Leases – one month to go!

What's the status of the top 5 airline industry issues?

December 2018

The 1 January deadline for the adoption of the new leases standard *IFRS 16 Leases* for 31 December reporting airlines is almost upon us. We thought it would be useful to share what KPMG member firms are hearing from the field in terms of the status of the top five identified airline industry issues. We have issued this document with the intention of sharing the directional status of on-going *IFRS 16 Leases* conversion projects. However, airlines do need to consider their own facts, circumstances and agreements in coming to their own conclusions.

Top 5 issues update

1. Additional USD lease debt on balance sheet
2. Aircraft sale and leaseback transactions
3. Aircraft leases
4. Airport terminal contracts
5. Aircraft parts pools

This publication is intended to provide a short and sharp snapshot into a number of the issues that airlines have identified as specifically relevant to the sector in regard to the adoption of the new *IFRS 16 Leases* standard. If you are still dealing with a number of these issues or other implementation challenges, we have included in this document our **KPMG regional airline leaders** who are available to speak to you.

Current status

1. Additional USD debt on balance sheet

Potential impact

The new standard brings onto balance sheet more USD debt given airline's current operating leases are usually priced in USD. As non US functional currency airlines are almost universally short of USD, this will cause more foreign exchange volatility in the financial statements as additional USD liabilities are i.e translated at reporting dates.

Latest update

There are a number of risk management strategies that airlines employ to manage foreign exchange and liquidity risks. Depending on these risk management strategies, there are a number of potential hedging solutions to mitigate this foreign exchange volatility. These involve;

- Matching USD denominated assets or cash inflows, such as receivables and future USD revenues, with the USD lease obligations;
- Matching USD foreign exchange risk embedded in the on balance sheet aircraft fleet with the USD lease obligations; and
- Purchasing USD derivatives cover in the capital markets to translate the cash flows.

This is a complex area and if your airline is still navigating how to address this issue, we recommend moving quickly as hedge designations need to be in place at transition to be most effective.

2. Aircraft sale and leaseback transactions

Potential impact

The one-off gains we have seen under *IAS 17 Leases* from sale and lease back transactions of aircraft purchased by airlines and then packaged into operating leases will be significantly reduced by the new standards rules for longer term sale and lease back transactions.

Latest update

KPMG professionals understand that there are mixed views on whether this historical outcome was considered by airlines as a good outcome or not.

Some argue that users of the financial statements ignored these "one-off" gains and reducing them is better for reporting of the on-going run rate cost of aircraft capacity. Others contend that management's ability to procure aircraft at competitive prices will not be recognized under *IFRS 16 Leases*, when genuine profits on sale are being realized.

Regardless, these new rules have been set and we shall see the impact on these structures for new transactions post implementation of IFRS 16 *Leases* as the commercial sale and leaseback deals are completed. What KPMG professionals are not hearing is that the accounting will drive a change in the behavior in regard to the decision to lease or not to lease new aircraft deliveries on order from the manufacturers.

Current status

3. Aircraft leases

Potential impact

Two of the key issues that have been under consideration with regard to aircraft leases include;

- Assessment of lease term;
- The treatment of return and restoration provisions and through life engine and major airframe maintenance accounting

The second issue has been complicated by the varying practices today in the treatment of through lease life maintenance costs and restoration costs for major engine and airframe event and inspections.

Latest update

Assessment of lease term

For operating leased aircraft KPMG professionals are seeing a mixture of airlines taking the minimum lease terms for the long term aircraft operating leases and some also considering the extension options based on a combination of economic considerations and historical practices. Interestingly KPMG professionals are starting to see that the debt numbers that are being calculated are less than the notional capitalizations of debt historically calculated by the rating agencies. The ultimate amount of lease liability calculated will require clear communication to the market and rating agencies.

Return and restoration provisions

IFRS 16 requires the estimated costs to dismantle, remove or restore, measured in accordance with IAS 37 to be included in the ROU asset at lease commencement date. Lessors typically require lessees to meet maintenance obligations upon return of the aircraft. These maintenance obligations can be broadly segregated into 2 categories; time based maintenance events and usage based maintenance events. Time based maintenance events are required to be performed regardless of whether the aircraft has been used (e.g. an airframe check which is required to take place every 8 years) and typically should be capitalised into the ROU asset with a corresponding provision recognised. Usage based maintenance events are performed only after a predetermined number of flight cycles/hours have elapsed (e.g. an engine overhaul is performed only after a certain number of flight cycles have elapsed).

Usage based maintenance events and restoration

With regard to accounting for usage based maintenance events for operating leased aircraft, there are currently an observed number of practices by different airlines, often referred to as the components approach, the provision approach or a combination of both. A summary of these were included in *IATA's 2016 Airline Disclosure Guide on Maintenance accounting* published in conjunction with KPMG.

When working with airlines on the new standard, KPMG professionals continue to see elements of the components and provision approaches under consideration. However, the old maintenance "holiday" – in which some airlines neither depreciated a maintenance component nor accrued a maintenance provision prior to the first checks – ends with the requirement to componentize the ROU asset.

Current status

4. Airport terminal contracts

Potential impact

Airlines use airport infrastructure assets that they typically do not own. These arrangements are usually contained in multiple contracts signed between the airline and airport operator over extended time periods.

There are different levels of exclusivity in these contracts, for instance the space dedicated to a single airline for their airport lounges, offices and aircraft hangars are often subject to a "lease" contract, however much of the airport usage charges are under usage-based contracts. For example runway usage and terminal passenger facility usage are often variable payments based on activity. Such contracts are rarely accounted for as leases under IAS 17.

Latest update

Home hubs

The airline's home hub was identified early as high risk agreements that may include a lease by airlines. Even where these facilities are subject to variable Passenger Facility Charges (PFC) the lease or no lease classification is important due to the standards requirement to disclose variable lease payments versus their recognition on balance sheet. Interestingly, but perhaps in retrospect not surprisingly, it appears that airports are exerting significant control of the assets in these agreements which is resulting in a non-lease classification for many agreements by airlines.

Outstations and hangars

Initial concerns were raised about the sheer volume of these facility agreements that may come on the balance sheet under the new lease standard requirements. What KPMG professionals are hearing is that lounges, office space in terminals and exclusive use hangers are indeed looking like leases that require capitalization. However, in many instances, gates, check in counters and baggage areas are less likely to be leases. Typically KPMG professionals are hearing that the substitution rights that airports have, and the ability to control the identified assets in these agreements are driving this outcome.

5. Aircraft parts pools

Potential impact

Historically airlines have entered into some arrangements whereby service providers provide access to shared aircraft parts pools that are partly housed on the premises of the airlines. The potential for these to be leases was raised as an adoption issue for those parts housed on the airlines premises.

Latest update

KPMG professionals are hearing in many instances that the accounting treatment for these arrangements as service contracts is not changing. This is primarily due to the genuine substitution and control rights held by suppliers which is supported by the fact that aviation parts are highly regulated and homogeneous which allows the rapid transfer and utilization between pool participants.

How KPMG can help - KPMG's Aviation practice

KPMG's Aviation practice is dedicated to supporting companies in this sector in understanding industry trends and business issues.
Member firms offer customised, sector-specific services that can add value to your most pressing business requirements. At KPMG`s extensive network of professionals combines a global perspective with in-depth industry knowledge to help companies adjust to today's rapidly changing market.

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