

IFRS 16: Implications for Operating Lease Liabilities



Scope
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In January 2019, a new accounting standard for leases, IFRS 16, will come into effect, requiring companies to capitalise operating leases for the first time. The new standard, which will supersede the current IAS 17, aims to improve comparability and transparency of financial statements among the different sectors and companies. As a result, reported financial debt and total assets will increase, and operating lease costs will be reclassified to depreciation and interest expense. Furthermore, there will be more disclosure requirements, for instance, the leased assets in each asset class must be included in the financial statement notes. Nevertheless, Scope Ratings does not expect major changes in its credit rating approach, as the calculation of Scope-adjusted debt already includes operating lease liabilities.

IAS 17: Operating vs finance leases

Lease contracts currently fall under IAS 17. This standard requires the lessee to capitalise finance leases, increasing the reported debt balance, but not operating leases, which are disclosed as off-balance sheet items. Payments to the lessor are classified as operating expenses and reflect the financed asset's amortisation, interest and depreciation. Due to mandatory and voluntarily options, financial statement notes must disclose operating lease payments made in the respective year as well as any leasing liabilities in future years. Lessees also have to test whether the contracts they have entered into are an operating or finance lease. According to IAS 17.10, a contract is usually treated as finance lease if:

- The lease transfers ownership of the asset to the lessee by the end of the lease term.
- The lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than fair value at the date the option becomes exercisable that, at the inception of the lease, it is reasonably certain that the option will be exercised.
- The lease term is for the major part of the economic life of the asset, even if title is not transferred at the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset.
- The lease assets are of a specialised nature such that only the lessee can use them without major modifications being made.

IFRS 16: Implications on lease contracts

Lease contracts are less standardised than bank loans or corporate bonds, giving companies much more flexibility when negotiating them. Moreover, under IAS 17, operating leases have no impact on debt and interest expense. These aspects give companies an enormous incentive to use operating leases: in 2016 about 45% of lease contracts negotiated were of this type, according to Bundesverband Deutscher Leasing-Unternehmen. Given their widespread use, PwC estimates that, once IFRS 16 is in place, many industries will see a substantial increase in interest-bearing liabilities and financial leverage. Retailers and airlines especially will see leverage levels rise (see Figure 1).

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Bloomberg: SCOP

Implications of IFRS 16 varies among sectors

Figure 1: Implications of IFRS 16 on reported financials for selected sectors

Sector	Median increase in debt	Median leverage change
Retail	98%	1.17 → 2.47
Airlines	47%	3.26 → 3.63
Health care	36%	2.11 → 2.92
Transport and infrastructure	24%	2.21 → 2.52
Telecommunication	21%	1.65 → 2.00
Industrial	14%	1.25 → 1.34
Construction	14%	2.13 → 2.18
Chemicals	13%	1.76 → 1.71
Pharmaceuticals	8%	0.85 → 0.89
Real estate	6%	5.64 → 4.62
Utilities	2%	3.51 → 3.18

Source: PwC

Rental payments as starting point for calculation

Operating leases in the credit rating assessment

In credit analyses, rating agencies have long included operating lease commitments in adjustments of interest-paying debt. This involves calculating operating lease commitments as a product of rental payments per year as well as a multiple, typically between five and eight times the annual rent. This multiple is based on the asset's average remaining useful life and the sector's characteristics, like the type of asset. This gives much room for interpretation when building assumptions. Moreover, rating agencies generally reclassify one-third of operating lease costs to depreciation and the rest to interest expense.

Net present value as the starting point for adjustment

Scope's approach to operating leases

Our corporate rating methodology uses the net present value of operating lease payments to adjust debt when calculating leverage. In the absence of either nominal or net present value, Scope calculates a proxy. We generally discount future operating lease payments by five per cent and reclassify operating lease expenses. Reported interest expense is increased by five per cent of the present value of lease commitments for the respective period. The remaining amount is reclassified as depreciation expense.

IFRS 16 will require companies to use their incremental borrowing rate when calculating the net present value of future operating lease payments. Of course, incremental borrowing rates vary between companies and are influenced by many factors. Scope believes the difference between an individual company's approach and Scope's will only have a minor effect on the financial ratios in Scope's credit metrics, as a 5% discount rate for the debt adjustment of operating leases will be maintained.



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