KPMG

Impact of IFRS 16 on non-GAAP performance measures

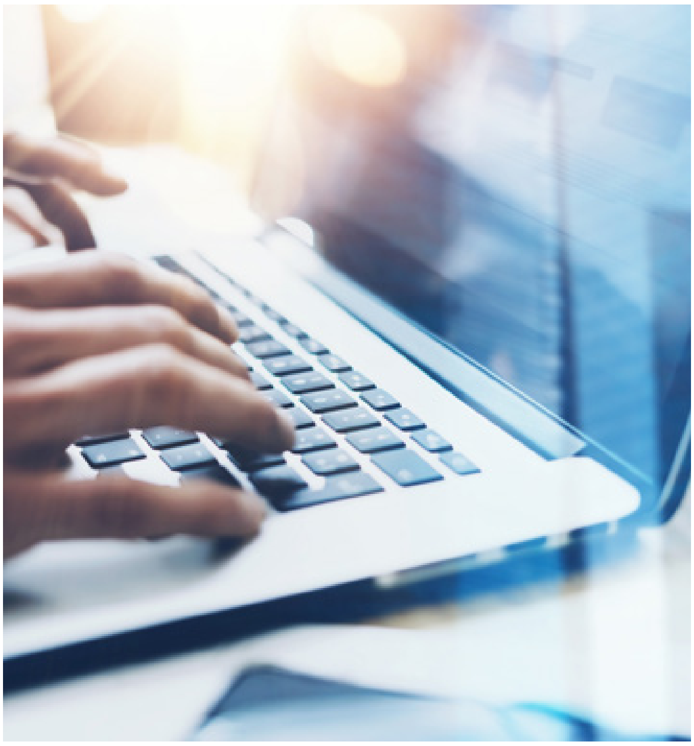
Executive Summary

As of 1 January 2019, the new IFRS 16 standard on leases has come into effect for most IFRS reporters. The implementation of IFRS 16 has been a priority over the past year and has proven a challenge for companies across various industries. In light of the recent IASB Exposure draft introducing more transparency and guidance on the use of management's own performance measures (or 'KPIs') and considering the significant impact this standard has on KPIs, we analyzed how companies report KPIs post-IFRS 16 and whether any trends can be observed across industries. We have reviewed financial statements, half-year reports and analyst presentations of a sample of 12 listed IFRS reporters in the Netherlands (AEX-index) and complemented these with several IFRS reporters in the Oil & Gas, Retail and Telecommunication industries[1]. This publication provides observations in relation to the impact of IFRS 16 on non-GAAP performance measures (or 'KPIs') reported by these companies.

The majority of the listed entities in the Netherlands have opted for the modified retrospective approach and have recognized the cumulative effect as an adjustment to equity at the date of initial application without restatement of the comparative financial information. Besides the reported financial information, IFRS 16 has a significant impact on a number of KPIs. For companies that applied the full retrospective approach the KPIs are restated in accordance with IFRS 16. Since KPIs are generally derived from the restated GAAP measures this is relatively simple. However, companies applying the modified retrospective method face a challenge in providing KPIs that are useful in the sense that they indicate the trends in underlying business performance of current versus previous periods.

The most prominent changes to KPIs reported by the entities in our sample that are impacted by the implementation of IFRS 16 are (adjusted) EBITDA, net debt and free cash flow. In order to ensure the financials are comparable over time, several of the entities in our sample have redefined some of these KPIs or have defined new KPIs altogether. Examples include 'EBITDA – After Leases' for Telcos and 'Cash Capital Expenditure' for capital intensive industries like Oil & Gas.

1 Our sample consists of the following companies: Royal Dutch Shell, Unilever, ASML, Heineken, RELX, Philips, Ahold Delhaize, DSM, AkzoNobel, Wolters Kluwer, ArcelorMittal, KPN, Equinor, Total, British Petroleum, ENI, Repsol, Beter Bed, Grandvision, Stern Group, TesCo, Carrefour, Deutsche Telekom, Orange, Telefónica, Telecom Italia and Telenor ASA



Possible scenarios to present post-IFRS 16 KPIs

The changes in KPI definitions require attention of the users of the financial statements in order to allow for accurate period-over-period comparison. We observe various practices for presenting KPIs post-IFRS 16:

- Restate prior period KPIs as if IFRS 16 was always applied (generally applicable in combination with the full retrospective approach)
- Provide a like-for-like comparison with or reconciliation to IAS 17, the previous leasing standard
- Provide a qualitative only explanation of the impact of IFRS 16 on KPIs in first year of adoption
- Redefine KPIs or define new KPIs to monitor underlying business performance post IFRS 16

Regardless of the approach taken, we note that companies have generally made a significant effort in providing the appropriate information to facilitate the comparability of their KPIs.

