www.pwc.no

Why IFRS 16 matters to the shipping industry

October 2017

pwc

Executive summary

New lease standard to be effective 1 January 2019. Early implementation permitted together with IFRS 15 (effective 1 January 2018).

Implementation strategy: either full retrospective methodology (comparative figures to be restated and effect on opening balance 1 January 2018) or simplified approach (full effect on opening balance 1 January 2019) with some practical exemptions.

Lessor accounting mainly unchanged, but significant impact for lessees:

Lessees will have to recognise a right to use asset and a corresponding lease liability for almost all operating lease agreements, including bareboat charter and time charter.

- Effects on main key accounting metrics such as increase in EBITDA, increase in total balance and decrease in equity percent at initial recognition for lessees.
- Financial covenants for lessees likely to be impacted.

As a consequence, lessees might consider to renegotiate contracts with lessors, for example by reducing the length of the lease contracts and then use the practical exemption for short-term leases.

Another possible impact of the standard could be a change in the behavior of the charterers towards particular types of charter arrangements such as affreightment or service types contracts.

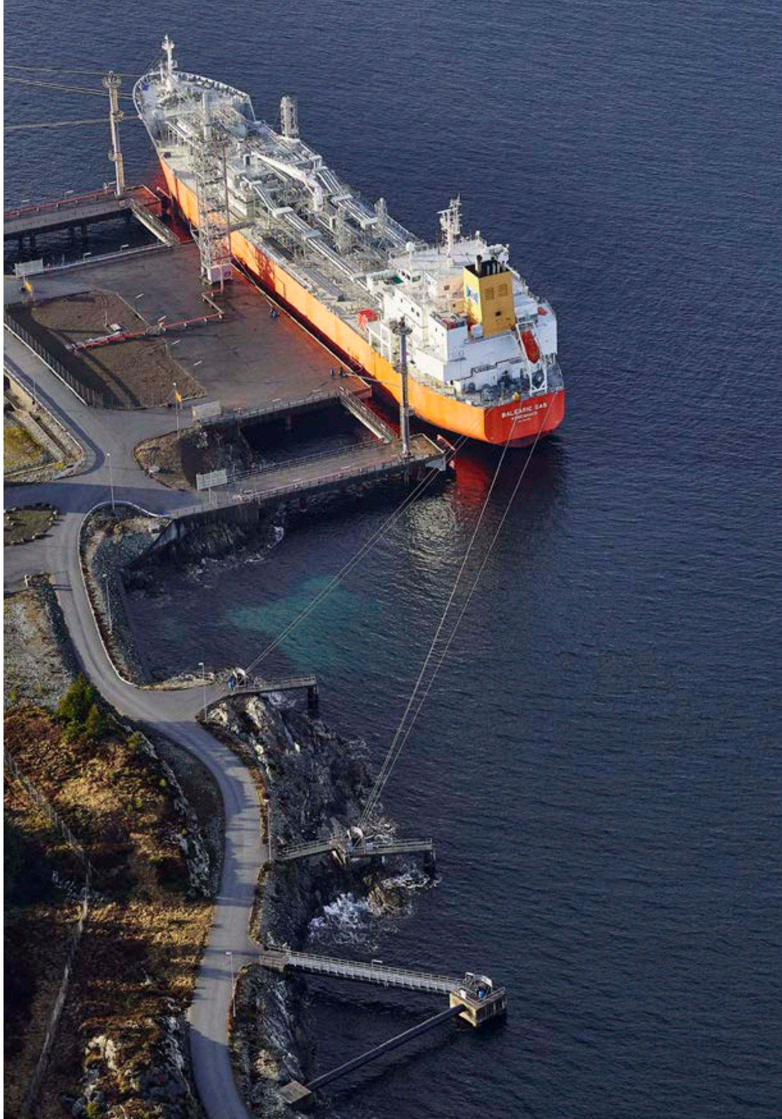
The standard could also have a significent impact on the shipping industry`s customer base. This will lead to a change in the behavior of the customers when negotiating for new contracts which will impact the industry.

M&A and Capital Market transactions: might affect pricing and equity story. Simplified approach as choice of implementation strategy will likely impact trend discussions with analysts, potential investors, stake and stockholders.

IFRS 16 high level impact assessment of shippingcompanies

The high level impact assessment is based upon a PwC study on how the new lease standard is effecting IFRS reporting shipping companies listed on the Oslo Stock Exchange. See further details below.

