www.pwc.com

A study on the impact of lease capitalisation

IFRS 16: The new leases standard

February 2016

pwc

Contents

1. Overview

In collaboration with the Rotterdam School of Management, in the Netherlands, we have conducted a global study to assess the impact of the new leases standard on the financial statements, key financial ratios and performance measures on a sample of 3,199 listed IFRS reporting organisations across a range of industries and countries (excluding the United States)

The study identifies the minimum impact of capitalising the operating lease commitments as disclosed in the published financial statements for 2014. In view of organisations assessment of the lease term under the new standard, the inclusion of amongst others in-substance fixed payments and variable payments linked to an index or rate, the eventual impact may be much greater. Furthermore, the study takes no account of transitional reliefs that are available upon adoption of the new leases standard on 1 January 2019.

Highlights from the study include:

The median increase in entities' debt loads would be around **22%**

The median increase in Earnings Before Interest, Tax, Depreciation and Amortisation ('EBITDA') would be around **13%**

The median leverage (bearing debt/EBITDA) increases from **2,03 to 2,14**

The range of potential impacts is wide, but **53%** of entities would experience an increase in debt of over **25%**

The impact of the new standard differs significantly between industries. The industries that are likely to experience the most significant impact on reported financial ratios and performance measures are:

Retail

Airlines

Professional Services

Health Care

Textile and Apparel

Wholesale

Analysts, banks and some rating agencies generally use a 'rule-of-thumb' to adjust the financial statements for the effects of off-balance sheet operating leases. Many currently use a multiple of 8x annual rental expenses rather than the disclosed operating lease commitments in financial statements. The multiple approach using the 'rule-of-thumb' generally results in more significant adjustments to the financial statements.

2. IFRS 16 – The scope of the new leases standard

The IASB published IFRS 16 Leases in January 2016 with an effective date of 1 January 2019. The new standard requires lessees to recognise nearly all leases on the balance sheet which will reflect their right to use an asset for a period of time and the associated liability for payments.

Leasing is an important and widely used financing solution. It is a flexible solution that allows companies to access and use property and equipment without needing to incur large cash outflows and it enables lessees to address the issue of obsolescence and residual value risk. In fact, sometimes leasing is the only way to obtain the use of a physical asset that is not available for purchase.

Under existing rules, lessees account for lease transactions either as operating or as finance leases, depending on complex rules and tests which, in practice, use 'bright-lines' resulting in all or nothing being recognised on balance sheet for sometimes economically similar lease transactions. Under the new leases standard, lessees are required to recognise nearly all leases on the balance sheet which will reflect their right to use an asset for a period of time and the associated liability for payments. All lease liabilities are to be measured with reference to an estimate of the lease term, which includes optional lease periods when an entity is reasonably certain to exercise an option to extend (or not to terminate) a lease.

- **Lessees**

It is anticipated that lessees will be greatly affected by the new standard. The impact on their financial reporting, asset financing, contract and data management, IT systems, processes and controls is expected to be substantial. Many companies lease a vast number of small and/or big-ticket items, including IT and other equipment, cars, power plants, retail stores, cell towers, trains and aircraft.

- **Lessors**

The accounting for lessors largely remains unchanged. However they might see an impact to their business model and lease products due to changes in needs and behaviour of their customers (i.e. lessees).

Scope

The scope of IFRS 16 is generally similar to IAS 17 and includes all contracts that convey the right to use an asset for a period of time in exchange for consideration, except for licences of intellectual property granted by a lessor, rights held by a lessee under licensing agreements (such as motion picture films, video recordings, plays, manuscripts, patents and copyrights), leases of biological assets, service concession agreements and leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources. There is an optional scope exemption for lessees of intangible assets other than the licences mentioned above.

However, the definition of a lease is different from the current IFRIC 4 guidance and might result in some contracts being treated differently in the future. IFRS 16 includes detailed guidance to help companies assess whether a contract contains a lease or a service, or both. Under current guidance and practice, there is not a lot of emphasis on the distinction between a service or an operating lease, as this often does not change the accounting treatment.

