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Implications of IFRS 16 on Indian Airline Industry



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ABSTRACT

The introduction of IFRS 16 has given a new dimension for lease accounting as against IAS 17. As a result of this, the advantage of off-balance sheet financing under IAS 17 has been superseded and all the leased items now needs to be recognised as leased assets and leased liabilities and lease operations needs to be capitalised. This paper explores the prospective effects of IFRS 16 - Leases, on financial performance of airline industry particularly Indigo Ltd. Using financial statements for the year 2018-2019 as per IAS17 and 2019-2020 as per IFRS 16, this study tries to assess the impact of IFRS 16 in the financial ratios, financial indicators, and financial status of Indigo Ltd. The effect on total liabilities, total assets, EBITDA are also analysed. The implications of IFRS 16 for financial statement users were also addressed in this study.

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1.0 INTRODUCTION

For a last few decades, Leasing has been adopted by large number of industries worldwide as an appropriate system for funding assets (Zamora-Ramírez and Morales-Díaz, 2019). The advantage of off-balance sheet financing under IAS-17 has offered greater flexibility for the companies to engage more in operating leases. However, the IAS-17 model has received much criticism from researchers, accountants and stakeholders of financial reports as all claimed that companies are not accounting all lease obligations and resources in the statement of financial position which leads to a lack of translucency and comparability (Zamora-Ramírez and Morales-Díaz, 2019). With the introduction of IFRS-16, the controversies in the treatment of lease obligations and resources were rectified (IFRS Foundation, 2016a). As a result of this, all long-term leases need to be recognised as leased assets and leased liabilities and almost all lease operations should therefore be capitalised (Magli *et al.*, 2018).

Though many studies exists in worldwide context regarding the impact of IFRS 16 on financial reporting among various sectors (Spånberger and Rista, 2020; Zamora-Ramírez and Morales-Díaz,

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2019), a comprehensive and analytical study in Indian context is not available in the literature. Since Indian economy is following a policy of carving out of and carving in IFRS while developing Indian Accounting Standards, it is relevant to study the initial implications of IFRS 16 on Profit and Loss Account and Balance Sheet. According to the study (Tofanelo *et al.*, 2021) companies operating in airline industries engaged more in operating leases are most affected by IFRS 16, therefore it is contemplated that impact of implementation of IFRS 16 is remarkable in this sector in Indian market. Therefore, the purpose of this research is to predict the short-term effects of implementing IFRS 16 at India's biggest airline, Indigo Ltd. Because financial ratios are a reflection of a company's success, we also look at how IFRS 16 has changed those ratios.

1.1 Objectives of the Study

- To understand the consequences of IFRS 16 in the financial statements of Indigo Ltd.
- To analyse the effect of IFRS 16 in the financial performance indicators of Indigo Ltd.
- To find out the implications of IFRS 16 for financial statement users.

1.2 Literature Review

Based on her analysis of 15 European airlines, Veverkova (2019) found that IFRS 16 has a significant impact on key financial measures such debt equity ratio, asset turnover ratio, and return on equity. The implementation of IFRS 16 has no effect on several ratios.

The effect of IFRS 16 is examined by looking at the financial statements and key ratios of the Turkish airline sector. The results reveal that ROA decreases significantly as a consequence of an increase in assets and liabilities caused by the inclusion of operating leases in the balance sheet Öztürk and Serçemeli (2016).

In their study, Alabood *et al.*, (2019) examined the effects of IFRS16 adoption on three Middle Eastern airlines. They concluded that lease capitalization significantly impacts key financial ratios, strengthening the credibility of financial statements.

2.0 METHODOLOGY

This study is investigating the effect of IFRS 16 on financial statements and key financial ratios of airline industry. According to the study of Bohusova and Svoboda (2015), the most impacted segment is airline industry due to the industry's heavy dependence on leasing aircraft and airport operations on a global scale. The selection of the company in this study considered the Indigo Ltd, the largest airline company in India with highest market share of 53.9% as of April 2021, according to IBEF. Based on the OAG Frequency & Capacity Statistics 2022, Indigo Ltd is the world's fastest growing airlines with 41.3% growth.

To analyse and compare the financial implications of IFRS 16, the financial statements for the year 2018-19 prepared as per IAS 17 and 2019-2020 prepared with IFRS16 were considered. Data were gathered from the annual statement of respective company's website. The key financial indicators like total liabilities, total assets and EBITDA were examined to study the impact of IFRS 16 on financial statements. The financial ratios under liquidity, solvency and profitability were also computed to find out the consequences of applying IFRS while preparing financial statements. Under liquidity ratios, current ratio is taken. Interest coverage ratio and debt ratio were examined in solvency ratios. Among profitability ratios, asset turnover ratio, EPS and return on capital were taken.

