**In depth**

A look at current financial reporting issues

**Shipping industry supplement for IFRS 16, ‘Leases’**

**At a glance**

The new lease accounting standard, IFRS 16, ‘Leases’, will fundamentally change the accounting for lessees, and it is likely to have significant business implications. The International Accounting Standards Board (IASB) issued the standard in January 2016.

Almost all leases will be recognised on the balance sheet for a lessee, with a right-of-use asset and a lease liability which will result in more expenses in profit or loss during the earlier life of a lease. This will have an associated impact on key accounting metrics. The PwC Global Lease Capitalisation study, performed in 2015, indicated that there would be a median debt increase of 24% and a 20% median increase in EBITDA for the transport and infrastructure industry. Management will need to communicate clearly the impact of changes to stakeholders.

This supplement highlights some of the most challenging areas for lessees (the ‘charterers’) in the shipping industry as they transition to the new standard. These include:

- determining whether an arrangement is or contains a lease;
- identification of triggering events which might require reassessment of the lease and accounting for modifications; and
- the judgement required on measurement of lease liabilities, both initially and subsequently, due to volatility in the shipping industry.

Lessor accounting is substantially unchanged by the new standard. Lessors might be impacted, however, by:

- the definition of a lease;
- accounting for subleases; and
- the accounting for sale and leaseback transactions.

In addition, IFRS 16 introduces new extensive disclosure requirements (further detail is provided in Appendix G to the Illustrative IFRS consolidated financial statements for 2017 year ends).

The new standard could have a business impact on ship owners/lessors, since charterers might change their behaviour when negotiating new contracts, as a result of the significant impact of the new standard on their financial reporting.
Overview

IFRS 16 requires lessees to capitalise all leases, except for short-term leases and leases of low-value assets. This is a significant change from IAS 17, ‘Leases’, where operating leases were off balance sheet.

The accounting model for lessors is substantially the same as under existing IFRS. Lessors will classify leases as operating or financing. A lease that transfers substantially all risks and rewards incidental to ownership is classified as a finance lease. All other leases are classified as operating leases.

Effective date and transition

The new standard is effective for annual reporting periods beginning on or after 1 January 2019.

Earlier application is permitted, but only in conjunction with adopting IFRS 15, ‘Revenue from contracts with customers’. This means that an entity is not allowed to apply IFRS 16 before applying IFRS 15. The date of initial application is the beginning of the annual reporting period in which an entity first applies IFRS 16. Lessors should consider adoption of IFRS 15 and IFRS 16 at the same time, in order to avoid different accounting treatments relating to non-lease components in 2018 and 2019.

Transition to the new standard can be performed using:

- a full retrospective approach under IAS 8, ‘Accounting policies, changes in accounting estimates and errors’; or
- a simplified approach. Under the simplified approach, lessees do not need to restate comparative information, but they should instead recognise the cumulative effect of applying the standard as an adjustment to the opening retained earnings at the date of initial application.

Other practical expedients are also provided; for example, an entity is not required to reassess existing contracts at the date of initial application.

Impact

The accounting changes are just the most obvious impact that the new standard will have on the shipping industry. Companies will also need to analyse how the new model will affect current business activities, contract negotiations, budgeting, key metrics (including calculation of financial ratios linked to loan covenants), systems and data requirements, and business processes and controls.

Lack of convergence with US GAAP

Although initially the IASB and the US-standard setter (the FASB) intended to develop a converged standard, ultimately only the guidance on the definition of a lease and the principle of recognising all leases on the lessee’s balance sheet are expected to be aligned. In other areas, differences remain. As a result, financial information published under IFRS or US GAAP will still not be comparable. Refer to the PwC publication, ‘In depth US2016-02: Transportation and logistics industry supplement’, for discussion on the impact of the new US leasing standard on the transportation and logistics industry.

More information

In depth INT2016-01 is a comprehensive analysis of the new standard.

‘In the Spotlight: An industry focus on the impact of IFRS 16 – Shipping’ also looks at some of the practical issues that lessees and lessors in the industry might face.
Does the contract contain a lease?

Lease accounting guidance applies to any arrangement that conveys the right to control the use of an identified asset for a period of time in exchange for consideration. At first sight, the definition looks straightforward. In practice, it can be challenging to assess whether a contract conveys the right to use an asset, or whether it is, instead, a contract for a service that is provided using the asset.

