

## **IFRS 16: changes to the financial metrics of retailers**

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<p>International Accounting Standards (IAS) and international Financial Reporting Standards (IFRS) are a major part of accounting all over the world and changes in these standards affect plethora of businesses. The objective of this thesis was to research the effect on financial ratios and metrics of Finnish retailers caused by IFRS 16 Leases which superseded IAS 17 Leases.</p> <p>The research consists of theoretical and empirical chapters: the theoretical chapter defines leasing and then addresses the changes IFRS 16 introduces to the financial statements. The empirical chapter examines two Finnish retailers, S-Group and Kesko, and presents quantitative analysis of the publicly available audited financial statements of the entities.</p> <p>The findings revealed significant changes in multitude of metrics and ratios: profitability ratios increased, whereas the changes in debt-related metrics such as gearing, debt-to-assets became indicative of riskier companies. Increased debt load in form of increased lease liability was the underlying reason for such effects, and the changes in operating expenses and depreciation affected the profitability.</p> <p>The publicly available data does not disclose all the necessary information; therefore, the results of the research are not completely accurate. However, they are still indicative of approximate changes caused by IFRS 16.</p>	
<b>Keywords</b> International Financial Reporting Standards, leasing, right-of-use asset	

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# 1 Introduction

In this chapter an overview of thesis content is presented including background, research question, demarcation as well as the relevance of the topic.

## 1.1 Background

As more and more companies have been expanding their operational area to the world-wide level, the necessity for internationally accepted principles for accounting arose. In order to facilitate transparency, comparability, accountability within companies International Financial Reporting Standards Foundation has introduced a set of high-quality global standards in the form of International Financial Reporting Standards (henceforth - IFRS) and International Accounting Standards (henceforth - IAS). (IFRS Foundation 2018.)

International Financial Reporting Standard 16 Leasing (henceforth – IFRS 16) took effect on 1 January 2019. The new standard superseded IAS 17 Leases. (Deloitte 2019, IAS 17 – Leases.)

Plethora of companies have adopted IFRS and IAS in their financial reporting. Additionally, the companies are obligated to use IFRS in their bookkeeping in conjunction with the local GAAP (generally accepted accounting principles) if certain criteria are met, said criteria vary from country to country. Large number of jurisdictions in the EU area stipulates that publicly listed domestic and foreign legal entities must comply with IFRS, such is the legislation with the Finnish jurisdiction, in which the case companies chosen for this research operate. (IFRS 2018, Finland.)

## 1.2 Research Question

The aim of this thesis was to examine the effect the implementation of the new IFRS standard, namely IFRS 16 Leasing, on companies which operate in retail sector. The outcome of the thesis was a comparison between financial indicators calculated in accordance with IAS 17 and IFRS 16.

Research question (henceforth - RQ): What changes does IFRS 16 introduce to the financial ratios of retailers?

Investigative question 1 (henceforth - IQ): What are the differences between IAS 17 and IFRS 16 from lessee's point of view?

IQ2: How will the changes in recognition of lease liability change journal entries?

IQ3: How will the financial indicators of the retailers be affected by the new standard?

Table 1 below presents the theoretical framework, research methods and results chapters for each investigative question.

Table 1. Overlay matrix

<b>Investigative question</b>	<b>Theoretical Framework*</b>	<b>Research Methods</b>	<b>Results (chapter)</b>
<i>IQ 1.</i> What are the differences between IAS 17 and IFRS 16 from lessee's point of view?	IAS 17 and IFRS 16 texts, academic theory	Desktop study	2
<i>IQ 2.</i> How will the changes in recognition of lease liability change journal entries?	IAS 17 and IFRS 16 texts, articles from sources and databases	Analysis of articles content	2
<i>IQ 3.</i> How will the financial indicators of the retailers be affected by the new standard?	Financial reports, calculations	Desktop study	4

### 1.3 Demarcation

The companies which were examined in this thesis are based in Finland. Said companies are either publicly listed and/or have independent audit and their financial reporting is done in accordance with IFRS. Since the lessees are the party affected the most by the new standard and the accounting for lessors remains mostly unchanged (PwC 2016, 1), this thesis was focusing on the former's point of view. Additionally, this thesis focused on two types of financial reports: profit and loss statement, statement of financial position (also called balance sheet). Cash flow statement and statement of changes in equity were excluded from the research.

## **1.4 International Aspect**

IFRS is a financial reporting standard used around the globe, so the results will be applicable to any company using the IFRS. An international standard was analysed using the Finnish companies as an example.

## **1.5 Benefits**

The main benefit of this thesis lies in the fact that it presents a clear example of the changes caused by IFRS 16 as well as detailed calculations necessary for its implementation.

A benefit for the investors which are considering investing in a company that has adopted IFRS is the fact that it is generally more investor-friendly than local accounting principles. Additionally, IFRS reporting is internationally comparable since it differs from local practices, thus facilitating investors to make an informed decision while evaluating several companies located in various countries as a potential investment. (IFRS 2020.)

Lastly, writing a thesis on the topic adds value to me as potential employee in the field of accounting since multiple companies have their financial reporting done in accordance with said standards.

## **1.6 Key Concepts**

IFRS (international financial reporting standards) – set of guidelines (in some cases obligatory rules) companies use when preparing their financial statements. IFRS is used internationally, 87% of all jurisdictions compel publicly listed companies to report under it and in the remaining countries its usage is acceptable. (IFRS 2018, 2.)

Lease, leasing contract implies that the lessee has the right to control the asset for a specified period of time provided consideration is paid to the lessor (Deloitte 2018, IFRS 16 - Leases).

Right-of-use asset – an asset i.e. subject of the lease a lessee can use for the lease term. The right-of-use is provided to lessee by the lessor. (EY 2018, 128.)

