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Navigating a Vessel Through the New Revenue and Leases Standards

The Bottom Line

- In May 2014, the FASB issued its final standard on revenue from contracts with customers, [ASU 2014-09](#).¹ The new standard outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers. Primarily in response to concerns expressed to the FASB about applying the requirements in ASU 2014-09, the Board subsequently issued amendments² to the ASU that (1) clarify aspects of applying the new revenue guidance and (2) remove certain rescinded SEC guidance on revenue. Collectively, ASU 2014-09 and the amendments form ASC 606³ (the new revenue standard).
- In February 2016, the FASB issued [ASU 2016-02](#),⁴ its final standard on leases (codified in ASC 842 — the new leases standard). The primary objective of the leases project was to address the current off-balance-sheet financing concerns related to a lessee's operating leases. In early January 2018, the Board issued a [proposed ASU](#)⁵ (the January 2018 proposed ASU) that would amend the new leases standard to provide entities with certain practical expedients that would (1) limit application of the new standard to the most recent period presented (i.e., entities would not be required to restate comparative periods) and (2) not require lessors to separate lease and nonlease components when certain conditions are met.
- Because water vessels ("ships" or "vessels") are key to cargo-moving arrangements in the shipping industry, suppliers (e.g., shipowners) and customers (e.g., charterers) may provide or receive a service. In addition, the arrangement may be a lease of a vessel. Consequently, entities that engage in the moving of cargo on water vessels should analyze all contracts between their suppliers and customers, since they may need to account for the entire contract, or part of the contract, in accordance with the new revenue and leases standards.

¹ FASB Accounting Standards Update No. 2014-09, *Revenue From Contracts With Customers*.

² Refer to Deloitte's [A Roadmap to Applying the New Revenue Recognition Standard](#) for details on the various amendments.

³ For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's ["Titles of Topics and Subtopics in the FASB Accounting Standards Codification."](#)

⁴ FASB Accounting Standards Update No. 2016-02, *Leases*.

⁵ FASB Proposed Accounting Standards Update, *Leases (Topic 842): Targeted Improvements*.

Beyond the Bottom Line

This *Shipping Spotlight* discusses the new revenue and leases standards with a focus on implementation considerations for the shipping industry. Specifically, this publication addresses select aspects of the new revenue and leases standards that relate to certain common arrangements in the shipping industry, such as (1) voyage charters, (2) contracts of affreightment, (3) time charters, (4) bareboat charters, and (5) vessel pool arrangements. For a comprehensive overview of the new leases standard, including illustrative examples, frequently asked questions, and recent FASB tentative decisions, see Deloitte's [March 1, 2016](#), [April 25, 2017](#), and [December 5, 2017](#), *Heads Up* newsletters. In addition, refer to Deloitte's [A Roadmap to Applying the New Revenue Recognition Standard](#) for authoritative guidance and Deloitte's interpretive views related to the new revenue standard.

As discussed further below, the scope of the new leases standard relies on whether there is an identified asset (i.e., property, plant, or equipment) and whether control of the identified asset transfers to the customer (i.e., from the lessor to the lessee) during the term of the contract. Accordingly, because a vessel is central to voyage, time, and bareboat charters, we discuss these arrangements by evaluating whether (1) the arrangement is or contains a lease in accordance with ASC 842 and (2) there are any nonlease components that should be accounted for in accordance with ASC 606. In other words, because the scope of the new revenue standard excludes performance obligations that are leases, an entity should first assess whether the contract is a lease in its entirety or contains a lease in accordance with ASC 842 and apply the revenue recognition requirements in ASC 606 to the remainder of the contract (i.e., the portion of the contract that is not a lease).

Overview of the New Revenue Standard

The goals of ASU 2014-09 and the corresponding amendments are to clarify and converge the revenue recognition principles under U.S. GAAP and IFRSs while (1) streamlining, and removing inconsistencies from, revenue recognition requirements; (2) providing "a more robust framework for addressing revenue issues;" (3) making revenue recognition practices more comparable; and (4) increasing the usefulness of disclosures. The new revenue standard states that the core principle for revenue recognition is that an "entity shall recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services."