EBITDA 16% ↗	*Total Assets* 7% ↗
Total Debt 14% ↗	*Equity share of total assets* 5% ↘



Overview

The new lease model in brief

The distinction between operating and finance leases is eliminated for lessees and a new lease asset (representing the right to use the leased item for the lease term) and lease liability (representing the obligation to pay rentals) are recognised for all leases. Optional exemptions are available for short-term leases (lease terms shorter than 12 months) and leases of low value assets (below USD 5 000).

Lessees should initially recognise a right-of-use asset and lease liability based on the discounted payments required under the lease, taking into account the lease term as determined under the new standard. Initial direct costs and restoration costs are also included in the right-of-use asset.

The main principles of lessor accounting does not change and lessors continue to reflect the underlying asset subject to the lease arrangement on the balance sheet for leases classified as operating. For financing arrangements or sales, the balance sheet reflects a lease receivable and the lessor's residual interest, if any.

Why the new standard matters to the shipping industry

The shipping industry will be 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 effect on a shipping company that charter in vessels on bareboat or time-charter agreements would increase in line with the length of the contracts.

PwC's study of a sample of listed IFRS reporting companies on the Oslo Stock Exchange indicated that there would be an average increase in EBITDA of 16 percent, an average asset and debt increase of 7 percent and 14 percent, respectively, and an average decrease in equity percent of 5 percent for the shipping industry.

Whilst the new standard leaves lessor accounting substantially unchanged, it could 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 (lessees). 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 (lessees) financial reporting is therefore significant and could lead to a change in the behavior of the charterers (lessees) when negotiating for new contracts. This may have a business impact on ship-owners (lessors) as well.

Key questions for the industry

What type of arrangements might meet the new definition of a lease?

According to the new standard, the following arrangements are likely to be effected :

- **Bareboat charters** will typically meet the new definition of a lease since under these agreements the charterer controls the use of the ship for a period of time.
- **Time charters** 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 assets 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.

Which shipping industry participants are likely to be most impacted?

- Since the **most significant implications** of the new standard affect lessees, 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. This could mean shorter charter arrangements or more affreightment contracts.

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

For lessees, the new accounting treatment will immediately affect a range of key metrics monitored by stakeholders, including:

- **Increase in total liabilities and total assets** (through

initial recognition of a right to use asset and lease liability)
- **Decrease in equity in percent** of total balance (since the effect on total equity will normally be lower than the increase on asset and liabilities)
- **Increase in EBITDA** (increases as rental expense will be replaced by interest and amortisation).

What are the wider potential business impacts?

- **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.

Will an entirely new system to track and administer leases be needed?

Many lessees currently manage operating leases on spread-sheets 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 and its disclosure requirements.

What other departments other than accounting might be impacted?

In general, the transition and implementation of IFRS 16 will require **cross-functional participation and communication** within the entity. 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. Other departments, such as Treasury, Legal and IT, may also need to participate in the preparation process.

Any other financial reporting issues to consider?

Implementation strategy:

- **Retrospective approach** - Determine the carrying amounts of all leases in existence at the earliest comparative period (1 January 2018 for 1 January 2019 adopters) **as if** those leases had **always** been accounted for applying **IFRS 16** and to **restate comparative information.**
  Even though users of financial information find the trend information useful, the cost of full retrospective application with restatement of comparative information would be significant for many lessees and might not be justified.

- **Simplified approach (or "cumulative catch-up method)** - Applying IFRS 16 retrospectively (with some practical expedients) with the **cumulative effect** of initially adopting IFRS 16 recognised as an **adjustment to** the **opening balance of retained earnings** (or other component of equity, as appropriate) at the date of initial application (1 January 2019). **No restatement of comparative periods.**

  a) **The lease liability is to be measured by using information available at the date of transition:** the present value of all remaining lease payments, discounted using the lessee's incremental borrowing rate **at the date of initial application (1 January 2019).**

  b) The right of use asset can either be recognized at:

  i. **Its carrying amount as if IFRS 16 has always** been **applied, but** discounted using the lessee's **incremental borrowing** date at the date of **initial application** (1 January 2019); or
  ii. An **amount equal to the lease liability** (adjusted by the amount of any previously recognized prepaid or accrued lease payments).

The choice for right to use asset recognition is to be performed on a lease-by-lease basis.

This method eliminate the need to restate comparative information on transition (less costly) and eliminate the need to operate with two sets of accounting requirements at any point as for the retrospective approach. Companies will need to disclose information on transition about leases that were previously classified as operating leases, which will help explaining the effect of the change towards IFRS 16.

- The simplified approach method will normally lead to higher depreciation for the right of use asset than the retrospective approach.

- The carrying amount method ref. b) i. for recognizing the right of use asset will normally lead to lower depreciation compared to method b) ii. above.