By way of illustration, an entity might want to transport a specified cargo by ship from location A to location B, in accordance with a stated timetable, for a period of five years. To achieve this, it could either charter a ship over this period or it could contract to buy the transport service from a freight carrier/operator (for example, through a contract of affreightment). In both cases, the goods will arrive at location B — but the accounting might be quite different.

PwC observation

The accounting for lease contracts classified as operating leases under IAS 17 and service contracts was quite similar. This is not the case under the new IFRS 16 guidance. Under IFRS 16, almost all leases (except for short-term leases and leases of low-value assets) will be recognised on the balance sheet of the lessee. There will be a greater focus on identifying whether a contract is, or contains, a lease.

An asset is typically identified by being explicitly specified in a contract. However, an asset can also be identified by being implicitly specified in a contract.

If an arrangement identifies the asset to be used, but the supplier has a substantive contractual right to substitute that asset, the arrangement does not contain an identified asset. A substitution right is substantive if (a) the supplier can practically use another asset to fulfil the arrangement throughout the term of the arrangement, and (b) it is economically beneficial for the supplier to do so. The supplier’s right or obligation to substitute an asset for repairs, maintenance, malfunction, or technical upgrade does not preclude the customer from having the right to use an identified asset.

An identified asset must be physically distinct. A physically distinct asset might be an entire asset or a portion of an asset. For example, a building is generally considered physically distinct, but one floor within the building could also be considered physically distinct if it can be used independently of the other floors (for example, point of entry or exit, access to lavatories, etc). A capacity portion of an asset is not an identified asset if (a) the asset is not physically distinct (for example, the arrangement permits use of a portion of the capacity of an oil tanker), and (b) a customer does not have the right to substantially all of the economic benefits from the use of the asset (for example, several customers share an oil tanker, and no single customer uses substantially all of the capacity).

A customer controls the use of the identified asset by possessing the right to (a) obtain substantially all of the economic benefits from the use of such asset (‘economics’ criterion); and (b) direct the use of the identified asset throughout the period of use (‘power’ criterion). A customer meets the ‘power’ criterion if it holds the right to make decisions that have the most significant impact on the economic benefits derived from the use of the asset.
The standard gives several examples of relevant decision-making rights. The following questions need to be considered when evaluating which party holds the relevant decision-making rights in the shipping industry:

**Which party decides ...**

- which goods are transported?
- how often goods are transported?
- where goods are transported?
- how often the asset is used?
- the minimum capacity at which the asset operates?
- which route is taken?

If the charterer makes the above decisions, the contract will meet the definition of a lease.

In some cases, the above decisions are pre-determined in the contract. If the use of the asset is pre-determined, the contract contains a lease if the charterer has the right to direct the operations of the asset without the ship owner having the right to change those operating instructions, or if the charterer has designed the asset in a way that pre-determines how and for what purpose the asset will be used throughout the period of use.

There can be terms in the contract that are protective in nature. Such terms might be included to protect the supplier’s asset, the supplier’s personnel and to comply with regulations. For example, a charterer is normally prevented from sailing a ship into waters with a high risk of piracy or from transporting dangerous materials/cargo. The existence of such protective rights alone does not prevent a customer from having the right to direct the use of an asset.

The new model differs, in certain respects, from the current risks and rewards model, and it might result in the identification of fewer leases compared to current guidance. However, under current lessee guidance, leases are often off-balance sheet operating leases and, as such, application of lease accounting might not have had a material impact on the income statement. Determining whether to apply lease accounting to an arrangement under the new guidance is likely to be far more important, since virtually all leases will result in recognition of a right-of-use asset and lease liability.

**PwC observation**

The shipping industry arrangements, and their treatment under the new standard, are listed below:

- **Bareboat charters** will typically meet the new definition of a lease; this is because, under these agreements, the charterer controls the use of a specific ship.
- **Time charters and pool arrangements** (that are similar to time charters from the perspective of the pool as a lessee) are likely to contain both a lease (that is, the right to use a specific ship, since the charterer/pool controls the use of a specified ship) and service components (that is, operation and maintenance of the ship by the ship owner). A lessee can choose, by class of leased asset, not to separate services from a lease and, instead, to account for the entire contract as a lease (see ‘Components, contract consideration and allocation’ below).
- **Voyage charters** are not likely to meet the new definition of a lease, because the charterer typically does not have the right to direct the use of the ship (that is, how the ship is operated). Rather, they are contracts for the provision of a service by the vessel owner/operator.
Similarly, contracts of affreightment are unlikely to meet the definition of a lease, since they have characteristics indicating that they are contracts for the provision of a service rather than the use of an identified asset.

