IFRS 16 LEASES – TRANSITION ARRANGEMENTS FOR SHIPPING

UPDATE: SHIPPING

Since the new leasing standard, IFRS 16 Leases, came into force preparers in the shipping industry will need to consider how they will implement the standard as it contains a number of choices. The date of initial application, the first day of the period when the standard is initially applied, will be key to some of these, including options around transition.

The implementation of a new standard requires entities to change the way transactions are reported, including giving supporting disclosures. To enable comparability of financial performance and position, changes to the way an entity accounts will require adjustments to previously presented comparatives. An entity must look at transactions in the future but also re-account for those in the past. Or maybe not for leases.

LEASE DEFINITION

Although the definition of a lease is slightly different under IFRS 16 from IAS 17, an entity can apply IFRS 16 to those contracts that were a lease under the old standard as at the date of initial application. The ability not to have to reassess whether a contract is, or is not, a lease, having already made this assessment for IAS 17, does look to be an attractive exemption. Its practical impact may, in many cases, be limited but if it is not taken an entity will still have to consider transactions even if the conclusion reached is that there are no further contracts within scope.

This exemption applies to both lessees and lessors.

> “An entity can apply IFRS 16 to those contracts that were a lease under IAS 17 as at the date of initial application.”

LESSEES

Lessees have a two stage choice about how they implement the standard having identified the leases to which it applies.

The first choice is to either:

- apply the changes retrospectively to all prior periods presented, which typically will be the current year and a single comparative year, as well as the opening balances, or
- leave the comparative figures as previously presented but account for the cumulative impact of adopting the IFRS 16 as an adjustment to the opening position as at the date of initial application. This is a ‘modified retrospective approach’.

Under the latter option, the first set of accounts where IFRS 16 is applied will not contain statements of comprehensive income , statements of financial position or statements of cash flows which are comparable over the two years presented.

Where the modified retrospective approach is applied a further choice is available. This will only apply to leases that were previously classified as operating leases under IAS 17. The respective asset and liability are accounted prospectively from the start of the period applying IFRS 16.

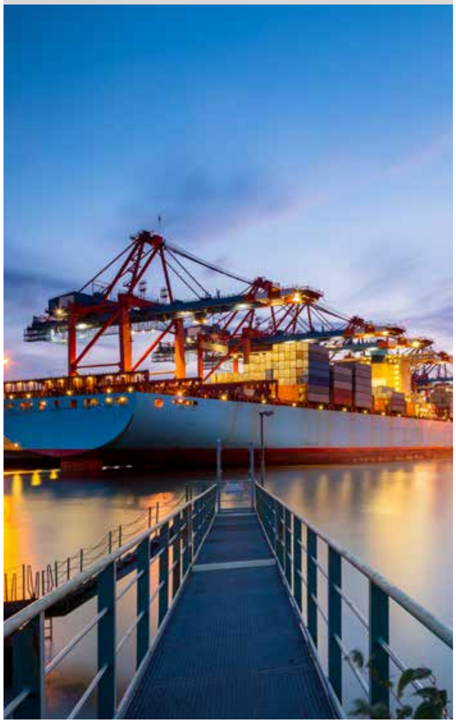
CONTACT

MICHAEL SIMMS
PARTNER
+44 (0) 20 7651 1184
michael.simms@bdo.co.uk

RICHARD GREINER
PARTNER
+44 (0) 20 7651 1430
richard.greiner@bdo.co.uk

CASSIE FORMAN-KOTSAPA
PARTNER
+44 (0) 20 7651 1318
cassie.forman-kotsapa@bdo.co.uk

For more information and advice on IFRS 16, please get in touch.



LESSEES

Leasees previously accounted for as an operating lease

Firstly, determine the lease liability. This is the present value of the remaining lease payments but discounted using the incremental borrowing rate as at the date of initial application.

