It's a MATTER of company's VALUE?!

-- IFRS16 and evaluation of company's business --

IFRS Digital Reporting Workshop 16th

Date and time : 3rd Sep 2019, 18:30-20:00

The amendment of Accounting Standard affects company Value?

IFRS 16 is the standard on Lease. It became mandatory this year, companies having many lease contracts for buildings or vehicles had a big impact on their financial statements. Liabilities became larger, and ROA became smaller (as what used to be expenses turned to asset/liability). Should a company change its strategy? Should lease industry change their business model? Before that, what is the relation between accounting standard and company business?

Some might have been surprised that a big change in ROA (worse) was caused because of IFRS 16. There are about 200 companies adopting IFRS. If all companies revised at the same time, it would have been easy to make comparisons within the industry. Amendments to IFRS always make Japanese investors, analysts and information vendors feel that “comparability” is difficult to be achieved.
However, some investors say that they are already adjusting to it. The company's expected debt was taken into account in the corporate value. In Japan, many shops, warehouses, and trucks that are very important for retail and transportation, which are difficult to operate without lease, have been using operating lease. **Shouldn't they be “assets”?** IFRS 16, the matter is not only comparability, whether they are accounted for as asset / Liabilities or not. We started to discuss here and consider the relation between accounting standard and company value.
Let’s see our discussion!

Special Speaker	Former IASB board member
Attendees	16 Investors, 2 Investor(or Analyst) organization, 10 Information providers/Researchers, 6 Company side (include Independent non - executive director), 4 Auditor, 1 Academic, 7 Regulator/Accounting setter/etc

IFRS16 Report of CFA institute

CFA Institute warned analysts

CFA Institute published a report "Leases: WHAT INVESTORS NEED TO KNOW ABOUT THE NEW STANDARD" .
https://www.cfainstitute.org/-/media/documents/article/position-paper/cfa-leasing-paper.ashx.

IFRS abolished the classification of 'operating leases', while US GAAP did not abolish the classification. Therefore, the transition procedure is slightly different, but it will be handled in a similar way after application as both standards require recognition of right of use assets for virtually all leases in the balance sheets.

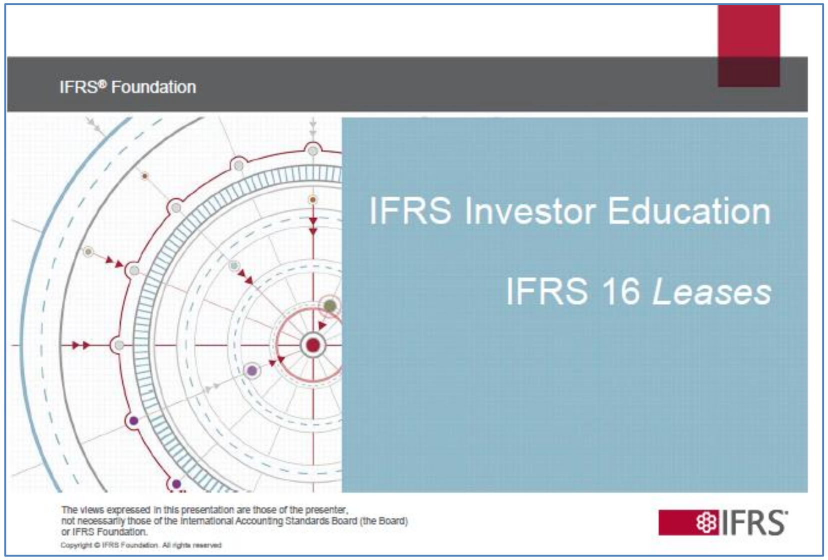
・New lease accounting standard is effective from FY2019
-Although the new standard has a significant impact on the BS for companies of limited industries (especially the railway, aviation, telecom, and transportation sectors), they also have an impact on the PL and cash flow statement.
• The CFA Institute published a report for investors, focusing on lessee accounting that is likely to be particularly affected by the new lease accounting standards.
• This report summarizes the matters that investors should understand about the impact of the new accounting standards (10 themes) by comparing US GAAP with IFRS.

10 themes

I. The Basics of the New Standard
II. Transition to the New Standard
III. Disclosures in Advance of the Change
IV. Impact on the Financial Statements
V. Impact on Non-GAAP Measures
VI. Cash Flow statement
VII. Significant Impact for the financial rations.
VIII. New Disclosures of the Lease Accounting.
IX. Sector that has a big impact from new standard
X. Markets React

IASB also has been educating investors

- Investor engagement team issued paper for investors and analysts, information providers.



