



Point of view

Aviation implications of the new leasing standard

In a nutshell

- IFRS 16 *Leases* has been published and is effective for periods beginning on or after 1 January 2019.
- For lessees with operating leases an 'aircraft' (right-of-use) asset will come on balance sheet together with a lease liability.
- Significant KPIs including ROCE will be affected – for some it will increase, for others decrease.
- For foreign currency leases there will be increased profit and loss volatility as the lease liability is retranslated.
- For a 'wet' lease only payments for the aircraft need to be recognised, the service element may be separated with the accounting unchanged.
- The changes for an entity and the comparison with peers will need to be explained to stakeholders.

What's happened?

The International Accounting Standards Board (IASB) has published a new Standard, IFRS 16 *Leases*. For lessees the new Standard brings most leases on balance sheet under a single model similar to the existing finance lease model. However, lessor accounting with the distinction between operating and finance leases remains largely unchanged. Subject to EU endorsement, IFRS 16 is effective for periods beginning on or after 1 January 2019, with earlier adoption permitted if IFRS 15 has also been applied.

What does it mean for the aviation industry?

The new Standard, in addition to bringing substantial new assets and liabilities onto airlines' balance sheets, will have an impact on reported profit and performance measures such as return on capital employed (ROCE). Perhaps most significantly the impact on individual airlines will depend on their particular

financing and leasing structures and may be very different from the impact on their peers.

Airlines will need to assess early the impact on their results, and if possible on that of their peers, and to develop a plan for explaining this to their shareholders and other stakeholders.

Lessees' balance sheets grossed up for operating leases

The main headline of IFRS 16 is that leases previously treated as operating leases will generally now be on-balance sheet. A lessee will recognise a right-of-use asset and a lease liability, and consequently depreciation and interest expense in the profit and loss account. The limited recognition exemptions permitted are unlikely to be of much relevance for airlines, given they relate to leases with a lease term of 12 months or less and leases of underlying assets which have a low value when new.

The funding structure of airlines across the world differs significantly with some carriers financing aircraft through longer term finance lease or mortgage finance, while others use shorter operating leases. For carriers with sizeable aircraft operating lease portfolios, the effect is likely to be significant. There may also be properties and other tangible assets held under operating leases, or leases of spares embedded in a maintenance contract and in addition a lessee may elect whether to apply IFRS 16 to leases of intangible assets such as landing slots.

What will this do to KPIs?

To make the results of airlines comparable, analysts have historically used a 7x multiple of the annual aircraft operating lease cost as a proxy for the debt relating to these leases. However, this takes no account of the differences between airlines in their lease structures (e.g. the differences in the duration of the operating leases).

The impact of the change in debt will be particularly significant for return based performance measures, such as ROCE. These are important performance measures for airlines as they require a significant amount of capital for their operations and are used as a benchmark for whether airlines are generating the returns required by shareholders – something which has been challenging for the industry historically!

For example for airlines where the average remaining term of their leased aircraft is shorter it is likely that their lease obligations, measured under the new standard, could be lower than using the 7x multiple and as a result their ROCE metrics would improve under the new rules. The opposite will be true for those airlines with a longer average term remaining.

Profit or loss volatility from foreign currency leases

Foreign currency lease liabilities will be retranslated at each reporting date, with movements recorded in profit or loss, rather than as an adjustment to the right-of-use asset. This is likely to be particularly relevant for companies with

a functional currency other than US dollars, since many aircraft leases are denominated in USD. Companies may wish to consider their treasury strategy and whether they are able to apply hedge accounting to address this volatility.

Combined lease and service contracts

IFRS 16 only requires lessees to bring the leasing component of a contract on-balance sheet. For example, looking at a 'wet' lease of an aircraft which includes the provision of crew services, it is just the payments for the right to use the aircraft that must be included in the lease liability and right-of-use asset. The allocation of payments between the lease and non-lease components is made on the basis of relative stand-alone prices. In many cases, prices for comparable 'dry' leases of the aircraft may be available to help estimate those stand-alone prices. As a practical expedient, lessees can elect to treat entire contracts that contain a lease as a single lease, removing the need for an unbundling exercise but increasing the liability and asset recorded.

The discount rate – a practical challenge?

Under IFRS 16, the discount rate to be used in measuring the liability for future lease payments is the rate implicit in the lease. Determining the rate implicit in the lease however requires knowledge of the underlying asset's residual value and its fair value. Where the implicit rate is not readily available to a lessee it uses an incremental

borrowing rate, the rate it would pay to borrow the necessary funds over a similar term, and with a similar security. Determining this hypothetical borrowing rate may still present practical challenges and may require a considerable use of judgement.

Where can I go for more information?

This publication highlights just some of the issues that will be of particular interest to those in the aviation industry. More detailed information on the new Standard can be found in Deloitte's IFRS in focus publication, available at www.iasplus.com

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