

# Analysing lessee financial statements and Non-GAAP performance measures

## Introduction

Investors and company managers generally view free cash flow (FCF) as excess cash generated by the company that is available for distribution or reinvestment into the business. Consequently, these measures are widely used in analysing companies' financial health and intrinsic value. In fact, FCF is one of the most widely used non-GAAP performance measures<sup>1</sup> by professional investors (as highlighted in a CFA Institute survey of institutional investors and analysts published in 2016<sup>2</sup>).

It is common for companies to report such non-GAAP measures, although investors calculate them independently from the information provided in the financial statements. When calculating FCF for a lessee company from the information provided in its financial statements, investors need to pay special attention to how cash flows related to leases are reflected in the statement of cash flows. Comparing the FCF of lessee companies with companies that make outright purchase of assets may require analysts to perform adjustments to the amounts

presented by lessee companies in the statement of cashflows. In this article, we explore approaches to calculate or adjust reported FCF measures of lessees.

Before delving into these approaches, we provide a brief introduction to IFRS 16 *Leases* as it sets out the new requirements that lessee companies must apply for annual reporting periods beginning 1 January 2019. Upon reading this publication, you will develop a better understanding of the financial reporting similarities and differences between lessee companies and companies that make outright purchases of assets. Moreover, you will develop an understanding of how to use information contained in the new disclosures under IFRS 16 to adjust lessee FCF measures to compare them with the FCF measures of companies that buy assets.

For a detailed discussion on IFRS 16 for investors, please refer to our [Investor Perspectives](#) article on leases and the [IASB Investor Update](#) newsletter (June 2018).



1 Non-GAAP performance measures are commonly referred to as non-GAAP financial performance measures or alternative performance measures.

2 See 'Bridging the Gap: Ensuring Effective Non-GAAP and Performance Reporting', CFA Institute, 2016.

## Financial reporting for lessees under IFRS 16 Leases

IFRS 16 *Leases* came into effect on 1 January 2019 and requires companies to report all leases on the balance sheet (except where exemptions apply). With the new requirements, in many cases, the lessee will recognise equal amounts of leased assets (also called right of use or RoU assets) and lease liabilities at initial recognition of the lease. The lease liability will be calculated as the present value (PV) of the future lease payments discounted using an appropriate rate. This calculation resembles that for finance leases as required in IAS 17 *Leases*, which IFRS 16 supersedes.

We expect this change to bring greater comparability and consistency in lessee accounting. Improved clarity and consistency mean that investors will no longer have to analyse two separate accounting treatments for operating and finance leases as all leases will be treated in the same manner.

“Investors may need to make adjustments to Free Cash Flow measures to incorporate additional leasing information disclosed under IFRS 16.”

In addition, the balance sheets and profit and loss accounts (P&L) of companies that lease assets will be more comparable with those of companies that purchase or own assets (see Table 1). Therefore, investors may feel less inclined to adjust financial statements to compare the efficiency, return and leverage ratios of companies. However, the statement of cash flows will still vary across companies, and we illustrate how leasing information provided under IFRS 16 can be used to adjust cash flow information to calculate adjusted FCF measure for lessees. This will allow for comparison with FCF measures of companies that own or purchase assets.

**Table 1: Comparison of financial statements**

	Purchase of assets (with borrowing)	Leasing of assets	Implications for financial analysis
<b>Balance sheet reflects</b>	<ul style="list-style-type: none"> <li>owned assets</li> <li>borrowings</li> </ul>	<ul style="list-style-type: none"> <li>leased assets (right of use)</li> <li>lease liabilities</li> </ul>	ratios related to efficiency, return and leverage that make use of P&L and balance sheet are more comparable
<b>P&amp;L reflects</b>	<ul style="list-style-type: none"> <li>depreciation of owned assets</li> <li>interest charge on borrowings</li> </ul>	<ul style="list-style-type: none"> <li>depreciation of leased asset</li> <li>interest charge on lease liabilities</li> </ul>	
<b>Cash flow statement reflects</b>	<i>in the year of asset purchase</i> <ul style="list-style-type: none"> <li>capital expenditure or capex (outflow in CFI*)</li> <li>borrowing (inflow in CFF*)</li> </ul>	<i>in the year of initiating new lease of an asset</i> <ul style="list-style-type: none"> <li>no capex in CFI</li> <li>lease repayment in CFF (outflow)</li> </ul>	measures such as FCF are less comparable
	<i>over life of loan</i> <ul style="list-style-type: none"> <li>loan repayment (outflow in CFF*)</li> </ul>	<i>over lease term</i> <ul style="list-style-type: none"> <li>repayment of lease liability (outflow in CFF)</li> </ul>	
<b>Key non-cash adjustments</b>	depreciation on owned asset is added back in CFO* calculations	depreciation on leased asset is added back in CFO calculations	

