

## IFRS industry insights

### The Leases Project – An update for the shipping industry

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During April 2011, the IASB and FASB (the “Boards”) continued their discussions on the leases project and made a number of tentative decisions which differ from the proposals in the exposure draft (ED) that was issued last year. Specifically, the Boards reached tentative decisions on the definition of a lease, separating lease and non-lease components and the pattern of expense recognition. Also, the Boards reversed its previous decision on variable lease payments. These are some of the topics that shipping industry respondents expressed concern over in their comment letters on the ED. In the second part of our IFRS Industry Insights series for the shipping industry, we discuss these topics and the affect the tentative decisions may have on the shipping industry.

#### Definition of a lease

The ED defines a lease as “a contract in which the right to use a specified asset or assets is conveyed, for a period of time, in exchange for consideration.” The ED includes the following two principles, based on the existing guidance in IFRIC 4 *Determining Whether an Arrangement Contains a Lease*, relating to that definition:

- The fulfilment of the contract depends on providing a specified asset or assets; and
- The contract conveys the right to control the use of a specified asset for an agreed period of time.

Several shipping industry respondents acknowledged that the ED’s definition of a lease would likely include bareboat charters. However, several respondents expressed concern that the ED’s definition of a lease could lead to confusion about whether a voyage charter or time charter would be considered leases, service contracts or a combination of both.

Respondents from the shipping industry were generally supportive of the view that time and voyage charters should be considered transportation service contracts.



In April 2011, the Boards tentatively decided that a “specified asset” would be an identifiable asset that is explicitly or implicitly identified in the contract. An asset would be implicitly identified if it would not be practical and economically feasible for the owner to substitute alternative assets in place of the underlying asset during the lease term. Conversely, a contract would not be a lease if it would be practical and economically feasible for the owner of the asset to substitute the underlying asset and substitution could occur at any time without the customer’s consent; however, a supplier’s right or obligation to substitute other assets only when the specified asset is not operating properly does not prevent the customer from controlling the use of the asset. In reaching this tentative decision, the Boards rejected the view of defining a specified asset more broadly as an asset of a particular specification rather than as an asset that is uniquely identified.

The Boards also tentatively decided that a contract would convey the right to control the use of the underlying asset if the customer has the ability to direct the use, and receive the benefit from use, of a specified asset throughout the lease term. The ability to direct the use of a specified asset would include determining how, when, and in what manner the specified asset is used or determining how the specified asset is used in conjunction with other assets or resources to deliver the benefit from its use to the customer. If a customer can specify the output or benefit from use of the asset, but is unable to make decisions about the input or process that result in that output, the ability to specify the output would not, in and of itself, be determinative that the customer has the ability to direct the use of the asset. In contrast, if the supplier operates an asset according to the instructions of the customer, the customer has the ability to direct the use of that asset.

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## The proposed definition of a lease could have a significant effect on those shipping entities that enter into long-term time-charters ...

A customer's ability to receive the benefit from use of a specified asset refers to its present right to obtain substantially all of the potential economic benefits from use of that asset throughout the lease term.

The tentative decision does not refer to the pricing of the output as a consideration in determining whether a purchaser has right to control the use of the underlying asset.

In circumstances in which the supplier directs the use of the specified asset used to perform services requested by the customer, the Boards tentatively decided that customers and suppliers would be required to assess whether the use of the asset is an inseparable part of the services requested by the customer (if inseparable, the entire contract would be accounted for as a service contract because the customer has not obtained the right to control the use of the asset) or a separable part of the services provided. The Boards directed the staffs to clarify the wording and perform outreach activities to understand any potential problems with this tentative decision. It is therefore uncertain at this time how the separable versus inseparable guidance would affect the conclusion as to whether a shipping contract is a lease or a service.