In some cases, the factors that indicate that control of the asset has passed to the customer might not be obvious and might require significant judgement. Careful assessment of the facts and circumstances, considering all relevant rights, will be required.

The following examples illustrate how an entity determines whether a contract is, or contains, a lease.

Example 1 – Identifying a lease: voyage charter

Facts: Charterer enters into a contract with ship owner for the transportation of cargo from Rotterdam to Sydney. The ship is explicitly specified in the contract, and ship owner does not have substitution rights. Charterer has not specified any modifications to the ship. The cargo will occupy substantially all of the capacity of the ship. The contract specifies the cargo to be transported on the ship and the dates of loading and discharging. Ship owner operates and maintains the ship and is responsible for the safe passage of the cargo on board the ship. Charterer is prohibited from hiring another operator for the ship or operating the ship itself during the term of the contract. Also, charterer cannot alter the routes or the dates for the transportation.

Question: Does the contract contain a lease?

Discussion: The contract does not contain a lease.

There is an identified asset. The ship is explicitly specified in the contract, and ship owner does not have the right to substitute that specified ship.

Charterer has the right to obtain substantially all of the economic benefits from use of the ship over the period of use. Its cargo will occupy substantially all of the capacity of the ship, thereby preventing other parties from obtaining economic benefits from use of the ship.

However, charterer does not have the right to control the use of the ship, because it does not have the right to direct its use. Charterer does not have the right to direct how and for what purpose the ship is used. How and for what purpose the ship will be used is pre-determined in the contract (that is, the transportation of specified cargo from Rotterdam to Sydney within a specified time frame), and charterer did not design the ship. Charterer has no right to change how and for what purpose the ship is used during the period of use.

Example 2 – Identifying a lease: time charter

Facts: Charterer enters into a contract with ship owner for the use of a specified ship for a five-year period. The ship is explicitly specified in the contract, and ship owner does not have substitution rights. Charterer decides what cargo will be transported, and whether, when and to which ports the ship will sail, throughout the five-year period of use, subject to restrictions specified in the contract. Those restrictions prevent charterer from sailing the ship into waters at a high risk of piracy or carrying hazardous materials as cargo.
Ship owner operates and maintains the ship and is responsible for the safe passage of the cargo on board the ship. Charterer is prohibited from hiring another operator for the ship or operating the ship itself during the term of the contract.

**Question:** Does the contract contain a lease?

**Discussion:** The contract contains a lease. Charterer has the right to use the ship for five years.

There is an identified asset. The ship is explicitly specified in the contract, and ship owner does not have the right to substitute that specified ship.

Charterer has the right to control the use of the ship throughout the five-year period of use, because:

a) Charterer has the right to obtain substantially all of the economic benefits from use of the ship over the five-year period of use. Charterer has exclusive use of the ship throughout the period of use.

b) Charterer has the right to direct the use of the ship, because the conditions in paragraph B24(a) of IFRS 16 exist. The contractual restrictions about where the ship can sail, and the cargo to be transported by the ship, limit the scope of charterer’s right to use the ship. However, they are protective rights that protect ship owner’s investment in the ship and ship owner’s personnel. Within the scope of its right of use, charterer makes the relevant decisions about how and for what purpose the ship is used throughout the five-year period of use, because it decides whether, where and when the ship sails, as well as the cargo that it will transport. Charterer has the right to change these decisions throughout the five-year period of use.

Although the operation and maintenance of the ship are essential to its efficient use, ship owner’s decisions in this regard do not give it the right to direct how and for what purpose the ship is used. Instead, ship owner’s decisions are dependent on charterer’s decisions about how and for what purpose the ship is used.

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**Components, contract consideration and allocation**

An arrangement might contain lease and non-lease components that are subject to different accounting models. Non-lease components are those items or activities that transfer a good or service to the lessee. Arrangements might also contain multiple lease components. IFRS 16 requires each separate lease component to be identified and accounted for separately. The right to use an underlying asset is a separate lease from other leases within the contract where the lessee can benefit from using the underlying asset on its own, or together with resources readily available to the lessee, and the underlying asset is not highly dependent on, or highly interrelated with, other underlying assets in the contract. The above criteria are similar to those in IFRS 15 for analysing whether goods or services provided to customers are distinct.