Initial recognition of the lease – accounting for right-of-use asset and lease liability by the lessee (IFRSbox 2016).

Finance lease — one of the two types of lease established by IAS 17 Lease, which implies that at the end of lease period the ownership of the leased asset will be passed to the lessee, the lessee is allowed to buy the asset at a price lower than its market value, the asset is useful to lessee without any major changes to it. (Deloitte 2019, IAS 17.)

Operating lease — any lease that does not fit the criteria of the finance lease. (Deloitte 2019, IAS 17.)

Financial ratios – calculations used to determine the financial health of the company based on the values and numbers reported in financial statements. Ratios can be used to evaluate the company's liquidity, solvency, profitability etc. (CFI 2019.)

## 2 IFRS 16 requirements for financial reporting

This chapter examines the new standard and compares it to the superseded IAS 17. The purpose of this chapter is to establish the basic theoretical framework necessary for further analysis. Additionally, lease vs buy decision, its implications, advantages and disadvantages are discussed.

The central phenomenon is IFRS 16 and leasing. This, in term, necessitates defining the concepts of right-of-use asset and lease liability, because these are essential for lease accounting.

Financial ratios were calculated to measure the company's state while its reporting had been done according to IAS 17 and then the ratios for current state, i.e., under IFRS 16, were calculated and the two were compared in order to pinpoint changes caused by the new standard. The main focus of IFRS 16 is lease which in essence is a loan, a debt-related figure, therefore, operating profit, total assets and total liabilities were affected, which in turn alters ratios and metrics such as leverage, EBITDA margin, return on assets among others (PwC 2016, 2).

Theory and models required:

- definition of lease as established by IAS 17 and IFRS 16
- right-of-use asset
- lease liability
- journal entries for lessee
- conditions for the exemption
- financial ratios

Theory framework is summarised in Figure 1.

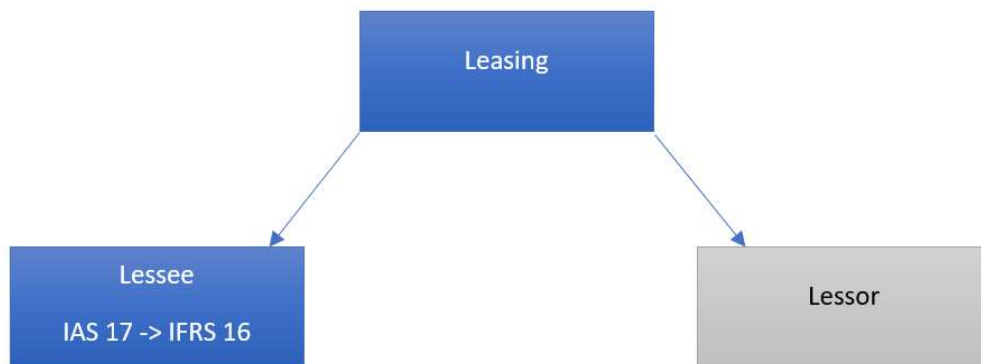


Figure 1. Theoretical framework

One of the main sources of information related to changes in the field of accounting and finance has always been consulting companies, which tend to issue guidelines and overviews of a certain phenomenon, and IFRS 16 is no exception. PwC, Deloitte, KPMG have published articles on the matter. Additionally, the supporting material on IFRS 16 that has been released by the International Accounting Standards Board was used.

## 2.1 Leasing and buying

Whenever there is a necessity to use an asset, the company has an option of either buying or leasing it. Buying an asset transfers its ownership and risks from one party to another whereas leasing implies that the ownership stays with the lessor and the lessee pays for usage price of an asset. Taxes also play in role in the buy or lease decision, although the details vary from company to company due to tax legislation. (Lasfer, Levis 1998, 159.) Generally speaking, companies may lease an asset, because it is easier to receive tax allowance on a leased asset (Smith, Wakeman 1985, 896).

One of the main reasons assets are leased rather than purchased is to minimise the expenses: the purchase price is the cost of the entire asset, which is higher than the price to use it. Additionally, leasing an asset means that the risks, such as obsolescence, are not transferred to the lessee. (Nolo 2020.) Apart from that, the necessity for the equipment may be a temporary one, therefore, companies opt to lease it for only a certain period of time, which by extent minimises the costs (Contino 1996, 20).

Leasing companies are also more lenient than banking institutions: the requirements in terms of solvency, credit rating tend to be less high than these of banks. However, since the ownership remains with the lessor, it also receives the gains produced by the asset: in

case the asset in question appreciates during the period due to, for example, effects of buyer's demand, the lessee is not entitled to any of these gains. (Contino 1996, 16.)

Coyle (2000, 12—15) names the following components of a lease agreement:

- Asset. Normally the lessee is able to choose any model from any supplier, some restriction may be applied, however: the options are limited by a certain range of models which tends to occur if the vendor financing options is present, i.e., the vendor lends money to the potential lessee to afford the former's product or service.
- Lease period. The rental agreement specifies the timeframe during which the lessee is entitled to using the asset in question. The leasing period is separated into primary and secondary: after the time of primary period elapses, the lessee has the option to return the asset to the lessor, alternatively, the lease may be renewed.
- Rental payments. Rental payments are calculated on the basis of plethora of factors, such as value of the lease, lessee's credit rating, primary period's length etc;
- Renewal options.
- Early termination.
- Equipment upgrades, maintenance.

Each option provides the company with various advantages and disadvantages, and leasing is arguably more suitable for certain types of businesses, which are summarised in table 2.