\* CFI: Cash flow from investing activities, CFF: Cash flow from financing activities, CFO: Cash flow from operating activities

## Free cash flow-based performance measures

'Free cash flow' is not defined in IFRS Standards. In most cases, this measure (let's call this version FCF1) is calculated as cash flow from operating activities (CFO) less capital expenditure (or capex). Let's assume that the starting point of this calculation is the required CFO subtotal (calculated as per IAS 7 *Statement of Cash Flows*) and that reported capex is used to complete the calculation. We highlight next how the use of reported capex limits the usefulness of FCF1 (for lessees) in making cross-company comparisons.

### What do the Standards say about reporting capex?

IAS 7 requires companies to report cash payments to acquire property, plant and equipment, intangibles and other long-term assets in the cash flow from investing (CFI) section of the statement of cash flows. Since leasing is not considered as an investing activity under these reporting requirements, no cash flows related to leasing are reported as capex in CFI. Only the cash flows related to lease repayments are reported in the cash flow from financing (CFF) section.

### Identification of the comparability blind spot in FCF measures

For a lessee, even though the cash generated using the leased assets is included in the FCF measure (via CFO), no capital cost is captured in capex. The FCF measure for such a company will seem more favourable compared to the equivalent measure for a company that purchases its assets outright (and therefore reports a higher upfront capex, thus reducing free cash flow). The difficulty with comparison is exacerbated in growing companies, where the FCF growth of the lessee appears much higher (discussed in the section labelled 'Digging deeper').



### Considering this incomparability in analysis

When comparing FCF of lessees with companies that make outright purchase of assets, adjustments to the FCF measures of lessees may be required to enable comparisons. We discuss a possible adjustment approach using a case study that compares the financial statements of two hypothetical companies, Let's-Lease Plc (a lessee) and Big-Buy Plc (a purchaser of assets).

In this case study, we demonstrate:

- (a) how FCF measures of two companies that are similar, except in their decision to lease vs. purchase assets (see case study, Section I), can be presented differently; and
- (b) how information provided under IFRS 16 by Let's-Lease can be used to make adjustments that allow for an 'apples-to-apples' comparison with the FCF measures presented by Big-Buy.