For multiple-element arrangements that contain a lease, entities must perform an assessment to identify whether there are multiple lease components, using the IFRS 16 guidance.

The guidance in IFRS 16 specifies that amounts payable by the lessee for activities and costs that do not transfer a good or service to the lessee (for example, charges for administrative tasks, property taxes and insurance) are not separate components of
the contract, but they are considered part of the total consideration allocated to the separately identified components of the contract.

Once the lease and non-lease components are identified, contract consideration is allocated to each component.

IFRS 16 provides guidance for both lessees and lessors.

Lessees should allocate the contract consideration based on:

- the relative stand-alone price of each lease component; and
- the aggregate stand-alone price of the non-lease components.

The prices are determined based on the price that a lessor or similar supplier would charge for that component separately. If observable prices are not readily available, a lessee should estimate the price, maximising the use of observable information.

Lessees should allocate contract consideration to the separate lease and non-lease components in accordance with the transaction price allocation guidance in IFRS 15.

Subsequently, lease components are accounted for in accordance with IFRS 16, while non-lease components are accounted for by applying other relevant standards. For example, a lessor would account for non-lease service components using IFRS 15.

As a practical expedient, lessees are allowed not to separate lease and associated non-lease components and, instead, to account for both as a single lease component. This policy choice needs to be made by class of underlying asset.

If components are not separated, a lessee will recognise a higher lease liability, and so it is likely that this expedient will be used only where service components are not significant.

The practical expedient available to lessees for lease and non-lease components is not available to lessors.

**PwC observation**

*Often, arrangements involving a lease in the shipping industry contain multiple components. For example, time charters are likely to contain both a lease (that is, a right to use the ship) and service components (that is, operation and maintenance of the ship by the ship owner). Under existing guidance, companies might not separate lease and non-lease components, because to do so would not have an accounting impact. Under the new guidance, this allocation takes on greater significance.*

*Judgement will be required in determining the separate lease and non-lease components for both lessees and lessors. Also, judgement will be required for lessees in determining whether to apply the practical expedient of not separating the lease and non-lease components. Application of the expedient will result in larger lease obligations and right-of-use assets being recorded in the balance sheet. Lessees might analyse the significance of the non-lease components for a given asset class, to determine where it makes sense to elect not to separate.*
Example 3 – Identifying components within an arrangement

Facts: Charterer enters into a time charter with ship owner in which ship owner will provide transportation services to charterer for a five-year period, using a ship that is explicitly specified in the contract. Ship owner does not have substitution rights in relation to the ship that is specified in the contract. Ship owner is responsible for operating the ship using its own crew, maintaining the ship and insuring it. Also, ship owner is responsible for providing cleaning services (‘holds cleaning’) throughout the contract period. Charterer will provide the dates of travel and the arrival and departure locations. Ship owner cannot use the ship for any other purpose when it is not being used by charterer. Charterer will pay to ship owner: (a) a fixed amount per day for chartering the ship; (b) a fixed amount per month for CVE (communication/victuals/entertainment); and (c) a fixed amount for each holds cleaning.

Question: What are the components in this arrangement?

Discussion: The contract contains one lease component, which is the lease of the ship, and two non-lease components, which are the services to operate the ship and cleaning services.

Insurance does not represent a separate good or service. Therefore, the element of the fixed payment per day for chartering the ship, which covers the ship’s insurance, is not considered a separate component, and it instead forms part of the overall contract consideration to be allocated to the lease and non-lease components.

Charterer can either:

a) separate the lease from the non-lease components and allocate consideration to each component or;

b) apply the practical expedient and account for both the lease and the associated non-lease components as a single combined lease component.

If charterer decides to separate the lease from the non-lease components, it should allocate the contract consideration to the separate lease and non-lease components based on their relative stand-alone prices. This exercise can be complex and could involve judgement, since the relative stand-alone prices might not be readily available. For example, in the above scenario, charterer could use the charter rate under a bareboat charter to determine the stand-alone price for the lease of the ship.

Payments (b) and (c) in the above scenario relate specifically to the non-lease components. As discussed above, if the charterer decides to separate the lease from non-lease components, the non-lease components should be accounted for in accordance with other applicable standards. [IFRS 16 para 16].