3.0 ANALYSIS OF CONSOLIDATED STATEMENTS OF 31/3/2019 & 31/3/2020

3.1 Implications on Balance Sheet

The Statement of Assets and Liabilities will be impacted by the implementation of IFRS 16 because the enterprise needs to recognise a new group of resources as the right-of-use assets and the corresponding lease commitments. Thus, the companies that engaged in extensive off-balance sheet leases have to now report significantly higher resources and commitments which in turn may effect the equity. The value of equity will decrease due to the quick reduction in the book value of leased assets over lease commitments. The duration of lease agreements, effective rate of interest and amortisation of asset may also affect the equity.

Assets	As of 31/3/19	As of 31/3/2020	Difference	%
NON-CURRENT ASSETS				
a) Property, plant, and equipment	56,315.54	24,984.69	(26,330.85)	-46.7
b) Right of use assets	-----	142,461.38	-----	
c) Capital work in progress	220.15	1,292.70	1,072.55	4.87
d) Intangible assets	304.88	335.91	31.03	10.17
e) Intangible assets under development	16.14	109.69	93.55	5.79
f) Financial assets				
1. Investments	1.25	1.85	0.6	0.48
2. Loans	5,839.08	12,741.54	6,902.46	1.18
3. Other financial assets	1,988.21	58.30	(19,299.1)	-9.70
g) Deferred tax assets (net)	-----	2,949.44	-----	-----
h) Income tax assets	1,240.35	4,291.79	3,051.44	2.46
i) Other non -current assets	3,158.76	7,142.69	3,983.93	1.26
TOTAL NON-CURRENT ASSETS (A)	69,084.36	196,369.98	127,285.62	1.84
CURRENT ASSETS				
a) Inventories	2,114.41	2,861.28	746.87	0.35
b) Financial assets				
1. Investments	65,165.70	94,991.67	29,825.97	0.45
2. Trade receivables	3,624.67	2,596.11	(1,028.56)	-0.28
3. Cash	7,127.83	6,760.42	(367.41)	-0.05
4. Bank balance	78,935.80	101,533.64	(22,597.84)	-0.28
5. Loans	4,669.61	4,551.23	(118.38)	-0.02
6. Other financial assets	7,925.20	6,231.06	(1,694.14)	-0.21
c) other current assets	11,469.76	4,589.17	(6,880.59)	-0.56
TOTAL CURRENT ASSETS (B)	181,032.98	224,114.58	43,081.6	0.23
TOTAL ASSETS (C = A + B)	250,117.34	420,484.56	170,367.22	0.68
EQUITY AND LIABILITIES				
EQUITY				
a) Share capital	3,844.07	3847.96	3.89	0.001

b) Other equity	65,603.82	54,776.43	6,979.43	0.10
TOTAL EQUITY (D)	69,447.89	58,624.39	10,823.5	0.15
LIABILITIES				
NON-CURRENT LIABILITIES				
a) Financial Liabilities				
1. Borrowings	21,936.69	3,465.96	(18,470.73)	0.84
2. Lease Liabilities	---	155,791.01	----	
3. Other financial liabilities	33,878.94	30,388.86	(3,490.08)	0.10
b) Provisions	2,736.69	----		
c) Deferred tax liabilities	644.16	5,533.23	4,889.07	7.58
d) Other non-current liabilities	345.18	369.77	24.59	0.07
e) Deferred incentives	41,143.59	2,206.31	(38,937.28)	0.94
TOTAL NON-CURRENT LIABILITIES (E)	100,685.02	197,755.05	97,070.03	0.96
CURRENT LIABILITIES				
a) Financial Liabilities				
1. Trade Payables	----	-----	-----	----
2. Lease Liabilities	---	64,544.27	-----	
3. Other financial liabilities	21,230.48	45,897.39	24,666.91	1.16
b) Provisions	1,635.43	13,950.90	12,315.47	7.5
c) Current Tax liabilities	33.51	30.76	(2.75)	-0.08
d) other current liabilities	31,793.4	23,551.09	(8,242.31)	-0.25
e) deferred incentives	10,739.15	476.05	(10,263.1)	-0.95
TOTAL CURRENT LIABILITIES (F)	79,984.43	164,105.12	84,120.69	1.05
TOTAL EQUITY AND LIABILITIES (G = D + E + F)	250,117.34	420,484.56	170,367.22	0.68

Source: Annual Reports

On analysing, the balance sheet of the company as of 31/3/2019 and 31/3/2020, we can notice that a right to use asset of 142461.38 and a corresponding lease obligation of 155,791.01 as per IFRS16 appear on the balance sheet as on 31/3/2020 that are not presented in 31/3/2019, thereby increasing the amount of assets and liabilities as against off-balance sheet financing. This will have impact on the net financial position and overall monetary commitments will increase.