Lease and non-lease components

Currently, many arrangements embed an operating lease into the contract or operating lease contracts include non-lease (e.g. service) components. However, many entities do not separate the operating lease component in contracts because the accounting for an operating lease and for a service/supply arrangement generally have a similar impact on the financial statements today. Under the new leases standard, lessee accounting for the two elements of the contract will change because all leases will have to be recognised on the balance sheet[1].

The new lease model

The distinction between operating and finance leases is eliminated for lessees, and a new lease asset (representing the right to use the leased item for the lease term) and lease liability (representing the obligation to pay rentals) are recognised for all leases[1].

Lessees should initially recognise a right-of-use asset and lease liability based on the discounted payments required under the lease, taking into account the lease term as determined under the new standard. Initial direct costs and restoration costs are also included in the right-of-use asset.

Lessor accounting does not change and lessors continue to reflect the underlying asset subject to the lease arrangement on the balance sheet for leases classified as operating. For financing arrangements or sales, the balance sheet reflects a lease receivable and the lessor's residual interest, if any.

[1] When certain criteria are met there are optional exemptions available for short term leases (lease terms shorter than 12 months) and leases of low value assets. These leases do not have to be recognised on the balance sheet but can be accounted for similar to an operating lease in accordance with IAS 17 today and remain off balance.

3. Impact of the new standard

The study has quantified the impact of the new leases standard on financial ratios and performance measures reported by 3,199 IFRS reporters worldwide. The impact of the changes to lease accounting is that the reported debt and EBITDA will increase; for certain entities and industries that increase will be substantial.

3.1. Summary of study results

The study has quantified the minimum impact of the new leases standard on financial ratios and performance measures reported by IFRS reporters worldwide. Based on the 2014 operating lease commitment disclosures in financial statements of 3,199 entities worldwide, we expect that the reported debt of these entities will increase with a median of 22%. 53% of the entities will see an increase in their debt of over 25% based on this study.

The study also shows that the impact on financial ratios differs significantly by industry. Industries that will see the larges impact on reported financial ratios and performance measures are:

- Retail
- Airlines
- Professional services
- Health Care
- Textile and Apparel
- Wholesale

For retailers, the reported debt balances are expected to increase by a median of 98% and the median leverage ratio (calculated as debt divided by EBITDA) will increase from 1,17 to 2,47. Solvency for retailers is expected to decrease from 40,8% to 27,5%. Approximately 35% of the retailers will see an increase of reported debt balances of over 25%.

There are significant differences in the effects of lease capitalisation by industry and also between individual entities within the same industry.

The tables on the next pages include a summary of the impact per industry and geographic area. Certain entities have limited debt balances/low leverage. As a consequence the impact of capitalisation of operating lease commitments is relatively high on the average changes for financial ratios. Therefore, the impact per industry is calculated by using the median values rather than average values as these are not influenced by outliers.

Summary of the lease capitalisation impact for industries:

Industry	Median increase in debt	% entities with over 25% increase	Median increase in EBITDA
Retail	+98%	35%	+41%
Airlines	+47%	50%	+33%
Professional services	+42%	40%	+15%
Health Care	+36%	62%	+24%
Textile and Apparel	+28%	49%	+18%
Wholesale	+28%	39%	+17%
Transport and Infrastructure	+24%	43%	+20%
Entertainment	+23%	67%	+15%
Telecommunication	+21%	52%	+8%
Lodging	+16%	50%	+9%
Industrial	+14%	30%	+9%
Construction	+14%	9%	+8%

Industry	Median increase in debt	% entities with over 25% increase	Median increase in EBITDA
Chemical	+13%	61%	+6%
Food and Agriculture	+12%	78%	+7%
Pharmaceutical	+8%	48%	+5%
Broadcasting	+7%	42%	+11%
Financial services	+6%	37%	+6%
Real estate	+6%	74%	+1%
Extractive companies	+4%	54%	+3%
Utilities	+2%	59%	+2%