The new revenue standard is effective for calendar periods beginning January 1, 2018, for public business entities, and January 1, 2019, for all other entities.

The new revenue standard indicates that an entity should perform the following five steps in recognizing revenue:

- "Identify the contract(s) with a customer" (step 1).
- "Identify the performance obligations in the contract" (step 2).
- "Determine the transaction price" (step 3).
- "Allocate the transaction price to the performance obligations in the contract" (step 4).
- "Recognize revenue when (or as) the entity satisfies a performance obligation" (step 5).



Connecting the Dots — Preparing for the Changes

As a result of the new revenue standard, entities will need to comprehensively reassess their current revenue accounting and determine whether changes are necessary. In addition, among other things, the new revenue standard requires significantly expanded disclosures about revenue recognition, including both quantitative and qualitative information about (1) the amount, timing, and uncertainty of revenue (and related cash flows) from contracts with customers; (2) the judgments, and changes in judgments, used in applying the revenue model; and (3) the assets recognized from costs to obtain or fulfill a contract with a customer.

Contract Costs

In addition to providing guidance on recognizing revenue in ASC 606, ASU 2014-09 also provides guidance on how to account for certain types of contract costs, including incremental costs to obtain and costs to fulfill a contract with a customer. This guidance is codified in ASC 340-40.

ASC 340-40-25-1 through 25-4 provide an overall, comprehensive framework to account for costs of obtaining a contract that are within the scope of ASC 606. That is, if a contract falls within the scope of ASC 606, an entity should look to ASC 340-40 for all relevant guidance on costs of obtaining a contract. ASC 340-40 requires an entity to capitalize the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs. When determining whether a cost represents an “incremental cost to obtain a contract,” entities should consider whether the cost would have been incurred if the customer (or the entity) decided that it would not enter into the contract just as the parties were about to sign the contract. If the costs (e.g., the legal costs related to drafting the contract) would have been incurred even though the contract was not executed, the costs would not be incremental costs of obtaining a contract.

Further, ASC 340-40-25-5 through 25-8 provide guidance related to costs to fulfill a contract with a customer that are not addressed by another ASC topic (e.g., inventory; property, plant, and equipment; intangible assets). For fulfillment costs that are not within the scope of another ASC topic, ASC 340-40 requires an entity to capitalize the fulfillment costs (and recognize such costs when, or as, the related performance obligations are satisfied) if all of the following criteria are met. Specifically, to capitalize costs to fulfill a contract, the costs must:

- “[R]elate directly to a contract or to an anticipated contract that the entity can specifically identify (for example, costs relating to services to be provided under renewal of an existing contract or costs of designing an asset to be transferred . . .).”
- “[G]enerate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future.”
- Be “expected to be recovered.”

Alternatively, if any of these criteria are not met, the entity should expense the costs as incurred. ASC 340-40 includes specific examples of costs that may relate directly to an executed contract with a customer or a specific anticipated contract with a customer (e.g., direct labor, direct materials, allocations of costs that relate directly to the contract, and costs that are explicitly chargeable to the customer). ASC 340-40 also provides examples of costs that do not relate specifically to a contract and therefore should be expensed as incurred (e.g., general and administrative costs not explicitly chargeable to the customer, wasted materials and labor, resources not reflected in the price of the contract, and costs related to an entity's past performance).

ASC 340-40 also includes guidance related to the amortization and impairment of incremental costs to obtain and costs to fulfill a contract.