Table 1

Financial Debt before IFRS 16 and after IFRS 16

	31/3/2019	31/3/2020	Difference	%
Net financial debt before IFRS 16	56150.81	34224.59	(21926.22)	-0.39
Lease liabilities as per IFRS 16	NA	155,791.01	155,791.01	
Net Financial debt after IFRS 16	NA	190015.6	190015.6	

Source: Own computation

The table reveals that the net financial debt shows a significant increase in the year 2020 due to exact disclose of net lease obligations as per IFRS 16. Before the application of IFRS 16, the amount

of debt is 34224.59 as of 31/3/2020 representing off- balance sheet financing which is later raised to 190015.6 due to recognition of lease liabilities .

The primary distinction between the balance sheets of 2018-19 and 2019-2020 is the inclusion of lease liabilities and a right of use asset that are omitted from the 2018 balance sheet. In this instance, the asset is equal to the present value of the lessee's minimum lease payments, which will be amortised. On the other hand, the lessee's minimum lease payment and any accrued but unpaid expenses are included in the lease liabilities. The main change due to the implementation of IFRS 16 is reflected in increase of financial debt due to the inclusion of lease liabilities.

3.2 Implications on Income Statement

The notable change in Income statement under IFRS 16, is regards with treatment of lease expenses. Earlier, lease rental which are treated as operating costs now needs to be treated as depreciation of the right to direct the use of assets as well as interest expense which in turn leads to increased depreciation and interest expense and reduced operating costs. As a consequence of this, the calculated value of EBITDA and EBIT will increase significantly. The amount of these costs will vary depending on the term of the contract, how quickly the asset is being depreciated, and the implicit interest rate for each period.

Table 2

Income Statement

	For the year ended 31/3/2019	For the year ended 31/3/2020	Difference	%
INCOME				
Revenue from operations	284,967.72	357,560.01	72592.2	0.25
Other Income	13,245.98	15,355.09	2109.11	0.15
TOTAL	298,213.70	372,915.10	74701.4	0.25
EXPENSES				
Aircraft fuel expenses	119,427.93	124,537.94	5110.01	0.42
Aircraft and engine rentals	38,610.32	4966.5	(33643.82)	0.87
Supplementary rentals	36,820.05	58,672.37	21852.32	0.59
Aircraft fees	24,489.34	29,116	4626.66	0.18
Purchase stock	1397.95	1809.08	411.13	0.29
Change in inventories	(6.55)	(30.53)	(23.98)	-3.66
Employee costs	32,105.57	47,009.59	14904.02	0.46
Finance costs	5,089.63	18,758.71	13669.08	2.68
Depreciation and amortization expenses	7595.80	39,739.29	32143.49	4.23
Foreign exchange loss	4674.87	15,461.89	10787.02	2.30
Other expenses	2982.57	35,340.04	32357.47	10.84
TOTAL EXPENSES	299,687.48	375,471.79	75784.31	0.25
LOSS BEFORE TAX	(1473.78)	(2556.69)	-1082.91	-0.73
TAX EXPENSE				

Current tax	15.24	91.30	76.06	4.99
Deferred tax	(3061.49)	(311.21)	-2750.28	0.89
TOTAL TAX EXPENSE/CREDIT	(3046.25)	(219.91)	2826.34	-0.82
PROFIT/LOSS FOR THE YEAR	1572.47	(2336.78)	(764.31)	(-0.48)

While comparing the income statement as of 2018-19 and 2019-20, the net loss of the company increases substantially due to the increase in operating costs such as aircraft fuel expenses, rentals, increase in depreciation and interest expense, amortisation and impairment losses. Indeed, total expenses increases under IFRS 16, and this led to an overall increase of the loss for the year that from 1572.47 – in 2018-19 becomes – (2336.78) in 2019-20.

3.3 Implications on Cash Flow Statement

Transition from IAS 17 to IFRS 16, the overall cash flow transferred between lessor and lessee will remain unchanged, instead it is only anticipated to have an influence on how cash flow is categorised through operational and finance activities. The effect will be reduction in operating cash flow and an increase in financing cash outflow. The cash out flow classified as operating activities under off balance sheet leases is now treated as cash outlay in financing activities. All principal repayments including interest are included in financing activities. All of this occurred because, under IAS 17, corporations portrayed the cash outflows that resulted from off-balance-sheet leases as operational activities.

