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TRANSPORT

Shipping insights briefing

Lease accounting proposals

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Do you enter into a charter agreement and work out the accounting impact later… maybe it's time you changed?

As we highlighted in our recent publication (Shipping Insights 3: Thriving in a challenging world), if enacted as proposed, the new lease accounting standard will result in significant changes for shipping companies and port operators. Rarely do accounting standards affect the operating model, but the joint proposals of the International and US accounting standard setting bodies may result in may shipping sector companies re-looking at ways in which they finance and operate. This short publication clarifies the impact for lessees (where the impact will be greatest).

Overview of proposed changes

Initial and immediate impact

- Operating leases, which currently are not included on the balance sheet, will in future be included as a right to use asset and a lease liability, increasing debt and gearing.
- The measurement of the asset and liability is based on longest probable lease term, and must include estimates of contingent payments such as inflation clauses.
- Operating lease rentals that are currently recognised on a straight line basis will in future be replaced by amortisation of the right to use asset, which we expect will usually be straight line, and the interest expense on the financial liability, which will be front loaded. The overall effect is the front loading of leasing costs.

- Operating lease rentals are currently included as operating expenses; in future they will be replaced by amortisation and interest expense, increasing EBITDA.

Impact and consequence of transition

- The transitional arrangements require management to assess all existing leases on a lease-by-lease basis on first time adoption.
- The assessment involves considerable judgement as it includes: determining whether a contract is a lease, a service contract or a purchase; determining the longest probable lease term; and estimating future contingent rentals, expected payments under residual value guarantees and term option penalties. In addition, the appropriate discount rates will need to be determined.

Ongoing monitoring of impact

- At each reporting date, management will have to revisit the exercise performed at transition on all new and existing leases in order to ascertain whether there have been significant changes since the previous reporting period.
- If changes have occurred, then the right of use asset and lease liability are recalculated, which may increase the volatility of the financial statements on an annual basis.

Practical issues for lessees under the proposed changes

Initial and immediate impact

- The scope of the proposed standard is wide effecting the whole spectrum of assets within the sector (including ships, containers, land and property, equipment etc.). And whereas voyage charters, for example, may still be outside the scope, bareboat charters, previously "off balance sheet" may now have to be brought on.
- Management will have to explain the impact of the changes to stakeholders, including analysts, shareholders, lenders and other creditors. To do this, management will need to have a full assessment of the impact and a comprehensive strategy for informing stakeholders of the changes.
- Management is likely to have to renegotiate banking covenants to take account of the changes. Lenders may take this opportunity to strengthen covenants, impose penalties or restrict companies' ability to borrow.

Impact and consequence of transition

- Management will need to review each lease to determine whether it should be classified as a lease, a service contract or a purchase or, in the case of a sale and leaseback, a sale of the asset and consider the impact of those contracts not treated as leases (e.g. hire purchase contracts).
- Management will be required to make considerable judgements when determining the value of the lease payments. This may include long term forecasts of sales, usage or other factors that may affect the lease payments.

KPMG professionals from our Global Shipping Practice are already assisting companies assess the likely consequences of these proposals – such early planning and consideration merely highlights the size of the impact companies are expecting. Bringing together our shipping industry experience and technical accounting knowledge, we can provide companies with insight to interpret the literature and tailor the right response for you.

- Where future rentals are based on movements in indices, interest rates or tax, management will need to forecast the movement in those indices, interest rates or tax assumptions in order to estimate future rentals and ensure that the systems adequately recalculate the rentals.
- Management will need to forecast the likely outcome of rent reviews or turnover rents, where property leases contain such variations.
- Management will be required to forecast any usage charges, where leases contain such items; this includes certain office equipment leases, where rentals vary according to use, and vehicle contracts containing mileage penalties.

Ongoing monitoring of impact

- This will require an 'industrialisation' of the process, such that management is able to recalculate lease amounts quickly and efficiently and determine the correct accounting treatment of any adjustments identified.
- Additionally, management will need to embed a process to update the assumptions in each and every lease at every reporting date.
- Management will need to consider and potentially reassess the tax and deferred tax impact on the leases.
- For entities with numerous leases this may require investment in or modification of systems.

How KPMG can help

Initial and immediate impact

- Providing lease education and training.
- Performing the calculations for you to quantify the impact of the changes.
- Reviewing your calculations, providing assurance to the board on the detail of the calculations and/or the methods used.
- Provide assistance on the data used to renegotiate banking covenants or restructuring debt obligations.

Impact and consequence of transition

- Working with you to develop the data required to perform the analysis.
- Reviewing the forecasts you prepare and providing assurance on the methodology used to generate them.
- Providing tax assurance services on the consequences of the changes.
- Performing the detailed calculations to prepare the transition adjustments.

Ongoing monitoring of impact

- Working with you to design processes and controls for collecting and updating data at each reporting date.
- Helping you to design, procure, select and implement IT systems to deal with the changes.
- Providing assurance on 'dry runs' used to test the process to perform the calculations.

Contact us

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