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The Effect of The Recent IFRS 16 on Major Financial Statements' Ratios

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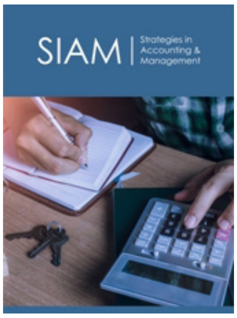

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Abstract

Companies adopting the recent IFRS 16 would be required to capitalize all their previous "off-balance-sheet" operating leases as finance leases. This dramatic shift is expected to have a significant effect on major financial statements' ratios which indicate the level of profitability, financial risk, and liquidity of the company. This review will look at the main financial statements' ratios, and at the expected effect that the switch from the superseded IAS 17 to IFRS 16 will have on them.

Keywords: IFRS 16; Finance leases; Off-balance-sheet leases; IAS 17; Financial statements' ratios

Abbreviations: IFRS: International Financial Reporting Standard; IASB: International Accounting Standards Board; IAS: International Accounting Standard; EBITDA: Earnings Before Interest, Tax, Depreciation, and Amortization; ASC: Accounting Standard Codification; US GAAP: United States Generally Accepted Accounting Principles

Introduction

The International Accounting Standards Board (IASB) had issued IFRS 16 'Leases' in 2016, and it became effective for periods beginning on or after 1 January 2019. Therefore, the first annual reports applying the new standards will be issued in 2020. The main change from the superseded IAS 17 'leases' is the elimination of the dual model where leases were classified as either operating or financing, with elaborate tests to determine the classification. In the new IFRS 16 all leases, for the lessee company, are to be treated as right-of-use assets under one model, which is essentially equivalent to the finance lease category in IAS 17 (the change affects only lessee companies as IFRS 16 did not make any significant changes to lessor accounting). Therefore, when lessee companies switch from IAS 17 to IFRS 16, they would need to re-account for all their previous operating leases as finance leases. This dramatic shift is expected to have a significant effect on major financial statements' ratios which indicate the level of profitability, financial risk, and liquidity of the company. This review will look at the main financial statements' ratios, and at the expected effect that the switch from IAS 17 to IFRS 16 will have on them (for common definitions of ratios see Wahlen, Baginski, and Bradshaw [1].

Discussion

Leverage ratios

In the superseded IAS 17, while finance leases were capitalized, operating leases were treated as a rental. This made operating leases effectively "off balance sheet", showing no liability or asset. However, in IFRS 16, companies with leases that were previously operating leases will have to capitalize those leases as finance leases, recognizing a right-of-use asset against a long-term lease liability. The amount added to assets and liabilities will be the same and will equal the discounted future lease payments (as defined in IFRS 16). Equity is not expected to change due to this capitalization. Therefore, the debt to equity ratio (= total liabilities / shareholder's equity) is expected to increase, increasing the perceived financial risk of the company as it shows that the company relies more heavily on debt. With regard to the debt ratio (= total liabilities / total assets), although both liabilities and assets would increase in the same amount, if the debt ratio previously was lower than 1 (which is commonly the case, unless the company has negative equity), the ratio will have to increase. Milian & Lee [2], using preliminary quarterly results from the 2019 financial year, found that the increase in leverage for companies with a high intensity of operating leases can decrease share price up to 10.5%. The asset turnover ratio (=net sales/total assets), which is a common efficiency ratio, is expected to decrease, as assets will increase with no expected change in net sales.

Profitability ratios

The effect of the switch to IFRS 16 has an indeterminate effect on net profit. Operating leases in IAS 17 had a straight-line "rental" expense, equal to the annual lease payments. However, when those leases become finance leases under IFRS 16 they will have two expense components: amortization expense for the right-of-use asset and interest expense on the lease liability. While the amortization component would usually be straight-line, the interest expense component, by its nature, would be higher in the first years of lease (as the liability balance is high) and will decrease as the end of the lease term approaches. The total expense over the whole lease term has to be equal for a IAS 17 operating lease and an IFRS 16 finance lease (the total expense has to equal the total payments), however, while an operating lease spreads the total expense evenly over the lease term, a finance lease will front-load the expense to the early years of the lease. In the early years of the lease, finance leases will have a higher annual expense, while in the later years of the lease, operating leases will have a higher expense. Therefore, the effect of the switch to IFRS 16 on net profit will depend on the average age of the operating leases the company had previously. If most operating leases were new (which is common if the company is a high growth company), net profit will decrease. However, the opposite will happen if operating leases were mostly at the end of their term.