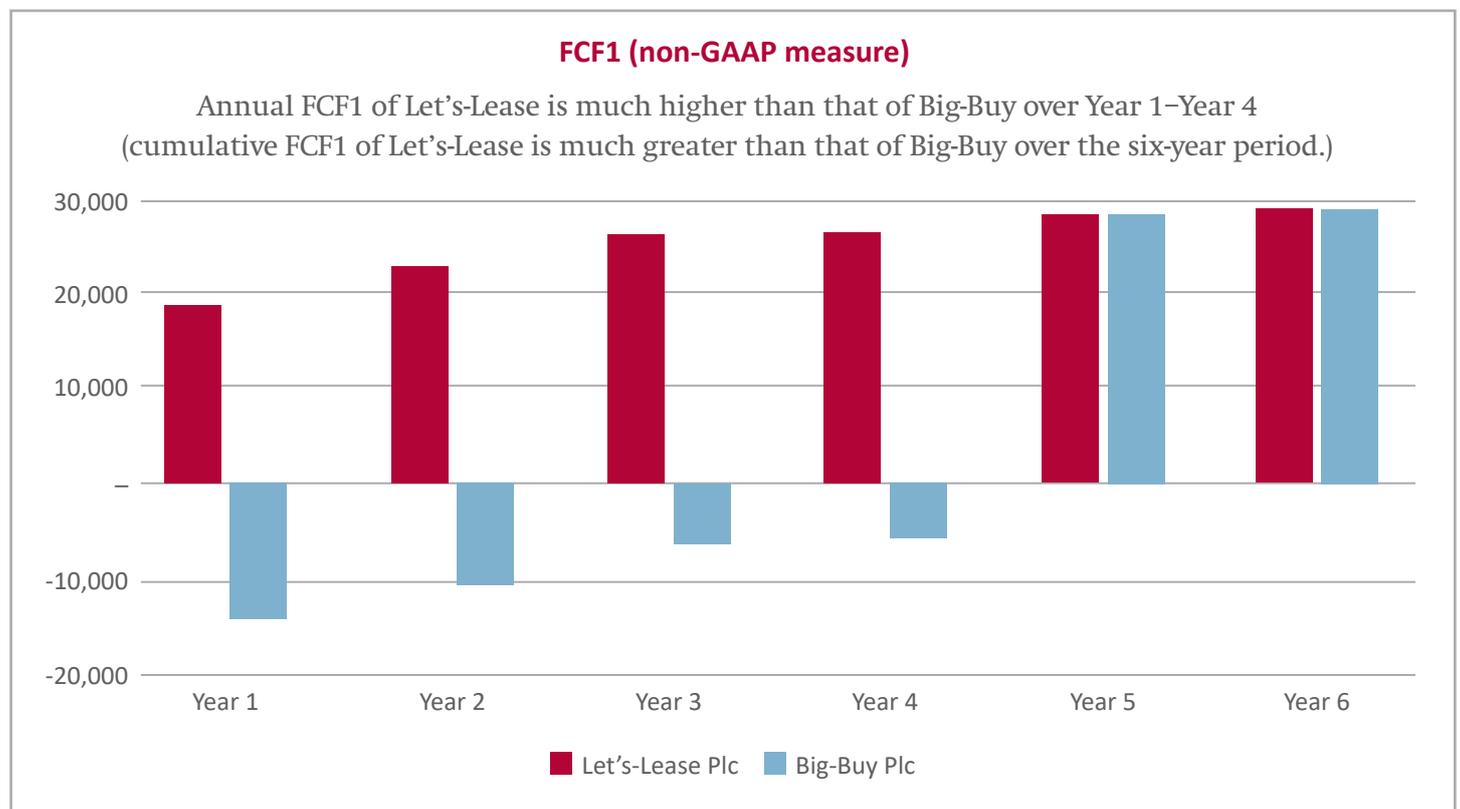
## A graphical depiction of the comparability blind spot

### Comparing unadjusted FCF1 of Let's-Lease Plc with Big-Buy Plc

Chart 1 shows a comparison of the unadjusted FCF1 of Let's-Lease (lessee) and the FCF1 of Big-Buy (purchaser) over a six-year period. We will elaborate on the mechanics of these calculations in the case study section. For now, we want to highlight the comparability blind spot—the unadjusted annual FCF1 of Let's-Lease is significantly higher than the annual FCF1 of Big-Buy, particularly from Year 1 to Year 4 (see Chart 1). By the end of the six-year period, Let's-Lease has a higher cumulative FCF1 than that of Big-Buy.

Our proposed adjustment approach will bring the annual FCF1 of both companies in line for enhanced comparability.