Overview of the New Leases Standard

The new leases standard introduces a lessee model that brings most leases onto the balance sheet. The standard also aligns certain underlying principles of the new lessor model with those in ASC 606 (e.g., those that help entities evaluate how collectibility should be considered and determine when profit can be recognized). The new leases standard also addresses other concerns related to the current leases model, which is almost 40 years old. For example, the new standard eliminates the requirement that entities use bright-line tests in current U.S. GAAP to determine lease classification. The standard also requires lessors to be more transparent about their exposure to risks regarding the changes in value of their residual assets and about how lessors manage that exposure.

The new leases standard is effective for calendar periods beginning January 1, 2019, for public business entities, and January 1, 2020, for all other entities. Entities have the option to early adopt the new leases standard, such that both the new revenue and leases standards would be adopted contemporaneously.



Industry Perspective — Impact on the Shipping Industry

The changes introduced by the new leases standard may significantly affect entities in the shipping industry because of their extensive use of fixed assets (i.e., vessels) under contracts that may qualify as leases under the new guidance. Agreements that shipping entities enter into also may include services and other components critical to completing the contracts, such as operating and maintaining a vessel throughout a voyage. Although under current guidance the accounting for operating leases is often similar to that for service contracts, this will no longer be the case under the new leases standard. The scoping of these arrangements as either a service or lease may determine whether they are reflected on or off the balance sheet under the new standard. Therefore, shipping entities will need to assess the population of their contracts to determine whether such agreements meet, or have components that meet, the new definition of a lease.

Implications for Shipping Industry Entities

Voyage Charters

A voyage charter is the hiring of a vessel for a single voyage or consecutive journeys from the named port of loading to the port of destination. The customer in need of transporting its cargo (the “charterer”) contracts with a vessel owner (“carrier” or “shipowner”) to transport a contractually agreed-upon amount of cargo. The consideration in the contract (or “freight”) is determined either on a variable rate related to the cargo (e.g., cargo weight, volume, or units) or on a lump-sum basis. In addition, the cargo will be transported on a “full cargo” basis, which obligates the charterer to pay freight for the contractually-stipulated amount of cargo in the contract regardless of whether less than the full cargo is loaded onto the vessel. In other words, in a voyage charter, the charterer is typically responsible to pay for any “dead” freight.

In addition, a voyage charter agreement usually includes a “laytime and demurrage” clause. Laytime is a specified amount of time within which the charterer is permitted to load and discharge its cargo. If the laytime is exceeded, the charterer is responsible to pay the carrier specified damages, which may include liquidated damages called demurrage.

Examples of voyage charters include (1) spot charter (per-day or per-ton rate), (2) parcel tankers (i.e., use of tanks to store cargo on the vessel that is transporting the cargo), and (3) container shipments. In addition, while not a voyage charter, contracts of affreightment may contain characteristics similar to voyage charters, as further discussed below.⁶

⁶ A contract of affreightment is a contract similar to a voyage charter, but the shipowner agrees to transport a number of cargoes, typically within a specified period.

Determining Whether a Contract for a Voyage Charter Contains a Lease

The first step in identifying whether a contract for a voyage charter contains a lease is to evaluate whether fulfillment of the contract depends on an identified asset. To satisfy this condition, two criteria must be met. The first criterion is that the vessel is an identified asset. That is, the vessel must be either explicitly specified in the contract or implicitly specified (e.g., implicit identification may occur because of limited assets that can fulfill the specifications in the contract or the customer takes substantially all of the asset's capacity). The second criterion is that the shipowner does not have a substantive right to substitute the asset (i.e., there are no substantive substitution rights). For a substantive substitution right to exist, the shipowner (1) must have the practical ability to substitute the asset with an alternative asset throughout the period of use and (2) would benefit economically from its right to substitute the asset. Generally, substitution rights for warranty and maintenance reasons are not substantive substitution rights.

The evaluation of whether a contract depends on an identified asset is performed as of the inception date of the arrangement by determining the following:

1. Is the vessel a specified asset?

Generally, yes. Typically, the vessel to be used in a voyage charter is named, and therefore is explicitly specified in the contract.