The proposed definition of a lease could have a significant effect on those shipping entities that enter into long-term time charters that currently may not be treated as leases. Specifically, if the specified vessel is available for the charterer's use throughout the term of the contract and the charterer is able to make decisions about how, when and in what manner the vessel is used, it appears that the charterer would have the ability to direct the use of the asset, and therefore, the contract would likely be considered a lease. A vessel owner or charterer would no longer be able to rely on the fact that the vessel is managed by employees of the owner, the owner of the vessel maintains possession of the vessel during the contract term and the contract includes off-hire provisions in reaching the conclusion that a time charter is a service rather than a lease. Under the proposed definition, a contract would be a lease if a charterer has the ability to make decisions about using the specified asset that significantly affects the benefits received from that use throughout the contract term. For example, the charterer may need to determine (1) how, when, and in what manner the vessel is used or (2) how the vessel is used in conjunction with other assets or resources to deliver the benefit from its use to the purchaser, in order for the purchaser to conclude that it has the right to control the underlying asset.

The following example, adapted from the example in a staff agenda paper that was prepared for the Boards, illustrates the staffs' views on the application of these tentative decisions:

A charterer enters into a time charter contract with a vessel owner for transportation of cargo services on a named vessel for five years. The charterer may be chartering the ship either to carry its cargo or cargos owned by third parties. The charterer pays a daily or monthly hire, based on the market rate at the date of the contract, for the use of the ship and navigation and cargo management services (including the use of the ship's captain, crew and equipment such as the ship's cranes and loading gear). The vessel owner remains responsible for the navigation and condition of the ship. The vessel owner pays for all of the operating expenses of the ship, while the charterer pays for the fuel used by the ship, except when the ship is off-hire. The charterer also pays for the port costs. Under the time charter, the vessel owner is responsible for maintenance and overhaul, cleaning services relating to the cargo space, insurance and regulatory compliance on matters of ship safety. In addition, the vessel owner is responsible for the cargo when it is onboard its ship and for its safe management while the cargo is in its care and custody.

The time charterer determines the cargo to be transported, and the timing and location of delivery (i.e., the time charterer determines when and to which ports the ship sails). The time charterer does not pay for hire when the ship is off-hire. The ship might be off-hire for maintenance or repairs, because of unavailability of crew or for safety reasons such as weather conditions. The time charterer can declare when the ship is off-hire if the agreed conditions for doing so under the time charter are met. The vessel owner pays for the costs of the ship when it is off-hire.

The staffs tentatively concluded that this example meets the definition of a lease based on the following analysis:

### **Fulfilment of the contract depends on the use of a specified asset**

Fulfilment of the contract depends on the use of the ship, which is explicitly identified in the contract. It is unlikely to be practical and economically feasible for the vessel owner to substitute another ship for the ship specified in the contract.

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... the Boards tentatively decided that lessees would be required to allocate between lease and non-lease components based on their relative standalone purchase prices.

#### **Contract conveys the right to control the use of a specified asset**

The time charterer has the right to control the use of the vessel because it has the right to obtain substantially all of the economic benefits from use of the vessel throughout the term of the contract—the vessel is available for the time charterer’s use throughout the term of the contract unless the vessel is off-hire. Because the vessel owner does not get paid if the vessel is off-hire, the vessel owner would ensure that the vessel is available for the time charterer’s use for the maximum amount of time possible during the term of the contract.

Additionally, the time charterer has the ability to direct the use of the vessel. Although the captain is an employee of the vessel owner, the captain operates the ship according to the instructions of the time charterer. Specifying the timetable for travel and the destination of the vessel, in effect, means that the time charterer determines how, when and in what manner the vessel is used. The captain has discretion in operating the vessel but that discretion is generally limited to ensuring that the vessel operates safely and properly. The decisions of the time charterer about the timing and destination of the vessel are those that significantly affect the benefit that it receives from use of the vessel because the time charterer indirectly determines the speed and direction of the vessel. Although the captain is actively operating the vessel, it does so according to the instructions of the time charterer. The vessel owner retains the majority of the risks associated with ownership of the ship and operates the vessel, but does not control its use during the term of the contract.