3.4 Implications on Financial Ratios

The IASB points out that with adoption of IFRS 16, financial ratios are also subjected to significant changes. Due to the elimination of off-balance sheet financing, all leases are required to be treated in the way that the financial leases are treated under IAS 17 and thus all long-term leases need to be capitalised. As a result of this, some notable changes in key financial indicators will occur in financial statements prepared as per IFRS 16.

The following table illustrates the anticipated impact of IFRS 16 on a selection of indicators often used to analyse financial statements, including significant off-balance-sheet items.

Indicator	Heads of classification	Effect and Reason
Current Ratio Current Assets/Current Liability	Liquidity	The ratio will decrease due to quick reduction in the value of leased assets and increase in lease commitments
Debt Equity Ratio Debt/Equity	Long term solvency	With the increase in liabilities due to additional lease commitments and decrease in the value of equity due to reduction in assets quickly over obligations will increase the debt equity ratio.
Interest Coverage EBITDA/ Interest expense	Long term solvency	Lease rental shown as operating costs in income statement is now treated as depreciation of right to use of asset and interest expense which in turn leads to increased EBITDA
Asset turnover Sales / Total assets	Profitability Index	The ratio will decrease because total assets will quick decrease due to leased assets as compared to lease commitments
EBIT / Operating profit	Profitability Index	Depreciation charge additions result in a decrease compared to off-balance sheet expenditure.

EBITDA	Profitability Index	EBITDA will increase due to representation of depreciation and interest expense
Profit or loss	Profitability Index	Depends on lease arrangements, effective interest rate, amortization of assets
Earnings Per Share Profit available / Number of shares	Profitability	EPS change as per changes in profit and loss for the respective year
ROE Net Income/Equity	Profitability	Return on Equity will decrease due to the quick reduction in the book value of leased assets over lease commitments.

Source: Effect Analysis, 2016

3.5 Ratio Analysis

3.5.1 Liquidity Analysis

Liquidity refers to the ability of the firm to convert its assets into liquid cash without affecting its share price. The current ratio is the ratio between assets and liabilities which is an indicative of the company's ability to repay obligations on time with available current assets.

	Year	
	2018	2019
Current Ratio	2.26	1.37

Source: Money Control

The result shows that there is a decrease in the ratio from 2018 to 2019 current liabilities increased more quickly due to the inclusion of lease liability while current assets do not increase.

3.5.2 Acid Test Ratio

Acid test ratio measures the company's ability to pay its current liabilities with near cash or quick assets.

	Year	
	2018	2019
Quick Ratio	2.24	1.35

Source: Money Control

There is a decrease in quick ratio from 2018 to 2019 indicating that company is in a struggling stage to meet its current obligations and is forced to depend on external sources.

3.5.3 Leverage Ratio

Leverage ratio measures company's ability to meet its long-term debt obligations.

3.5.4 Debt Ratio

Debt ratio is the indicative of percentage of company's assets that are provide with debt.

	Year	
	2018	2019
Debt Ratio	0.06	0.32

Source: Money Control

Compared to 2018, the debt ratio increased in 2019 because total liabilities of the firm increased due to recognition of lease commitments in balance sheet and value of equity decrease due to decline in the book value of leased assets over lease obligations.

3.5.5 Profitability Analysis

Profitability analysis deals with company's ability to generate profits. The most affected profitability ratio is Return on Asset Ratio. The ratio will decrease due to new assets recognised in the year 2019 with the inclusion of right of use asset. Return on Equity will also decrease due to the quick reduction in the book value of leased assets over lease commitments.

4.0 CONCLUSION

The advent of IFRS 16 has forced the companies to avoid the loopholes of taking advantage of off-balance sheet financing. As a result of this, all long-term leases are required to be capitalised and enterprise needs to recognise a new group of resources as the right-of-use assets and the corresponding lease commitments.

The primary objective of this research is to analyse how IFRS 16 affects Indigo Airlines' financial statements and key performance metrics. Right of use assets were recognised as assets on the balance sheet for the first time with the adoption of IFRS 16, increasing the total asset value, while lease obligations were recognised as a separate line item, increasing the total liability amount. As a result of the capitalization of operating leases that is required by IFRS 16, both the D/E and D/A ratios have increased. Under profitability ratios, ROA and ROE also significantly changed. These all are indicative that the IFRS 16 have led to great change in the preparation of financial statements demanding full disclosure of all material facts which in turn influence the decision making of users and company itself.

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