS 17. For example, if a lessee's lease portfolio is evenly distributed (ie the same number of leases start and end during a period and the terms of the new leases are similar to those that have completed), then the overall effect of IFRS 16 on profit or loss will be neutral. If the composition of a lessee's portfolio is not evenly distributed, then there would be an effect on profit or loss. However, a lessee's lease portfolio would usually have to change quite significantly to have any noticeable effect on profit or loss.¹⁴

Effects on the income statement

↑↑	EBITDA
↑	Operating profit and finance costs
↔	Profit before tax

For companies that have material off balance sheet leases, IFRS 16 is expected to result in higher profit before interest (for example, operating profit or EBIT) compared to the amounts reported applying IAS 17. This is because, when applying IFRS 16, a company presents the implicit interest in lease payments for former off balance sheet leases as part of finance costs. In contrast, when applying IAS 17, the entire expense related to off balance sheet leases was included as part of operating expenses. The size of the increase in operating profit, and finance costs, depends on the significance of leasing activities to the company, the length of its leases and the discount rates applied.

The example in the appendix to this article illustrates this.

¹⁴ See sub-section on 'recognition—portfolio of leases' and Appendix D of the [Effects Analysis of IFRS 16](#) (pages 45–46, 98–101) for further information about the likely effects on a portfolio of leases.

<i>Similarities and differences: IFRS Standards vs US GAAP</i>		
	IFRS 16	US GAAP
Revenue	x	x
Operating costs ¹⁵	---	<i>Single expense</i> ¹⁶
EBITDA	↑↑	↔
Depreciation and amortisation	<i>Depreciation</i>	<i>Depreciation</i> ¹⁷
Operating profit	↑	↔
Finance costs	<i>Interest</i>	<i>Interest</i> ¹⁷
Profit before tax	↔ ¹⁸	↔



Because of the effect of holding a portfolio of leases, IFRS 16 is expected to result in little change to profit or loss for many lessees.

Cash flow statement

Although the accounting for leases changes, the cash paid for leases does not. However, investors will see the classification of reported cash flows change compared to IAS 17.

7 Leases are financing activities

To retain the link between the balance sheet, income statement and cash flow statement, IFRS 16 requires a lessee to classify cash payments for (a) the principal portion of lease liabilities within financing activities and (b) the interest portion of lease liabilities in accordance with the requirements relating to other interest paid. This is consistent with the usual treatment of cash flows under IFRS Standards.

Effects on the cash flow statement

- ↑ **Cash from operating activities**
- ↓ **Cash from financing activities**
- ↔ **Total cash flow**

IFRS 16 is expected to reduce operating cash *outflows*, with a corresponding increase in financing cash *outflows*, compared to the amounts reported applying IAS 17. This is because, when applying IAS 17, companies presented cash outflows on former off balance sheet leases as operating activities. In contrast, when applying IFRS 16, principal repayments on all lease liabilities are included within financing activities. Interest can also be included within financing activities under IFRS Standards. The example in the appendix to this article illustrates this.

¹⁵ Excluding depreciation and amortisation.

¹⁶ For former off balance sheet leases.

¹⁷ For former on balance sheet leases.

¹⁸ Little change expected for many companies because of the effect of holding a portfolio of leases.

Note disclosures

Lease assets, expenses related to leases and cash flows

For material leases, IFRS 16, like IAS 17, requires a company to provide a breakdown of the expense related to leases in the notes to the financial statements. Unlike IAS 17, a company is also required to provide information about lease assets by class of asset being leased, and the total amount of lease cash outflows. This information is required to provide a complete picture of a company's leasing activities to investors.

Maturity analysis of the lease liabilities

Unlike IAS 17, IFRS 16 relies on the requirements of IFRS 7 *Financial Instruments: Disclosure* for the disclosure of a maturity analysis of lease liabilities. This means that the same approach a company takes to analyse its other financial liabilities should also apply to lease liabilities.

IFRS 7 requires a company to use judgement in determining which time bands should be disclosed to provide useful information to investors, whereas IAS 17 prescribed time bands of less than one year, between one and five years, and more than five years.

