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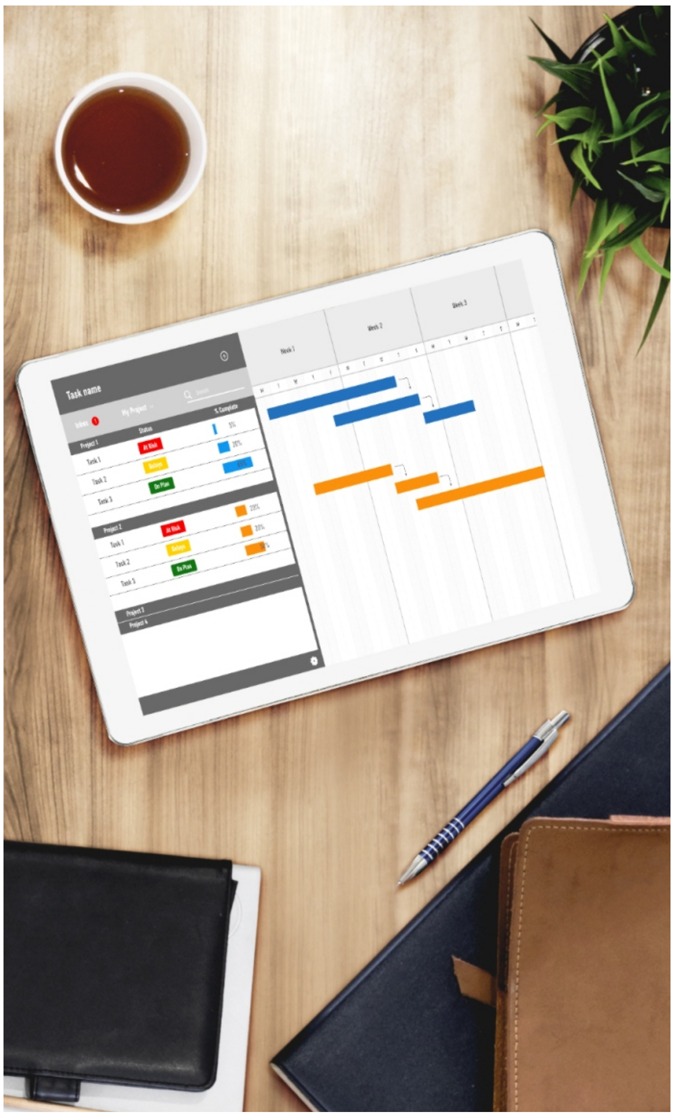
# *Cracking the Code:* How Lease Accounting is Redefining Balance Sheets



Sapna Malya, Anirudh Goel,
Syed Shayan Mahtab & Saket Nayal

***Problem of Practice:***

*Since 2016, accounting boards worldwide have advocated for greater lease accountingtransparency. However, it was not until 2019 that the implementation of new lease accounting standards, IFRS 16/Ind AS 116 (Indian standard), brought significant changes for companies. These changes have had far-reaching implications, affecting various parameters used to analyse corporate financial performance. A key question arises:* ***'How can companies effectively incorporate the new lease accounting standards to ensure compliance while minimizing financial and operational disruptions?'***

*According to research by Ciao-Wei Chen, Maria Correia and Oktay Urcan, the adoption of these standards has macro- and micro-level implications that companies must navigate carefully.*[1] *At the company level, Chief Financial Officers (CFOs) and Chief Operating Officers (COOs) must reassess their operating assets and liabilities, as the new regulations limit the headroom for additional debt on balance sheets. These changes require organizations to implement strategic adjustments, enhance data management processes and improve internal coordination to meet compliance requirements, while ensuring business continuity. On a macro level, policymakers must recognize that compliance with these standards reduces financial flexibility, potentially impacting capital expenditures and debt management strategies*

[1] The article 'Accounting for Leases and Corporate Investment' by Ciao-Wei Chen, Maria Correia and Oktay Urcan, featured in Volume 98, Issue 3 of *The Accounting Review*, talks about the real effects of lease-capitalization rules on corporate investment and how the introduction of these rules leads to a decrease in investment, which is more pronounced for firms with high reliance on leases

## Decline of operating leases

The implementation of the new lease accounting standards, IFRS 16/Ind AS 116, has significantly impacted companies worldwide, particularly companies in capital-intensive sectors like technology, aviation, telecom, oil and gas and retail, which have huge assets on operating leases (*see Table 1*).