#### **Contracts that contain both lease and service components**

The ED would generally not apply to the “distinct” service components of a contract that also contains a lease. A service component would be considered ‘distinct’ if the entity or another entity either sells an identical or similar service separately or the entity could sell the service separately because the service has a distinct function and a distinct profit margin. Lessees and lessors would allocate the payments required under the contract between the distinct service and lease components in proportion to the standalone selling price of each component. However, if the lessee or lessor is unable to allocate the payments, the entire contract would be accounted for as a lease. If the service component is not distinct from the lease component, the entire contract would be accounted for as a lease.

In March 2011, the Boards tentatively decided that in contracts that include both lease and non-lease components, lessees and lessors would identify and separately account for the non-lease components in the contract. The distinct versus non-distinct guidance included in the ED would not be carried forward to the final standard.

Further, the Boards tentatively decided that lessees would be required to allocate between lease and non-lease components based on their relative standalone purchase prices. If the purchase price of one component in a contract that contains a lease is observable, a lessee would apply the residual method to allocate the price to the component for which there are no observable purchase prices. The Boards tentatively decided that lessees would treat the entire contract as a lease when there are no observable prices for any of the components.

The tentative decision to require separation of lease and non-lease components will require lessees to determine the components of an arrangement based on the revised definition of a lease. The tentative decision to allocate based on observable purchase prices will require lessees to obtain the information relating to the pricing of the components from lessors or other third party sources. In shipping, the availability of third party vessel managers will mean that purchase prices for the service component will generally be observable. The purchase price for the lease of the asset component (i.e., a bare boat) may also be observable.

#### **Pattern of expense recognition for lessees**

The ED proposed that rental expense would be replaced with amortisation expense and interest expense, with total expense being recognised earlier in the lease term. Many respondents to the ED did not agree with the proposal because it would result in:

- higher expenses in earlier periods of the lease; and
- further divergence from the cash payments made in lease contracts.

In addition, for leases previously accounted for as operating leases, some financial statement users indicated they would prefer to see lease payments treated as rental expense in profit or loss.

In April 2011, the Boards tentatively decided that there should be two types of leases for lessees and lessors – finance and other-than-finance leases – and the determination of whether a lease is a finance or other-than-finance lease would be based on the existing indicators in paragraphs 7-12 of IAS 17 *Leases*.

For both finance and other-than-finance leases, the liability to make lease payments and the right-of-use asset would be initially measured at the present value of the lease payments. However, the pattern of expense recognition for finance lease would be on an accelerated basis while the pattern of expense for an other-than-finance lease would be on a straight-line basis. The liability to make lease payments would be measured using the effective interest method and amortisation / depreciation of the right-of-use asset would be based on the difference between the straight-line amount and the interest expense amount.

The interest and amortisation / depreciation expense amounts would be presented on a single-line item as rental expense in profit or loss.

The tentative decision to have two types of leases does not affect the proposal in the ED that would require a lessee to recognise an asset and liability under the right-of-use model but would alleviate concerns regarding the accelerated expense recognition pattern.

#### **Variable lease payments**

The ED would require the use of a probability-weighted expected outcome approach to estimate lease payments including contingent rentals, term option penalties and residual value guarantees. Many respondents to the ED objected to this proposal, noting that the approach would be costly to implement and could result in unreliable estimates for long-term leases.

In April 2011, the Boards tentatively decided that variable lease payments should not be included in the measurement of a lessee's liability to make lease payments and a lessor's lease receivable unless the variable lease payments are disguised minimum lease payments. Disguised minimum lease payments are those variable lease payments that are structured in such a way that they are in-substance fixed lease payments. The final standard is expected to include guidance to assist in identifying disguised minimum lease payments. This tentative decision reverses a previous decision that would have included variable lease payments that are "reasonably certain" of being paid to the lessee.

The Boards' tentative decision to limit recognition of variable lease payments to disguised minimum lease payments will alleviate many concerns expressed by shipping industry respondents regarding unreliable estimates of variable lease payments.

#### **Looking ahead**

The Boards still have a number of issues to discuss and will need to determine whether re-exposure of the proposals is necessary. The final standard is expected to be issued by the end of 2011. We will provide you periodic updates as significant decisions are reached by the Boards.

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