Secondly, determine the right of use asset. Here the lessee is presented with a further choice, either:

- the right of use asset is set equal to the amount of the lease liability, adjusted for any prepaid or accrued amounts, or
- the right of use asset is determined as if IFRS 16 had been applied since commencement of the lease but applying the discount rate used to calculate the lease liability above.

The first option has the benefit of being simple. The second option will generally result in a lower right of use asset being recognised, which will mean a lower depreciation expense in future periods.

EXAMPLE

This can be illustrated with a simple example. A four year lease, with annual rentals paid in advance of $100, and an incremental borrowing rate of 10%.

At commencement the present value of the payments is $348. If the date of initial application is the start of the second year the liability will be $273. The liability is this amount under both options. The entity then has a choice to set the right of use asset ('ROUA') to the amount of the liability, $273 (modified approach 1), or to use the amount of $348 adjusted for amortisation for the period prior to initial application. Assuming a straight line policy, the right of use asset would be $261 (modified approach 2), giving a net adjustment to equity, retained earnings of the difference, $12. The principal repayment amount is $99 throughout.

$	INCOME STATEMENT		STATEMENT OF FINANCIAL POSITION			
	2018	**2019**	**1 Jan 2018**	**31 Dec 2018**	**1 Jan 2019**	**31 Dec 2019**
IAS 17						
Lease expense	100	100				
IFRS 16						
Fully retrospective						
Depreciation	87	87				
Interest	25	17				
ROUA			348	261	261	174
Lease liability			348	273	273	191
Modified approach 1						
Lease expense	100					
Depreciation		91				
Interest		17				
ROUA					273	182
Lease liability					273	191
Modified approach 2						
Lease expense	100					
Depreciation		87				
Interest		17				
ROUA					261	174
Lease liability					273	191
Equity adjustment					(12)	

LESSEES

The amount of adjustment to equity will depend upon where in the life of the lease the date of initial application falls. To add to the dilemma of which option may be preferred, IFRS 16 does permit this choice to be made on a lease by lease basis. For a large number of leases this may be impractical in the absence of a systematic approach.

Not all operating leases will need to be adjusted for. If the lease is of a low value asset, an indicative amount being $5,000, the entity may elect to exclude these from the requirement to recognise on the statement of financial position. The entity may also exclude from the adjustment those leases for which, although they may not have been short term leases with a lease term, including any reasonably certain options, of less than 12 months at commencement, the remaining lease term is less than 12 months at the date of initial application.

Is there anything else to ease this calculation? It is permissible to use a single discount rate for a portfolio of leases with 'reasonably similar characteristics'.

It is a matter of judgement about what reasonably similar characteristics means but if the leases were not for similar periods for a similar class of underlying assets it may be hard to justify a single discount rate.

Other factors to consider

Consideration must be given to possible impairments. But assistance is also given through a practical expedient which permits an assessment of whether the lease may have been onerous when previously accounted for as an operating lease. The right of use asset is adjusted for any previous provision for onerous leases immediately before the date of initial application. When taken, the entity does not need to perform a separate impairment review.

The standard envisages the use of hindsight. However, the standard is unclear about the extent of hindsight that may be used – merely giving an example of the lease term. The use of such an example does suggest that hindsight may be used for more areas than this.

