In the Spotlight
An industry focus on the impact of IFRS 16 – Chemicals

October 2016

IFRS 16, 'Leases'

The new lease accounting standard will fundamentally change the accounting for lease transactions and is likely to have significant business implications.

Almost all leases will be recognised on the balance sheet, with a right of use asset and financial liability that recognise more expenses in profit or loss during the earlier life of a lease.

This will have an associated impact on key accounting metrics, and clear communication will be required to explain to the impact of changes to stakeholders.

Why the new standard matters to the chemicals industry

The chemicals industry is likely to be significantly affected by the new standard, given the capital intensive nature of the industry and the use of off-balance sheet operating leases for chemicals assets. The PwC Global Lease Capitalisation study indicated that there would be a median debt increase of 13% for chemicals companies, and 6% median increase in EBITDA.

The new lease standard can shed new light on industry specific topics such as customer supply contracts and the challenges in determining whether there is a lease or a service. Types of arrangement where the guidance in the new standard might identify an embedded lease are tolling agreements and contracts for the use of assets (such as storage tanks, pipelines and transport hubs) which are owned and operated by suppliers and service providers to chemicals companies.

A significant number of fixed assets in the chemicals industry are leased and have been considered operating leases. Therefore these leases have not previously had any impact on the balance sheet. The amount recorded in the income statement was typically on a straight line basis and entirely included in operating expenses. The new lease standard will not only have an impact on the balance sheet, but also on the operating costs, with a split of the expense between operating and finance costs.

The exemption for short-term leases and small assets is unlikely to provide significant relief to chemical companies.

A practical guide to the new standard and its effects

In depth INT 2016-01 provides a comprehensive analysis of the new standard.

This Spotlight summarises the main aspects of the standard, highlighting some key challenges and questions management should ask as they prepare for transition.

Although the new standard will not be effective until 2019, the extent of data-gathering and requirement to embed new processes for many entities means that, for many, preparations should begin now.

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The new standard on a page

When is the effective date?	The new leasing standard will become effective in 2019 and include pre-existing leases (however, there are some reliefs on transition).
What is the scope of the standard?	The standard covers every lease except for rights to explore non-regenerative resources, rights held under certain licensing agreements, leases of biological assets and service concession arrangements. For lessors, licences of intellectual property granted are excluded from IFRS 16.
Are there any exemptions?	A recognition and measurement exemption for *short term leases* and *leases of low value assets* is available as a policy choice.This is only available to the lessee and is unlikely to have a practical effect for the industry.
What is the definition of a lease?	A lease is a contract (or part of a contract) that conveys the right to use an asset for a period of time in exchange for consideration. A contract contains a lease if fulfilment depends on an *identified asset* and it conveys the *right to control the use* of that identified asset throughout the period of use. Each *lease component* should be identified and accounted for separately.
What is an identified asset?	An asset can be identified explicitly or implicitly. A contract does not depend on an identified asset if the supplier has a substantial right to substitute the asset.
What is the "right to control the use" of an asset?	A customer has the right to control the use of an identified asset if they have the right to obtain *substantially all of the economic benefits* from the use of the asset and the *right to direct the use* of the asset, i.e. to decide how and for what purpose it is used.
When is an arrangement split into separate lease components?	A right to use an asset is a separate lease component if the lessee can benefit from the asset on its own (or together with readily available resources) and the asset is neither interdependent nor highly correlated with any other underlying asset in the contract.
What is recognised on the balance sheet?	*Lessees* will recognise almost all leases on the balance sheet (as a "right-of-use asset" and "lease liability"). *Lessors* will still distinguish between finance leases (recognise a lease receivable) and operating leases (continue to recognise the underlying asset).
How is a lease initially measured by lessees?	The lessee recognises: • a lease liability at the present value of future lease payments; and • a right-of-use asset to an equal amount plus initial direct costs and restoration costs.
What does a lessee recognise in profit or loss?	A lessee will recognise: • interest on the lease liability • depreciation of the right of use asset Variable lease payments not included in the lease liability are recognised in the period the obligation is incurred.
Is lessor accounting affected?	IFRS 16 does not make any substantial changes to lessor accounting.

Key questions for the industry

Q: What types of arrangement might meet the new definition of a lease?

A: Most rental contracts for fixed assets are likely to qualify as leases. Such contracts will meet the key criteria for a lease, being the right to control the use of an asset, and obtaining the related economic benefits from that use.

There might be arrangements where the right to control the use of the asset is not so well defined and the entity might not have the full economic benefit. For example arrangements with other parties with respect to tank storage, pipelines, transport hubs and molds used in manufacturing. Tolling agreements might also contain embedded leases, but since such agreements are often arrangements with other group companies the impact will most likely be on statutory separate financial statements. Careful analysis of the terms of the various arrangements should be made as these might meet the definition of a lease, instead of being considered a service.

