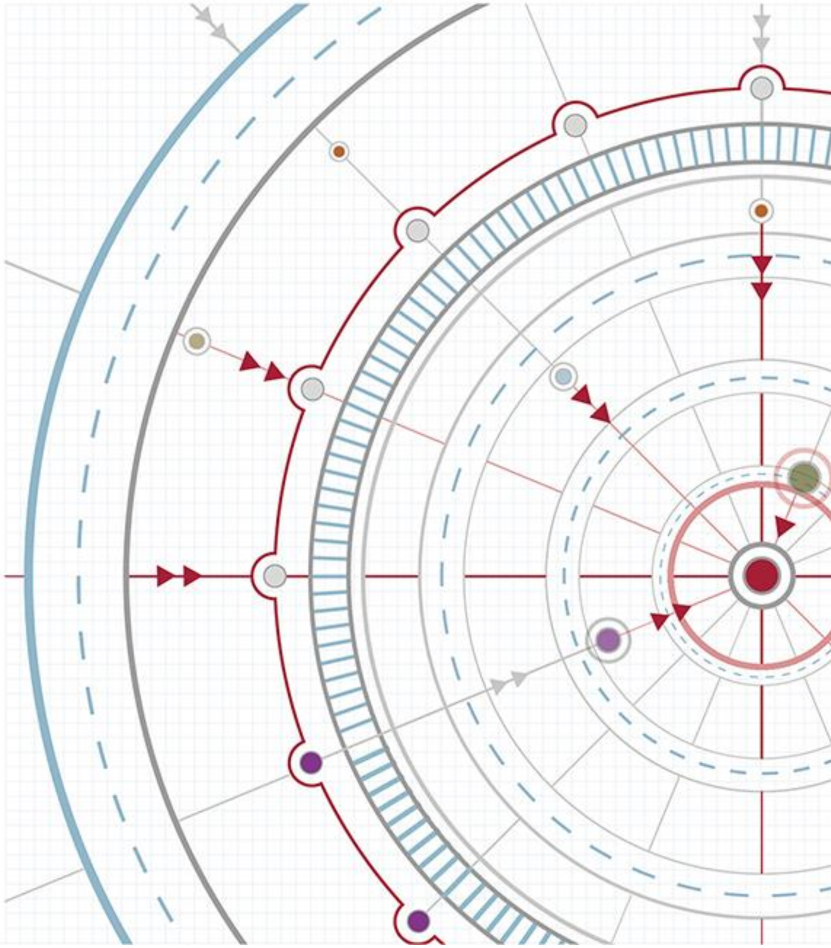
IFRS® Foundation



Business implications of IFRS 16

Emerging Economies Group
May 2018

Agenda paper 1B

The views expressed in this presentation are those of the presenter,
not necessarily those of the International Accounting Standards Board or IFRS Foundation.

IFRS®

Program for today
Operational & other practical considerations

- Key financial metrics
- Debt covenants
- Cost of borrowing
- Reporting systems
- Other implications

Key financial metrics

What's changed for lessors & lessees?

Changes to lessor accounting

- Substantially carry forward IAS 17 accounting requirements; some additional disclosure requirements

Changes to Lessee accounting

- Former operating leases capitalised. All[1] leases accounted for similarly to today's finance leases

Balance Sheet	Income statement	Cash flow statement
↑ Leased assets	↓ Operating expense	↓ Operating flows
↑ Financial Liabilities	↑ Finance cost	↑ Financing flows
↓ Equity		

[1] Exemptions for short-term leases and leases of low-value assets

Lessee’s key financial metrics

Effects of IFRS 16 on the following key financial metrics will depend on the lease portfolio

Solvency
• **Interest cover** = EBITDA / Interest expense
Profitability
• **Profit or loss**
• **EPS**
• **ROCE** = EBIT / (Equity + Financial liabilities)

Different effects by company / industry

Industry sector	Long-term financial liabilities to equity ratio			EBITDA (in billions of US$)		
	Reported on balance sheet (IAS 17)	If all leases on balance sheet (IFRS 16)	Increase (percentage points)	Reported on balance sheet (IAS 17)	If all leases on balance sheet (IFRS 16)	Increase
Airlines	123%	251%	1.28	51.6	73.8	43%
Travel and leisure	118%	191%	0.73	50.3	63.3	26%
Retailers	48%	103%	0.55	270.4	347.7	29%
Transport	54%	84%	0.30	71.2	87.6	23%
Telecommunications	79%	96%	0.17	399.3	434.5	9%
Distributors	91%	104%	0.13	29.4	35.0	19%
…	…	…		…	…	
Total sample(1)	**59%**	**74%**	**0.15**	**3,394**	**3,722**	**10%**

(1) 1,022 IFRS/US GAAP listed companies (excluding banks and insurance companies) each with estimated operating lease liabilities of >$300M (discounted basis). Data obtained from financial data aggregators that may contain errors; this information should, therefore, be used with a degree of caution.