*Table 1: Percentage of companies affected by the new lease standard across the globe*

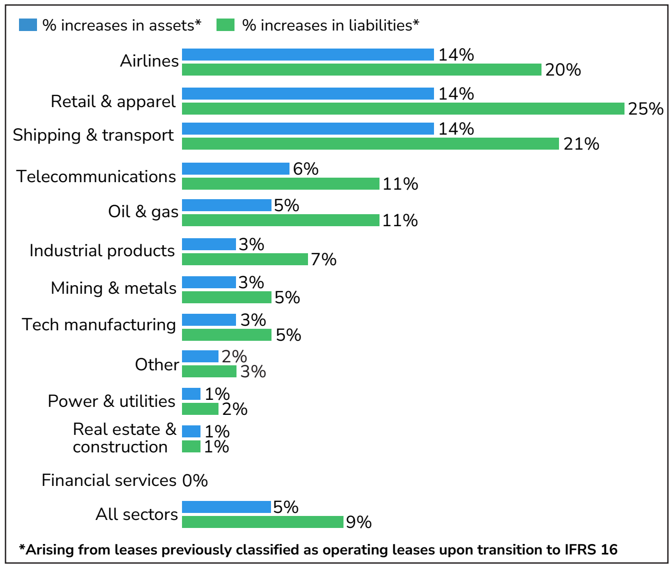
| Region | Percentage of Companies Affected |
|---|---|
| North America | 62% |
| Europe | 47% |
| Asia/ Pacific | 43% |
| Latin America | 23% |
| Africa / Middle East | 23% |
| Total future minimum payments for off-balance sheet leases (undiscounted) | US$ 2.86 trillion |

*Source: The International Accounting Standards Board (IASB)*[2]

Leases are classified into two types: operating and finance leases. Operating leases were traditionally treated as off-balance sheet items, with lease payments recorded as operating expenses, making financial obligations appear lower and financial health better. In contrast, finance leases are recognized on the balance sheet, where leased assets and corresponding liabilities are recorded, reflecting the lessee's ownership risks and rewards. Operating leases provided flexibility but distorted financial reporting, while finance leases offered transparency but increased reported liabilities.

*Why does the change matter to a CFO of a capital-intensive company?* Previously, operating leases for more than a year were recorded as operating expenses in the profit and loss account, meaning they had no impact on the balance sheet, allowing companies to appear 'asset-light'. However, IFRS 16/Ind AS 116 mandates capitalization of nearly all leases onto the balance sheet. This change increases the company's reported asset values by recognizing leased assets and, at the same time, raises liabilities due to the inclusion of future lease payments. A global survey of Fortune Global 500 companies across 12 sectors, conducted by Ernst & Young in 2020, indicated a 14% increase in total assets and a more than 20% rise in liabilities, with the airline, retail, apparel and shipping sectors being the most affected (*see Figure 1*).[3]

*Figure 1: Impact on assets and liabilities of certain sectors due to IFRS 16 as of 2020*




*Source: Ernst & Young Global Limited, June 2021*[4]

The lease liabilities are classified as long-term debts, which can negatively impact key financial ratios, such as the debt-to-equity ratio (financial metric that shows the amount of debt a company has compared to its assets) and reduce the company's ability to take on additional debt (*see Figure 2*).[5] A 2019 study by PWC, examining the impact of the lease accounting standard on NSE Nifty 50 companies, revealed that the average debt would rise by approximately 7% and the debt-to-equity ratio would increase by about 10%. For 32% of the companies, this ratio could surge by as much as 25%.[6]