Table 2. Lease-heavy industries (PwC 2016, 8)

<b>Industry</b>	<b>Asset(s) typically leased</b>
Retailers	Real estate lease (store premises)
Telecommunication	Machinery (network towers, satellite components)
Construction	Heavy machinery
Transportation	Fleet (aircrafts, trains, motor vehicles)

## **2.2 Differences between accounting for lease under IAS 17 and IFRS 16**

The goal of the International Accounting Standards Board is to develop internationally acceptable financial reporting standards, and the result of their work is the set of Interna-

tional Financial Reporting Standards, which are designed to improve transparency, accountability and efficiency, as listed in the mission statement of the organisation. (IFRS 2020.)

IAS 17 establishes two types of leases: finance lease and operating lease. Finance lease is the term interchangeably used with capital lease. Finance lease usually lasts throughout the entire useful life of an asset in question, and most of risks and gains as well as necessity to maintain and insure the asset are the responsibility of the lessee. Rental payments tend to equal capital value of the asset. Legal title of ownership stays with the lessor, but it may be eventually transferred to the lessee. Contrary to finance lease, operating lease tends to be a financial commitment for a shorter period of time, normally shorter than the asset's useful life. Lessor is the one responsible for maintenance and insurance of the asset. (Coyle 2000, 35.)

Under IAS 17 the type of lease would determine the accounting used by the lessee, and it is presented in Table 3.

Table 3. Lessee's accounting for lease under IAS 17 (IAS 17 1997, 20-27)

Type of lease	Accounting for the lease	Impact on financial reporting	
		Balance sheet	Profit and loss statement
Finance lease	The lease is recorded as an asset and a liability in the balance sheet, totalling fair value of the asset in question. When the lease payments are made, they are apportioned between outstanding liability and finance charge. The lessee should apply depreciation policy to the leased asset.	Asset and lease liability  Accumulated depreciation  Reduction in lease liability	Finance charge  Depreciation expense
Operating lease	The lease payments are recorded on profit and loss statement as an expense, straight-line calculation is used	N/A	Rental expense

Under IAS 17, the lessee would use the following journal entries for a finance lease:

1. Initial recognition: Debit Fixed Assets, Credit Finance Lease Liability

2. Subsequent payments: Debit Finance Charge (interest), Finance Lease Liability, Credit Cash. (IFRSbox 2012.)

Operating lease is recorded as a rental expense on the profit and loss statement (IFRS-box 2012).

IFRS 16 supersedes IAS 17: the new standard is to be applied to annual periods starting from 1 January 2019 (Lenz 2019).

As mentioned previously, the IAS distinguishes two types of lease, finance and operating, the latter is not recognised on the balance sheet. One of the features of the new standard is the fact that said classification is disposed of: all leases will be reflected in the balance sheet regardless of whether it is a finance or operating lease. (Taurae, Meurer & Carmichael 2016, 1-3.) The transition of all lease liabilities to balance sheet facilitates better transparency: the investors, auditors, banks did not possess exact amount of lease liabilities of an entity in question, therefore, assumptions had to be made, but under IFRS 16 the lease obligations can be calculated precisely. (The Treasurer 2016, 8.) The effect on the financial statements is summarised in Table 4.

Table 4. Changes in accounting of operating leases under IFRS 16 (International Accounting Standards Board 2016a, 12)

<b>Financial Statement</b>	<b>Changes</b>
Balance Sheet	Lease assets and leased liabilities accounted for
Profit and Loss Statement	Depreciation of leased assets and interest on lease liabilities recognised
Cash Flow Statement	Separation of cash into principal payment and interest payment

According to IFRS 16, the contract should be examined in order to determine whether it corresponds to the requirements of the lease contracts. Contract is considered to have a lease provided there is an identified asset and the lessee possesses the right-of-use for a specified time frame and consideration is paid for it. (IFRS 16 2016, B20.)

Two important terms are established in this definition: identified asset and right-of-use. The identified asset can be stated in the contract either explicitly or implicitly, the former is self-explanatory: the contract states, for example, the model of a machine that will be leased. The idea for the latter is that the lessor fulfils the contract obligation in some way. Right-of-use refers to transfer of significant economic benefits to the lessee and the fact that the lessee can decide how to use the identified asset for the duration of the contract.

However, benefits originating from the ownership of the leased asset, such as tax credits, are ignored. (Taurae et al. 2016, 4.)

Should the contract fulfil these criteria (identified asset, entitlement of the customer to the economic benefits generated by said asset, right-of-use belonging to the customer), then the contract is considered to have a lease (Taurae et al. 2016, 5).

The lessee should determine lease and non-lease components of the contract. Lease contracts tend to include non-lease components also known as service components and only lease components should be accounted for in accordance with IFRS 16. (International Accounting Standards Board 2016a, 11.)

The lessee then determines the amount of lease liability and right-of-use asset. Lease liability is calculated as the sum of outstanding payments at the contract commencement date multiplied by the discount factor, which is calculated based on the interest rate. The interest rate, however, is not always available to the lessee, because the factors that are known to the lessor determine it. Therefore, assumptions on the part of the lessee are required. Alternatively, the lessee may choose to use incremental borrowing rate permissible by IFRS 16. The incremental borrowing rate is calculated as the interest rate the lessee would have to pay for a lease under similar conditions, i.e., similar asset value, time period, economic environment. (International Financial Reporting Standard 16 2016, paragraph 26.)

Right-of-use asset is a sum of lease liability and direct initial costs. If the lessee has made lease payments prior to or on the commencement date, the amount is adjusted. The value of asset also comprises costs of its disposal. Additionally, lease incentives from the lessor are deducted from the value of right-of-use asset. (International Financial Reporting Standard 16 2016, paragraph 26.)

Thus, the journal entry of lease recognition, as defined by International Financial Reporting Standard 16 (2016, paragraph 16), is the following:

- Debit Right-of-use Asset
- Credit Lease Liability

As mentioned previously, initial direct costs, disposal costs are also included in the right-of-use asset amount calculation, and International Financial Reporting Standard 16 (2016, paragraph 16) specifies the following journal entries:

- Debit Right-of-use asset

- Credit Cash (i.e., payment for initial direct costs, e.g. negotiations costs, legal fees), Credit Provision for asset disposal

The journal entries during the lease period are presented in Table 5. Lease liability may be remeasured in case of lease modification. (International Financial Reporting Standard 16 2016, paragraph 16).