Industry	Median leverage change		Median solvency change	
Retail	1,17	2,47	40,8%	27,5%
Airlines	3,26	3,63	25,1%	19,4%
Professional services	0,53	0,96	40,3%	37,5%
Health Care	2,11	2,92	22,3%	19,2%
Textile and Apparel	1,17	1,50	51,2%	45,4%
Wholesale	2,04	2,31	30,7%	28,9%
Transport and Infrastructure	2,21	2,52	35,9%	29,9%

Industry	Median leverage change	Median solvency change
Entertainment	1,78 → 1,30	30,4% → 25,3%
Telecommunicatio n	1,65 → 2,00	22,3% → 21,5%
Lodging	2,15 → 2,55	40,3% → 37,5%
Industrial	1,25 → 1,34	54,9% → 52,7%
Construction	2,13 → 2,18	38,5% → 37,4%
Chemical	1,76 → 1,71	37,5% → 35,0%
Food and Agriculture	2,10 → 2,02	43,0% → 40,4%

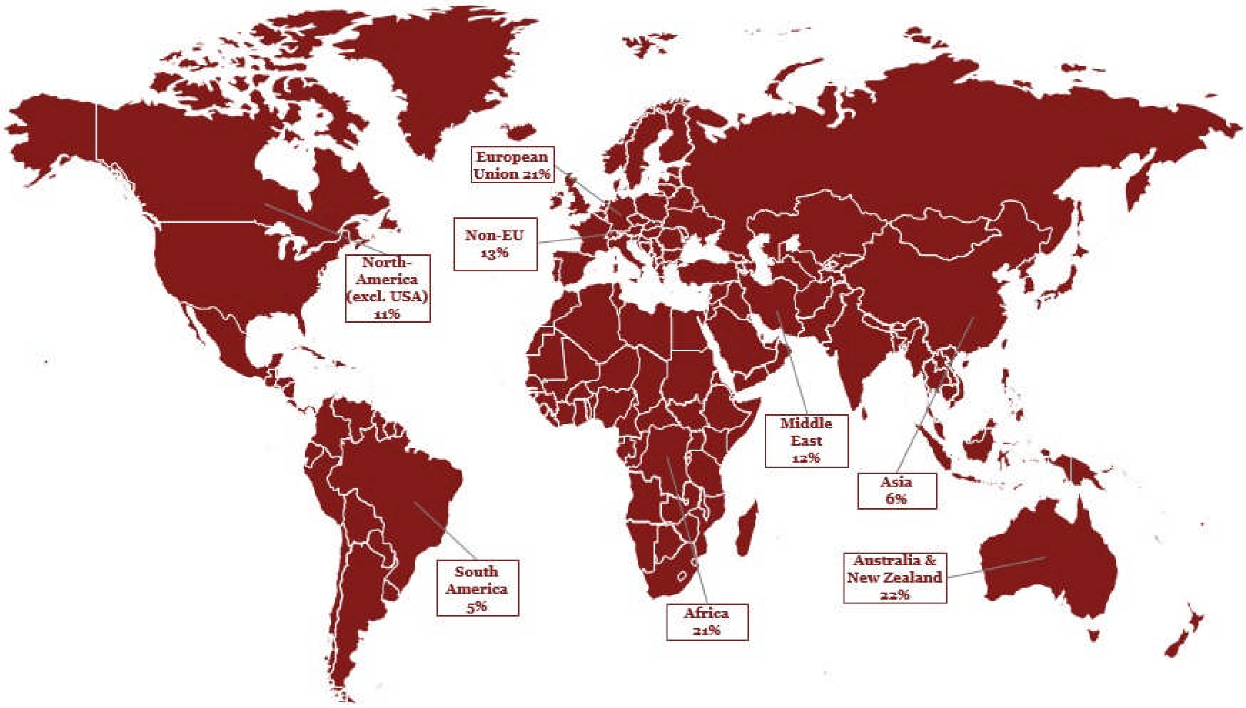
Industry	Median leverage change		Median solvency change	
Pharmaceutical	0,85	0,89	48,5%	48,0%
Broadcasting	3,28	3,00	(22,1)%	(21,4)%
Financial services	1,94	1,68	12,1%	12,1%
Real estate	5,64	4,62	49,8%	44,9%
Extractive companies	0,11	(0,11)	71,1%	69,1%
Utilities	3,51	3,18	28,2%	27,5%

