

In the Spotlight

An industry focus on the impact of IFRS 16 – Shipping

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IFRS 16, Leases

The new lease accounting standard will fundamentally change the accounting for lease transactions and is likely to have significant business implications.

Almost all leases will be recognised on the balance sheet, with a right of use asset and financial liability that recognise more expenses in profit or loss during the earlier life of a lease.

This will have an associated impact on key accounting metrics, and clear communication will be required to explain to the impact of changes to stakeholders.

Why the new standard matters to the shipping industry

The shipping industry is likely to be one of the most affected by the new standard, given that bareboat, time-charter contracts and other arrangements that are widely used in the industry will typically fall under the definition of a lease. The PwC Global Lease Capitalisation study performed in 2015, indicated that there would be a median debt increase of 24% and a 20% median increase in EBITDA for the transport and infrastructure industry.

Whilst the new standard leaves lessor accounting substantially unchanged, it will have a significant impact on the industry's customer base, its charterers (lessees). Historically, most charter contracts have been considered as operating leases and have, therefore, not had any impact on the balance sheets of charterers. Charter-in-hires were typically recognised in the income statement on a straight-line basis over the lease term and classified, in their entirety, as operating expenses. Under the new lease standard, these contracts will be recognised on the balance sheet and the income statement charge will need to be allocated between operating expenses (depreciation) and finance costs. The impact of the new standard on the charterers' financial reporting is, therefore, significant and may lead to a change in the behavior of the charterers when negotiating new contracts. This will have a business impact on ship-owners (lessors) as well.

An In depth guide to the new standard and its effects

In depth INT 2016-01 provides a comprehensive analysis of the new standard. This Spotlight summarises the main aspects of the standard, highlighting some key challenges and questions management should ask as they prepare for transition.

Although the new standard will not be effective until 2019, the extent of data-gathering and requirement to embed new processes for many entities means that, for many, preparations should begin now.



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The new standard on a page

<i>When is the effective date?</i>	The new leasing standard will become effective in 2019 and include pre-existing leases (however, there are some reliefs on transition). Early application is permitted.
<i>What is the scope of the standard?</i>	The standard covers every lease except for rights to explore non-regenerative resources, rights held under licensing agreements, leases of biological assets and service concession arrangements. For lessors, leases of intellectual property are excluded from IFRS 16; lessees are not required to apply IFRS 16 to certain rights held under licensing agreements.
<i>Are there any exemptions?</i>	A recognition and measurement exemption for <i>short term leases</i> and <i>leases of low value assets</i> is available as a policy choice. However, this is only available to the lessee.
<i>What is the definition of a lease?</i>	A lease is a contract (or part of a contract) that conveys the right to use an asset for a period of time in exchange for consideration. A contract contains a lease if fulfilment depends on an <i>identified asset</i> and it conveys the <i>right to control the use</i> of that identified asset throughout the period of use. Each <i>lease component</i> should be identified and accounted for separately.
<i>What is an identified asset?</i>	An asset can be identified explicitly or implicitly. A contract does not depend on an identified asset if the supplier has a substantial right to substitute the asset.
<i>What is the “right to control the use” of an asset?</i>	A customer has the right to control the use of an identified asset if he has the right to obtain <i>substantially all of the economic benefits</i> from the use of the asset and the <i>right to direct the use</i> of the asset, i.e. to decide how and for what purpose it is used.
<i>When is an arrangement split into separate lease components?</i>	A right to use an asset is a separate lease component if the lessee can benefit from the asset on its own (or together with readily available resources) and the asset is neither interdependent nor highly correlated with any other underlying asset in the contract.
<i>What is recognised on the balance sheet?</i>	<i>Lessees</i> will recognise almost all leases on the balance sheet (as a “right-of-use asset” and “lease liability”). <i>Lessors</i> will still distinguish between finance leases (recognise a lease receivable) and operating leases (continue to recognise the underlying asset).
<i>How is a lease initially measured by lessees?</i>	The lessee recognises: • a lease liability at the present value of future lease payments; and • a right-of-use asset to an equal amount plus initial direct costs.
<i>What does a lessee recognise in profit or loss?</i>	A lessee will recognise: • interest on the lease liability • depreciation of the right of use asset Variable lease payments not included in the lease liability are recognised in the period the obligation is incurred.
<i>Is lessor accounting affected?</i>	IFRS 16 does not change lessor accounting.

Key questions for the industry

Q: What types of arrangements might meet the new definition of a lease?

A: According to the new standard, the following arrangements are likely to be treated as follows:

- **Bareboat charters** will typically meet the new definition of a lease as, under these agreements, the charterer controls the use of the ship.
- **Time charters** and **pool arrangements** are likely to contain both a lease (i.e. right to use the ship) and service components (i.e. operation and maintenance of the ship by the ship owner). A lessee can choose, by class of leased asset, not to separate services from a lease and instead account for the entire contract as a lease.
- **Voyage charters** are not likely to meet the new definition of a lease, as the charterer typically does not have the right to direct the use of the ship, i.e. how and for what purpose the ship is used.
- Similarly, **contracts of affreightment** are unlikely to meet the definition of a lease, since they are contracts for the provision of a service rather than the use of an identified asset.

Q: What might evidence a “right to control the use” of an asset?

A: The “right to control the use” of the ship might be evidenced by the exclusive use of the ship by the charterer, where they have the ability to decide whether and what cargo will be transported and when and to which ports the ship will sail to throughout the period of use, even if protective rights exist.

Moreover, the “right to control the use” of the ship might be evidenced even in cases where the charterer does not have the exclusive use of the ship but the charterer’s cargo occupies substantially all of the capacity of the ship, thereby preventing other parties from obtaining economic benefits from the ship. In these cases, the charterer shall also have the ability to make decisions about how and for what purpose the ship is used to conclude that he has the “right to control the use” of the ship.