Additional disclosures

For leases that contain complex features (for example, variable lease payments, extension options and residual value guarantees), IFRS 16 requires a company to disclose material company-specific information that is not covered elsewhere in the financial statements (if any). This information is expected to differ between companies.

Unlike IAS 17, IFRS 16 does not include a list of prescriptive qualitative disclosures. Instead, it sets out objectives and requires companies to determine the information that would satisfy those objectives. This is because IFRS 16 aims to improve the effectiveness of lease disclosures by focussing on the information that is most useful to investors. Accordingly, IFRS 16 requires companies to disclose information in the notes that, together with the information provided in the three main financial statements, gives a basis on which investors can assess the effect that leases have on the financial position, financial performance and cash flows of the company.

Similarities and differences: IFRS Standards vs US GAAP

The Board does not expect significant differences in disclosure to be provided by companies applying IFRS Standards and companies applying US GAAP because the disclosure requirements are similar. Nonetheless, there are some differences in the requirements mainly because of differences in the respective lessee accounting models.

The example in the appendix to this article illustrates some of the disclosures that we expect will be provided by a company implementing IFRS 16 and the US GAAP model.

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Appendix

Appendix—illustrative example on how the changes will affect the three main financial statements, commonly used financial ratios and disclosure in the notes

This example illustrates the estimated effects of IFRS 16 by comparing the reported financial information applying previous accounting requirements (IAS 17) to the information that is expected to result from applying IFRS 16 and the US GAAP model (US GAAP).

The example includes some common ratios used by investors and analysts in assessing financial leverage and performance.¹⁹

Background information

The company is an airline. Applying IAS 17, the company reports approximately 80 per cent of its aircraft fleet on the balance sheet (ie around 80 per cent of the company's aircraft fleet is owned or leased under finance leases). The company leases (under former off balance sheet leases) approximately 20 per cent of its aircraft fleet as well as various buildings.

¹⁹ Various assumptions needed to be made when preparing the estimated effects applying IFRS 16 and the US GAAP model illustrated in this example. The main assumptions made are the following:

- (a) a discount rate of 5 per cent applies to all former off balance sheet leases;
- (b) applying IFRS 16, lease assets are depreciated on a straight-line basis;
- (c) applying the US GAAP model, leases are classified in the same way as they were applying previous lease accounting requirements;
- (d) leases of low-value assets and short-term leases are not material; and
- (e) the example does not include (i) any possible difference in lease liabilities recognised applying IFRS 16 and the US GAAP model relating to the reassessment of inflation-linked payments; and (ii) any effects on tax.

In addition, to provide more realistic information, estimates have been prepared on the basis that all companies hold a 'rolling' portfolio of leases. Average lease terms have been estimated based on information disclosed in the financial statements.

The information in this example has been prepared using reported information for a number of companies. It includes estimates and assumptions that could contain errors, and should be used with a degree of caution. The information has been prepared for illustrative purposes only—the actual effect of IFRS 16 on specific companies and industries could differ materially from those presented herein.

1. The balance sheet—higher assets and higher liabilities

Balance sheet	IAS 17	IFRS 16	US GAAP
Property, plant and equipment	27,886	27,886	27,886
Lease assets	12,030	25,430	12,030
Other ²⁰	9,114	8,952	8,952
Total non-current assets	49,030	62,268	63,791
Total current assets	21,152	21,152	21,152
Total assets	70,182	83,420	84,943
Borrowings	9,430	9,430	9,430
Lease liabilities	10,516	25,277	10,516
Other liabilities	34,818	34,818	34,818
Total liabilities	54,764	69,525	69,525
Equity	15,418	13,895	15,418
Total liabilities and equity	70,182	83,420	84,943

Effects on the balance sheet

- *IFRS 16 vs IAS 17*: increase in lease assets and lease liabilities as explained in Section 'Balance sheet' on pages 4–5 of this document.
- *IFRS 16 vs US GAAP*: lease assets and equity higher when applying US GAAP as explained in Section 'Balance sheet' on pages 4–5 of this document.