- Lease expense will comprise of two components

	IAS 17		IFRS 16
	Finance leases	Operating leases	All leases
Revenue	x	x	x
Operating costs *(excluding depreciation and amortisation)*	—	Single expense	—
EBITDA			⇧⇧
Depreciation and amortisation	Depreciation	—	Depreciation
Operating profit			⇧
Finance costs	Interest	—	Interest
Profit before tax			⇔

Additional P/L information related to leases provided in the notes

IFRS

P&L metrics, margins and ratios	IFRS 16 "New Accounting"
EBITDAR	No change
EBITDA	Higher
EBIT	Higher
Net income	…it depends
ROA	Lower
Asset Turnover	Lower
ROE	….it depends

Leverage analysis	IFRS 16 "New Accounting"
Debt/Equity	Higher
Interest coverage (EBIT/Interest)	Lower

Company X

More short life lease obligations

	Maturity							
	Total	less than 1 month	1–3 months	3–6 months	6 months –1 year	1–3 years	3–5 years	more than 5 years
Bank borrowings	1,625				285	740	600	
Lease liabilities	2,300	70	140	210	400	750	620	110
Trade and other payables	350	70	190	90				

Company Y

	Maturity						
	Total	less than 1 month	1–6 months	6 months –1 year	1–2 years	2–3 years	more than 3 years
Bonds	2,100	7	34	40	79	1,940	
Lease liabilities*	4,970			340	310	290	4,030
Trade and other payables	980	280	700				

*Further information about the maturity of lease liabilities is provided in the table below:

More long life lease obligations

	Maturity						
	Total	less than 1 year	1–5 years	5-10 years	10-15 years	15-20 years	20-25 years
Lease liabilities	4,970	340	1,200	1,110	1,050	970	300

Companies can use **most relevant time bands** for their lease portfolio

Impact on the financial statements　(CFA institute)

FINANCIAL STATEMENT CAPTION	US GAAP		IFRS
	OPERATING	FINANCE	FINANCE
BALANCE SHEET (TRANSITION & INCEPTION)			
ASSETS Right-of-Use Asset	Equal to Lease Liability at Inception ↑	Equal to Lease Liability at Inception ↑	Equal to Lease Liability at Inception ↑
LIABILITIES Lease Liability (Current & Long-Term)	Present Value of Future Lease Payments ↑	Present Value of Future Lease Payments ↑	Present Value of Future Lease Payments ↑
EQUITY*	Retained Earnings ↔	Retained Earnings ↔	Retained Earnings ↔
INCOME STATEMENT			
OPERATING EXPENSES Lease Expense	Straight-Line Lease Expense ↔	—	—
Right-of-Use Asset Amortization	—	Amortization of Right-of-Use Asset (Straight-Line) ↑	Amortization of Right-of-Use Asset (Straight-Line) ↑
Interest Expense		Effective Interest Method (Higher at Inception) ↑	Effective Interest Method (Higher at Inception) ↑
STATEMENT OF CASH FLOWS			
OPERATING CASH INFLOWS	↔	↑	↑
FINANCING CASH OUTFLOWS	—	↑	↑

Non-GAAP measure such as EBIT, EBITDA, will be affected by new standard.

	SCENARIO #1	SCENARIO #2	SCENARIO #3
	OPERATING	FINANCE	FINANCE
Revenues	1,600	1,600	1,600
Expenses			
Salaries	750	750	750
Selling & Administrative	150	150	150
Operating Lease Expense	100		
Amortization of Right-of-Use Asset		65	74
Operating Expenses	1,000	965	974
Operating Income	600	635	626
Interest Expense	-	35	44
Income Before Tax	600	600	582
Income Taxes (20%)	120	120	116
Net Income	480	480	466
EBT	600	600	582
EBIT	600	635	626
EBITDA	600	700	700
EBITDAR	700	700	700

Basically change of standard does not affect the actual cash flow. But you need to bear in mid the following points:

- Cash flow disclosure will be different.
  - ✓ Operating cash flow
  - ✓ Financing cash flow
- In case that tax rule changes(with this change of standard), cash flow might be affected.
- In case that the lease contract changes (with this change of standard), cash flow might be affected.

