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Mr. Hans Hoogervorst
The Chairman
International Accounting Standards Board (IASB)
30 Cannon Street
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20 September 2013

Dear Sir,

IASB PROPOSALS ON ACCOUNTING STANDARDS FOR LEASE CONTRACTS – IFRS EXPOSURE DRAFT ED/2013/6

I am writing on behalf of the International Chamber of Shipping (ICS), which is the principal international trade association for shipowners and operators, representing all sectors and trades. ICS membership comprises national shipowners' associations from 35 countries - from the Americas, Asia and Europe - representing around 80% of the world merchant fleet.

Further to the International Accounting Standards Board's (the "Board") notice of May this year, inviting views on the revised IFRS Exposure Draft ED/2013/6, we are grateful for this opportunity to comment on the draft proposals for the reporting of lease contracts. The comments below represent the consensus view of our membership.

It will be recalled that ICS previously submitted comments to the Board, on behalf of the international shipping industry on IFRS's previous Exposure Draft ED/2010/9, on 14 December 2010 and again on 11 July 2011 following a meeting with the Board on 30 March 2011. Our member associations have also met separately with the Board to convey their views and concerns.

This level of contact indicates the very high interest that the shipping industry has in these proposals. Shipowners are interested because shipping is an asset intensive industry using a multiplicity of contracts in pursuit of their business activity to hire out vessels and provide shipping services for the worldwide transportation of cargoes. These contracts, which include bareboat, time and voyage charters as well as contracts of affreightment, have been in use, in one form or another, for decades, if not for centuries and reflect well understood principles of contractual relationships. Under some of these contracts, those with a right of use of an asset are not necessarily the legal owner. For example, the use of relatively short term charter agreements (i.e.,

short when compared with the asset life) reflects the business models of many participants: Owners of tonnage trade it, either by voyage or term to a multitude of shippers over the asset life, or by selling and buying new and second hand tonnage. These businesses are ship owners and not financing houses. For the same reason, many owners and operators will have a flexible mix of owned and chartered tonnage so as to give operational flexibility, rather than to achieve a particular balance sheet presentation. At the other end of the spectrum there are long term arrangements, the bareboat charters, by which the shipowner will effectively part with all control over the ship asset and the risk, similar to a sale arrangement.

As the Board's explanatory notes point out, current lease accounting rules (IAS 17 *Leases*) focus on identifying when a lease is economically similar to purchasing the asset being leased. When a lease is determined to be economically similar to purchasing the underlying asset, the lease is classified as a finance lease and reported on the lessee's balance sheet. All other leases are classified as operating leases and are not reported on the lessee's balance sheet. This mode of classification and accounting rules takes appropriate account of most business models. It is focused on the nature of the contract rather than the nature of the underlying asset. It results in lease classification and accounting that more closely resembles the economic nature of the arrangement between the lessor and lessee.

In our previous submissions, we expressed concerns on the lack of precision in the earlier proposals with regard to the definition of leases, pointing out that this could give rise to an interpretation that all contracts used within the industry could be caught within the definition and not just those which are finance arrangements. In particular, we highlighted our concern that operational arrangements such as time charters and other similar contracts for *transportation services* utilised by international ship operating companies could fall within the definition when in fact such arrangements should not be treated as leases for accounting purposes. We therefore sought clarity on this and requested that such contracts be excluded from the proposed Accounting Standard. We refer in this respect to our previous letter of 11 July 2011 and in particular to the annex thereto (reproduced at the end of this letter for ease of reference) describing the nature of a time charter contract.

Having considered this issue again in the light of the new proposed standard, the current classification in IAS 17 and the treatment of service contracts remains valid in our view and we have seen no justification for departure from this model and its replacement with a "right of use of asset" model particularly when this proposed model contains a separate and seemingly illogical treatment for a particular type of asset, namely, real estate. Having said this, we understand that some readers of financial statements have expressed concerns that financial reporting could be improved to make available more information of certain contracts that are notionally operating leases but which in fact have characteristics more similar to a finance arrangement. We submit that this can be done through adjustments to the existing model in IAS 17 rather than through introducing an entire new conceptual model of the "right of use of an asset" as proposed in the ED which, in our view, is overly complex and will not achieve the stated objectives of improved reporting and more meaningful financial information.

Our more detailed comments on the new proposed Standard are set out below:

ED/2013/6

As an initial point, we question the rationale for the decision in the ED to distinguish Type A and Type B leases by reference to the underlying asset when the proposed reporting standard for all other assets is based on a "principle approach".