**Chart 1: FCF1—Measure of free cash flow defined as CFO less capex**

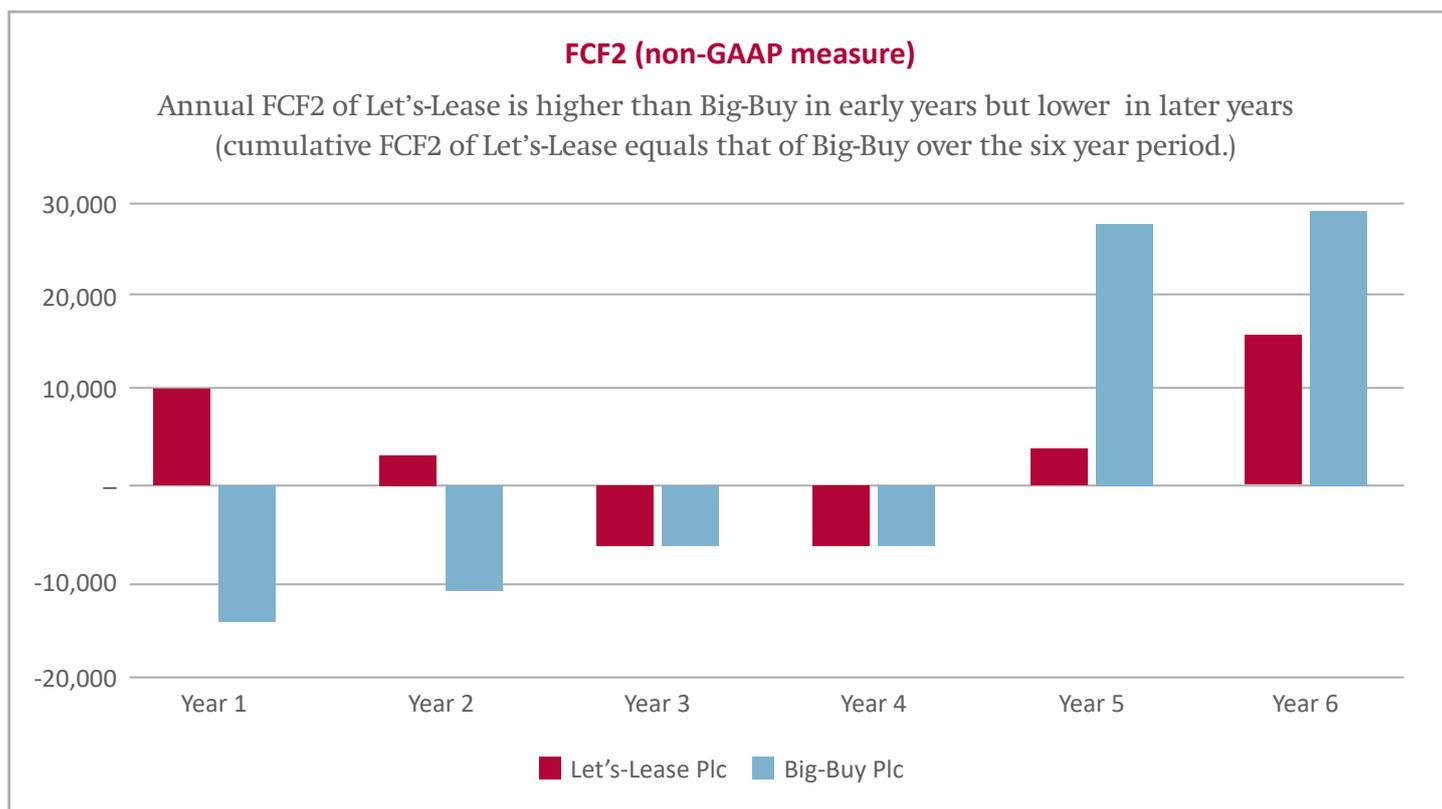


### Defining an alternate FCF measure that's better for comparisons

Another approach commonly observed for computing and presenting FCF is CFO less capex and repayment of lease liabilities (we call this measure FCF2). This approach, unlike FCF1, takes into consideration the cash outflows (lease repayments) related to leasing activity, but spreads them over the life of the lease (unlike capex for Big-Buy, which is expensed upfront).

We can see from Chart 2 that the annual FCF2 of Let's-Lease is higher than that of Big-Buy in early years but lower in later years. In contrast to FCF1, the cumulative FCF2 for Let's-Lease equals that of Big-Buy over the six-year period.

**Chart 2: FCF2—Measure of free cash flow defined as CFO less capex & lease repayments**



The reason why cumulative FCF2 over the six-year period for Let's-Lease and Big-Buy is the same is because its calculations (discussed further in the case study segment related to cash flow statements) include the repayment towards lease liabilities thereby spreading out the capital cost towards the leased asset.

Some may view FCF2 as an improvement over FCF1, although it still exhibits shortcomings for the purpose of cross-company comparisons (see Comparison of FCF under FCF2 in Section III of the case study).

In the next section—case study—we develop the financial statements of Let's-Lease and Big-Buy to highlight the drivers of the FCF measures for the two companies. We assume that IFRS 16 has been applied in both cases, which means that all leases are recognised on the balance sheet and there is no distinction between operating and finance leases. The case study allows us to illustrate how some of the new disclosures under IFRS 16 can be incorporated into financial analysis.