Impact on the financial indicators (CFA institute)

Financial ratios are greatly affected by new standards.

- ✓ Balance Sheet Ratio (Solvency Ratios / Liquidity Ratios)
- ✓ Profitability Ratios (EPS)
- ✓ ROE (broken down into each component by Dupoint Formula)
- ✓ Cash flow ratio (Performance Ratios / Coverage Ratios)

DUPONT (ROE) FORMULAS			
DESCRIPTION	**RATIO**	**OPERATING LEASE**	**FINANCE LEASE**
Return on Equity	Net Income / Average Shareholders' Equity	– / – = –	↓ / – = ↓
Return on Assets	Net Income / Average Total Assets	– / ↑ = ↓	↓ / ↑↑ = ↓
Leverage	Average Total Assets / Average Shareholders' Equity	↑ / – = ↑	↑ / – = ↑
Net Profit Margin	Net Income / Revenue	– / – = –	↓ / – = ↓
Total Asset Turnover	Revenues / Average Total Assets	– / ↑ = ↓	– / ↑ = ↓
Tax Burden	Net Income / EBT	– / – = –	↓ / ↓ = –
Interest Burden	EBT / EBIT	– / – = –	↓ / ↑↑ = ↓
EBIT Margin	EBIT / Revenues	– / – = –	↑ / – = ↑

↑ (Increase), ↓ (Decrease), – (No Change), ↑↑ (Greater Increase)

Sectors which has a big impact (CFA institute)

- The result of the research conducted by CFA Institute showed us the fact that retail and transportation industries are most affected.

TABLE 13. IMPACT OF LEASE STANDARD CHANGE: PRO FORMA ASSETS AND LIABILITIES RECOGNIZED—GREATEST CHANGE

($ IN MILLIONS)	SECTOR	INDUSTRY	TOTAL ASSETS	COMMON EQUITY	ESTIMATED ROU ASSET & LIABILITY	% INCREASE IN TOTAL ASSETS	STATED FINANCIAL LEVERAGE	REVISED FINANCIAL LEVERAGE	CHANGE IN FINANCIAL LEVERAGE	% CHANGE FINANCIAL LEVERAGE
Foot Locker	Consumer Discret.	Apparel Retail	$3,961.0	$2,519.0	$4,410.0	111.3%	1.57	3.32	*1.75*	*111.3%*
Gap	Consumer Discret.	Apparel Retail	7,989.0	3,144.0	7,800.0	97.6%	2.54	5.02	*2.48*	*97.6%*
Michael Kors Holdings	Consumer Discret.	Apparel, Accessors. & Luxury Gds.	2,409.6	1,592.6	1,995.0	82.8%	1.51	2.77	*1.25*	*82.8%*
Chipotle Mexican Grill	Consumer Discret.	Restaurants	2,045.7	1,364.4	1,672.9	81.8%	1.50	2.73	*1.23*	*81.8%*
TJX Companies	Consumer Discret.	Apparel Retail	14,058.0	5,148.3	9,548.4	67.9%	2.73	4.59	*1.85*	*67.9%*
Tractor Supply Co	Consumer Discret.	Specialty Stores	2,868.8	1,418.7	1,917.0	66.8%	2.02	3.37	*1.35*	*66.8%*
Ross Stores	Consumer Discret.	Apparel Retail	5,722.1	3,049.3	3,194.4	55.8%	1.88	2.92	*1.05*	*55.8%*
Starbucks	Consumer Discret.	Restaurants	14,365.6	5,457.0	7,975.2	55.5%	2.63	4.09	*1.46*	*55.5%*
Dollar General	Consumer Discret.	General Merchandise Stores	12,516.9	6,125.8	6,489.1	51.8%	2.04	3.10	*1.06*	*51.8%*
Ulta Beauty	Consumer Discret.	Specialty Stores	2,908.7	1,774.2	1,449.4	49.8%	1.64	2.46	*0.82*	*49.8%*
Dollar Tree	Consumer Discret.	General Merchandise Stores	16,332.8	7,182.3	8,061.0	49.4%	2.27	3.40	*1.12*	*49.4%*
Ralph Lauren	Consumer Discret.	Apparel, Accessors. & Luxury Gds.	5,652.0	3,299.6	2,763.0	48.9%	1.71	2.55	*0.84*	*48.9%*
Tapestry	Consumer Discret.	Apparel, Accessors. & Luxury Gds.	5,831.6	3,001.9	2,547.0	43.7%	1.94	2.79	*0.85*	*43.7%*
Advance Auto Parts	Consumer Discret.	Automotive Retail	8,482.3	3,415.2	3,200.9	37.7%	2.48	3.42	*0.94*	*37.7%*
Darden Restaurants	Consumer Discret.	Restaurants	5,292.3	2,101.7	1,992.0	37.6%	2.52	3.47	*0.95*	*37.6%*
FedEx	Industrials	Air Freight & Logistics	48,552.0	16,073.0	17,952.0	37.0%	3.02	4.14	*1.12*	*37.0%*