Lease assets and liabilities relating to former on and off balance sheet leases required to be presented in separate line items applying US GAAP. *[Neither IFRS 16 nor US GAAP requires presentation of lease assets and liabilities on the face of the balance sheet—amounts shown here only for illustrative purposes.]*

²⁰ Other non-current assets applying IAS 17 include advance off balance sheet lease payments that are no longer reflected in that way applying IFRS 16 and the US GAAP model.

The information in this example has been prepared using reported information for a number of companies. It includes estimates and assumptions that could contain errors, and should be used with a degree of caution. The information has been prepared for illustrative purposes only—the actual effect of IFRS 16 on specific companies and industries could differ materially from those presented herein.

2. The income statement—net profit is not expected to change much for most lessees, but sub-totals such as EBITDA will change

Income statement	IAS 17	IFRS 16	US GAAP
Revenue and other income	67,272	67,272	67,272
Operating costs ²¹	(60,893)	(58,340)	(60,893)
EBITDA	6,379	8,932	6,379
Depreciation and amortisation	(3,908)	(5,674)	(3,908)
Operating profit	2,471	3,258	2,471
Net finance costs	(865)	(1,656)	(865)
Profit before tax	1,606	1,602	1,606
Income tax	(285)	(285)	(285)
Profit for the year	1,321	1,317	1,321

Effects on the income statement

- *IFRS 16 vs IAS 17 and US GAAP*: previous reported amounts are not expected to change applying US GAAP as explained in Section 'Income statement' on pages 6–7 of this document.

EBITDA is noticeably higher applying IFRS 16 because it does not include any expense related to leases. Operating profit is also higher applying IFRS 16 because it includes only a portion of expenses related to leases as explained in Section 'Income statement' on pages 6–7 of this document.

Profit for the year is only marginally different between IFRS 16 and IAS 17 / US GAAP because the company holds a portfolio of leases starting and ending in different years.

²¹ Excluding depreciation and amortisation.

3. The cash flow statement—no change to total cash flow, watch for changes to operating and financing activity cash flow figures

Cash flow statement	IAS 17	IFRS 16	US GAAP
Operating activities	6,265	8,026	6,265
Investing activities	(5,190)	(5,190)	(5,190)
Financing activities	(851)	(2,612)	(851)
Total cash inflow	224	224	224

Effects on the cash flow statement

- IFRS 16 vs IAS 17 and US GAAP: total cash flow does not change, but the mix will change applying IFRS 16 because operating cash flows are higher and financing cash flow are lower compared to IAS 17 and US GAAP.

Net cash flows from operating activities higher applying IFRS 16 (with corresponding increase in cash outflows from financing activities) as explained in Section 'Cash flow statement' on page 7 of this document. *[In this example, the company reports interest within operating activities.]*

22 Calculated based on reported information without adjustment.

The information in this example has been prepared using reported information for a number of companies. It includes estimates and assumptions that could contain errors, and should be used with a degree of caution. The information has been prepared for illustrative purposes only—the actual effect of IFRS 16 on specific companies and industries could differ materially from those presented herein.

4. The effect on financial analysis—commonly used financial ratios (if based on reported figures) will be affected by the accounting change

Common ratios ²²	IAS 17	IFRS 16	US GAAP
Financial leverage			
[A] Debt (borrowings plus lease liabilities) to EBITDA	3.1	3.9	5.4
[B] Interest cover (EBITDA to net finance costs)	7.4	5.4	7.4
Performance			
[C] ROCE (Return On Capital Employed)	7.0%	6.7%	4.9%

[EBITDA: operating profit plus depreciation and amortisation]

[ROCE: Return = operating profit; Capital employed = equity plus borrowings plus lease liabilities]

Effects on commonly used ratios

Financial leverage

[A] Debt to EBITDA: ratio of debt to EBITDA applying IFRS 16 (3.9 times) higher than when applying previous lease accounting requirements, because debt (defined in this example as borrowings plus lease liabilities) increases by more than the increase in earnings. Ratio of debt to earnings applying US GAAP (5.4 times) higher than when applying IFRS 16 because the earnings measure (ie EBITDA) applying US GAAP includes expenses related to former off balance sheet leases whereas EBITDA applying IFRS 16 does not. When companies applied previous lease accounting requirements, credit analysts and others often calculated lease-adjusted leverage ratios by adjusting (a) debt (to capitalise off balance sheet leases) and also (b) earnings (to add back rental expense for off balance sheet leases (for example, EBITDAR)). This resulted in a leverage ratio calculated on a basis similar to that provided by IFRS 16 (for example, EBITDA applying IFRS 16 excludes all expenses related to leases so IFRS 16 EBITDA = IAS 17 EBITDAR and US GAAP EBITDAR).