## Case study (leasing vs outright purchase of assets)

### Section I—Key inputs and assumptions

- **Let's-Lease and Big-Buy are two manufacturing entities with similar operations.** Both companies present their financial statements applying IFRS Standards.
- **Let's-Lease's approach to lease recognition**
  - It leases an asset at the beginning of Year 1 for a term of three years.
  - It leases the identical asset with the same terms at the beginning of Year 2, Year 3 and Year 4. Consider a six-year period covering the life of all four leases; Let's-Lease has applied IFRS 16 to all its leases.
  - The initial recognition of a lease results in a lease liability and a RoU asset of the same amount, equal to the PV of the lease payments.
  - It depreciates each RoU asset fully over a three-year period on a straight-line basis.
- **Big-Buy's approach to purchasing assets**
  - Big-Buy purchases identical assets in the same time periods as Let's-Lease but finances its purchases entirely with borrowings. Therefore, for each asset, Big-Buy takes out four three-year loans at the beginning of years 1, 2, 3 and 4.
  - Big-Buy depreciates each asset fully on a straight-line basis over its useful life (3 years).
- **Discount or borrowing rate assumptions for Let's-Lease and Big-Buy.** For simplicity and to allow for comparison, the interest rate implicit in each lease for Let's-Lease and the borrowing rate for Big-Buy is the same (4.24% a year). For both companies, the interest expense and the repayment for the lease liability or borrowing are derived from effective interest rate calculations shown in Table 2.
- **Estimating the lease liability for Let's-Lease and the loan value for Big-Buy.** Assume that for Let's-Lease, the end of year cash payments to the lessor for each lease and, for Big-Buy, the cash payments to the creditor for each loan are known—CU10,000 in Year 1, CU12,000 in Year 2 and CU14,000 in Year 3. These assumptions allow us to calculate PV of cash payments and, therefore, the lease liability for Let's-Lease and the loan value for Big-Buy. Table 2 summarises the assumptions and calculations for a single asset, whether leased, or purchased using borrowings.

**Table 2: Assumptions and calculations for a single asset leased or purchased with borrowings**

CU mn	Year 1	Year 2	Year 3
Cash payment (to lessor/creditor)	10,000	12,000	14,000
PV of remaining payments (at beginning of year)	33,000	24,398	13,431
Interest (@4.24% of PV)	1,398	1,033	569
Repayment (cash payment less interest)	8,602	10,967	13,431

- **P&L assumptions:** Both companies have the same revenue—CU20,000 in Year 1, CU25,000 in Year 2, and CU30,000 in each Year 3 to Year 6. Neither company incurs other expenses except depreciation and interest, which are the same for each company (see Table 4).

## What is reported on the balance sheet for each leased and purchased asset?

Based on the assumptions and the calculations in Table 2, at the inception of the lease contract, Let's-Lease reports a RoU asset of CU33,000 and a lease liability of CU33,000.

Similarly, at the time of purchase of the asset, Big-Buy reports an identical amount of assets (CU33,000 of property, plant and equipment or PP&E) and liabilities (CU33,000 of borrowings).

Since a new asset is leased or purchased at the beginning of each of Year 1, 2, 3 and 4, the same reporting outcome is realised in each case. This allows us to calculate, for the six-year period, the RoU assets for Let's-Lease and the PP&E for Big-Buy, both as gross (as recognised upon initial recognition) and as net of depreciation (carried out on a straight-line basis over a three-year period for each asset).

For simplicity, we do not de-recognise each asset after it has been fully depreciated in three years. This has no impact on the net asset values or cash flows but affects the gross asset and accumulated depreciation amounts presented. We have used this assumption to make it easier for you to follow the cumulative capex or addition to RoU assets, as these are also reflected in the gross PP&E/RoU assets figures on the balance sheets.

### Section II—Financial statements of Let's-Lease and Big-Buy

Based on the assumptions above, comparable balance sheet and P&L for both companies are shown in Table 3 and Table 4.