(Continued)

TABLE 13. IMPACT OF LEASE STANDARD CHANGE: PRO FORMA ASSETS AND LIABILITIES RECOGNIZED—GREATEST CHANGE (Continued)

($ IN MILLIONS)	SECTOR	INDUSTRY	TOTAL ASSETS	COMMON EQUITY	ESTIMATED ROU ASSET & LIABILITY	% INCREASE IN TOTAL ASSETS	STATED FINANCIAL LEVERAGE	REVISED FINANCIAL LEVERAGE	CHANGE IN FINANCIAL LEVERAGE	% CHANGE FINANCIAL LEVERAGE
Best Buy Co	Consumer Discret.	Computer & Electronics Retail	13,049.0	3,612.0	4,692.0	36.0%	3.61	4.91	*1.30*	*36.0%*
American Airlines Group	Industrials	Airlines	51,396.0	3,926.0	16,800.0	32.7%	13.09	17.37	*4.28*	*32.7%*
Fastenal	Industrials	Building Products	2,910.5	2,096.9	931.8	32.0%	1.39	1.83	*0.44*	*32.0%*
PVH	Consumer Discret.	Apparel, Accessors. & Luxury Gds.	11,885.7	5,536.4	3,729.0	31.4%	2.15	2.82	*0.67*	*31.4%*
Alaska Air Group	Industrials	Airlines	10,740.0	3,721.0	3,312.0	30.8%	2.89	3.78	*0.89*	*30.8%*
Tiffany & Co	Consumer Discret.	Apparel, Accessors. & Luxury Gds.	5,468.1	3,248.2	1,628.4	29.8%	1.68	2.18	*0.50*	*29.8%*
Walgreens Boots Alliance	Consumer Staples	Drug Retail	66,009.0	28,274.0	19,578.0	29.7%	2.33	3.03	*0.69*	*29.7%*
Half Robert Int'l	Industrials	HR & Employment Services	1,867.5	1,105.3	525.0	28.1%	1.69	2.16	*0.47*	*28.1%*
United Continental	Industrials	Airlines	42,326.0	8,806.0	11,526.0	27.2%	4.81	6.12	*1.31*	*27.2%*
Quanta Services	Industrials	Construction & Engineering	6,480.2	3,795.6	1,657.2	25.6%	1.71	2.14	*0.44*	*25.6%*
Estee Lauder Companies	Consumer Staples	Personal Products	11,568.0	4,384.0	2,742.0	23.7%	2.64	3.26	*0.63*	*23.7%*
O Reilly Automotive	Consumer Discret.	Specialty Stores	7,571.9	653.0	1,791.7	23.7%	11.59	14.34	*2.74*	*23.7%*
V F Corp	Consumer Discret.	Apparel, Accessors. & Luxury Gds.	9,958.5	3,719.9	2,277.8	22.9%	2.68	3.29	*0.61*	*22.9%*
Southwest Airlines Co	Industrials	Airlines	25,110.0	10,430.0	5,634.0	22.4%	2.41	2.95	*0.54*	*22.4%*
Under Armour	Consumer Discret.	Apparel, Accessors. & Luxury Gds.	4,006.4	2,018.6	847.2	21.1%	1.98	2.40	*0.42*	*21.1%*

Discussion

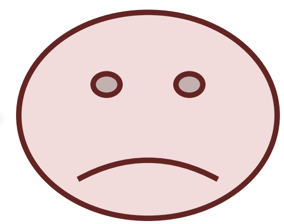
Auditor

Further to challenges associated with the 10 items covered by the CFA report, J-GAAP financial statements may be more complicated. According to PITF No. 18, it is possible for companies preparing Japanese GAAP consolidated financial statements to consolidate IFRS subsidiary financial statements without unifying all accounting policies of the subsidiaries. However, since there is no explicit requirements of the PITF on footnote disclosures, the disclosure practice might not as robust as it could be. If the overseas subsidiary applies IFRS and the parent company applies Japanese GAAP, the judgment of what to disclose on leases might be different.