Lessees previously accounted for as finance leases

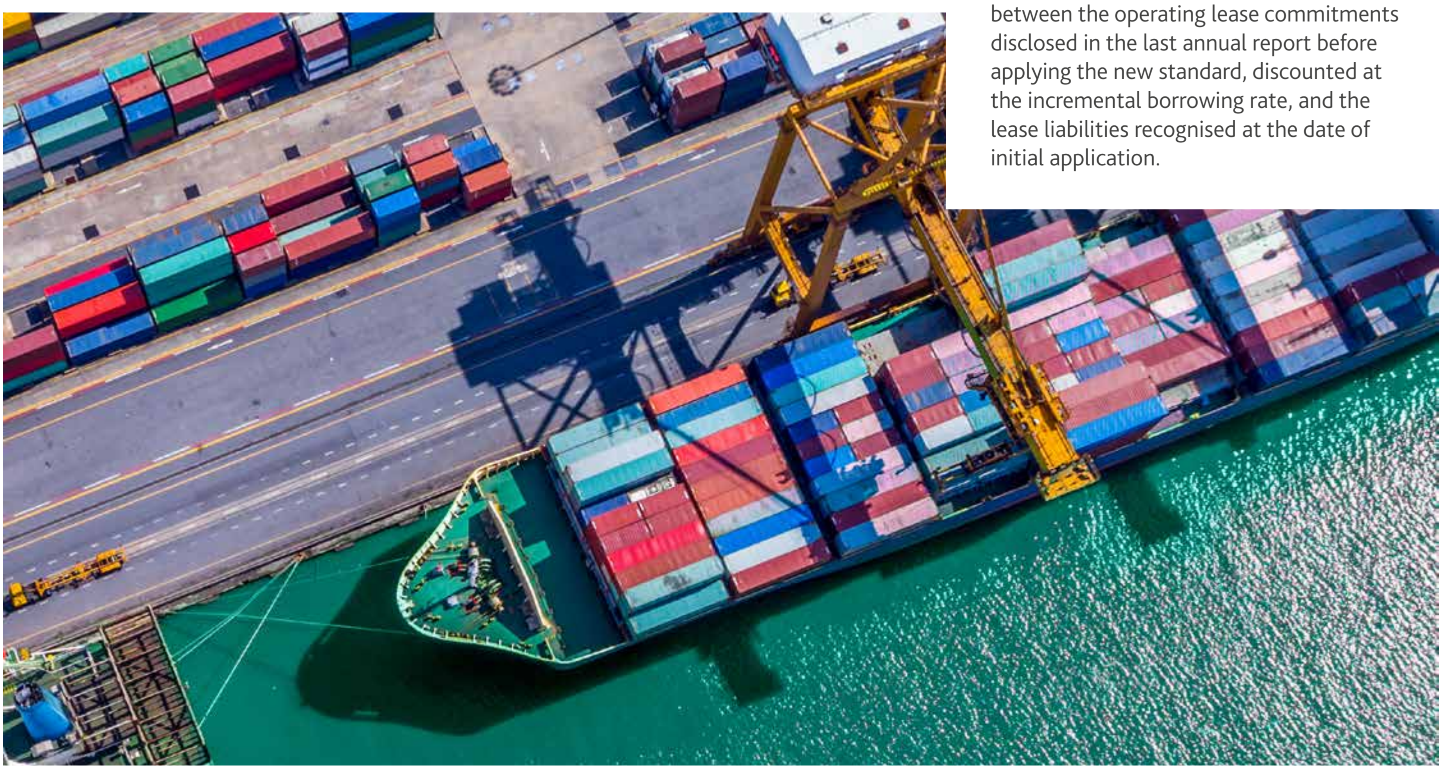
For leases which were classified as finance leases under IAS 17, broadly the existing treatment will continue. The carrying amount at the date of initial application of the lease asset and lease liability will be the right of use asset and lease liability under IFRS 16.

"For leases which were classified as finance leases under IAS 17, broadly the existing treatment will continue."

Transition disclosures

As part of the transition under the modified retrospective approach, some specific disclosures are required. These include the weighted average incremental borrowing rate used for the lease liabilities.