Having said this, and without prejudice to our overriding concern on the need for an entirely new conceptual model, the new Exposure Draft is an improvement on the previous draft in some respects: in particular, it now includes important guidance for an entity when deciding whether a contract (which does not concern real estate) is a lease as defined. It also confirms the tentative decision reached previously by the Board that short term contracts for less than 12 months in length need not be reported in the financial statements. This limited exemption is welcome, however, the term of 12 months appears to be arbitrary and has not been clarified with reference to any conceptual principle referred to elsewhere in the ED such as to the life of an asset. We would therefore request the Board to clarify the conceptual rationale for this term. In considering this, we would ask the Board to note that in the context of an asset such as a ship with an expected life of 25 years, a maximum period of three or even five years would be equally justifiable as a short term lease. **We would suggest therefore that any exemption should be by reference to the expected life of an asset rather than an arbitrary period to be applied to all assets.**

The new Exposure Draft is also an improvement in that the definition of lease now contains an important requirement of "control" and includes guidance as to how "control" is to be assessed. Having considered this definition and the related guidance closely, it is clear that some of the contracts commonly used in the shipping industry do not convey to the customer the right to control the use of the specified asset because he has not the right to determine or change during the term of the contract, decisions on how the ship is to be operated nor the operator of the asset (paragraph 14). These decisions remain with the shipowner (supplier) and would include matters such as:

- the jurisdiction of the ship (the flag State) – which can be changed during the term of the contract, but only by the shipowner/ operator;
- insurance provider (P&I and H&M and other insurances for the ship and crew);
- crewing and management;
- decisions on care of the cargo carried on board the ship; under many shipping contracts where the ship is contracted out for employment to another party, the shipowner nevertheless retains the responsibility for cargo carried on board and retains the risk of, and liability for, for the care of that cargo under separate bills of lading contracts issued by the shipowner to third party cargo interests.

- Decisions concerning the operation of the ship itself, notably decisions on safe operation; international maritime liability conventions provide that compulsory liabilities for pollution, passenger claims, etc., remain with the registered owner/operator and not any other party even when the ship is on charter.
- Decisions to substitute the ship in the event of specified events occurring (such as breakdown, requirement to comply with the ship's maintenance schedule);

The aforementioned decisions are vital to the use of the ship asset. They would "significantly affect the economic benefits to be derived from the use of the asset during the term of the contract" (paragraph 13). As an example, the decision on the flag State of a ship will determine the regulatory environment with which the ship is to comply. This will have a direct impact on the markets in which the ship can operate. While, therefore, the customer (charterer) is given the right to decide which cargoes to carry and for whom and at what price, the economic benefit that he can expect to derive from the time or voyage charter service will be limited by the way in which the ship is operated (its flag State, insurer, crew nationality, etc.) – control of which is retained by the shipowner.

Under other shipping contracts, such as a bareboat charterparty, the shipowner (the supplier) contracts (usually long term and for a fee), the operation of the ship to the bare-boat charterer (the customer). The ship is then operated by the bare-boat charterer as if he owned it. He then makes the decisions described above such as ship's jurisdiction, insurance, crewing, management, cargo care and responsibility for any liability to cargo interests, etc., and has therefore effective control over the operation of the ship. In these cases, the arrangement is similar to a finance lease and would therefore more closely fall within the definition of lease in the ED.

Service Contracts Excluded

It is very encouraging to note what appears to be (at paragraphs 12-19), an exclusion for service contracts. We infer this exclusion from, in particular, the provision in paragraph 19, and the definition of a lease generally, however, the ED does not state in clear terms that service contracts are excluded from the proposed Standard and it also does not clearly define "services". We understand though from our discussions with the Board and also the documents accompanying the ED that the Board's intention is not make any changes to the financial reporting of service contracts. This is important to the shipping industry as many contracts in use by the industry fall in this category and to bring them into the Lease Standard would cause great disruption. **We submit that the ED would be improved, and would assist the decision as to whether a contract falls within the proposed Standard, if it were to include more explicit guidance on what constitutes a contract for services.**

Also with regard to paragraph 19 as presently worded, we believe that paragraph 19 (b) is incorrect when it refers to "the asset has been designed to function...". In our view, this would be more accurately phrased as "...*the right to use* the asset has been designed...". This would capture more appropriately the intention of the provision and

moreover, would be consistent with the principle underlying the lease definition, that this is a right to use an asset rather than the asset itself.