KPIs redefined or newly added

EBITDA

Many companies have put in a significant effort to allow for trend analysis of the EBITDA KPI (or similar measures) adjusting for IFRS 16. This was expected due to the prominence of this KPI for many companies and the large impact of IFRS 16 on this KPI compared to IAS 17[2] for most companies. Some companies, and almost all (4 out of 6) Telcos in our sample, have added an EBITDA after leases measure ('EBITDA-AL') to their KPIs, whilst continuing to report their EBITDA. We see this less in the rest of the sample. One Retailer included EBITDAR as a KPI (Earnings Before Interest, Taxes, Depreciation Amortization and Rent), but already included this KPI before adoption of IFRS 16. It will be interesting to see if the 2020 reports will still contain both EBITDA and EBITDA-AL when prior year financials are also reported on IFRS 16. On that note, one Retailer in our sample indicated that in their opinion EBITDA has become less relevant post-IFRS 16 and that they will likely change to EBITA as their profitability KPI instead as of financial year 2020.

CAPEX

Due to the adoption of IFRS 16, the link between the increase in tangible fixed assets and investments has become weaker as companies recognize right-of-use assets under this header on the balance sheet whereas there is no cash-out related to 'acquiring' these assets. We notice new KPIs - such as 'cash capital expenditures' – have been introduced by several companies in our sample to enable users to bridge between increases in tangible fixed assets in total and the cash capital expenditures during the period. Especially for companies that present the right-of-use assets within property, plant and equipment, this KPI can facilitate the understanding of IFRS 16 right-of-use assets additions versus cash investments.

Cash Flow and Net Debt

The impact of IFRS 16 on the classification of cash flows[3] has resulted in several entities modifying their definition of free cash flow and related KPIs. In addition, as expected, the adoption of IFRS 16 has a significant impact on net debt and gearing due to the inclusion of lease liabilities. We note that companies use different approaches to the treatment of lease liabilities in their net debt KPI. Many companies include the lease liability in the calculation of net debt since the liability is considered a long-term financial liability, and explain the impact of IFRS 16. However several companies have redefined their net debt definition to exclude the lease liability or introduced an additional KPI to show net debt both including and excluding lease liabilities.

2 Under IAS 17, operational lease expenses were presented as part of other expenses in EBITDA ('above the line'), whereas under IFRS 16 these are now reported as part of depreciation or interest expenses ('below the line').

3 Lease payments that were previously classified as cash flows from operating or investing activities are now presented as cash flows from financing activities.

Differences across industries

In analyzing the financial statements of companies, we looked for trends in a number of selected industries - Oil & Gas, Retail and Telecommunications - as to how they are dealing with IFRS 16 in their KPIs. We note a number of similarities within these industries.

All Telcos in the sample include an EBITDA after leases ('EBITDA-AL'). A measure used less frequently by companies in other industries in our sample. On the other hand, all but one of the retailers in our sample include lease payments in their calculation of free cash flow. For the Oil & Gas industry and for the other KPIs in the Telecommunications and Retail industries, we observe a variety of approaches applied across the companies in our sample towards dealing with IFRS 16 in their KPIs.

Targets post IFRS 16

The question remains whether the adjustments made to the reported KPIs are permanent or will be reported in the current year only to facilitate a proper comparison with prior periods. We note that most companies remain relatively silent on the impact of IFRS 16 on their performance targets going forward. Some companies in the sample have indicated that the 2019 financial performance will be measured on a pre-IFRS 16 basis and the 2020 targets will be defined using those pre-IFRS 16 results as an input.

Carefully review the definitions of KPIs

One of the goals of IFRS 16 is to increase the comparability between companies that own and lease assets. The jury is still out on whether the standard will accomplish this. Our analysis of non-GAAP measures is no exception to this. While we see a variety of approaches to deal with the challenge to communicate about the underlying business performance in the midst of all the changes in the primary financial metrics caused by IFRS 16, we observe some emerging industry trends in revising the definitions and/or adopting new KPIs post-IFRS 16. Time will tell whether these industry trends will eventually converge to standard practices. In view of all the changes, users of the financial statements should keep an eye out for differences in and changes to the definitions of these KPIs when analyzing the performance of companies.

Contact

Philip Takken
Audit, Technology, Media & Telecom
Partner, KPMG The Netherlands
T: +31 20 656 8372
M: +31 6 1373 0127
E: takken.philip@kpmg.nl

Gijs de Graaff
Capital Markets Accounting
Advisory Services
Director, KPMG The Netherlands
T: +31 20 656 7757
M: +31 6 2000 0806
E: degraaff.Gijs@kpmg.nl

Janpiter Nijp
Capital Markets Accounting
Advisory Services
Manager, KPMG The Netherlands
T: +31 20 656 8074
M: +31 6 5367 1291
E: nijp.Janpiter@kpmg.nl