**Table 3: Balance sheet figures for both companies are identical**

Let's-Lease (CU mn)	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
<b>Assets</b>						
Gross RoU assets	33,000	66,001	99,001	132,001	132,001	132,001
Accumulated depreciation	(11,000)	(33,000)	(66,001)	(99,001)	(121,001)	(132,001)
Net RoU assets	22,000	33,000	33,000	33,000	11,000	–
Cash	10,000	13,000	7,000	1,000	5,000	21,000
<b>Liabilities</b>						
Lease liability	24,398	37,829	37,829	37,829	13,431	–
<b>Equity</b>	7,602	8,171	2,171	(3,829)	2,569	21,000
Big-Buy (CU mn)	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
<b>Assets</b>						
Gross PP&E	33,000	66,001	99,001	132,001	132,001	132,001
Accumulated depreciation	(11,000)	(33,000)	(66,001)	(99,001)	(121,001)	(132,001)
Net PP&E	22,000	33,000	33,000	33,000	11,000	–
Cash	10,000	13,000	7,000	1,000	5,000	21,000
<b>Liabilities</b>						
Loans	24,398	37,829	37,829	37,829	13,431	–
<b>Equity</b>	7,602	8,171	2,171	(3,829)	2,569	21,000

**Table 4: P&L for Let's-Lease and Big-Buy are identical**

P&L of Let's-Lease (CU mn)	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Revenue	20,000	25,000	30,000	30,000	30,000	30,000
Depreciation of RoU asset	(11,000)	(22,000)	(33,000)	(33,000)	(22,000)	(11,000)
Interest on lease liabilities	(1,398)	(2,431)	(3,000)	(3,000)	(1,602)	(569)
Net profit	7,602	569	- 6,000	- 6,000	6,398	18,431
P&L of Big-Buy (CU mn)	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Revenue	20,000	25,000	30,000	30,000	30,000	30,000
Depreciation of PP&E	(11,000)	(22,000)	(33,000)	(33,000)	(22,000)	(11,000)
Interest on loans	(1,398)	(2,431)	(3,000)	(3,000)	(1,602)	(569)
Net profit	7,602	569	- 6,000	- 6,000	6,398	18,431

We are now ready to examine the cash flow statements of Let's-Lease (Table 5) and Big-Buy (Table 6). In the cash flow statements, we can observe differences between the amounts presented by each of the companies. The notable difference between the cash flow statements of Let's-Lease and Big-Buy is in the cash flows from investing and financing activities sections (highlighted in the statements in Tables 5 and 6).

### Some key observations on the two cash flow statements

- Let's-Lease reports no capex in cash flow from investing activities (CFI) for the leased assets, and the cash paid towards repayment of the lease liability is reported in cash flow from financing activities (CFF).
- In contrast, Big-Buy reports capex in CFI, and the amounts reflected in CFF towards net repayment of loans are different to those for Let's-Lease across many years.

We can verify observations in Charts 1 and 2 that compare the FCF measures for Let's-Lease and Big-Buy using the data in Table 5 and Table 6 (ie using the formula  $FCF1 = CFO - \text{fixed capital investment or capex}$ ). We can also verify the second FCF measure for Let's-Lease (ie using the formula  $FCF2 = CFO - \text{capex} - \text{repayment of lease liability}$ ).

**Table 5: Statement of cash flows for Let's-Lease**

Let's-Lease (CU mn)	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Net profit	7,602	569	(6,000)	(6,000)	6,398	18,431
Depreciation	11,000	22,000	33,000	33,000	22,000	11,000
Cash flow from operations (CFO)	18,602	22,569	27,000	27,000	28,398	29,431
Cash flow from investing activities (CFI)	–	–	–	–	–	–
Cash flow from financing activities (CFF)	(8,602)	(19,569)	(33,000)	(33,000)	(24,398)	(13,431)
Change in cash	10,000	3,000	(6,000)	(6,000)	4,000	16,000
Beginning cash balance	0	10,000	13,000	7,000	1,000	5,000
Ending cash balance	10,000	13,000	7,000	1,000	5,000	21,000

**Table 6: Statement of cash flows for Big-Buy**

Big-Buy (CU mn)	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Net profit	7,602	569	(6,000)	(6,000)	6,398	18,431
Depreciation	11,000	22,000	33,000	33,000	22,000	11,000
Cash flow from operations (CFO)	18,602	22,569	27,000	27,000	28,398	29,431
Cash flow from investing activities (CFI)	(33,000)	(33,000)	(33,000)	(33,000)	–	–
Cash flow from financing activities (CFF)	24,398	13,431	–	–	(24,398)	(13,431)
Change in cash	10,000	3,000	(6,000)	(6,000)	4,000	16,000
Beginning cash balance	0	10,000	13,000	7,000	1,000	5,000
Ending cash balance	10,000	13,000	7,000	1,000	5,000	21,000

### Section III—Tying it all together

#### Comparison of the P&L's and balance sheets

All else being equal, the two companies have the same reported profits and the same assets and liabilities over the six-year period. This results in comparable financial performance and financial positions, facilitating comparable ratio analysis without further adjustments.