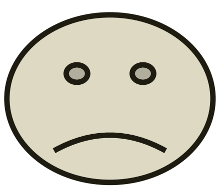
Accounting setter

Recently I read a report summarizing the adoption status of the new lease standard in the US for the first quarter of this year. I was surprised to see that the impact of Japanese companies might be even greater than that of US companies. From newspapers, you may already have understood likely effects on financial statements for companies using IFRS. I would like to know how your analysis might be affected with new accounting practice. For example, if you pay a lease charge for 15 years, my question is whether you would like to see debt on balance sheets for the charge.

I haven't taken into account the debt for continuing evaluation of the company business, so **<u>it is no effect for my analysis</u>**



Investor



company

I recognized that there was a considerable amount of free rent contracts for office buildings, etc. **<u>it became a significant PL impact.</u>** With J-GAAP rental contracts, it would be apportioned over the contract term (eg 5 years), but IFRS prorate over a longer period (eg 10 years) in order to expect a reasonable renewal, when applying IFRS16. Other than that, there is almost no impact on the final line of PL, but operating income raised because some expenses changed to interest expenses.

Comparability

Sell side analyst

I am an analyst in the trading sector on the sell side, so I felt a huge impact. **About 1 trillion yen, the debt became larger and ROA looked low.** Personally, as long as we understand it, we don't need to feel any problems, and there is no such thing happened so far.
If you don't know the change of the standard and compare horizontally or historically, and if you do not check the reason even if the ROA suddenly drops, there is a risk of misunderstanding. Regarding a big company, we don't worry so much they are explaining at the analyst meetings or if there are a lot of investors and analysts looking at it, but if it's not, you might be misunderstood.

For information providers**, long-term comparability is the most important.** In the next few years, investors will also be sensitive to this change, so I think they will look carefully at the analysis. But when the new generation analysts will see financial figures over the next 5 or 10 years, it is difficult to adjust how much the impact due to the standard changes should be adjusted for comparison.

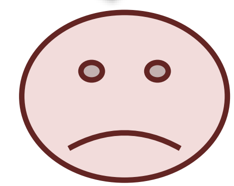
Information providers

What was “operating lease” ?

This change makes the odd impression for me, **because it looks like people living in apartments are treated suddenly the same as people who buy a house and pay a mortgage.** Even though it is not avoidable, in the case of the finance lease.

Investor

As it used to be, Daiei took advantage of the unrealized gains from rising prices at its owned property for stores, while Yoka-do （7&i holding) **was highly praised for efficient management without possession of assets.**
Such evaluation ways would be impossible in the future?



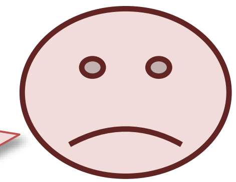
Investor

Now, J-GAAP is also considering to amend lease standard. There are over 3600 companies, so it will be a huge change. I think that some people judge investment (or voting) decision numerically, so is it really OK to change suddenly in a certain year?
In addition, as CFA institute report says, you should be careful that **companies might change the number artificially, or when the standards change, the company behavior would change,** so you may need to change your evaluation for them.,,,

Researcher

What is “asset” for company business?

If there is no asset impairment risk or there is no valuation gain on the balance sheet, it is odd for me.
If it is recorded in BS as an asset, I usually care what happens to its value. I feel strange that I don't need to worry about it. However, if you decide once, I want you not to change more.
I think it's just a rule, even we feel uncomfortable at the time of transition, we could get used to it. We (user) are fine both ways. It is just a matter of the rule.



Investor

Researcher

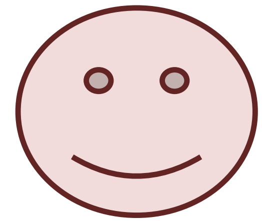
If something happens in the land where the building is originally rented as operating lease, **is impairment recorded?**

Auditor

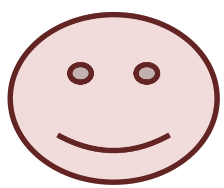
The retail industry buys things and sells them to someone. For retailers, it is important to sell at the best location. **Because it is important for retailers to stay ‘nimble’, they chose the contracts meeting characteristics of operating lease until now.** Is it OK that such strategy would not be reflected on financial statements?