*Figure 2: Effect of the new lease accounting standard on financial metrics*

| Metric | What it measures | Common method of calculation | Expected effect of IFRS 16 | Explanation |
|---|---|---|---|---|
| Leverage (gearing) | Long-term solvency | Liabilities / Equity | Increase | Increase because financial liabilities increase (and equity is expected to decrease). |
| Current ratio | Liquidity | Current assets / Current liabilities | Decrease | Decrease because current lease liabilities increase while current assets do not. |
| Asset turnover | Profitability | Sales / Total assets | Decrease | Decrease because lease assets will be recognised as part of total assets. |
| Interest cover | Long-term solvency | EBITDA / Interest expense | Depends | EBITDA will increase applying IFRS 16 as will interest expense. The change in the ratio will depend on the characteristics of the lease portfolio. |
| EBIT / Operating | Profitability | Various methods—Profit that does not consider earnings from investments and the effects of interest and taxes | Increase | Increase because the depreciation charge added is lower than the expense for off balance sheet leases excluded. |
| EBITDA | Profitability | Profit before interest, tax, depreciation and amortisation | Increase | Increase because expenses for off balance sheet leases are excluded. |
| EBITDAR | Profitability | Profit before interest, tax, depreciation, amortisation and rent | No change | No change because all lease-related expenses are excluded. |
| Profit or loss | Profitability | As reported applying IFRS | Depends | Depends on the characteristics of the lease portfolio and the tax rate. |
| EPS | Profitability | Profit or loss / Number of shares in issue | Depends | Depends on the effect on profit or loss, which depends on the characteristics of the lease portfolio and the effects on tax. |
| ROCE | Profitability | EBIT / Equity plus financial liabilities | Depends | EBIT will increase applying IFRS 16 as will financial liabilities. The change in the ratio will depend on the characteristics of the lease portfolio. |
| ROE | Profitability | Profit or loss / Equity | Depends | Depends on the effect on profit or loss, which in turn depends on the lease portfolio—if there is no effect on profit or loss, then the ratio will be higher because reported equity will decrease. |
| Operating cash flow | Profitability | Various methods—Cash flow from operating activities does not include cash related to equity and borrowings | Increase | Increase because at least part of the lease payments (those payments relating to the principal) will be moved to the financing section of the cash flow statement. |
| Net cash flow | Profitability and liquidity | Difference between cash inflows and cash outflows | No change | No change No change because cash will not be affected. |

*Source: The International Accounting Standards Board (IASB)*[7]

In the profit and loss statement, lease rentals are no longer recorded as an expense. Instead, the financial statements now show depreciation of leased assets and interest costs, which leads to an improvement in EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization), potentially giving a more favourable view of the company's operating performance (see Table 2).[8]

*Table 2: Percentage change in EBITDA after implementing the new Lease Standard in different sectors (as per IASB Report 2016)*

| Industry sector | EBITDA in millions of USD | | Increase in EBITDA (percentage) |
|---|---|---|---|
| | Before IFRS 16 | After IFRS 16 | |
| Airlines | 51,652 | 73,849 | 43% |
| Retailers | 2,70,403 | 3,47,716 | 29% |
| Travel and Leisure | 50,299 | 63,279 | 26% |
| Transport | 71,177 | 87,580 | 23% |
| Telecommunications | 3,99,328 | 4,34,452 | 9% |
| Energy | 6,88,370 | 7,45,273 | 8% |
| Media | 1,18,156 | 1,28,959 | 9% |
| Distributors | 29,350 | 35,047 | 19% |
| Information Technology | 2,98,655 | 3,12,392 | 5% |
| Healthcare | 2,54,616 | 2,65,181 | 4% |
| Others | 11,62,512 | 12,28,643 | 6% |
| Total | 33,94,490 | 37,22,371 | 10% |

*Source: The International Accounting Standards Board (IASB)*[9]

## Dealing with the change

The research by Chen et al explores the real-world impact of lease accounting standards on businesses. It indicates that the new lease capitalization requirements have a significant effect on firm-level investment. To comply, companies must collect, analyse and report additional lease-related data. During this process, they may identify areas of overinvestment that could be reduced or eliminated. The new accounting rules can also negatively impact debt covenant ratios, prompting lenders to impose more restrictive loan terms. As a result, projects that previously had a positive Net Present Value (value of future cash flows discounted to the present) may become unviable, leading to a substantial reduction in capital expenditures for lease-heavy companies.

