Transportation and logistics breaking news

New leases standard (IFRS 16)

New leases standard (IFRS 16) is published and will change the business decision of transportation and logistics companies!

Summary

The International Accounting Standards Board ("IASB") published the new leases standard on 13 January 2016. The new standard will have a significant impact to transportation and logistics companies (in particular for shipping and aviation companies). The impacts of the new standard include:

New lease definition

Under the new standard, a contract contains a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange of consideration. The classification of the leasing models commonly used in the shipping and aviation sectors can be analysed as follows:

Leasing model	Classification	Analysis
Bare boat charter/ dry lease	Lease	Lessee can control the use of the identified assets (e.g. direct the routes or parking locations for the vessels/aeroplanes)
Time charter/ wet lease	Lease + Service	Lessee can control the use of the identified assets and the lessor also provides services (e.g. crews and maintenance etc.) to the lessee
Voyage charter	Service	Lessee cannot control the use of the identified assets (e.g. the operation of the vessels/aeroplanes and the routes are controlled and directed by the crews of lessor)

Lessees

One model

Finance and operating leases have different accounting treatment under existing standard. Finance leases are required to be "On Balance Sheet" i.e. recognising an asset and corresponding liabilities in the financial statements; while operating leases are "Off Balance Sheet" and the lease expenses are recognised on a straight-line basis along the lease period. Under the new lease standard, except for certain short-term leases and leases of low-value assets are exempted, all other leases are required to be "On Balance Sheet". This implies the balance sheet of lessees will significantly expand, corresponding with their existing operating lease commitment.

In addition, recognition of operating lease expenses will be changed from the existing straight-line model (same monthly lease payment) to a "front-loaded" model as finance lease, i.e. the lease expenses (asset depreciation plus interest) at the initial period of the lease is higher than the operating lease expenses recognised in accordance with the straight-line model under the existing standard.

Recognition and measurement

Apart from the recognition of lease liabilities and right-of-use assets on balance sheet, the new standard also provides some new regulations on the recognition and measurement which may be challenging to shipping and aviation companies when these regulations are put into practice.

Separation of lease and service components in time charter/wet lease

If a contract contains both lease and service components, the new standard requires to separate these and recognise them at their respective fair values. Even though the new standard grants a practical exemption which allows the whole contract being accounted for as a lease, this may significantly increase lease liabilities. If there is a separation, the high volatility of charter rates of shipping and aviation sectors may make it challenging to determine the fair values of the lease and service components for separation.

Impairment assessment of right-of-use assets

A lessee shall apply IAS 36 Impairment of Assets to determine whether the right-of-use asset is impaired and account for any impairment loss identified. The volatility of charter rates of shipping and aviation sectors will also increase the risk of impairment.

Sub-lease

The operation model of shipping and aviation sectors commonly involves sub-leases i.e. charter-in an asset from an entity and then sub-lease the asset to another entity for operation and sale and lease back arrangements. Under the new standard, a lessee (who is also the lessor in the sub-lease contract) is required to consider the terms and condition of both the charter-in contract and the sub-lease contract. If the right to control the use of the identified asset is substantially transferred from the lessee to the sub-lessee through the sub-lease arrangement (i.e. finance lease), the lessee will recognise a lease receivable instead of a right-of-use asset. It affects the timing, amount and account for the subsequent recognition of expenses.

Moreover, the new requirements on variable lease payments and re-measurement of lease liabilities, sale and lease back arrangement will also increase the complication of measurement.

Lessors

For lessors, the accounting stays almost the same. However, the lessor will also be affected because the new lease standard has updated guidance on the definition of a lease, sub-lease, as well as the guidance on the combination and separation of contracts.

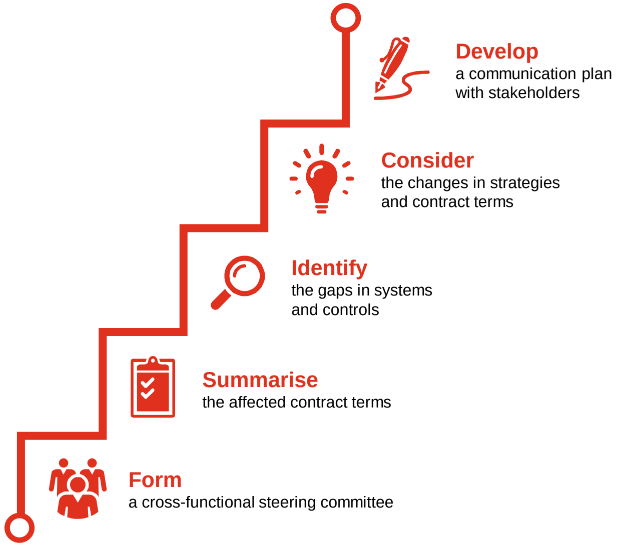
At the very least, lessors' lease arrangements may be restructured because of the change of lessees' accounting treatment, and it will impact lessors' business model and the business negotiations between lessors and lessees.

How your company may be impacted?

1. **Financial statements and financial ratios:**
   The increase of both assets and liabilities and the change in the expense recognition pattern ("front-loaded") may have significant impacts on the commonly used financial ratios of the lessees: assets liabilities ratio, current ratio, EBIT, net profit, EPS, ROE, operating cash flow, etc.
2. **Business decision:**
   At present, lessees opt to lease rather than purchase fixed assets so as to avoid reflecting the liabilities in the financial statements. Therefore, the new lease standard may affect lessees' "purchase or lease" business decisions, and correspondingly the lessors may need to adjust their business strategy.
3. **Contracts with other business partners:**
   The change of financial ratios may trigger an entity to re-negotiate the loan agreements with lenders, etc.
4. **Staff compensation assessment:**
   If an entity's compensation plan is linked to financial ratios, the entity may need to re-develop its compensation assessment basis.
5. **Tax implications:**
   The timing and the amount of tax payments may be affected by the change of lease and service classification and expense recognition pattern.
6. **System and information gathering:**
   The new standard requires more information than what would have been captured in the financial reporting system in the past. An entity may need to update its existing system to gather the relevant lease information.
7. **Controls and processes:**
   The new standard requires more judgement and disclosures to be made, controls and processes may need to be updated.
8. **Budgeting:**
   The lessees' assets, liabilities and expenses will be changed under the new standard, and all these have to be considered in the budget.
9. **Investor relations and capital monitoring:**
   Stakeholders have to understand the impact of the new standard on an entity's financial statements and an entity should consider communicating with the stakeholders at an appropriate time. Moreover, an entity should also consider the regulatory requirements, e.g. capital sufficiency ratio, etc.

Prepare for the changes

Although the effective date of the standard is 1 January 2019, numerous lease contracts have long lease terms and a widespread implications. Besides, the identification and assessment of contracts is time consuming. An entity should commence the assessment immediately and take appropriate actions.



How PwC can help?

This breaking news summarises the main aspects of the new standard and highlights some key challenges and questions that management of transportation and logistics companies may encounter as they prepare for the transition. We will provide a more comprehensive analysis on the implications of the new standard on transportation and logistics companies through our publications and seminars in the coming months.

Furthermore, PwC can help you to understand and assess the implications of the new lease standard to your business from various perspectives, including training, contract review (including key information gathering and recommendations on modifications of lease contracts etc.), implication analysis, scenario modelling and lease business/finance/management system solutions etc. If necessary, please contact us.

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