Initial measurement of lease liability

The lease liability is initially recognised at the commencement date and measured at an amount equal to the present value of the lease payments during the lease term that are not yet paid.

Lease payments consist of the following components:

- fixed payments (including in-substance fixed payments), less any lease incentives receivable;
- variable lease payments that depend on an index or a rate;
• amounts expected to be payable by the lessee under residual value guarantees;
• the exercise price of a purchase option (if the lessee is reasonably certain to exercise that option); and
• payments of penalties for terminating the lease (if the lease term reflects the lessee exercising the option to terminate the lease).

Variable lease payments that are not based on an index or a rate are not part of the lease liability. These include payments linked to a lessee's performance derived from the underlying asset. Such payments are recognised in profit or loss in the period in which the event or condition that triggers those payments occurs.

Similar to IAS 17, the new standard defines ‘the lease term’ as the non-cancellable period of the lease, plus periods covered by an option to extend or an option to terminate if the lessee is reasonably certain to exercise the extension option or not to exercise the termination option.

The interpretation of the term ‘reasonably certain’ under IAS 17 has been a source of long and controversial discussions that have led to diversity in practice. To address this, the new standard states the principle that all facts and circumstances creating an economic incentive for the lessee to exercise the option must be considered, and it provides some examples of such factors:

• **Contractual terms and conditions for optional periods compared with market rates**: It is more likely that a lessee will not exercise an extension option if lease payments exceed market rates. Another example of terms that should be taken into account are termination penalties. It is more likely that a lessee will not exercise a termination option if the agreement includes substantive termination penalties.
• **Significant leasehold improvements undertaken (or expected to be undertaken)**: It is more likely that a lessee will exercise an extension option if the lessee has made significant investments to improve the leased asset or to tailor it for its special needs.
• **Costs relating to the termination of the lease/signing of a replacement lease**: It is more likely that a lessee will exercise an extension option if doing so avoids costs such as negotiation costs, relocation costs, costs of identifying another suitable asset, costs of integrating a new asset, and costs of returning the original asset in a contractually specified condition or to a contractually specified location.
• **The importance of the underlying asset to the lessee’s operations**: It is more likely that a lessee will exercise an extension option if the underlying asset is specialised or if suitable alternatives are not available.
• **Combination with other features**: If an option is combined with one or more other features (for example, a residual value guarantee), with the effect that the cash return for the lessor is the same regardless of whether the option is exercised, an entity should assume that the lessee is reasonably certain to exercise the option to extend the lease (or not to exercise the option to terminate the lease).

Where the option can only be exercised if one or more conditions are met, the likelihood that those conditions will exist should also be taken into account.

In addition, a lessee’s past practice regarding the period over which it has typically used particular types of asset, and its economic reasons for doing so, might provide evidence of whether a lessee might or might not exercise an extension or termination option.

The assessment of whether an option is reasonably certain to be exercised is made at the commencement date (that is, the date on which the lessor makes the underlying...
asset available for use). See ‘Lease modification and reassessment’ below for discussion on subsequent reassessment.

The lease payments should be discounted using the interest rate implicit in the lease. If a lessee cannot readily determine the interest rate implicit in the lease, it can use its incremental borrowing rate, adjusted to reflect the terms and conditions of the lease.

**PwC observation**

In the shipping industry, lease payments might take a variety of forms. The charterer might be required to pay equal fixed payments, escalating fixed payments, or fixed payments plus index (and there might be a floor in the index) throughout the lease term. All of these lease payments will be included in the initial measurement of the lease liability. In particular, defined fixed payments will be included in the initial measurement of the lease liability, while variable lease payments based on an index will be included using the index at the commencement date. This means that lessors will not forecast future developments regarding the index, but they will include the initial lease payments as they are, based on the index at the date of initial recognition. In addition, any floor in the index will be included in the initial measurement of the lease liability, because it represents an in-substance fixed payment.

Other shipping arrangements require the charterer to pay based on actual charterer’s results (known as ‘profit sharing’). There might be cases where the charterer is required to pay an amount based only on profit sharing, or to pay a fixed amount plus an amount for profit sharing, or to pay an amount for profit sharing with a floor. In these cases, only the fixed payments are included in the initial measurement of the lease liability. The payments for profit sharing are variable payments, and they are only recognised in profit or loss in the period in which the event or condition that triggers those payments occurs. If the charterer is required to pay an amount for profit sharing with a floor, the floor is an in-substance fixed payment, and it is included in the initial measurement of the lease liability.