[B] Interest cover: increase in earnings measure (ie EBITDA) applying IFRS 16 is not proportionate to the increase in interest. As a result, interest cover ratio decreased to 5.4. The decrease in interest cover applying IFRS 16 is substantial because (a) expenses related to leases are large relative to the profitability of the company and (b) the company has long term off balance sheet leases. This effect is comparable to the effect of a debt financed asset purchase.

Performance

[C] Return On Capital Employed: ROCE applying IFRS 16 (6.7 per cent) lower than when applying previous lease accounting requirements (7.0 per cent) because the increase in operating profit is not proportionate to the increase in capital employed. The increase in capital employed applying IFRS 16 and US GAAP appropriately reflects that the company operates its business using leased assets as well as owned assets. ROCE is substantively lower applying US GAAP (4.9 per cent) because operating profit does not change but reported capital employed is significantly higher than when applying previous lease accounting requirements. Information from investors and analysts, and companies that prepared non-GAAP lease-adjusted information, indicates that adjustments were made to previous reported operating profit when off balance sheet leases were included as part of capital employed. Reported operating profit applying IAS 17 was often adjusted to add back estimated interest on off balance sheet leases (similar to the outcome applying IFRS 16).

The information in this example has been prepared using reported information for a number of companies. It includes estimates and assumptions that could contain errors, and should be used with a degree of caution. The information has been prepared for illustrative purposes only—the actual effect of IFRS 16 on specific companies and industries could differ materially from those presented herein.

5. The effect on disclosure—increased information provided on this source of financing

The following paragraphs illustrate the information that a company is expected to present in the notes to its financial statements applying previous lease accounting requirements and in applying IFRS 16 and the US GAAP model. The illustration does not include any additional relevant information required by paragraph 59 of IFRS 16, or any qualitative disclosures required by the US GAAP model.

IAS 17

Leased assets²³

Property, plant and equipment includes leased assets whose underlying contracts are structured as on balance sheet leases (finance leases). The following table shows leased assets for which the company is a lessee:

	Aircraft	Real estate and other	Total
Costs²⁴			
Opening balance	13,527	825	14,352
Additions	2,483	–	2,483
Closing balance	16,010	825	16,835
Accumulated depreciation²⁴			
Opening balance	(3,340)	(560)	(3,900)
Depreciation for the year	(835)	(70)	(905)
Closing balance	(4,175)	(630)	(4,805)
Net carrying amount			
Opening balance	10,187	265	10,452
Closing balance	11,835	195	12,030

On balance sheet lease obligations

Future minimum lease payments arising from on balance sheet leases are as follows:

	<1 year	2–5 years	>5 years	Total
Lease payments	1,426	5,405	5,529	12,360
Discount	(269)	(948)	(627)	(1,844)
Present value	1,157	4,457	4,902	10,516

Off balance sheet lease commitments

Future minimum lease payments arising from off balance sheet leases are as follows:

	Aircraft ²⁵	Real estate and other ²⁵	Total	Sub-leases
<1 year	2,308	503	2,811	16
2–5 years	6,324	1,633	7,957	31
>5 years	4,239	4,748	8,987	28
	12,871	6,884	19,755	75

Expenses related to off balance sheet leases recognised in the income statement amount to 2,630 and include 77 of contingent rents. Income from sub-leases amounts to 59.

²³ This information may be presented in the notes section related to 'property, plant and equipment'.