Table 5. Lessee's journal entries for subsequent calculations. (International Financial Reporting Standard 16 2016, paragraph 36.)

<b>Description</b>	<b>Debit</b>	<b>Credit</b>
Right-of-use asset: accounting for depreciation	Depreciation (PL)	Accumulated Depreciation of right-of-use asset
Lease liability: accounting for interest	Interest expense (PL)	Lease liability
Lease liability: accounting for lease payments	Lease liability	Cash/Bank account

Exemptions are specified within the text of the standard, and the lessee can decide on their own how they account for it: either in accordance with IFRS or similarly to the way operating leases were accounted for under IAS 17. In order to receive exemption for a lease, Taurae et al. (2016, 12) states that either of the following condition should be met:

1. Short-term leases (12 months or less).
2. The asset is of low value. There is no definitive monetary standard of "low value", the general assumption is that should the asset value be less than 5 000 US dollars, then it may be exempt if the lessee so desires.

### **2.3 Financial ratios overview**

Financial ratios are used in order to measure various metrics related to financial state of the company, most common ratios categories include solvency, profitability, efficiency, liquidity. (Goel 2015, 3.)

For this particular research the ratios which had been affected the most by the implementation of the new standard were selected. Since IFRS 16 impacted indicators related to liabilities and assets, a set of ratios and metrics dependent on them was compiled.

Current ratio was used to investigate how the implementation of IFRS 16 had affected the liquidity of the company. This ratio also demonstrates whether the company can handle its short-term financial obligations. The ratios are normally compared to the average of the

industry in question: same or slightly higher value than that of the industry signifies a company that manages its assets efficiently in order to meet its short-term debt. (Rist, Pizzica 2014, 36.)

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

Several debt ratios were calculated since the transfer of liabilities to balance sheet would be reflected in debt-related markers. Gearing is commonly used as a means to measure debt management of an entity. Gearing demonstrates the method of financing: lower value means equity financing prevails whereas very high value is an indication that debt financing is prominent, the latter tends to signify a riskier company. (Rist, Pizzica 2014, 35.)

$$\text{Gearing} = \frac{\text{Total liabilities}}{\text{Total equity}}$$

Leverage ratios have similar function, namely measuring the amount of debt the company has compared to various other indicators. In this research debt-to-assets leverage ratio will be calculated. Similarly to gearing, higher value indicates a riskier company as it signifies increased debt load. (Rist, Pizzica 2014, 40.)

$$\text{Debt - to - assets} = \frac{\text{Total liabilities}}{\text{Total assets}}$$

Return on assets describes how much profit the company generates from its assets. Higher value is better for the investors, because it implies that the company has used the invested resources efficiently. (Braun, Tietz 2015, 858.)

$$\text{Return on assets} = \frac{\text{Net income} + \text{Interest expense}}{\text{Average total assets}}$$

One of the profitability ratios selected for this research is earning before interest and taxes (EBIT). The value of this metric lies in the fact that it excludes effect of taxes and non-operating expenses on the profitability of the entity, thus demonstrating how much profit the company generates out of its core business. (Rist, Pizzica 2014, 27.)

$$\text{EBIT} = \text{Net income} + \text{Taxes} + \text{Interest}$$

Earnings before interest, taxes, depreciation and amortisation (EBITDA) will be examined as well, because it will be used in later calculations. IFRS 16 affected this value, EBITDA increased for plethora of business which rely on operating lease contracts: previously the operating leases were recorded as rental expenses in profit and loss statement. However, under IFRS 16 the expenses of a lease reflected on profit and loss statement and by extension on EBITDA are depreciation and amortisation, both of which are excluded from EBITDA calculation. (PwC 2016, 5-7.) EBITDA is useful metrics for investors, because it can be valuable for forecasting future cash flows (CFI 2015). EBITDA is expected to increase under IFRS 16, the percentage increase varies from industry to industry with retailers and airlines being the most affected (PwC 2016, 8).

$$EBITDA = \text{Operating profit} + \text{Depreciation} + \text{Amortisation}$$

In addition to EBITDA, EBITDA margin will also be calculated in order to determine the amount of earnings made by the company before interest, taxes, depreciation and amortisation which is good indicator for comparing the profitability of companies working in the same sector as it eliminates non-operating expenses. Higher percentage denotes higher profitability. However, this margin is better used in conjunction with other ratios and metrics. (CFI 2016.)

$$EBITDA \text{ margin} = \frac{EBITDA}{\text{Total sales}}$$

### **3 Research Methods**

A combination of qualitative and quantitative methods was utilised depending on the IQ.

IQ1: What are the differences between IAS 17 and IFRS 16 from lessee's point of view?

This IQ required the study of supporting material provided by the creators of the standard, the International Accounting Standards Board, as well as the articles made by consulting companies on the subject-matter. Financial statements of the case companies were used as well, because the companies have comments on the implementation of the standard in the notes to financial statements.

IQ2: How will the changes in recognition of lease liability change journal entries?

Similarly to IQ 1, this question necessitated familiarisation with the standard IFRS 16 which was best achieved via desktop study of the materials issued International Accounting Standards Board.

**IQ 3: How will the financial indicators of the retailers be affected by the new standard?**

This IQ benefitted from the usage of quantitative data which was gathered and calculated via the study of the financial statements. Comparing ratios and other financial metrics did not require face-to-face interactions, therefore, desktop study sufficed for this part of the research. However, some metrics were not available to general audiences, therefore, assumptions were necessary, these are discussed in their respective chapter.