Purchase and extension options are very common in shipping arrangements. The initial measurement of the lease liability is likely to be challenging, since charterers will need to assess, at the commencement date of the lease, whether the exercise of these options is reasonably certain.

**Initial measurement of right-of-use asset**

The right-of-use asset is initially recognised at the commencement date and measured at cost, consisting of:

- the amount of the initial measurement of the lease liability;
- any lease payments made to the lessor at or before the commencement date, less any lease incentives received;
- the initial estimate of restoration costs; and
- any initial direct costs incurred by the lessee.

Initial direct costs are incremental costs of a lease that would not have been incurred if the lease had not been executed. Any costs that would have been incurred, even if the lease was not executed, are not incremental costs, and they should be excluded from initial direct costs.
Depending on the specific facts and circumstances, payments made by lessees for improvements to the underlying asset should either be included in the right-of-use asset, recognised as a separate asset or immediately expensed. In relation to the reimbursement of costs by lessors for leasehold improvements, judgement is required on whether this represents an incentive and should be accounted for in accordance with IFRS 16.

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**Lease modification and reassessment**

A lease modification is any change to the terms and conditions of a contract that results in a change in the scope of, or the consideration for, use of an underlying asset.

**Lessees**

Lessees account for a modification as a separate lease if: (i) the modification increases the scope of the lease by adding the right to use one or more assets; and (ii) the consideration for the lease increases by an amount commensurate with the stand-alone price for the increase in scope.

Where a modification is a separate lease, the accounting for the original lease is unchanged, and the new lease component(s) should be accounted for at commencement in the same way as any other new lease.

Where a lease is modified but not accounted for as a separate lease, the lessee will allocate the consideration in the modified contract to the lease and non-lease components. The lessee will also determine the lease term of the modified lease and remeasure the lease liability by discounting the revised lease payments using a revised discount rate.

For lease modifications that decrease the scope of the lease, the lessee should decrease the carrying amount of the right-of-use asset to reflect the partial or full termination of the lease. For all other lease modifications, the lessee should make an appropriate adjustment to increase or decrease the right-of-use asset, depending on the nature of the modification.

There are circumstances in which a lessee will also be required to assess, and potentially remeasure, the right-of-use asset and lease liability subsequent to lease commencement, even without a lease modification. The table below lists these circumstances and the impact on the lessee’s accounting due to these circumstances.
### Remeasure lease liability

<table>
<thead>
<tr>
<th>Event</th>
<th>Remeasure lease liability</th>
<th>Update discount rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>A significant event or change in circumstances occurs, which gives</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>the lessee a significant economic incentive to exercise a renewal</td>
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<tr>
<td>option/not to exercise a termination option that was previously</td>
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<tr>
<td>not included in the lease term (or not to exercise a renewal option/</td>
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<td>to exercise a termination option that was previously included in the</td>
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<tr>
<td>lease term)</td>
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<tr>
<td>The lessee actually exercises an option previously not included/does</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>not exercise an option previously included in the lease term</td>
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</tr>
<tr>
<td>(or becomes contractually obliged to do so/prohibited from doing so)</td>
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<td></td>
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<tr>
<td>An event/change in circumstances/exercise (as described above)</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>occurs for a purchase option</td>
<td></td>
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<tr>
<td>Changes occur in the index/rate on which lease payments are based,</td>
<td>✓</td>
<td></td>
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<tr>
<td>which result in a change in cash flows</td>
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<td>*</td>
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<tr>
<td>Changes occur in amounts expected to be due under a residual value</td>
<td>✓</td>
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<td>guarantee</td>
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</tbody>
</table>

* If the payments change based on floating interest rates, the discount rate is updated; for changes based on another index or rate, it is not updated.

### PwC Observation

**Reassessment of the likelihood of exercise of an extension, termination or purchase option, and consequent reassessment of the lease term, is required when a triggering event occurs which is within the control of the lessee and was not previously included in the determination of the lease term. If the triggering event is not within the control of the lessee, reassessment is not required.**

A change in market-based factors will not, in isolation, trigger a reassessment of options. For example, a reassessment would not be triggered if a lessee is chartering a ship, and current market conditions for the specific region change in a way that lease payments in the extension period are now considered below market.

