IFRS 16 LEASES – AN INTRODUCTION FOR SHIPPING

UPDATE: SHIPPING

The new standard, IFRS 16 Leases, was issued in early 2016, and has been effective since 1 January 2019. The long lead in period has provided preparers and users, including those in the shipping industry, with time to contemplate, understand and prepare for the new requirements.

When the IASB issued its proposals to remove the distinction between a finance lease and an operating lease for lessees, bringing all lease arrangements "onto the balance sheet", the impact on the shipping industry was expected to be significant. And whilst certain economic factors may have dampened the magnitude of the change, through the shortening of average charter duration, this IFRS requires shipping entities to get to grips with its requirements.

LESSEES

IFRS 16 removes the distinction between an operating lease and a finance lease for lessees. For all arrangements that meet the definition of a lease, other than those for a year or less, the lessee must determine and account for the lease liability and the related 'right of use asset'.

The scope of the standard is critical – if an arrangement is not a lease then IFRS 16 does not apply. A lease is a contract, or part of a contract, where one party has the right to control the use of an identified asset for a period of time in exchange for consideration. The asset must be identified. This could be explicitly or implicitly.

Even where the asset is identified, if the owner has the right to substitute an alternative asset then it will not be a lease. Simply having a substitution right is not enough – the owner must have the practical ability to substitute an alternative asset over the period of the contract, and there must be an economic benefit to the substitution. Merely having the ability to substitute does not mean that the arrangement is not a lease.

If a vessel is chartered from a third party but they have the right to substitute an alternative vessel then, unless there is a benefit to them from making any substitution, this would not be substantive and the arrangement would be a lease.

Who has control of the asset?

The right to direct the use of, and hence control, the asset is key. If the lessee can determine, for example, the routes a vessel takes, whose cargo is carried, what cargo is carried and what speed the vessel may sail at, there will be control. The existence of restrictions which are intended to protect the interests of the owner of the underlying asset will not necessarily prevent control of the vessel from passing. If those restrictions are limited, for example to not pass through areas of piracy or to not carry specified prohibited goods, then the arrangement would still be within scope. Each arrangement must be assessed on its own merits and, possibly, judgement made.

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The ability to direct the route would be a key factor for a charter. If a charterer does not have the ability to determine the route taken then it will not be a lease.

If a contract is made for the transportation of goods between specified ports then this will not be a lease but a contract for services. An example of this would be a contract of affreightment. Although this may appear to be outside the scope, a point may be reached whereby a long-term agreement for the transportation of goods over a pre-defined route should be accounted for as a lease.

Accounting for separate components

If the contract has multiple components, for example a time charter rather than a bareboat charter, the lessee may choose to separate the different components and account for each accordingly. Such separation is only possible if the components are neither highly interdependent and the underlying asset can be used on its own, or with resources that are readily available. Whilst a vessel does require crewing and maintenance to operate, these are readily available resources and so a time charter would be split into an amount for the hire of the asset and an amount for operating costs. This split would be made on the basis of relative standalone prices, or an estimate thereof if not available.

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.

A practical expedient is included which permits the lessee to treat the whole amount as a single lease component. This has the effect of increasing the lease liability (and the right of use asset) and, in shipping, is not expected to be a popular expedient.

RECOGNISING THE RIGHT OF USE ASSET

At commencement, a right of use asset is recognised. The amount of the asset is the lease liability together with any payments made prior to commencement, direct costs incurred, together with any dismantling and restoration costs that are expected to arise at the end of the lease.

DETERMINING THE LEASE LIABILITY

The lease liability is simply the present value of the lease payments due. This is a function of:

- The lease term
- Lease payments
- Discount rate

The lease term is the non-cancellable period adjusted for options to extend or terminate that are 'reasonably certain' to be exercised.

The payments will include fixed and certain variable amounts, residual guarantees, purchase options that are reasonably certain to be exercised, and penalties from termination if termination is reasonably certain. For example, if you assume a shorter life based on the exercise of a termination clause, the liability must include the termination payment. If you assume a longer life based on a termination option not being exercised, the liability would exclude the termination payment.

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The discount rate is that 'implicit in the lease'. Determining this rate is more challenging for arrangements that would have been operating leases under the previous requirements. IFRS 16 does permit, as an alternative, the lessee to use their incremental borrowing rate. This will need to reflect the amount that the lessee would have to pay to borrow a similar amount for a similar period with similar security. In the absence of any directly comparable borrowings this will require judgement to estimate, as the lease liability is effectively additional, or incremental, borrowings.

Variable rate payments

If a lessee enters into a charter with variable rates, the rates being linked either to an inflation index or to an index which reflects market prices, such as the Baltic Indices, the same approach is taken, but the lease payments are based upon the cash amounts at inception. The effect of changes in the respective index are accounted for only when they change the cash flows. There is no attempt to estimate those future rates.

SUBSEQUENT MEASUREMENT

The right of use asset is accounted for using either the cost model or the revaluation model. The cost model will result in the asset being depreciated over the lease term, subject to impairment reviews where there are indications of a possible impairment. A revaluation approach may be used where this basis is used for comparable owned assets.

The lease liability will be adjusted for interest on the liability, less payments made.

Changes in the assessment of options

If after commencement there is a change in the assessment of an option, the liability shall be re-measured to reflect these changes and discounted using a revised discount rate. The change in the liability from reassessment, be it an increase or decrease, is reflected directly in the right of use asset. If the liability is increased there is an addition to the asset. If the liability is reduced the asset is reduced by the same amount. If any reduction in the lease liability exceeds the carrying amount of the asset, any excess is recognised immediately as income.

LESSORS

For lessors, the distinction between a finance lease and an operating lease remains, with classification continuing to be set by whether the arrangement 'transfers substantially all the risks and rewards incidental to ownership of the underlying asset'. IFRS 16 gives some indications of when this may be the case, but these are comparable with the previous requirements and it is not expected that the assessment will usually differ under the new standard.

The accounting is also similar, with a finance lease being accounted for as a disposal of the underlying asset and the recognition of a lease receivable, with payments under the lease being a mixture of settlement of the lease receivable and interest income. With an operating lease the underlying asset remains and the rental income is recognised over the lease period.

Lessor subleases – on or off?

As noted above, lessor accounting has not changed fundamentally, whilst lessee accounting has. That can give rise to some new issues where a company is both lessor and lessee, chartering an asset in but also chartering it out.

Where a vessel is leased in, any subsequent leasing out of that asset will require an assessment of whether the sublease comprises a finance or operating lease. Previously this would have only been done for owned asset or assets which were chartered in under a finance lease.

The classification of a sublease for an intermediate charterer is determined not by reference to the underlying asset but by reference to the right of use asset arising from the head lease. If the sublease transfers "substantially all the risks and rewards" of the head lease it will be a finance lease, otherwise it will be an operating lease. Although the assessment is based on whether substantially all the risks and rewards pass under the sublease, if the period of the sublease is for substantially the whole of the remaining life of the head lease it is probable that the sublease will be a finance lease. The accounting will be similar to that noted above for lessors.

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