The effect on the commonly used profit measure of EBITDA (Earnings Before Interest, Tax, Depreciation, and Amortization) will be more predictable. The operating lease expense was considered "rent expense", and so included in EBITDA. However, the finance lease expense is comprised of interest and amortization, which are excluded from EBITDA. Therefore, EBITDA is expected to increase significantly. Similarly, the measure of operating income, which excludes interest expense (but includes amortization), is more likely to increase even in cases where net income decreases. An increase in EBITDA can increase the valuation of the firm and may also help the company in acquiring debt [3].

As to ratios, the return on equity ratio (=net income/ shareholder's equity) is indeterminate, because equity will not change, while net income may increase or decrease as explained above. The return on assets ratio (=net income/total assets) is more likely to decrease because assets will increase significantly (due to the capitalization of the leases) while the effect on income may be milder. The operating margin ratio (=operating income/ Net sales) will increase, as operating income is likely to increase (as explained above) while net sales are not expected to change. An important ratio that combines profitability and leverage is the interest coverage ratio (=Operating income/Interest expenses). As discussed above, operating income will likely increase because it excludes interest expense. Interest expense will increase as finance leases have an interest expense component while operating leases do not. If the interest coverage ratio is significantly above 1, it is more likely that the percent increase in interest expense will be higher than the percent increase in operating income, which will decrease the ratio, and will indicate that the company is less able to pay its debt.

Liquidity ratios

Capitalizing as finance lease the previously "off balance sheet" operating leases will increase both total assets and total liabilities. Although the increase in total assets will all be reflected in non-current assets (as right-of-use assets are non-current intangibles in the balance sheet), the increase in total liabilities will affect both non-current and current liabilities, where the current liabilities will be the lease payments expected in the next financial year. Therefore, if we look at the liquidity related current ratio (= current assets / current liabilities), this ratio is expected to decrease, which indicates a worsening of liquidity (the same effect is expected for the acid-test ratio, and the cash ratio).

A significant positive expected effect on the financial statements is an increase in the operating cash flow in the cash flow statement. While the entire annual payment on an operating lease was considered "rent expense" and therefore classified as an operating cash flow, the payment on a finance lease includes repayment of principal and interest on the lease liability, with the principal classified as a financing activity and the interest as either financing or operating activity (IFRS allows those two options in IAS 7). Even if the interest is considered an operating cash flow, there would still be a significant increase in the operating cash flow (Barton, Hansen, and Pownall [4] find that in some environments the operating cash flow may even have a stronger effect on share price than net income). However, the effect on the popular operating cash flow ratio (=operating cash flow/current liabilities) is indeterminate because both the numerator and the denominator are expected to significantly increase.

US GAAP

The United States Financial Accounting Standards Board (FASB) has also issued a recent standard on leases (ASC 842) which became effective at the same time as IFRS. Although ASC 842 also requires capitalization of previously "off-balance-sheet" operating leases, it did not go as far as IFRS 16 to treat all leases as finance leases. The income statement and cash flow statement treatment in ASC 842 still follows a dual model of operating and finance leases, with few changes from the previous rules. Therefore, the effect of ASC 842 on US companies will mostly be limited to the ones described in the section on leverage ratios above and will not include the other effects on profitability and cash flow.

Conclusion

The adoption of the new IFRS 16 is expected to have a significant effect on the financial statements ratios of companies that previously had a material number of operating leases under the superseded IAS 17. As this is purely an accounting change, with no change in real cash flow or business strategy, further research is needed to estimate how those changes in leverage, profitability, and liquidity ratios will affect how the market perceives those companies.

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