Generally, notwithstanding these improvements, we are very concerned with the complexity of the proposals and the degree of judgement that would be required to interpret them properly. A high level of training and judgement will be necessary to ensure that contracts are classified and reported appropriately in the accounts. It is inevitable that the shipping industry will incur costs in ensuring that the appropriate level of training is either brought in-house or is purchased through external service providers. The complexity of the proposals will also give rise to the risk of differing interpretations which could lead to a change in the way operators do business – this cannot be the intention or the objective of the proposed changes.

As an example of the scope for differing interpretations, whilst we are clear that time and voyage charters fall outside the definition of the lease in the proposed Standard, there are entities both within and outside the industry which are interpreting these contracts as containing both lease and non-lease elements and concluding that the lease elements need to be reported in the balance sheet. As we have pointed out previously, in our letter of 11 July 2011, reporting the lease element in a time/voyage charter arrangement is an impossible exercise and a meaningful result will not be obtained. This is because there is no open market for ships to be marketed separately from the crew and other services on a time charter contract basis. The only market for the ship to be marketed separately from the crew and related services is on a bareboat basis and this form of charter operates in an entirely separate market from the time or voyage charter basis and the two cannot be likened. Moreover, the price of the time charter services is dependent on supply and demand at the time at which it is marketed and this can fluctuate enormously according to market conditions and the data applied, for both the ship and the services and general trading conditions. For these reasons, the reassessment of the lease (significant economic incentive) would be particularly troublesome to do, and would result in an accounting (non-cash) volatility that most preparers and readers will simply carve out - demonstrating its unhelpfulness.

The Board will appreciate that an interpretation that a time charter contract contains a lease element will lead to major disruption to the industry since it might result in operators carrying out the Lease Standard's reporting exercise for every charter arrangement of more than 12 months. Not only will this incur significant cost and require considerable training to enable the assessment of each contract, but the results obtained will not be meaningful to users of the financial statements, being based on theoretical and subjective models of prices.

CONCLUSION

We are very concerned that the case for the principles in the ED has still not been adequately made or explained. We maintain therefore that this should not be implemented. If, however, there is a widespread agreement on a need for improved reporting, we would suggest that this is done through adjustments to the existing model

in IAS 17; more clarity around lease classification could be given to prevent abuse at the margin of operating and finance lease; and more disclosure could be provided to enable readers to better understand the commitments to make payments. The cost benefit analysis would favour this proposal over the ED.

In conclusion, the Board is reminded that over 90% of the world's trade is transported by sea. A very large proportion of this is done using charter arrangements which under the current financial reporting system are classified, for sound economic and business reasons, as service contracts or operating leases as distinct from finance leases. It is of huge global importance therefore that the nature of these arrangements in the context of the Lease Standard is not confused or accounted for in the same way as finance leases. We would therefore strongly urge the Board to maintain the existing and well-understood classification model in IAS 17 and to use this as the model for improvements.

If, notwithstanding the views above, the Board proceeds with the proposed model, we would request this is clarified in the areas requested. We believe that this clarification would be achieved by:

1. Making the exemption from the reporting requirements referable to the expected life of an asset rather than to have the same term apply to all assets;
2. Including in paragraph 19 (b), the correction recommended above;
3. without prejudice to our primary position that a time charter is not a lease at all, we propose in relation to paragraph 20, an amendment to paragraph 20 (c) *viz*, where a contract contains both a lease and a service component and there is no observable price for any of the components, this should be regarded as not containing a lease at all. We make this proposal because the non-availability of an observable price would indicate that it is a services contract.

Finally, we would suggest that in view of the world-wide importance of time and voyage charter contracts, the accompanying document to the ED illustrating the various cases should specifically include such arrangements as contracts which do not fall within the definition of Lease. We believe that this would add important and necessary clarity. In our view time and voyage charterparties fall within the examples given in 2 and 5B, but because charterparties are such an important part of world trade, an express illustration is necessary for the avoidance of doubt.

Finally, if, contrary to our view, the Board considers that all contracts used in the shipping industry should be reported in the manner proposed in the draft ED, we would like to have the opportunity to meet with the Board to obtain a clear understanding of why the Board considers this to be the case. We would also ask the Board to clarify what useful information the users of the financial statements will obtain from the reporting of these business arrangements in circumstances when the reported information is likely to have been based on theoretical models and therefore, effectively, devoid of any meaning.

We again thank the Board for the opportunity to comment on the draft Exposure Document and would be happy to expand on any of the above.

