

# *In the Spotlight*

## An industry focus on the impact of IFRS 16 – Airlines

April 2016

### *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 industry*

The initiative to develop a new leases standard goes back to the time when Sir David Tweedie was the chairman of the International Accounting Standards Board. He joked that he wanted to fly in an aircraft that actually existed on an airline's balance sheet.

For decades, financing aircraft through off-balance lease models has been a well-established practice in the Airline industry. In addition, airport facilities which are essential to run airline operations are typically rented from the respective airport owner.

Under IFRS 16 substantially all lease contracts will be on the balance sheet of the lessee. Estimates suggest this change will mean that trillions of additional lease obligations will be added to the balance sheets of Airlines world-wide. As most lease obligations are denominated in US-Dollar, many airlines will also be exposed to additional foreign currency volatility into their profit or loss.

The recently published PwC study on the impact of lease capitalisation concludes that the Airline industry will be the second most impacted sector after the Retail industry. The median increase in on-balance debt is projected to be +47%. About 50% of Airlines are expected to increase debts by more than 25%. Due to the respective change in the profit or loss geography (with interest and depreciation presented instead of rental expenses), the median increase in EBITDA is projected with some +33%.

### *A practical 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

*When is the effective date?*

The new leasing standard will become effective in 2019 and include pre-existing leases (however, there are some reliefs on transition).

*What is the scope of the standard?*

The standard covers every lease except for rights to explore non-regenerative resources, rights held under certain licensing agreements, leases of biological assets and service concession arrangements.

For lessors, licences of intellectual property granted are excluded from IFRS 16.

*Are there any exemptions?*

A recognition and measurement exemption for *short term leases* and *leases of low value assets* is available as a policy choice. This is only available to the lessee and is unlikely to have a practical effect for the airlines industry.

*What is the definition of a lease?*

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 *identified asset* and it conveys the *right to control the use* of that identified asset throughout the period of use.

Each *lease component* should be identified and accounted for separately.

*What is an identified asset?*

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.

*What is the “right to control the use” of an asset?*

A customer has the right to control the use of an identified asset if they have the right to obtain *substantially all of the economic benefits* from the use of the asset and the *right to direct the use* of the asset, i.e. to decide how and for what purpose it is used.

*When is an arrangement split into separate lease components?*

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.

*What is recognised on the balance sheet?*

*Lessees* will recognise almost all leases on the balance sheet (as a “right-of-use asset” and “lease liability”).

*Lessors* will still distinguish between finance leases (recognise a lease receivable) and operating leases (continue to recognise the underlying asset).

*How is a lease initially measured by lessees?*

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 and restoration costs.

*What does a lessee recognise in profit or loss?*

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.

*Is lessor accounting affected?*

IFRS 16 does not make any substantial changes to lessor accounting.

### **Key questions for the industry**

**Q:** *What types of arrangement might not meet the new definition of a lease?*

**A:** Arrangements will need to be assessed to identify whether there is an identified asset. There is no identified asset where the supplier has a substantive right to substitute the asset.

*Example 1:* Airline enters into a 2-year contract with an aircraft owner (Supplier). Every Monday, Wednesday, Friday, Saturday and Sunday Supplier will exclusively transport passengers of Airline from Paris to Mallorca at 10am and at the same day from Mallorca to Paris at 6 pm. The type of aircraft is specified by Airline. Supplier owns more than one aircraft of this type. Supplier is permitted to substitute the aircraft at any time during the contract period and must substitute the aircraft if it is not working. Furthermore, Supplier is responsible for operating the aircraft, using its own crew.

**Assessment:** The contract does not contain a lease.

There is no identified asset. Supplier owns several aircrafts of the same type to fulfill its contractual obligations and can exchange the aircrafts without the permission of Airline. Even if the aircraft will be specified in the contract there is no identified asset because Supplier will benefit from using the aircraft for example on Tuesday and Thursday to carry out service for other customers. In addition, Airline wouldn't have the right to obtain substantially all of the economic benefits from the use of the aircraft.

*Example 2:* Airline enters into a contract with an airport operator (Supplier) to use a space in the airport to deploy its check-in machines and other equipment. The contract states the exact amount of space and that the space must be located in the entrance hall. However, Supplier has the right to change the location of the space allocated to Customer at any time during the contractual term. There are minimal costs to Supplier associated with changing the space for the Customer and there are several unoccupied places in the entrance hall of the airport that would meet the specifications for the space to be used by Customer.

