

CHINA: MOF ISSUES NEW ACCOUNTING STANDARD FOR LEASES

A revised PRC accounting standard (the "**No. 21 Standard**")¹ standardising the recognition and measurement of leases and the reporting of related information has been issued.² Broadly speaking, the No. 21 Standard adopts the approach established under the new lease accounting standard set by the IASB and known as IFRS 16.³

The main requirement of the No. 21 Standard (and the key change compared to the previous standard for leases) is to require all leases to be reflected on the financial statements of lessees. As a result, operating leases (other than short-term leases⁴ and low-value asset leases⁵) will no longer be treated as "off balance sheet" for lessees and, therefore, the distinction between an operating lease and a finance lease for accounting purposes will no longer apply. The accounting requirements for lessors remain substantially unchanged, i.e. lessors will continue to classify their leases as operating leases or finance leases and account for them separately.

Key issues

- Effective date
- Implications for aircraft lenders and lessors, including PRC lessors
- Implications for PRC airlines

EFFECTIVE DATE

The effective date of the No. 21 Standard is different for different companies, as set out below:

- 1 January 2019: for companies which are (i) listed on both a PRC and a non-PRC stock exchange (simultaneously); or (ii) listed on a non-PRC

¹ The No. 21 Standard "*Accounting Standard for Business Enterprises No. 21 – Leases*" was issued by the Ministry of Finance ("**MOF**") of the People's Republic of China ("**PRC**") on 7 December 2018.

² At a press conference held by MOF on 14 December 2018, MOF noted that the No. 21 Standard has been introduced "to standardise the recognition and measurement of leases and the reporting of information related to leases and to keep continuous consistency with the international financial reporting standards".

³ For a summary of IFRS 16, please see Clifford Chance's client briefing: "New lease accounting standard IFRS 16 – all change for lessees" at: https://www.cliffordchance.com/briefings/2016/06/new_lease_accountingstandardifrs16al.html

⁴ A lease whose term is no longer than twelve (12) months.

⁵ The No. 21 Standard defines "low value asset leases" as leases of assets of relatively low value assessed at the time when the assets are brand new.

stock exchange and which have adopted IFRS or the Accounting Standards for Business Enterprises⁶; and

- b) 1 January 2021: for any other PRC companies.

The supporting Circular⁷ also allows certain companies to adopt the No. 21 Standard ahead of the prescribed effective time, if certain requirements are satisfied.

IMPLICATIONS FOR AIRCRAFT LENDERS AND LESSORS, INCLUDING PRC LESSORS

Generally speaking, lessors and lenders should ascertain the impact of the above accounting changes on the obligations of their PRC lessee obligors under existing financing and leasing agreements. For example, a PRC lessee's financial covenants and other debt measurement clauses (such as financial indebtedness thresholds) may be affected by having to report all of its leases. As a result, lessees may request amendments to these provisions to take account of the new standard (noting that loan and lease agreements sometimes provide for a "frozen GAAP" approach), although it should also be noted that airlines and other operators of high-value, long-life assets choose to lease such assets for reasons other than simply the accounting treatment of such arrangements.

IMPLICATIONS FOR PRC AIRLINES

Three PRC airlines must adopt the No. 21 Standard as of 1 January 2019, namely Air China Limited (listed in Shanghai, Hong Kong and London), China Eastern Airlines Corporation Limited (listed in Shanghai, Hong Kong and New York) and China Southern Airlines Company Limited (listed in Shanghai, Hong Kong and New York). According to the annual reports of these airlines, they are already assessing the impact on their financial performance and position resulting from the adoption of IFRS 16.

⁶ The No. 21 Standard does not specifically state this but presumably this reference is to the applicable accounting standards of China.

⁷ This refers to the *Circular on the Revision and Issuance of the No. 21 Standard* issued by MOF on 7 December 2018.

CONTACTS



Paul Greenwell
Partner

T +852 2825 8857
E paul.greenwell
@cliffordchance.com



Katherine Ke
Counsel

T +86 21 2320 7248
E katherine.ke
@cliffordchance.com

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Clifford Chance, 33/F, China World Office 1,
No. 1 Jianguomenwai Dajie, Chaoyang
District, Beijing 100004, People's Republic of
China

Clifford Chance, 25/F, HKRI Centre Tower 2,
HKRI Taikoo Hui, 288 Shi Men Yi Road,
Shanghai 200041, People's Republic of China

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