Summary of the lease capitalisation impact on different regions:

Median increase in debt per geographical area:

Our study also shows that the impact on individual entities within an industry can be significantly different depending on its geographical location. Entities within Australia and New Zealand are expected to see a median increase in debt of 22%, followed by the European Union with a median increase of 21%. Entities within the European Union are expected to see a median increase in EBITDA of 11%. The median leverage for the entities within the European Union increases by 0,23 from 1,55 to 1,78.

The following figure includes the median increase in debt for a selection of key geographical areas:



Median increase in EBITDA and the change in median leverage and median solvency per geographical area:

The study also shows that the impact on individual entities within an industry can be significantly different depending on its geographical area. Entities within the European Union are expected to see a median increase in leverage from 1,55 to 1,78 and Non-EU an increase from 1,60 to 2,17. Median solvency seems to have a similar effect on most geographic areas with the European Union showing a decrease from 46,0% to 41,6%.

The following table includes the median increase in EBITDA and the change in the median leverage and median solvency.

Industry	Median increase in EBITDA	Median leverage change	Median solvency change
European Union	11%	1,55 1,78	46,0% 41,6%
Non-EU	8%	1,60 2,17	41,8% 40,4%
North-America (excl. USA)	6%	1,62 1,70	54,0% 50,2%
South America	6%	2,77 2,30	40,5% 37,2%
Asia	4%	0,97 1,05	56,8% 54,1%
Middle East	9%	2,56 2,20	43,9% 40,1%

Industry	Median increase in EBITDA	Median leverage change	Median solvency change
Africa	11%	1,08 → 1,37	50,4% → 47,4%
Australia and New Zealand	10%	0,98 → 1,14	62,9% → 58,2%

3.2. Our methodology

The study is based on the 2014 IFRS financial statements of 3,199 IFRS reporters in 51 countries worldwide (excluding the United States). The approach applied for the study was the constructive capitalisation approach which is based on the disclosed operating lease commitments in financial statements. Entities with no leases, a negative EBITDA or entities with zero debt were excluded from the study. The entities were aggregated into 20 main industries based on the Standard Industrial Classification (SIC) industry codes. The entities were also aggregated into eight geographies.

The disclosures in the financial statements include the operating lease commitments for minimum lease payments under IAS 17 Leases. The operating lease commitments under IFRS are generally disclosed in a first year lease commitment, lease commitment for the years two-five and lease commitment after five years. On the basis of these disclosures in the financial statements and certain assumptions, an allocation of lease payments was performed to individual years. These annual lease payments were subsequently discounted to calculate the lease liability. The discount rate applied was an entity's incremental borrowing rate taking into account the entity's credit rating. If a credit rating was not available, the discount rate used was based on a synthetic rating.

The increase in debt is determined using the calculated lease liabilities for off-balance operating leases and their relative impact on debt already on the balance sheets.

Leverage was defined as net debt divided by EBITDA. The calculated increase in lease liabilities was used to determine the increase in leverage presented together with the calculated increase in EBITDA (see below).

The increase in EBITDA was determined by adding back the disclosed annual rent expenses. In instances where these were not disclosed separately, the annual rent expense is approximated with reference to the disclosed first year operating lease commitments for the next year.

Contacts

For more information on leasing please get in touch with your local PwC contact.

Jay Tahtah
Partner - Capital Markets and Accounting Advisory Services

E: jay.tahtah@nl.pwc.com
T: +31 (0) 88 792 39 45

Erik Roelofsen
Professor of International Financial Reporting

E: erik.roelofsen@nl.pwc.com
T: +31 (0) 88 792 50 51

160215-135156-TS-OS