#### Comparison of FCF under the FCF1 metric

The total capex for Big-Buy over six years is CU132,000, which is shown in Big-Buy's CFI (as capex). This is the same amount that Let's-Lease recognises as RoU assets on the balance sheet (with an equal lease liability measure at initial recognition of leases). No capex is shown in the CFI of Let's-Lease however.

#### Key observations

- FCF1 of Let's-Lease and Big-Buy are not comparable without adjustments.
- FCF1 of Let's-Lease will be significantly higher in some years in comparison to Big-Buy (see Chart 1).

#### Comparison of FCF under the FCF2 metric

In the case of Let's-Lease, only the lease liability repayment appears in the cash flow statements (in CFF), and over the six-year period this amounts to CU132,000. The second FCF measure corrects for the capex adjustment needed in FCF1 by subtracting the lease repayments ( $FCF2 = CFO - \text{capex} - \text{lease repayments}$ , or  $FCF1 - \text{lease repayments} = FCF2$ ). The lease repayment deductions over the six-year period (ie CU132,000) in FCF2 of Let's-Lease is the same amount of capex done by Big-Buy (see bullet point two Comparison of FCF under the FCF1 metric).

#### Key observations

- FCF2 offers a more meaningful measure to compare free cash flow of the two companies.
- FCF2 has shortcomings on accounts of the timing mismatch or the reversal in FCF2 trends between Let's-Lease and Big-Buy (see Chart 2).

In order to make like-for-like comparisons, adjustments are still needed. This is where the IFRS 16 disclosures will be useful and we discuss the mechanics of the adjustments next.

## Section IV—Digging deeper

### How to adjust FCF1 of Let's-Lease

To make the appropriate adjustments that compensate for the comparability blind spot associated with FCF1, we make use of IFRS 16 disclosures on the addition to RoU assets (a requirement in the new Standard) via the following steps:

**Step 1:** Assess Let's-Lease's addition to RoU assets.

Based on the information presented in Section I, Let's-Lease has disclosed CU33,000 as addition to RoU assets in each of Year 1, 2, 3 and 4 in its IFRS 16 notes.

**Step 2:** Compute adjusted CFI by reducing reported CFI each year by the addition to RoU assets.

**Table 7: Adjusted CFI for Let's-Lease = reported CFI – addition to RoU assets**

Adjustments to CFI	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Reported CFI	–	–	–	–	–	–
Adjustment: addition to RoU assets	33,000	33,000	33,000	33,000	–	–
Adj. CFI or capex	(33,000)	(33,000)	(33,000)	(33,000)	–	–

**Step 3:** Compute adjusted FCF1 as reported CFO less adjusted CFI calculated in Step 2.

**Table 8: Adjusted FCF1 calculation for Let's-Lease.**

Adjusted FCF (Let's-Lease)	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
CFO	18,602	22,569	27,000	27,000	28,398	29,431
Adj. CFI or capex	(33,000)	(33,000)	(33,000)	(33,000)	–	–
Adj. FCF1	(14,398)	(10,431)	(6,000)	(6,000)	28,398	29,431

This results in the same FCF1 as Big-Buy's (Table 9).

**Table 9: Big-Buy's FCF1**

FCF1 (Big-Buy)	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
CFO	18,602	22,569	27,000	27,000	28,398	29,431
CFI or capex	(33,000)	(33,000)	(33,000)	(33,000)	–	–
FCF1	(14,398)	(10,431)	(6,000)	(6,000)	28,398	29,431

**Step 4:** Add as a source of financing in CFF the increase in lease liability.

**Table 10: Adjusted CFF calculation for Let's-Lease.**

Adjustments to CFF	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Reported CFF	(8,602)	(19,569)	(33,000)	(33,000)	(24,398)	(13,431)
Adjustment: addition of lease liability	33,000	33,000	33,000	33,000		
Adj. CFF	24,398	13,431	–	–	(24,398)	(13,431)

The adjusted CFF in Year 1 will be the reported repayment of lease liability of CU8,602 plus the additional CU33,000 of lease liability, which amounts to CU24,398. This results in same CFF of Big-Buy's (Table 11).