**Assessment:** The contract does not contain a lease.

The space where the check-in machines and the other equipment will be located is specified in the contract. However, fulfilment of the contract does not depend on the use of an identified space. Supplier has a substantive right to substitute the space Customer uses because Supplier has the practical ability to change the space used by Customer. There are several unoccupied places in the entrance hall that meet the specifications of the space used by Customer, and Supplier has the right to change the location of the space at any time without Customer's approval. In addition, Supplier would benefit economically from substituting the space. Besides the fact, that there would be minimal cost associated with changing the space used by Customer substitution allows Supplier to make the most efficient decision about the usage of the places.

**Q:** *How is the profit or loss for sale and leaseback transactions determined?*

**A:** Airline sells a 10-year old airplane (book value of 50 CU) to Lessor for 100 CU and immediately leases it back for 8 years. The lease agreement contains no repurchase obligation or any call or put option. There is a renewal option to extend the lease term for a further 5 years. However, at lease inception extension of the lease has been assessed as to not be reasonably certain. The present value of the 8 year leaseback rentals amount to 70 CU.

The rentals for the leaseback represents 70% of the airplane's fair value. This means that Airline has sold 30% of the airplane's residual value.

In accordance with the sale and leaseback provisions of IFRS 16 the seller-lessee (Airline) recognises a right-of-use asset of 35 CU which represents 70% of the former book value (i.e. the portion retained). There is a gain of 15 CU which represents 30% of the difference between the fair value of the airplane (30 CU) and the book value of the portion sold (15 CU).

**Q:** *How do repurchase agreements affect the accounting for sale and leaseback transactions?*

**A:** Assume the same fact pattern as in the sale and leaseback example above. However, the lease contains a repurchase agreement.

If the Airline has an obligation to purchase the airplane back then IFRS 15 requires the sale and leaseback transaction be accounted for as a financing. A financial liability would be recorded in accordance with IAS 39 (IFRS 9).

**Q:** *How are lease payments that depend on a rate accounted for?*

**A:** As of 1 January 2016 Airline enters into a 3 year lease agreement with rentals which vary based on the 3M-Euribor rate. The rentals will be paid monthly and amount to 10 CU at lease commencement. Every six month the rentals are adjusted to the then-prevailing 3M-Euribor plus 150 bpts. The incremental borrowing rate at lease commencement is 2.8%.

At commencement Airline measures the present value of the lease liability and the right-of-use asset by discounting 36 months of lease payments (i.e. 360 CU) using 2.8%.

As of 1 July 2016 the rentals have been increased to 11 CU due to a change in the 3M-Euribor. At that date Airline remeasures the lease liability to reflect this change. The new carrying amount of the lease liability is calculated as the present value of the outstanding 30 month of rentals (i.e. 330 CU). As the change in the lease payments results from a change in a floating interest rate (3M-Euribor) the Airline must also use a revised discount rate which reflects the change in the interest rate.

The difference between the carrying amount of the lease liability before and after the remeasurement results in a corresponding adjustment to the right-of-use asset.

**Q:** *Will IFRS 16 impact the accounting for maintenance?*

**A:** In many situations IFRS 16 will not change current practice in accounting for maintenance. However, if the airline will incur maintenance expenses before returning the aircraft back to the lessor due to contractually agreed return conditions, IFRS 16 requires those costs be included as part of the measurement of the right-of-use asset when the obligation is recognised. At the same time the airline would account for a provision in accordance with IAS 37. Subsequent accounting for the provision and the portion of the right-of-use asset that belongs to those future maintenance costs will be in accordance with IFRIC 1.

*Q: What areas might affect the lease liabilities recognised?*

A: Contingent rent, renewal/purchase options and other services received under the agreements might all affect the calculation of the lease liability.

*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, depreciation and amortization)
- Many airlines use Return on Capital Employed (ROCE) to measure the amount of value generated. The above mentioned implications will most likely also affect the individual ROCE calculations
- Cost of Available Seat Kilometers (CASK) is an important Non-GAAP measure which is used in the industry. Changes to EBITDA will affect this measure as well.
- Lump-sum adjustments used by analysts to calculate comparable level of debt from aircraft financing. These current adjustments will probably not concur with numbers calculated under IFRS 16. Therefore listed airlines should start communicating this to the analysts appropriately.

*Q: What are the wider potential business impacts?*

A: The new accounting treatment could affect a number of areas:

- 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 to minimize lease liabilities.

*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: Entities should take advantage of the long implementation period available. An initial assessment of people, processes, systems, data, governance and policy would be a good starting point.

*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.

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### Questions?

To have a deeper discussion, please contact:

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