Many shipping arrangements include charters that are linked to an index. Lessees will need to remeasure the lease liability, with a corresponding adjustment to the right-of-use asset, whenever there is a change in an index that results in a change in cash flows. This need for remeasurement is likely to be challenging, due to the volatility of the charter rates.
Lessors

Lessors in a finance lease apply the same criteria as lessees to decide whether to account for the modification as a separate lease. If it is not accounted for as separate lease, the modification should be accounted for as follows:

- If the lease would have been classified as an operating lease if the change had been in effect at inception, the lessor should account for the lease modification as a new lease from the effective date of the modification.

- Otherwise, the lessor should apply the requirements of IFRS 9, ‘Financial instruments’, to the lease receivable, to account for the change in terms.

For lessors in an operating lease, any modifications should be accounted for as new leases, effective from the date of the modification.

Other considerations

Sale and leaseback transactions

The accounting for sale and leaseback transactions is one of the main areas in which the new lease standard changes the current guidance.

The accounting for sale and leaseback transactions under IAS 17 mainly depended on whether the leaseback was classified as a finance or an operating lease.

Under IFRS 16, the determining factor is whether the transfer of the asset qualifies as a sale in accordance with IFRS 15. To make this assessment, an entity should apply the requirements in IFRS 15 for determining when a performance obligation is satisfied.

PwC observation

Sale and leaseback transactions are relatively common in the shipping industry. Under the new guidance, determining whether a sale has occurred might lead to different results compared to current accounting guidance.

Transfer of the asset is a sale

If the buyer/lessor has obtained control of the underlying asset and the transfer is classified as a sale in accordance with IFRS 15, the seller/lessee measures a right-of-use asset arising from the leaseback as the proportion of the previous carrying amount of the asset that relates to the right of use retained. The gain or loss that the seller/lessee recognises is limited to the proportion of the total gain or loss that relates to the rights transferred to the buyer/lessor.

If the consideration for the sale is not equal to the fair value of the asset, any resulting difference represents either a prepayment of lease payments (if the purchase price is...
below market terms) or an additional financing (if the purchase price is above market terms). The same logic applies if the lease payments are not at market rates.

The **buyer/lessor** accounts for the purchase in accordance with applicable standards (such as IAS 16, if the underlying asset is property, plant or equipment) and for the leaseback in accordance with IFRS 16.

**Transfer of the asset is not a sale**

If the transfer is not a sale (that is, the buyer/lessor does not obtain control of the asset in accordance with IFRS 15), the seller/lessee does not derecognise the transferred asset, and it accounts for the cash received as a financial liability, applying IFRS 9. The buyer/lessor does not recognise the transferred asset and, instead, it accounts for the cash paid as a financial asset (receivable), applying IFRS 9.

**Subleases**

Under IAS 17, a **sublease** was classified with reference to the underlying asset. IFRS 16 now requires the lessor to evaluate the sublease with reference to the right-of-use asset. Since, typically, the fair value of the right-of-use asset is below the fair value of the underlying asset, subleases are now more likely to be classified as finance leases.

Aside from this, since the lessor of the sublease is, at the same time, the lessee with respect to the head lease, it will in any case have to recognise an asset on its balance sheet – that is, either:

- 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).

If the head lease is a short-term lease, the sublease should be classified as an operating lease.

For a sublease that results in a finance lease, the intermediate lessor is not permitted to offset the remaining lease liability (from the head lease) and the lease receivable (from the sublease). The same is true for the lease income and lease expense relating to the head lease and sublease of the same underlying asset.

**PwC observation**

*Subleases are relatively common in the shipping industry. Under the new guidance, lessors will need to evaluate the sublease with reference to the right-of-use asset, and so subleases are now more likely to be classified as finance leases.*

*Consequently, all companies in the shipping industry that charter-in vessels, that are subsequently sub-chartered out, will be impacted by the new standard.*
About PwC’s Shipping practice

PwC’s Shipping practice is focused on assisting companies in the shipping industry to face the challenges and to manage the risks of this exciting industry. Our experience and network of dedicated industry practitioners provide quality audit and professional services uniquely tailored to the needs of shipping companies, whether family-owned or publicly listed, large or small.

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Questions?

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