The aforementioned research methods are summarised in Table 6.

Table 6. Research methods

Research Phase	Phase 1	Phase 2
Source/respondent	Articles	Financial statements, notes to the financial statements
Data collection method	Secondary data: published sources	Secondary data: organisations' records
Data analysis method	Qualitative analysis of articles	Quantitative analysis of financial data
Consolidating the quantitative and qualitative results		
Relationships to IQs	IQ2	IQ1, IQ3

Retailers are known to utilise leasing in their operations extensively, therefore, the impact of IFRS 16 is noticeable and the empirical part of this thesis measures its effect on the financial metrics of the companies. The main players on the retail market of Finland are S-Group, Kesko Oyj and Lidl Ky. The latter will be excluded from this research due to the fact that Lidl's reporting is not based on IFRS (Lidl Suomi Kommandiittiyhtiö 2020, 5).

The theoretical part of this thesis was based on the material provided by IFRS Board, and this theory was applied in order to conduct the analysis of qualitative data. Said qualitative data was gathered from the annual reports of the companies. The numerical data necessary for the calculations is publicly disclosed and available on the websites of the companies.

## **4 Research Results and Analysis**

This chapter contains the calculations necessary for the evaluation of changes caused by IFRS 16 to the retail industry in Finland, namely to S-Group and Kesko. The year 2018 financial statements were used. The first subchapter introduces the companies in question and their relevant metrics as well as the calculation of ratios in accordance with IAS 17. The following subchapter contains the new set of ratios and metrics calculated based on IFRS 16.

### **4.1. Overview of the case companies**

The companies chosen for this research were Kesko and S-Group. These companies operate in the retail sector and can be considered close competitors, since they operate in the same field. Additionally, both entities engage in activities other than grocery trade: Kesko's other areas of business include car trade (Kesko Annual Report 2018, 5) and S-Group has businesses in the hospitality industry (S-Group and Responsibility 2019, 6).

### **4.2. Case companies under IFRS 16**

The publicly available information was not sufficient to calculate the changes caused by the implementation of IFRS 16, therefore, assumptions were necessary. One of such assumptions revolved around the discount rates which were used to discount lease payments. Lessees have various options for determining said discount rate: they can use so-called interest rate implicit in the lease, which is not available for all leases, therefore, the companies may use incremental borrowing rate (IFRS Foundation 2016, 35). Kesko opts for the latter, and it took into consideration factors such as credit rating, country risks etc (Kesko Annual Report 2019, 139). IFRS 16 uses 5% discount rate in their calculations (International Accounting Standards Board 2016a, 61). Additionally, since lease is in essence a loan, the interest on a corporate loan can be used as well. However, in one of their reports S-Group stated that the weighted average discount rate of rents in 2019 was 3,1% (S-Group Financial Statement 2019, 39) and this number was used in calculations for both case companies, as it can be considered more accurate for the industry in question.

Another piece of information not publicly available was the monetary amount of low value assets. As mentioned previously, exemptions may be applied to low value assets, however, it was impossible to estimate the value of assets which would be exempt, so the actual right-of-use/lease liability is likely to be lower than calculated in this research.

Other calculations necessary for the research were related to depreciation and interest: they need to be presented separately in the income statement (IFRS Foundation 2016, 12). The aforementioned 3,1% was used as the interest rate for the lease and the amount was deducted from operating lease expense to calculate depreciation expense.

The adjustments of the financial statements started with recalculation of lease liability which included discounting the lease payments by the interest rate, said interest rate had been defined as 3,1%. As for the length of the lease, the data is only partially available: the companies have three groups of leases based on their due dates, namely leases due within 1 year, later than 1 year and no later than 5 years, later than 5 years. The data collected from the financial statement of S-Group is presented in Table 7.

Table 7. Minimum lease payments under non-cancellable operating leases, S-Group 2018 (S-Group Financial Statement 2018, 48)

<b>Due date</b>	<b>Amount (MEUR)</b>
Within 1 year	144.80
Later than 1 year, no later than 5 years	567.80
Later than 5 years	789.60
<b>Total</b>	<b>1,502.20</b>

Thus, the amount of lease payment due within 1 year was ascribed to Year 1, the amount of leases due later than 1 year and no later than 5 years was equally distributed among Years 2, 3, 4, 5. The amount of lease due in Year 5, 141.95 MEUR, was assumed to be paid every subsequent year. Next step was calculating how many years are necessary in order to pay for the remaining amount of lease, 789.60 MEUR. This amount was divided by the value of lease in Year 5, giving the approximate quantity of years required. In this case dividing 789.60 MEUR by 141.95 MEUR yields 5.56 which was rounded to 6 years. The results of the calculations are illustrated in Table 8.

Table 8. Lease liability recalculation for S-Group

<b>Year</b>	<b>Future value of operating leases, MEUR</b>	<b>Discount factor</b>	<b>Present value of operating leases, MEUR</b>
1	144.80	1.00	144.80
2	141.95	1.03	137.68
3	141.95	1.06	133.54
4	141.95	1.10	129.53
5	141.95	1.13	125.63

6	141.95	1.16	121.85
7	141.95	1.20	118.19
8	141.95	1.24	114.64
9	141.95	1.28	111.19
10	141.95	1.32	107.85
11	79.85	1.36	58.84
Total (where applicable)	1,502.20		1,303.74

The total amount, 1,303.74 MEUR, was transferred to right-of-use assets under non-current assets, same amount was assigned to total liabilities. Note that the amount for Year 1 was recorded as current liabilities; 1,158.94 MEUR, the sum of amounts for Year 2 through Year 11 was assigned to non-current liabilities.

