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IFRS industry insights

The Leases Project – An update for the shipping industry

Respondents from the shipping industry expressed concern over a number of proposals in the ED …

In August 2010, the IASB and FASB (the "Boards") took a major step towards overhauling the existing lease accounting rules by issuing a set of proposals in the form of an exposure draft (ED). The proposals would significantly affect the accounting for lease contracts for both lessees and lessors across all industries. Since issuing the ED, the Boards have conducted extensive outreach. The comment period on the ED, which ended December 15, 2010, produced over 750 letters, and afterwards the Boards hosted roundtable sessions that included participants from all constituencies, including preparers, users, and auditors, from a wide cross section of industries. Respondents from the shipping industry expressed concern over a number of proposals in the ED, including the definition of a lease, lease term, variable lease payments and lessor accounting. The Boards recently discussed the first three of those topics (the Boards expect to tackle lessor accounting in April) and made some tentative decisions which differ from the proposals in the ED. The Boards will reach out to constituents over the next several weeks to gather feedback on these topics.

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 relating to that definition to help to assess whether a contract contains a lease:

a) the fulfilment of the contract depends on providing a specified asset or assets; and

b) 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 (the vessel owner is paid a fixed rate by the chartering party for a certain period of time and the chartering party is responsible for the operating and voyage costs including arranging for crewing). However, several respondents expressed concern that the ED's definition of a lease could lead to confusion about whether a voyage charter (i.e., the vessel owner maintains control of the ship and pays all operating and trip-related costs and receives a fee based on volume and ports) or a time charter (i.e., the vessel owner receives a fee based on a rate on a per day basis for a selected period of time and is responsible for paying all operating costs other than bunker costs and port charges, which are paid by the charterer) would be considered a lease, a service contract or a combination of both. Respondents from the shipping industry generally agreed that time and voyage charters should be considered transportation service contracts.

In February 2011, the Boards discussed the definition of a lease but made no tentative decisions. The Boards supported 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 supported an approach that would define the "right to control the use of a specified asset" consistently with the revenue recognition exposure draft *Revenue from Contracts with Customers*. Under this approach, a customer would have the right to control the use of a specified asset if it has the ability to direct the use, and receive the benefit from use, of the asset throughout the lease term. The Boards also supported clarifying whether a physical or nonphysical (capacity) portion of a larger asset can be a specified asset and providing guidance for an asset that is incidental to the delivery of specified service.

A transportation contract that states the type of vessel to be used for transporting a customer's goods rather than a uniquely identified vessel would appear to meet the broad definition of "specified asset" that the Boards currently support. However, the Boards also discussed whether the customer would have a specified asset if the customer is indifferent to the type of asset. For example, a customer that is indifferent to the type of vessel used to transport its goods could indicate that the use of the asset is just a means of providing transportation services. In discussing "control", the Boards questioned whether a customer receives a benefit from a specified asset when its benefit is dependent on additional operational services provided by the owner of the specified asset. For example, a contract that provides a customer not only capacity on a vessel for its goods but also requires the owner's personnel to operate the vessel may indicate that the contract is for transportation services rather than a lease. It is too early to tell what types of shipping contracts will meet the definition of a lease in the final IFRS but the current thinking of the Boards does provide some clarity on the likely direction of future discussions.

Lease term

The ED defines the lease term as the "longest possible term that is more likely than not to occur." The comment letters overwhelmingly disagreed with this proposal because many entities thought that a renewal option does not represent a liability until the lessee has actually exercised the option and estimating the lease term would be burdensome and costly to implement and could result in unreliable estimates for leases with multiple renewal options.

In February 2011, the Boards tentatively decided that "lease term" should be defined for the lessee and lessor as the non-cancellable period for which the lessee has contracted with the lessor to lease the underlying asset, together with any options to extend or terminate the lease when there is a "significant economic incentive" for an entity to exercise an option to extend the lease, or for an entity not to exercise an option to terminate the lease. Factors such as the existence of a bargain renewal option and a penalty for not renewing the lease would be considered in determining the lease term but past practice and management intent would not. The lease term would be reassessed only when there is a significant change in facts and circumstances.

The tentative decision to include renewal options in the lease term when there is a "significant economic incentive" to exercise the option represents a change from the ED because it raises the threshold for when renewal options would be included in the lease term. Judgement will be required, but the tentative decision is more closely aligned with IAS 17 *Leases* that uses a "reasonably certain" threshold. However, the requirement to reassess the lease term would represent a change from the current guidance.

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 February 2011, the Boards tentatively decided that all variable lease payments that are "reasonably certain" of being paid should be included in the measurement of a lessee's liability to make lease payments and a lessor's lease receivable and that estimate should be reassessed when there is a change in facts and circumstances. Variable lease payments that depend on a rate or index or that lack "commercial substance" would also be included in the lessee's liability and lessor's receivable.

Although this decision represents a change from the proposal in the ED because of the inclusion of a high threshold, entities would still be required to estimate the amount of "reasonably certain" variable lease payments throughout the lease term and reassess that estimate in the future. Shipping entities may not be able to ignore contingent rentals because there could be some level of contingent rentals, even far into the future, that will be reasonably certain of being paid by the lessee. The change to the definition of "lease term" noted above may provide some relief to entities that enter into leases that include renewal options and contingent rentals because the lease term may be shorter than it would have been under the ED.

The Boards still have a number of issues to discuss before finalising the project and issuing a final standard. We will provide you periodic updates as significant decisions are made by the Boards.

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