Companies with high lease obligations may also consider reducing their workforce to manage financial strain. The research also highlights that operating leases are now perceived as debt by credit rating agencies, creditors and investors, influencing debt covenants and risk premiums.

Adopting the new lease standard is a complex process that requires a deep understanding of the regulations and their implications. Careful planning is essential to ensure a smooth transition and maintain comparability of financial information.

Air France-KLM adopted IFRS 16 early in 2018 and has applied the complete retrospective approach to transition. Under the retrospective approach, a company applies the new standard to all leases and restates its prior financial information, recognising an adjustment in equity at the beginning of the earliest period presented. *Figure* 3 shows the extract from its interim report of 2018, when KLM adopted IFRS 16.[10]

*Figure 3: Extract from Air France KLM June 2018 interim report*

| In € millions<br>**Balance sheet as of January 1, 2017** | Published accounts | IFRS 9 impact | IFRS 15 impact | IFRS 16 impact – contracts capitalization | IFRS 16 impact – maintenance of leased aircraft | Restated accounts |
|---|---|---|---|---|---|---|
| **Asset** | - | - | - | - | - | - |
| Flight equipment | 9,119 | (26) | - | (94) | (241) | 8,758 |
| Other property, plant and equipment | 1,480 | - | - | (80) | - | 1,400 |
| Right-of-use assets | - | - | - | 4651 | 1154 | 5,805 |
| Deferred tax assets | 176 | 6 | 32 | 289 | 86 | 589 |
| Trade receivables | 1,868 | - | 26 | - | - | 1,894 |
| Other current assets | 1,105 | (1) | 23 | (52) | 5 | 1,080 |
| **Equity and liabilities** | - | - | - | - | - | - |
| Return obligation liability and other provisions (current and non-current term) | 2,327 | - | (106) | (1) | 1174 | 3,394 |
| Financial debt (current and non-current) | 8,452 | (4) | - | (175) | - | 8,273 |
| Lease debt (current and non-current) | - | - | - | 5656 | - | 5,656 |
| Deferred tax liabilities | (12) | - | (5) | - | - | (17) |
| Deferred revenue on ticket sales | 2,517 | - | 122 | - | - | 2,639 |
| Other current liabilities | 2,775 | - | 146 | 1 | (7) | 2,915 |
| Equity | 1,296 | (17) | (76) | (767) | (163) | 273 |
| • Holders of Air France-KLM | 1,284 | (17) | (76) | (766) | (163) | 262 |
| • Non-controlling interests | 12 | - | - | (1) | - | 11 |

Source: *Air France KLM First Half Financial Report Jan-Jun 2018*[11]

Walmart, on the other hand, used a modified retrospective approach to deal with the transition from the old standard to the new lease accounting standard. Under the modified retrospective approach, there is no requirement to restate the comparative financial information.

When it adopted the new standards, the following was mentioned in its annual report of 2020.[12] "...***In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842), which requires lease assets and liabilities to be recorded on the balance sheet. The Company adopted this ASU and related amendments as of February 1, 2019 under the modified retrospective approach and elected certain practical expedients permitted under the transition guidance, including to retain the historical lease classification as well as relief from reviewing expired or existing contracts to determine if they contain leases. For leases subject to index or rate adjustments, the most current index or rate adjustments were included in the measurement of operating lease obligations at adoption.***

***The adoption of this ASU and related amendments resulted in a $14.8 billion increase to total assets and a $15.1 billion increase to total liabilities in the first quarter of fiscal 2020. In the first quarter of fiscal 2020, the Company recognized $16.8 billion and $17.5 billion of operating lease right-of-use assets and operating lease obligations, respectively, and removed $2.2 billion and $1.7 billion, respectively, of assets and liabilities related to financial obligations connected with the construction of leased stores. Several other asset and liability line items in the Company's Consolidated Balance Sheet were also impacted by immaterial amounts. Additionally, the adoption resulted in a cumulative-effect adjustment to retained earnings of approximately $0.3 billion, net of tax, which primarily consisted of the recognition of impairment. The Company's Consolidated Statement of Income and Consolidated Statement of Cash Flows were immaterially impacted. Accounting policies as a result of the adoption of this ASU are described below. Refer to Note 7 for additional lease disclosures...***"

The transition phase of reporting is crucial for companies and, therefore, they need to consider the quantitative and qualitative factors to manage the stakeholder expectations. They need to understand the standard and assess the effects of the transition options on their financial reporting.