The companies stated their lease expenditure as part of the other operating expenses in accordance with IAS 17. Based on that, new finance expense and depreciation was calculated. Finance expense equalled lease expenditure multiplied by 3,1%, because it had been established as a suitable interest rate. Depreciation was the remaining amount of lease expenditure. For S-Group recalculated finance charge increased by 4.28 MEUR and depreciation rose by 133.82 MEUR. The sum of these amounts, 138.10 MEUR, was removed from other operating expenses, therefore, the operating income increased, ultimately equalling 64.98 MEUR. The result of the adjustments is presented in Table 9.

Table 9. S-Group: recalculation for IFRS 16

<b>Indicator</b>	<b>IAS 17, MEUR</b>	<b>IFRS 16, MEUR</b>	<b>Difference, MEUR</b>
Total assets	1,730.30	3,034.04	1,303.74
Total liabilities	1,069.60	2,373.44	1,303.74
Other operating expenses	389.00	250.9	-138.1
Depreciation/amortisation/impairment	61.20	195.02	133.82
Finance charge	4.40	8.68	4.28
Operating income	60.70	64.98	4.28

Note that net income remained the same: the increase in the operating income was counterbalanced by the increase in the finance charge, therefore, the bottom line of profit and loss statement did not change. However, EBITDA increased significantly, as the following sub-chapter demonstrates.

The same process was applied in order to modify the value of the lease liability for Kesko. The total amount of operating lease liability under IAS 17 for Kesko equalled 2,980.90 MEUR, and the company divided its lease payments in three categories based on their due date, the categories were the same as in S-Group, the lease classification is presented in Table 10.

Table 10. Minimum lease payments under non-cancellable operating lease agreements, Kesko 2018 (Kesko Annual Report 2018, 195)

<b>Due date</b>	<b>Amount (MEUR)</b>
Within 1 year	409.30
Later than 1 year, no later than 5 years	1,367.80
Later than 5 years	1,203.80
Total	2,980.90

The value of leases due later than 5 years equalled 1,203.20 MEUR, and the lease value for year 5 was 341.90 MEUR, the former was divided by the latter, resulting in 3.52, i.e., 4 years were required in order to pay for the remaining amount of lease, thus, the operating lease payments were distributed into 9 years, discounted by the discount factor 3,1%. The results of the calculations are presented in Table 11.

Table 11. Lease liability recalculation for Kesko

<b>Year</b>	<b>Future value of operating leases, MEUR</b>	<b>Discount factor</b>	<b>Present value of operating leases, MEUR</b>
1	409.3	1.00	409.90
2	341.95	1.03	331.67
3	341.95	1.06	312.70
4	341.95	1.10	312.02
5	341.95	1.13	302.64
6	341.95	1.16	293.54
7	341.95	1.20	284.72
8	341.95	1.24	276.15
9	177.95	1.28	139.39
Total (where applicable)	2,980.90		2,671.13

Similarly to S-Group, a number of lines in the financial statements of Kesko was modified under IFRS 16 using the same approach. Right-of-use assets and total liabilities increased by 2,671.13 MEUR. Current liabilities increased by 409.90 MEUR; non-current liabilities increased by 2,261.83 MEUR.

In the financial statements lease expenditure equalled 466.60 MEUR, therefore using 3,1% as the interest rate, the finance charge was calculated as 14.46 MEUR, thus depre-

ciation expense increased by 452.14 MEUR. The sum of these amounts was to be deducted from other operating expenses. Operating income was also impacted by the increase in depreciation. Table 12 illustrates these changes.

Table 12. Kesko: recalculation for IFRS 16

<b>Indicator</b>	<b>IAS 17, MEUR</b>	<b>IFRS 16, MEUR</b>	<b>Difference, MEUR</b>
Total assets	4,302.90	6,974.03	2,671.13
Total liabilities	2,104.60	4,775.73	2,671.13
Other operating expenses	1,034.30	567.70	-466.6
Depreciation/amortisation/impairment	146.90	599.04	452.14
Finance charge	12.40	26.86	14.46
Operating income	307.90	322.36	14.46

Similarly to S-Group, net income of Kesko remained unchanged.

The recalculation clearly shows how much a lease-heavy business is affected by the IFRS 16: as expected due to a large number of leases, liabilities, assets and in turn depreciation increased significantly for both companies in questions. The operating income increased as well, albeit not so drastically, however, changes in depreciation are to be reflected in subsequent EBITDA calculation.

The data presented in the Tables was sufficient for calculating the selected ratios which was conducted in the following subchapter.

### **4.3. Financial ratios of the case companies under IFRS 16**

As specified in the first chapter of this thesis, IFRS 16 affected most notably assets and liabilities as well as the operating income, which was most noticeable in debt-related ratios. The ratios and other financial metrics were calculated based on the data specified in the previous subchapters. The calculations of the ratios are presented in the Appendix 1 of this thesis.

Table 13. Current ratio comparison

<b>Company</b>	<b>Current ratio, IAS 17</b>	<b>Current ratios, IFRS 16</b>	<b>Change</b>
S-Group	1.12	0.96	-0.16
Kesko	1.20	0.98	-0.22

Current ratio was one of the ratios that has decreased. Current liabilities increased with the amount of lease due within 1 year. In case of S-Group the IAS 17 value of current assets was 983.1 MEUR and non-current assets equalled 877.30 MEUR. The latter was increased by 144.80 MEUR, the former did not change, since right-of-use assets were part of non-current assets.

As for Kesko, the original value of current assets was 2,179.70 MEUR and current liabilities were 1,809.50 MEUR. Under IFRS 16 409.30 MEUR was added to current liabilities, numerator of the ratio remained the same, thus resulting in decreased ratio.

It is worth noting, however, that current ratio is normally compared to the average of the industry, therefore, the decreased value does not make the companies immediately riskier, because the industry will set new standard for current ratio.