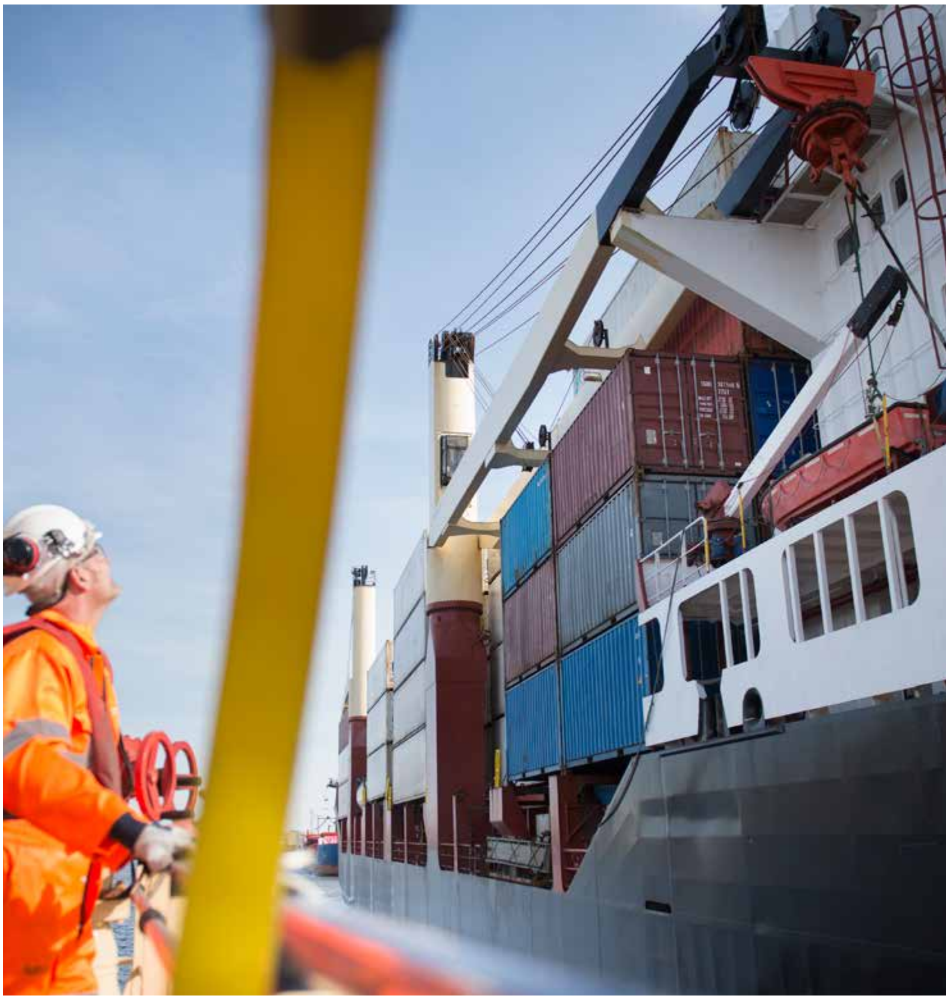
There must also be disclosed an explanation between the operating lease commitments disclosed in the last annual report before applying the new standard, discounted at the incremental borrowing rate, and the lease liabilities recognised at the date of initial application.



LESSORS

There are no adjustments for lessors on transition to the new standard except where the lessor is an intermediate lessor, for example with a time charter in and out or a bareboat charter in and out. Lessors which charter in and charter out vessels will have to reassess whether the leases out should continue to be accounted for as an operating lease or whether they are classified as a finance lease. This arises from the recognition of the charter in the statement of financial position. The assessment of whether the charter out is a finance lease or operating lease is made based upon whether substantially all the risks and rewards which have been chartered in are now chartered out. On transition, this assessment is based on the position, and remaining terms, as at the date of initial application.

"The assessment of whether the charter out is a finance lease or operating lease is based upon whether substantially all the risks and rewards which have been chartered in are now chartered out."



Sale and leaseback

If a sale and leaseback under IAS 17 was accounted for as a sale and finance lease, the lessee continues to account for the leaseback as for any other lease and continues to amortise any gain on sale over the lease term. If the leaseback was accounted for as an operating lease, the new requirements should apply to the leaseback from the date of initial application. Here the right of use asset should be adjusted for any deferred gains or losses from off-market rates that were recognised in the statement of financial position immediately before the date of application.

42000200

www.bdo.co.uk/en-gb/industries/shipping-and-transport