## Embracing the change

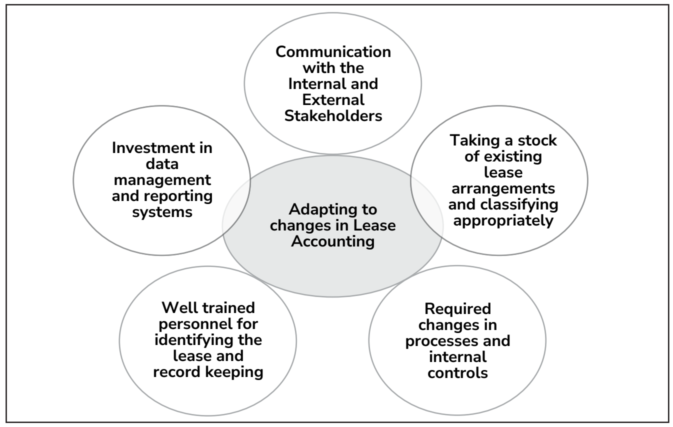
Companies must adopt a proactive approach to comply with the new lease accounting standards and minimize potential risks. This includes the following key actions:

- **Stakeholder communication and training:** Clear and effective communication with stakeholders is essential to ensure they understand the implications of IFRS 16/Ind AS 116. Companies should conduct training sessions and workshops for finance teams, executives, and other key personnel to build awareness and knowledge. Lenders should also be informed about changes in debt covenants resulting from the new lease accounting treatment. During the first year of transition, providing detailed comparative financial information — such as lease-adjusted leverage ratios and adjusted earnings (EBITDAR) — can help stakeholders better understand the impact.
- **Reviewing and assessing lease agreements:** Companies should thoroughly review all lease agreements to identify those that fall under IFRS 16/Ind AS 116. This process requires collaboration across departments, including finance, procurement and legal teams, to gather relevant lease data and evaluate its impact on financial reporting. Engaging lease accounting experts can be beneficial in accurately analysing lease arrangements and ensuring compliance.
- **Upgrading data management and reporting systems:** Organizations must assess their current data management and reporting systems to ensure they can handle the increased complexity and volume of lease data required by IFRS 16/Ind AS 116. This may involve upgrading existing software, implementing new reporting tools and strengthening data governance processes to improve accuracy, consistency and compliance with reporting requirements.

## Mitigating potential risks

The adoption of Ind AS 116 and IFRS 16 represents a significant shift in lease accounting. Under the new framework, companies must recognize leased assets and corresponding liabilities on their balance sheets, even if they do not own them. This change has far-reaching implications for financial reporting, particularly for companies with substantial lease obligations, as it alters key financial ratios and impacts strategic decision making.

*Figure 4: Requirements for adapting to changes in lease accounting*




*Source: Developed by authors*

The research by Chen et al highlights that firms with high lease obligations may experience reduced capital expenditures, workforce downsizing and tighter debt covenants due to the new accounting standards. While the changes introduce challenges, they also present an opportunity for companies to enhance financial accuracy and comparability.

To adopt these changes effectively, organizations must implement proactive strategies such as stakeholder communication and training, thorough review and assessment of lease agreements and upgrading data management and reporting systems. By implementing these measures, businesses can mitigate potential risks and ensure compliance while minimizing financial and operational disruptions.

Ultimately, adapting to the new lease accounting standards is not just a regulatory requirement but an opportunity to improve financial transparency and operational efficiency in the long run.


***Sapna Malya** is Professor with the Finance and Economics department at SPJIMR. You can reach out to her at **sapna.malya@spjimr.org***

***Anirudh Goel, Syed Shayan Mahtab and Saket Nayal** were students from SPJIMR's Post Graduate Programme in Management Class of 2024*

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