Sale and leaseback transactions:

The accounting for sale and leaseback transactions under the current leasing standard IAS 17 mainly depend on whether the leaseback is classified as a finance or an operating lease. Under the new leasing standard IFRS 16 the determining factor is whether the transfer of the asset qualifies as a sale in accordance with IFRS 15.

- If the transfer of an asset is a **sale in accordance with IFRS 15:** The seller/lessee shall measure the right of use asset arising from the lease back at the proportion of the previous carrying amount of the asset that relates to the right of use retained by the seller/lessee.
- If the transfer of an asset is **not a sale in accordance with IFRS 15, the transaction is accounted as a financing transaction:** the seller/lessee continues to recognise the transferred asset and recognises a financial liability equal to the transfer proceeds applying IFRS 9.

Sale and leaseback transactions entered into before the date of initial application are not reassessed at the date of initial application to determine whether the transfer of the underlying asset satisfies the requirements in IFRS 15 to be accounted for as a sale.

If the sale and leaseback transaction was accounted for as a sale applying IAS 17, the seller/lessee shall account for the leaseback in the same way as it accounts for any other lease that exists at the date of initial application.

Sub-lease classification:

IFRS 16 requires the intermediate lessor to **evaluate a sublease with reference to the right-of-use asset.**

For example, a lessor leases a ship (the underlying asset or head lease) for 10 years to an intermediate lessor. The 10 years lease is the intermediate lessor right to use asset. The intermediate lessor in its turn subleases the same ship for 8 years. The ship (underlying asset) has an economic life of 25 years. In order to assess whether the sublease is a financial lease or not, the intermediate lessor will need to assess the sublease (8 years) with reference to the **right-of-use asset (10 years)** and **not** the **underlying asset (25 years) as previously.**

This might result in subleases to be classified more often as finance leases rather than operating leases.

Effect on the balance sheet:
The intermediate 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). The lease liability to the head lease is retained in both case.

Effect on profit and loss:
If the sublease is classified as finance lease: the intermediate lessor recognizes both finance income on the sublease and interest expenses on the head lease liability.
If the sublease is classified as operating lease: the intermediate lessor recognizes a depreciation charge for the right-of-use asset and an interest expense on the head lease liability. The sublease will generate a lease or hire income.

Offsetting related to head lease and sublease of the same underlying asset is not permitted (unless permitted by IAS 1 in particular).

Methodology to calculate the IFRS 16 high level impact

PwC has conducted a study to assess the impact of the new leases standard on the financial statements, key financial ratios and performance measures on a sample of listed IFRS reporting companies on the Oslo Stock Exchange.

The study illustrates the impact of capitalising the operating lease commitments as disclosed in the published financial statements for 2016. In view of the company's assessment of the lease term under the new standard, the inclusion of amongst others in substance fixed payments and variable payments linked to an index or rate, the eventual impact may vary. Furthermore, the study takes no account of transitional reliefs that are available upon adoption of the new leases standard on 1 January 2019.

Analysts, banks and some rating agencies generally use a 'rule-of-thumb' to adjust the financial statements for the effects of off-balance sheet operating leases. Many currently use a multiple of 8x annual rental expenses rather than the disclosed operating lease commitments in financial statements. The multiple approach using the 'rule-of-thumb' generally results in more significant adjustments to the financial statements.

The effect in EBITDA was determined by adding back a calculated rental expense, equal to the total amount disclosed for the operational lease commitments divided by the projected years resulting from dividing the lease commitments over individual years.

The effect in total assets and debt is determined by using the calculated new lease asset and liability for off-balance operating leases and their relative impact on asset and debt already on the balance sheet.

The effect in equity percent was determined by using the calculated new lease asset and its relative impact on asset and equity already on the balance sheet.

For further information, please get in touch with your PwC contact or one of the below

PwC have significant experience from supporting companies of all sizes with their assessment and implementation of new accounting standards including IFRS 16 Leases.

Fredrik Melle
Capital Markets and
Accounting Advisory Services
fredrik.melle@pwc.com
phone: +47 95 26 00 13

Vincent Jérôme Noël
Capital Markets and
Accounting Advisory Services
vincent.noel@pwc.com
phone: +47 95 26 02 99

Fredrik Gabrielsen
Head of Shipping and Offshore
fredrik.gabrielsen@pwc.com
phone: +47 97 08 24 08

© 2017 PwC. All rights reserved. In this context, “PwC” refers to PricewaterhouseCoopers AS, Advokatfirmaet PricewaterhouseCoopers AS, PricewaterhouseCoopers Accounting AS and PricewaterhouseCoopers Skatterådgivere AS which are member firms of PricewaterhouseCoopers International Limited, each member firm of which is a separate legal entity.