Q: What might evidence a "right to control the use" of an asset?

A: The "right to control the use" of the assets might be evidenced by the exclusive use of the assets by the chemical company. For example, a tank storage unit of a supplier fixed on the premises of the chemical company and dedicated to the exclusive use of the chemical company might evidence that the supplier contract contains a lease. Although the supplier might only be able to substitute the tank storage in limited circumstances such as a need for major repairs, this would not invalidate the assessment that the arrangement contains a lease.

Q: What areas might affect the lease liabilities recognised?

A: The measurement of the lease liabilities will be judgmental and is going to be affected by different terms, including:

- Contingent rent, renewal and/or purchase options and other services received under the agreements might all affect the calculation of the lease liability. Given the continuous focus of chemical companies on optimizing production and manufacturing, the calculation of the lease liability is likely to be challenging. Lessees will need to assess whether it is reasonably certain to exercise the renewal and/or purchase options both initially and subsequently at each reporting date. Lease payments might be fixed, indexed, performance based or might include a minimum guaranteed consideration. Under IFRS 16, only fixed payments, indexed payments and variable payments that are in substance fixed payments will be included in the measurement of the lease liability.
- The lease payments shall be discounted using the interest rate implicit in the lease, and whenever that rate cannot be readily determined, the lessee's incremental borrowing rate adjusted to reflect the terms and conditions of the lease.

Re-measurement of the lease liability will also be required whenever cash flows under the lease change. Re-measurements would require a relevant adjustment to the right-of-use asset or might affect the Income Statement, depending on the circumstances. In addition, Income Statement volatility might also arise through foreign exchange differences on the translation of the lease liability and right-of-use asset to the lessee's functional currency, if applicable.

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

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

- Net debt and gearing (increases as lease liability included in net debt)
- Net assets (decreases as the right of use asset amortises on a straight line basis while lease liability is unwound more slowly in early years)
- EBITDA (increases as rental expense replaced by interest and depreciation)

Q: What are the wider potential business impacts?

A: The new accounting treatment could affect a number of areas:

- 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 to minimize lease liabilities.
- 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.

Q: Will we need to develop an entirely new system to track and administer leases?

A:

- Many lessees currently manage operating leases on spreadsheets 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.

Q: How and when should I start a program to manage change and meet compliance?

A: Entities should take advantage of the long implementation period available. An initial assessment of exposure to the new standard would be a good starting point, including people, processes, systems, data, governance and policy.

Q: What other departments other than accounting might be impacted?

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

Contact us

Questions?

To have a deeper discussion, please contact:

Chemicals contacts			
Territory	Name	E-mail	Telephone
China / Hong Kong	Grace Tang	grace.tang@cn.pwc.com	+86 (10) 6533 2999
France	Stephane Basset	stephane.basset@fr.pwc.com	+33 15 657 7906
Germany	Lutz Granderath	lutz.granderath@de.pwc.com	+49 20 1438 1520
Greece	Dinos Michalatos	dinos.michalatos@gr.pwc.com	+30 21 0687 4730
India	Uday Shah	uday.shah@in.pwc.com	+91 (22) 6669 1219
Italy	Andrea Brivio	andrea.brivio@it.pwc.com	+39 02 7785548
Japan	Taisuke Shiiono	t.shiino@jp.pwc.com	+81 (80) 3449 7698
Korea	Taeg-Hyun Hwang	thhwang@samil.com	+82 (0) 2709 0462
Netherlands	Antoine Westerman	antoine.westerman@nl.pwc.com	+31 88 792 4437
Netherlands	Jay Tahtah	jay.tahtah@nl.pwc.com	+31 88 792 4330
Russia	Ekaterina Osipova	ekaterina.osipova@ru.pwc.com	+7 49 5967 6396
Spain	Julio Balaguer	julio.balaguer@es.pwc.com	+34 915 684 451
Spain	Carlos Sobrino	carlos.sobrino.hernandez@es.pwc.com	+34 915 684 766
Switzerland	Christophe Bourgoin	christophe.d.bourgoin@ch.pwc.com	+41 58 792 2537
Switzerland	Rolf Johner	rolf.johner@ch.pwc.com	+41 58 792 7742
UK	Michael Jeffrey	michael.jeffrey@uk.pwc.com	+44(0)191 269 4435
Uruguay	Richard Moreira	richard.moreira@uy.pwc.com	+598 2916 0463 ext.1243
USA	Pam Schlosser	pamela.schlosser@pwc.com	+1 (717) 231 5900

Authored by:

Martin Verbeek
Phone: +31887926319
Email: martin.verbeek@nl.pwc.com

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