Yours faithfully,



Peter Hinchliffe
Secretary General

Appendix: (Annex from ICS' comment letter of 11 July 2011)

Annex

A. A Time Charter is not a lease but a contract for Services to perform Charterers' instructions for the carriage of goods

1. The Services contracted for are for the shipowner to perform the carriages of goods in accordance with the charterer's sailing instructions with the use of the ship and all ship management services. Charterer is unlikely to be able to use the ship alone and shipowner is unlikely to allow the ship to be used in this way. Thus the ship can only deliver benefits to Charterer when operated with the attendant services and officers and crew. That is, in our opinion, the basic characteristic of a service contract.
2. The ship management services involve, inter alia, the manning of the ship with officers and crew, shoreline management, a ship repair and maintenance programme, insurance.
3. The charterer's sailing instructions specify, inter alia, the loading and discharging ports (the "sailing schedule"), the description and quantity of cargo to be lifted, and bunkering ports to perform the carriages of goods.
4. The charterer is restricted as to where he may instruct the ship to go, for example, to sail only within the geographic limits insured for by the shipowner (Institute

Warranty Limits) and to safe ports. Thus the charterer does not have exclusive control of the right of use of the ship.

5. The Master retains the ultimate decision as to whether any sailing instruction is legitimate in terms of the ship and crew's safety and he may decline to follow them if considered unsafe. A recent example where the charterers were prevented by the Master and shipowners from calling at their nominated ports due to safety considerations was following the catastrophic earthquake and tsunami that struck the north-east coast of Japan in March. For owners with existing contractual commitments to load or discharge cargoes in Japan or for those contemplating trade to Japanese ports, one of the major concerns was the perceived potential risk to the crew, vessel and cargo of exposure to harmful levels of radiation from the Fukushima nuclear plant. Many ship operators invoked safety concerns to avoid sailing to ports in the country.
6. The safe port restriction includes the political safety of the ship, for example, the country of ship's registration may render it politically unsafe for that particular ship to call at a port in another country even though it is physically safe for the ship to call there. A charterparty is likely to contain any such restrictions on trading area.
7. The Master remains fully in control of all decisions concerning the safe operation of the ship, including routing of the ship for safety reasons, deployment of officers and crew.
8. The officers and crew operate or supervise the operation of the ship and ship's equipment.
9. The officers and crew remain the employees of the shipowner. The Charterers may not replace them.
10. The shipowner retains control of all aspects of the ship's condition and maintenance and may interrupt the time charterers' use of the services for necessary or routine maintenance purposes.
11. The shipowner retains legal responsibilities with respect to the activities of his ship and is held responsible for third party liabilities and takes out third party liability insurance for these risks.
12. The length of the time charter period will not affect the economic and legal relationship between the shipowner and the charterer.
13. In all material respects, the contract for a time charter service resembles a contract with a drilling company for the construction of an offshore oil well which the IASB

Staff paper found did not constitute a lease (**Agenda paper IASB 1D – appendix /FASB memo 158 – appendix**).

B. The service and use of asset components in the time charter contract are not separable.

1. The ship management element of the service includes: manning of the ship (officers and crew), shore-line management, ship and ship equipment repair and maintenance programme, insurance of ship/ship equipment and crew. All these elements are subject to variable costs. For example, the nationality of the officers and crew will affect the cost of manning, as will the frequency and location of repair/maintenance programme, choice of insurance provider. The services element is a highly significant aspect of the contract and is also extremely variable in terms of cost.
2. The officers and crew and ship management services are not separated from the use of the ship itself, they are marketed as a single entity, with the pricing of the charterparty reflecting, amongst a host of matters, the ship's value and the cost of the service elements.
3. There is no open market for ships to be marketed separately for a time charter contract on a bareboat type basis with charterers to then supply their own ship management services with officers and crew, ship repair and maintenance management programme, insurance, etc.
4. The price of the time charter services is dependent on supply and demand at the time at which it is marketed and can fluctuate enormously according to market conditions and the data applied, for both the ship and the services and general trading conditions.
5. The exercise of separating the two elements is complex and impractical and will be even more so for those companies that operate with many hundreds of time charterparty contracts in any one accounting period.
6. Owners are unlikely to provide potentially sensitive cost data to charterers and thus charterers will be left with estimating the ship values and service component costs such as manning, repair and maintenance, insurance, etc. The accuracy of the final calculation will depend on a charterer's knowledge of ship values and experience in

ship managing activities (which will vary from charterer to charterer) and will involve decisions which are highly subjective.

7. The Service components are too significant to be combined with lease components and recognised on the balance sheet.

C. In view of all of the above, the new IASB accounting Rules should contain an exclusion for contracts for services such as time Charters.