Implications of changes in metrics

- Communication of changes to investors and other stakeholders
- Remuneration schemes and staff bonuses
- Business combinations (eg prices based on EBITDA)
- Distributable profits
- Debt covenants

Debt covenants

Effects on debt covenants

- No significant effects if existing credit agreements
  - include clauses that protect companies from changes in accounting:
    - frozen GAAP and carve-outs
    - terms such as ‘debt’ and ‘EBITDA’ defined independently of IFRS requirements
    - good-faith re-negotiation
  - take into account operating leases
- Possible effects if covenants are linked to IFRS financial statements, without adjustments for operating leases
- To be considered in new financing arrangements

IFRS® Foundation

Cost of Borrowing

IFRS®

Today lease liabilities are estimated

- Credit rating agencies and many lenders estimate the effects of operating leases on leverage
- Some common estimation techniques over-estimate the lease liabilities for many companies

1,022 entities[(1)]	Reported on balance sheet (IAS 17)	If all leases on balance sheet (IFRS 16)	Common market practice (rent x8)
Long-term (LT) debt (In millions of US dollars)	6,440,942	8,102,729	9,063,971
LT debt to equity	59%	74%	82%

(1) 1,022 IFRS/US GAAP listed companies (excluding banks and insurance companies) each with estimated operating lease liabilities of >$300M (discounted basis). Data obtained from financial data aggregators that may contain errors; this information should, therefore, be used with a degree of caution.

Effects on the cost of borrowing

- IFRS 16 will
  - result in higher financial liabilities (and higher assets) for companies with significant operating leases
  - provide better information about existing lease commitments
- Effects on the cost of borrowing will depend on how different recognised lease liabilities are from those previously estimated by lenders
- Communication of significant changes to reported information to lenders is important
- Lenders set interest rates based in part on credit ratings

How will IFRS 16 affect credit ratings?

Fitch: *'lease accounting rule changes won't hit corporate ratings'*
(29 February 2016)

S&P: *'our opinion of a company's underlying creditworthiness will generally not change … if, as a result of the new lease accounting, we are provided with new information that we consider to be relevant to our opinion of a company's underlying creditworthiness, it will be incorporated in our analysis'*
(6 April 2016)

Moody's: *'Moody's has been formally adjusting for corporate lease-related debt since 2006 and has long considered the impact lease obligations have on debt capacity. As such, while reported lease debt will rise materially for many companies across a range of sectors, the rating agency does not expect rating changes.'*
(26 February 2016)

IFRS® Foundation

Reporting systems

IFRS®

Systems changes

- Information required to apply IFRS 16 is similar to that required to apply IAS 17, but need to
  - adapt systems to gather information on a more frequent basis than when needed only for disclosure purposes
  - determine discount rates
- Depreciation of lease assets in the same way as other fixed assets
- Measurement of lease liabilities similar to other financial liabilities
- Optional tracking of low-value asset and short-term leases

Information needed

Information needed	Possible source of information
Inventory of leases	▪ Procurement ▪ Corporate Real Estate ▪ Operations ▪ Legal ▪ Treasury ▪ Finance and Accounting
Terms and conditions	
Lease term - options	
Lease payments - inflation-linked payments - In substance-fixed payments	
Discount rate	
Initial direct costs	

Practical approach to gathering data

- Start sooner rather than later
- Establish a proper project governance structure
- Decide on whether you’ll take recognition exemptions
- Understand transitional reliefs
- High level impact assessment may identify scale of challenge ahead
- Ensure data gathered is robust
- “Tidying up” data gathered may require significant time
- Ensure systems readiness

Other implications

Other

- Lease negotiations
  - Short-term leases
  - Variable lease payments
  - Sale and leaseback
- Decision-making
  - All leases managed in the same way
  - Improvements in how business is financed and operated
  - Capex approval
  - Lease vs buy strategy
- Taxation

Audit challenges

- Identification of leases (identifiability and control of RoU)
- Discount rate
- Identification of portfolios
- In-substance fixed lease payments
- Reasonable certainty over extension options

Contact us

Keep up to date

- @IFRSFoundation
- IFRS-Foundation, IASB
- go.ifrs.org/email-alerts
- IFRS Foundation

Comment on our work

- go.ifrs.org/comment

Join the organisation, and help shape the future of financial reporting

- go.ifrs.org/careers

Questions or comments?