Q: What areas might affect the lease liabilities recognised?

A: The measurement of the lease liabilities will be highly judgmental and is going to be affected by the different terms, including:

- Contingent/variable hire, renewal and/or purchase options and other services received under the agreements – these might all affect the measurement of the lease liability. Given the volatility of the market, the calculation of the lease liability is likely to be challenging, as lessees will need to assess whether it is reasonably certain to exercise the renewal and/or purchase options both initially and subsequently at each reporting date. Also, lease payments may be fixed, indexed, performance based or might include minimum guaranteed consideration. Under IFRS 16, only fixed payments, indexed payments and variable payments that are in-substance fixed payments will be included in the measurement of the lease liability.
- The lease payments shall be discounted using the interest rate implicit in the lease, and whenever that rate cannot be readily determined, the lessee’s incremental borrowing rate adjusted to reflect the terms and conditions of the lease.

- Re-measurements of the lease liability will also be required whenever cash flows under the lease change. In cases where the charters are linked to an index, this need for re-measurement will likely be challenging due to the volatility of the charter rates. Re-measurements would require a relevant adjustment to right-of-use asset or might affect the Income Statement, depending on the circumstances. In addition, Income Statement volatility might also arise through foreign exchange differences on the translation of the lease liability and right-of-use asset to the lessee's functional currency, if applicable.

Q: Which shipping industry participants are likely to be impacted the most?

- A:
- Since the most significant implications of the new standard affect lessors, all types of vessel charterers operating in the shipping space will likely see the most significant impact on their financial reporting.
 - Companies that are involved solely in vessel owning are effectively lessors and will likely have the least impact on their financial reporting from the new standard.
 - However, it is possible that the impact of the standard on charterers will be such as to change the behavior of charterers towards particular types of charter arrangements, as companies try to manage the impact of the new accounting treatment of these contracts on their financial performance and accounting metrics. In this case, lessors would likely face business implications.

Q: What will be the impact of implementation on key accounting metrics?

- A: For lessees, the new accounting treatment will immediately affect a range of key metrics monitored by stakeholders, including:
- Net debt and gearing (increases as lease liability included in net debt)
 - Net assets (decreases as the right of use asset amortises on a straight line basis while lease liability is unwound more slowly in early years)
 - EBITDA (increases as rental expense replaced by interest and amortisation).

Q: What are the wider potential business impacts?

- A: The new accounting treatment could affect a number of areas for lessees:
- Debt covenants – covenants might need to be renegotiated.
 - Share-based payments – performance metrics might need renegotiation.
 - Dividend policy – the revised profile of the profit or loss expense might affect the ability to pay dividends.
 - Lease negotiations – although accounting should not be the key driver in commercial negotiations, market behavior might change towards shorter lease tenures or change of other terms to minimise lease liabilities. This will also impact lessors.
 - Future transactions – Decisions such as (re)financing or raising capital to fund growth, acquisitions and mergers and lease versus buy options are expected to be affected. Also, for anticipated capital market transactions any specific regulatory requirements regarding the presentation of historical information should be considered.

Q: Are there any other financial reporting issues that should be considered?

A: For lessees, other issues include the following:

- Adoption of IFRS 16 & IFRS 15 — adoption of IFRS 16 and IFRS 15 at the same time should be considered to avoid different accounting treatments relating to non-lease components in 2018 and 2019.
- Transition — entities can choose a ‘simplified approach’, which includes certain reliefs for the measurement of right-of-use asset and the lease liability and also does not require comparatives, instead of full retrospective application in order to facilitate transition. Also, entities are not required to reassess existing contracts, to determine whether the contracts contain a lease based on the new guidance.
- Impairment of right-of-use asset — challenges may be faced by lessees in determining whether the right-of-use asset is impaired, in accordance with IAS 36.
- Disclosure requirements — IFRS 16 requires more extensive disclosures, both qualitative and quantitative.
- US/IFRS lack of convergence — financial information published by different companies will still not be comparable since the two Boards have been unable to arrive at a converged standard.
- Sub-leases — IFRS 16 now requires the lessor to evaluate a sublease with reference to the right-of-use asset, and subleases are now more likely to be classified as finance leases. The lessor of a sublease will have to recognise an asset on its balance sheet — a right-of-use asset with respect to the head lease (if the sublease is classified as an operating lease) or a lease receivable with respect to the sublease (if the sublease is classified as a finance lease).

For a sublease that results in a finance lease, the intermediate lessor is not permitted to offset the remaining lease liability (from the head lease) and the lease receivable (from the sublease). The same is true for the lease income and lease expense relating to head lease and sublease of the same underlying asset.

This will have an impact on all companies chartering-in vessels that are subsequently sub-chartered out.

Q: Will we need to develop an entirely new system to track and administer leases?

A: Many lessees currently manage operating leases on spreadsheets or through the accounts payable system. Information needed to reassess lease terms and index-based payments at each reporting date will now need extensive data capture. Lessees might need to modify information systems, processes and internal controls to comply with the standard.

Q: How and when should I start a program to manage change and meet compliance?

A: Lessees should take advantage of the long implementation period available. An initial assessment of exposure to the new standard, would be a good starting point, including people, business operations and processes, systems, data, governance and policy.

Q: What other departments other than accounting might be impacted?

A: The tax department will need to assess how deferred tax liabilities might be affected. The human resources department should consider whether there are any effects on compensation metrics and policies. In general, the transition and implementation of IFRS 16 will require cross-functional participation and communication within the entity. Other departments, such as Treasury, Legal and IT, may also need to participate in the preparation process.



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