Voyage charters of cargo containers on parcel tankers, as well as contract of affreightment arrangements, may be exceptions. For contracts involving parcel tankers, the shipowner and charterer would need to determine whether the vessel is implicitly specified. The determination of an implicitly specified vessel would include whether the charterer's containers use substantially all of the parcel tanker's capacity.

In addition, a charterer would need to consider whether the containers used to move its cargo represent a lease. Further, a shipowner should evaluate whether it leases containers to a charterer (i.e., specifically in situations in which the shipowner provides such containers to the charterer in a voyage charter arrangement).

2. Does the shipowner have a substantive substitution right?

Generally, no. For the substitution right to be substantive, the shipowner must have the practical ability to substitute the vessel throughout the period of use, and the shipowner would obtain an economic benefit from substituting the vessel. Legally, the shipowner is not prohibited from substitution provided the substituted vessel meets the model type and characteristics specified in the contract. In addition, the shipowner would be required to substitute the vessel if the vessel is damaged.

However, substitution for damages or repairs is not considered substantive. In addition, the shipowner may not have the practical ability to substitute the vessel being used in a voyage charter during the period of use because the asset is at sea. However, assuming the shipowner does have the practical ability to substitute the asset, the shipowner would also need to obtain an economic benefit (e.g., the benefit of doing so would exceed the costs of substitution). Given a ship is at sea, it is likely that the costs to substitute the vessel would exceed the benefits related to substitution. Therefore, we would generally expect that it would be rare for shipowners to have substantive substitution rights for vessels in voyage charter arrangements.

However, although situations in which a substantive substitution right exists in voyage charter arrangements are expected to be rare, the evaluation is dependent on each arrangement's facts and circumstances. Accordingly, the parties to voyage charters should evaluate each contract to determine whether a substitution right exists and, if so, whether the substitution right is substantive.

Conversely, in contracts of affreightment, a shipowner's right of substitution is generally substantive because practically, it could use different vessels to carry the charterer's different cargoes over the contract period and the costs would probably not outweigh the economic benefits of substituting vessels.

In addition, the use of a customized vessel for the charterer could affect whether the shipowner has a practical ability to substitute the asset during the period of use and obtains an economic benefit. That is, the customization may mean (1) the shipowner does not have other assets to satisfy the terms of the contract and (2) the costs to substitute the asset (i.e., to acquire or modify another vessel) would exceed the economic benefits of substitution.

If the shipowner has a substantive substitution right, then an identified asset does not exist and the contract does not contain a lease. Therefore, the contract should be evaluated as a service contract under the provisions in ASC 606. Alternatively, if the shipowner determines that it does not have a substantive substitution right, then fulfillment of the contract depends on the use of an identified asset.

The next step in identifying whether a voyage charter contract contains a lease is to evaluate whether, as of the inception date of the arrangement, the charterer has the right to control the use of the vessel during the period of use (i.e., the term of the voyage). To control the use of the vessel, the charterer must (1) obtain substantially all of the economic benefits from using the vessel and (2) have the right to direct how and for what purpose the vessel will be used.

1. Does the charterer obtain the right to receive substantially all of the economic benefits from using the vessel throughout the period of use?

Generally, yes. In a voyage charter, the charterer provides full cargo for the vessel and is liable for any dead freight (i.e., excess capacity of the vessel).⁷ As a result, no other parties are expected to benefit from the use of the vessel during the contract term.

2. Does the charterer have the right to direct how and for what purpose the vessel will be used?

It depends. Some charterers may have discretion with regard to certain decisions in the contract, such as options embedded into a contract to designate load and discharge ports. In addition, the right to direct how and for what purpose the vessel may be used may be predetermined in the contract.

Accordingly, we believe there will be a need for entities to exercise significant judgment in determining whether a charterer's decision-making rights (such as the ability to change ports) demonstrate the charterer's ability to direct how and for what purpose the vessel is used. For example, it will be important to note how much latitude a charterer has in making decisions as well as whether decision-making rights are effectively predetermined in the contract.