How we can know the company value?

I used to invest in a company in the nursing care industry. Generally, They leased their buildings with operating leasing contract for 20 or 25 years. One day, we had information that the change of JGAAP might force them to put all those leasing on-balanced in a few years. We recalculated the corporate value. As we expected and MM theory might agree, the corporate value based on EVA was the same even after the change of accounting rule. Then, I discussed with team members “No change of corporate value. That is good! But wait a minute, we also have to forecast the stock price. The theoretical corporate value will not change, but the stock price may change. So when ROA changes, what will this be?” Actually, from long term investment point of view, the correction of stock price in this case might be a good chance to buy. If I picked up the a good aspect of this experience, we could identify essential risks of their business such as risks in continuing business that are not normally seen in operating leases. Even if the nursing care servicers might belong to the same industry in a large sense, the business risks of asset differ according to the types of businesses they are offering. Some company might be leasing relatively versatile facilities for elderly day care, but others were leasing apartments for elderly nursing home which were designed and built only for them. Through the change of accounting policy, we thought that **it would be good to see the essence of a company's business more severely.**



Investor



Investor

There is no impact our portfolio. This is because **our model has already taken into account of this change**.

Accounting Standards and company value

Management strategy is influenced by accounting rule, standards. For example, if you run a sports club, you may consider a financial strategy under the condition such as you can use leasing. Based on the premise that leasing can be used, we will create a financial strategy, business model, and a high-profit model. Analysts side think like this…"they are using leases, but in reality there are more assets, really making money." Then your value might get a discount. In the story of the health care service, for example, making elderly housing they can borrow more and more. But maybe they want to lease, is it really meaning an operating lease? Maybe not. the biggest problem was this question; "is this a really profitable business?". Maybe it is not a profitable business under this way, but it plays an important role in society. And when it comes to healthcare, maybe you shouldn't make money a lot. But, there are people who invest in it. **What kind of value creation is questioned.**

The essence is how much you invest in, but we don't know what the company owns when the real estate industry becomes a sharing economy. I feel that the actual creation of value would be a completely different meaning. In short, it couldn't make so much money, in retail, transport. They are using the leasing mechanism, **but if the accounting standards changes, the business model should be changed.** And the future management strategy will change.

Basically, there is no difference between operating leases and finance leases, so I can understand to unify them. But the story of the Yo-kado lease strategy that we discussed today, was also used in a Harvard case study. I cannot clearly agree that the view wasn't right… But **we have to think about the essence, once again.**

Toward the future accounting standard

- When investors make valuations, numbers tend to be conservative including discount rate. On the other hand, if new lease accounting is introduced, companies need to review each contract and evaluate how meaningful it is as a debt. Lease accounting requires the company to determine the discount rate themselves if the discount rate is not specified in the lease contract. For example, you must see how much your incremental borrowing rate is and how much you lease. Companies themselves can better understand whether they are thinking about management efficiency.
- Until now, there was no finance without assets, and without finance, it was categorized basically as a service. You may be using goods while receiving services. In that case, it was very simple and the lease amount was off the balance sheet and expensed using a straight line. However the moment you say this is an asset, it's a financial transaction and on-book as a liability. In reality, there are both elements of service and finance, and it is difficult to estimate how much is service and how much is finance. How they allocate it could change the message of the financial statements.
- Current Lease contracts are being more complex. In the past, companies built factories and purchased tangible goods which had values. However currently, there are leasing services such as cloud services, capacity management services, and car leasing. Regarding car leasing, the car should be an "asset", because you can use it for 3 years like your own car. However, if you have three years of car-sharing rights and the debt you pay is exactly the same with car leasing but does not have the right to use a specified car, application of IFRS 16 is subtle.
- Corporate value and future IFRS: The world has become a fluid society. Accounting standards based on tangible assets really work? How IFRS should tackle the issue? For example, for a company acquisition, goodwill is booked at the purchase price. However, in general, intangibles are a self-created value of in-house production. No acquisition price makes unable numerical evaluation. They are categorized as "non-financial information". It became more important these days. Bid coins, crypto currency, etc. they will be an argument that has to change the essence of accounting. However, the usefulness of accounting will not disappear as long as investors try to evaluate companies…

We so much appreciate Tak's great work for the IFRS!