IFRS 16 **in action**

Tesco explains how the new leasing standard will change some figures, but will ultimately have no economic impact on the business

Tesco plc recently hosted a briefing for analysts and investors at its UK HQ about IFRS 16, the new financial reporting standard on accounting for leases.

Tesco wanted to explain the nature of the standard and the associated changes to the presentation of the Tesco financial statements and performance measures using its most recently reported 1H 2018/19 results.

It stressed that the new standard will have no economic impact on the group. It also wanted to emphasise the standard would have no effect on how the business is run, or on cash flows. It does, however, have a significant impact on the way the assets, liabilities and the income statement of the group are presented, as well as the classification of cash flows relating to lease contracts.

IFRS 16 is effective for all accounting periods beginning on or after 1 January 2019. As such, Tesco's first reported accounting period under IFRS 16 will be the 2019/20 financial year, which runs from 24 February 2019 to 29 February 2020. As previously indicated, the group intends to adopt the standard fully retrospectively.

In summary, IFRS 16 seeks to align the presentation of leased assets more closely to owned assets. In doing so, a right of use asset and lease liability are brought on to the balance sheet, with the lease liability recognised at the present value of future lease payments. While the right of use asset is matched in value to the lease liability at inception, it differs in value through the life of the lease.

From an income statement perspective, the pre-IFRS 16 rental charge is replaced by depreciation and interest. IFRS 16 therefore results in a boost to operating profit, which is reported prior to interest being deducted. While depreciation reduces on a straight-line basis, interest is charged on outstanding lease liabilities and therefore for any given lease, interest is higher in the earlier years and the income statement below operating profit is highly dependent on average lease maturity. For an immature portfolio, depreciation and interest are higher than the rent they replace and therefore IFRS 16 is dilutive to EPS. For a mature portfolio, they are lower and therefore IFRS 16 is accretive.

Tesco's 1H 2018/19 financial statements, restated for IFRS 16, will form the prior period comparative numbers for the first published IFRS 16 accounts in October 2019. The headline impacts of IFRS 16 on these statements can be summarised as follows:

- Group sales and total cash flow are completely unaffected.
- Group operating profit increases by £188m to £1,121m as rent is removed and only part-replaced by depreciation; group operating margin increases by 59 basis points to 3.53%.
- Profit before tax and Diluted EPS both decrease, by £(101)m and (0.91)p respectively, due to the combination of depreciation and interest being higher than the rent they replace. This is due to the relative immaturity of the group's lease portfolio, with leases being around one-third expired on average. The proportion of EPS dilution will reduce as the portfolio matures and, most notably, as underlying earnings increase.
- Net assets are reduce by £(1.4)bn to £13.0bn, as a 'new' lease liability of £(10.6)bn and 'new' right of use asset of £7.8bn are recognised and onerous lease provisions and other working capital balances are derecognised.
- Total indebtedness increases by £(3.3)bn to £(15.8)bn due to lease extensions and contingent commitments being included and lease-specific discount rates being applied.

Tesco wanted to point out that the introduction of IFRS16 has no bearing on the plans or its financial ambitions.

The supermarket giant said it will continue to provide sufficient disclosure to translate progress against the 2019/20 ambitions back to a pre-IFRS 16 basis.

It's 2018/19 preliminary results will continue to be reported on a pre-IFRS 16 basis, accompanied by a headline summary of the impact of the new standard. The full 2018/19 financial statements prepared on an IFRS 16 basis will be shared shortly after the preliminary results. PQ