Table 14. Gearing comparison

<b>Company</b>	<b>Gearing, IAS 17</b>	<b>Gearing, IFRS 16</b>	<b>Change</b>
S-Group	1.62	3.59	1.97
Kesko	0.96	2.17	1.22

Debt-related metrics show the implications of IFRS 16 most noticeably. Total liabilities, i.e., debt grew by 1,303.74 MEUR and 2,671.13 MEUR for S-Group and Kesko, respectively, therefore, this increase had more than doubled gearing for both entities.

Table 15. Debt to assets comparison

<b>Company</b>	<b>Debt to assets, IAS 17</b>	<b>Debt to assets, IFRS 16</b>	<b>Change</b>
S-Group	0.62	0.78	0.16
Kesko	0.49	0.68	0.20

Debt to assets increased as well, albeit less drastically: the increased liabilities in the nominator were offset by increased assets in the denominator.

Table 16. Return on assets comparison

<b>Company</b>	<b>Return on assets, IAS 17</b>	<b>Return on assets, IFRS 16</b>	<b>Change</b>
S-Group	3.13%	2.45%	-0.68 pp
Kesko	4.36%	3.60%	-0.76 pp

Return on assets was another metric of the set that decreased. Numerator, the sum of net income and interest expense, increased, because the interest expense grew by 4.28 MEUR for S-Group and by 14.46 MEUR for Kesko. Net income did not change.

The denominator of the ratio was average total assets, which had grown due to increased assets. Total assets averaged 1,738.55 MEUR in case of S-Group, this value increased by 651 MEUR, ultimately reaching 2,390.42 MEUR.

As for Kesko, the average total assets equalled 4,387.25 MEUR, the recalculation added 1,335.56 MEUR, thus new value of average total assets for Kesko was 5,722.81 MEUR. Considering the significant change in the value of the denominator, the relatively minute increase in numerator could not offset the former, therefore, the ratio was lowered.

Table 17. EBIT comparison

<b>Company</b>	<b>EBIT, IAS 17</b>	<b>EBIT, IFRS 16</b>	<b>Change</b>
S-Group	61.50 MEUR	65.78 MEUR	4.28 MEUR
Kesko	307.9 MEUR	322.36 MEUR	14.16 MEUR

EBIT increased for both entities. IFRS 16 caused interest expense to grow by 4.28 MEUR and 14.46 MEUR for S-Group and Kesko, respectively, other parts of EBIT, taxes and net income, remained the same under IAS 17 and IFRS 16.

Table 18. EBITDA comparison

<b>Company</b>	<b>EBITDA, IAS 17</b>	<b>EBITDA, IFRS 16</b>	<b>Change</b>
S-Group	121.90 MEUR	268.68 MEUR	146.78 MEUR
Kesko	454.80 MEUR	948.26 MEUR	493.46 MEUR

EBITDA more than doubled for both companies. This increase was tied to the fact that increase in assets caused significant recalculations to depreciation. Depreciation increased by 599.04 MEUR for Kesko and by 133.82 MEUR for S-Group.

Increased interest expense also affected EBITDA, although its contribution was relatively modest: 4.28 MEUR and 14.46 MEUR for S-Group and Kesko, respectively.

Table 19. EBITDA margin comparison

<b>Company</b>	<b>EBITDA margin, IAS 17</b>	<b>EBITDA margin, IFRS 16</b>	<b>Change</b>
S-Group	1.70%	3.68%	1.98 pp
Kesko	4.38%	9.13%	4.75 pp

EBITDA margin increased for both entities due to the increase of EBITDA; sales i.e., the denominator remained the same, therefore, increased numerator resulted in increased margin.

EBITDA in the numerator was affected by the increased depreciation: 452.14 MEUR was added to Kesko's depreciation, thus resulting in a fairly noticeable increase of 4.75 pp in EBITDA margin, whereas S-Group's depreciation rose by 133.82 MEUR, and EBITDA margin increased by 1.98 pp.

## **5 Conclusion**

This chapter is a discussion of the results of the study: it presents the general conclusion, answers to the research question, limitations, suggestions for further research and reflection on learning.

### **5.1. General conclusion**

The general conclusion is an answer to the research question of this thesis: what changes does IFRS 16 introduce to the financial ratios of retailers?

The companies studied in this research belong to the retail sector, which is a business relying heavily on leases, therefore, the changes were noticeable. The implementation of IFRS 16 affected assets and liabilities and other debt-related metrics of the company, which are frequently used as part of formulae for ratios.

Apart from the ratios, financial reports of the companies which were studied were affected as well. Both entities selected for this research experienced significant increase in their total assets and total liabilities with the increase in right-of-use asset and lease liability, respectively. Income statement had several noticeable changes as well: operating income increased due to decreased operating expenses, and depreciation rose. However, the bottom line of the income statement, i.e., net income remained the same. It demonstrates that the underlying cash flows did not change, what changes was the way they were presented in the financial statements.

### **5.2. Answers to the investigative questions**

IQ1: What are the differences between IAS 17 and IFRS 16 from lessee's point of view?

The main idea of IFRS 16 is to transfer leasing-related information to the balance sheet of the company, previously operating lease payments and depreciation of the leased assets were part of the income statement. The lessees introduced right-of use asset on the asset side of their balance sheet and lease liability was to be increased on the liabilities side.

(PwC 2016, 4—7.)

IQ2: How will the changes in recognition of lease liability change journal entries?

The answer to this IQ is directly related to IQ1: right-of-use asset increased on the debit side, lease liability increased on the credit side. Subsequent calculations were required in order to record depreciation of the asset and interest expense on the lease, thus necessitating debiting depreciation and crediting accumulated depreciation; interest expense was recorded as debited interest expense and credited lease liability. (International Financial Reporting Standard 16 2016, paragraph 36.)

IQ 3: How will the financial indicators of the retailers be affected by the new standard?