**Table 11: Big-Buy's CFF**

CFF (Big-Buy)	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Reported CFF	24,398	13,431	–	–	(24,398)	(13,431)

## Other free cash flow measures

Although there may be agreement on what free cash flow means at a broad level (eg the cash left over after paying operating expenses and capex), there can be differences in the detail. We highlight other formulas for computing FCF measures that are commonly used by investors in financial analysis and valuation.

$$\text{Free cash flows to firm (FCFF)} = \text{CFO}^3 + \text{post-tax interest} - \text{capex}$$

$$\text{Free cash flows to equity (FCFE)} = \text{CFO}^3 - \text{capex} + \text{net borrowings}$$

These formulations of an FCF metric share the disadvantages that apply to the FCF1 metric that we previously discussed. Under both formulas, the capex figure for both FCFF and FCFE suffers from the blind spot related to leases. Therefore, it makes sense to make three adjustments:

- adjust the reported capex figure (as calculated for Let's-Lease ) to account for the effect of the addition of leased assets;
- adjust the post-tax interest to include interest paid to lessors; and
- adjust the net borrowings (as calculated for Let's-Lease in Section IV) by taking into consideration the addition of lease liabilities.

These adjustments can facilitate a more meaningful comparison between Let's-Lease and Big-Buy's FCFF, and FCFE.

<sup>3</sup> Assuming interest charge is presented in CFO.

## Some caveats to the adjustment approach

Our simplified case assumes that the leased assets and the purchased assets are identical (ie the lease term is equal to the useful life of the asset). IFRS 16 requires lease liabilities to be based on payments made over the lease term (as defined in the Standard) and the lease term may not always substantially be the same as the useful life of the asset. The IFRS 16 measurement for all leases reflects only the rights obtained to control the asset (which are limited to the lease term).

When leases are recognised on the balance sheet based on lease terms that are significantly shorter than the useful life of the underlying asset (as is often the case with operating leases), the RoU asset recognised on the balance sheet will not be similar to the amounts recognised had the asset been purchased outright (contrary to what is shown in our simplified case). This results in incomparability due to different capitalisation amounts on the balance sheets for lessees vs purchasers. Shorter lease terms provide companies with flexibility, which is reflected in the IFRS 16 measurement (ie a lower liability the shorter the term, all else being equal),—but companies must pay for this flexibility by incurring rollover risk from having to renegotiate their leases more frequently (if the lessee’s credit rating falls over time, it must renegotiate leases at less favourable rates).

In such cases, some analysts may prefer to adjust the lease liability at initial recognition (that is based on the lease term) to an amount that is based on the useful life or whole life of the asset.

Analysts often refer to this treatment as the ‘whole asset’ approach. We do not cover the mechanics of this adjustment in detail although with a few more assumptions, this should be an extension of the exercise described above (with additional adjustments made in the balance sheet and P&L). Such an approach can facilitate a comparative analysis of the companies that may yield additional insights.

## Conclusions

We believe investors will benefit from the implementation of IFRS 16 as it will lead to a better reflection of the economics of leasing on the financial statements of lessees. Additionally, IFRS 16 disclosures will allow investors to better assess the impact of leases on the financial position, performance and cash flows of the company. For example, companies will have to disclose quantitative information related to lease costs, cash flows, and assets for all material leases. This will include information such as the addition to RoU assets, break-down of the carrying value and depreciation of RoU assets by asset class, and a maturity analysis of all lease liabilities.

We believe analysts can look forward to making use of this wealth of information in their analysis of free cash flow by revisiting their own approach to computing the metric.

### For more information

If you would like to learn more about IFRS 16, *The Essentials* series or the IASB’s investor engagement activities, visit: [go.ifrs.org/Investor-Centre](https://go.ifrs.org/Investor-Centre).

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