²⁴ Applying previous requirements, the disclosure requirements for owned property, plant and equipment also applied to lease assets arising from on balance sheet leases. Those requirements did not require separate disclosure for leased assets and owned assets included in the same asset class (for example, leased aircraft separately from owned aircraft) – information about leased assets is shown here for illustrative purposes.

²⁵ Breakdown by class of leased asset was not required by IAS 17. However, some companies with significant amounts of off balance sheet leases often provided disclosures of lease commitments by class of leased asset.

The information in this example has been prepared using reported information for a number of companies. It includes estimates and assumptions that could contain errors, and should be used with a degree of caution. The information has been prepared for illustrative purposes only—the actual effect of IFRS 16 on specific companies and industries could differ materially from those presented herein.

IFRS 16

The carrying amount of lease assets, split by major class of asset, and new lease assets during the reporting period, are presented in the table below.

Lease assets	
Carrying amount of lease assets	25,430
<i>Of which</i>	
- Aircraft	21,459
- Real estate and other	3,971
Additions to lease assets	5,486

A maturity analysis of lease liabilities based on undiscounted gross cash flows is reported in the table below.

Lease liabilities ²⁶	
Less than 1 year	4,238
2 years	3,786
3 years	3,466
4 years	3,166
5 years	2,943
6 years	2,452
7 years	2,402
8 years	2,382
9 years	2,362
10 years	1,545
Between 10 and 15 years	1,965
More than 15 years	1,408
Total lease liabilities (undiscounted)	32,115

Income statement

Depreciation of lease assets	(2,672)
<i>Of which</i>	
- Aircraft	(2,268)
- Real estate and other	(404)
Interest on lease liabilities	(1,728)
	(4,400)
Variable lease payments	(77)
Sublease income	59
Gains on sale and leaseback transactions	100

Cash flow statement

Total cash outflow for leases	(4,096)
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²⁶ In accordance with IFRS 7, a company would apply judgement in determining which time bands to disclose.

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US GAAP

The carrying amount of lease assets, split by finance and operating leases, and lease assets obtained in exchange for lease liabilities during the reporting period are presented in the table below.

Lease assets	
Carrying amount of lease assets	26,953
<i>Of which</i>	
- Finance leases	12,030
- Operating leases	14,923
Lease assets obtained in exchange for lease liabilities²⁷	5,324
<i>Of which</i>	
- Finance leases	2,321
- Operating leases	3,003

A maturity analysis of lease liabilities is reported in the table below.

Lease liabilities	Finance leases	Operating leases
Less than 1 year	1,426	2,812
2 years	1,352	2,434
3 years	1,351	2,115
4 years	1,351	1,815
5 years	1,351	1,592
More than 5 years	5,529	8,987
Total lease liabilities (undiscounted)	12,360	19,755
Discount amount	(1,844)	(4,994)
Lease liabilities (discounted)	10,516	14,761

Income statement

Finance leases	
Depreciation of lease assets	(905)
Interest on lease liabilities	(937)
	(1,842)
Operating leases	
Lease expense	(2,553)
Variable lease payments	(77)
Sublease income	59
Gains on sale and leaseback transactions	100

Cash flow statement

Cash paid for amounts included in leases liabilities	(4,019)
<i>Of which</i>	
- Financing cash flows	(1,217)
- Operating cash flows	(2,802)
<i>Of which</i>	
- Finance leases	(1,466)
- Operating leases ²⁸	(2,553)

Other information

Weighted average remaining lease term	
- Finance leases	4.2 years
- Operating leases	7.3 years
Weighted average discount rate	
- Finance leases	5.5%
- Operating leases	5.0%

27 In the example the amount of new lease assets during the reporting period applying the US GAAP model differs from the amount reported as 'Additions to lease assets' applying IFRS 16 due to advance lease payments (ie advance lease payments do not result in lease liabilities).

28 In the example the amount of operating lease cash flows is assumed to be the same as the lease expense.

The information in this example has been prepared using reported information for a number of companies. It includes estimates and assumptions that could contain errors, and should be used with a degree of caution. The information has been prepared for illustrative purposes only—the actual effect of IFRS 16 on specific companies and industries could differ materially from those presented herein.