As stated previously, IFRS 16 affects a multitude of metrics which are frequently used in ratios formulae. Profitability metrics such as EBIT, EBITDA, operating income have increased, net income, however, does not change.

Debt-related ratios as well as several profitability ratios were affected. The lease, i.e., loan increased, therefore, gearing, debt-to-assets increased as well. Normally higher values of these ratios indicate a riskier company with heavier debt load. However, ratios are usually used in conjunction with industry average. (Rist, Pizzica 2014, 30.) With the adoption of IFRS 16 new industry standard will be established, and evidently it will be higher than the current values.

### **5.3. Limitations**

One of the main limitations was the lack of data. Although IFRS and IAS compel the companies to disclose their financial information, it was not sufficient to make precise calculations, and the research had to introduce assumptions, most notably — the interest rate for leases. In addition to interest rates, the monetary value of assets the company may choose to use apply exemptions to could not be estimated.

Lastly, the scope of this research was limited to changes on a scale of one country and the number of companies selected to study was limited to two.

### **5.4. Possible further research**

As mentioned previously, this research relied on assumptions in certain areas and, therefore, it would be valuable if one can access precise data the companies actually utilise, thus revealing how the estimations and the actual data differ.

In spring 2020 International Accounting Standards Board released a set of adjustments to IFRS 16 Leases, because the Board has considered the effects of COVID-19 pandemic on the lessee accounting (IFRS 16 and covid-19 2021). Further research can discover how said amendments affect the lease liability and by extension the metrics.

### **5.5. Reflection on learning**

The research process was simultaneously rewarding and difficult. I learned about databases and academic sources I had not used previously, so this is valuable knowledge for future academic assignments.

In order to gain complete understanding of the phenomenon studied in the research, I familiarised myself with multiple academic sources and financial statements. The latter was especially useful, because I have been reading notes to financial statements extensively and the process feels more natural now, which is useful for work as a financial management specialist in the future, also benefitted by the deepened understanding of IFRS.

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## Appendix 1. Ratio calculations

	S-Group. IAS 17	
divided by	Total liabilities	1069.60 MEUR
	Total equity	660.70 MEUR
	Gearing	1.62
divided by	Total liabilities	1069.60 MEUR
	Total assets	1730.30 MEUR
	Debt-to-assets	0.62
divided by	Net income + interest expense	54.40 MEUR
	Average total assets	1738.55 MEUR
	Return on assets	3.13%
plus	Operating profit	60.70 MEUR
	Depreciation/amortisation/impairment	61.20 MEUR
	EBITDA	121.90 MEUR
divided by	EBITDA	121.90 MEUR
	Sales	7303.50 MEUR
	EBITDA margin	1.7%
plus	Net income	48.7 MEUR
	Taxes	6.7 MEUR
plus	Interest	6.1 MEUR
	EBIT	61.5 MEUR
divided by	Current assets	983.1 MEUR
	Current liabilities	877.3 MEUR
	Current ratio	1.12

S-Group. IFRS 16

	Total liabilities	2373.34 MEUR
divided by	Total equity	660.70 MEUR
	Gearing	3.59

	Total liabilities	2373.34 MEUR
divided by	Total assets	3034.04 MEUR
	Debt-to-assets	0.78

	Net income + interest expense	51.60 MEUR
divided by	Average total assets	1738.55 MEUR
	Return on assets	2.45%

	Operating profit	64.98 MEUR
plus	Depreciation/amortisation/impairment	203.70 MEUR
	EBITDA	268.68 MEUR

	EBITDA	268.68 MEUR
divided by	Sales	7303.50 MEUR
	EBITDA margin	3.68%

	Net income	48.7 MEUR
plus	Taxes	10.98 MEUR
plus	Interest	6.1 MEUR
	EBIT	65.78 MEUR

	Current assets	983.1 MEUR
divided by	Current liabilities	1022.10 MEUR
	Current ratio	0.96

Kesko. IAS 17

	Total liabilities	2104.60 MEUR
divided by	Total equity	2198.30 MEUR
	Gearing	0.96
	Total liabilities	2104.60 MEUR
divided by	Total assets	4302.90 MEUR
	Debt-to-assets	0.49
	Net income + interest expense	191.30 MEUR
divided by	Average total assets	4387.25 MEUR
	Return on assets	4.36%
	Operating profit	307.90 MEUR
plus	Depreciation/amortisation/impairment	146.90 MEUR
	EBITDA	454.80 MEUR
	EBITDA	454.80 MEUR
divided by	Sales	10382.80 MEUR
	EBITDA margin	4.38%
	Net income	234.8 MEUR
plus	Taxes	11.2 MEUR
plus	Interest	61.9 MEUR
	EBIT	307.9 MEUR
	Current assets	2179.7 MEUR
divided by	Current liabilities	1809.5 MEUR
	Current ratio	1.20

Kesko. IFRS 16

	Total liabilities	4775.73 MEUR
divided by	Total equity	2198.30 MEUR
	Gearing	2.17

	Total liabilities	4775.73 MEUR
divided by	Total assets	6974.03 MEUR
	Debt-to-assets	0.68

	Net income + interest expense	191.30 MEUR
divided by	Average total assets	4387.25 MEUR
	Return on assets	3.60%

	Operating profit	307.90 MEUR
plus	Depreciation/amortisation/impairment	146.90 MEUR
	EBITDA	454.80 MEUR

	EBITDA	948.26 MEUR
divided by	Sales	10382.80 MEUR
	EBITDA margin	9.13%

	Net income	234.8 MEUR
plus	Taxes	25.66 MEUR
plus	Interest	61.9 MEUR
	EBIT	322.36 MEUR

	Current assets	2179.70 MEUR
divided by	Current liabilities	2218.80 MEUR
	Current ratio	0.98