However, if the right to direct how and for what purpose the vessel will be used is predetermined in the contract, the parties must further consider whether the charterer (1) operates the vessel and (2) was involved in the design of the vessel. Since charterers are rarely involved with the design of vessels, we believe this indicator would generally not be applicable. Thus, the determination of whether the shipowner or the charterer operates the vessel will be important in determining whether the charterer has the right to control the use of the vessel.

⁷ This conclusion generally does not apply to parcel tankers unless the number of containers represents substantially all of the vessel's capacity. In such cases, the charterer effectively has exclusive use of the vessel and, as a result, the charterer has the right to receive substantially all of the economic benefits throughout the period of use. However, the charterer would also need to consider whether the containers used to move its cargo represent a lease. Further, a shipowner should evaluate whether it leases containers to the charterer (i.e., in situations in which the shipowner provides such containers to the charterer in a voyage charter arrangement).

In voyage charters, the shipowner generally controls the operating decisions and directs either the shipowner's crew (or in some instances, a third-party crew that operates the vessel). Specifically, the shipowner would retain control over the operations of the vessel (e.g., by directing the captain to take certain routes and maintain specific speeds). Accordingly, assuming the right to direct the use of the asset is predetermined in the contract, the shipowner generally would operate (or control the operations of) the vessel and, therefore, the charterer does not have the right to control the use of the vessel.



Industry Perspective — Whether a Voyage Charter Contains a Lease

Some entities in the shipping industry believe that charterers have a right to direct how and for what purpose the vessel will be used because of contractual provisions that permit the charterer, with some discretion, to designate the ports of loading and discharge in a voyage charter. The contract may include a “menu” comprising a list of ports and corresponding prices for combinations of ports. Further, we understand that the port options may be within a specified — and often relatively narrow — geographic range. In addition, because shipowners need to manage logistics related to numerous contracts for customers at different ports, these voyage charters frequently require the charterer to declare the load and discharge ports either (1) before the vessel reaches the load port (in some instances, well before) or (2) soon after the vessel leaves the load port. For longer voyages, the charterer may also have the ability to designate a destination at a point later than a shorter voyage, but it may be limited to a certain distance from the listed ports. Therefore, we believe it will be important for shipowners and charterers to understand restrictions related to the charterer's ability to make decisions, including when such decisions can (or must) be made.

In a typical lease of a vessel, such as in a time or bareboat charter, the charterer is free to move the vessel to any location when and how the charterer chooses, even if there are certain contractual restrictions that address locations to which the vessel can travel (i.e., protective rights). Accordingly, in a manner consistent with a typical lease, the charterer's ability to designate the ports in a voyage charter should be substantive. As a result, it is important to assess the degree of latitude the charterer has in making relevant decisions about how and for what purpose the vessel is used, including the selection of geographic locations (e.g., the ports).

In assessing a charterer's degree of latitude to make decisions (e.g., where the vessel will travel), the parties to the voyage charter should first determine whether the charterer's rights to make decisions are part of the existing contract or represent modifications to the existing contract. This assessment should consider factors such as whether the contract stipulates the financial effects (pricing changes) related to the charterer's decisions or whether pricing would require a separate negotiation between the parties. We understand that frequently, voyage charter contracts will have flexible pricing provisions (e.g., for decisions such as declaring load and destination ports) such that separate negotiations are not required, and therefore such decisions would not represent modifications to the existing contract.

Next, assuming the charterer's decision-making rights would not represent modifications to the existing contract, the parties should assess whether the charterer's decision-making rights are substantive. In making this assessment, the parties should consider factors such as whether and, if so, the degree that the charterer's decisions would affect the economic benefit that the charterer would derive from the vessel. For example, assuming the contract specifies three ports from which a charterer can select as a load destination, the parties may consider whether the flexibility associated with the charterer's ability to select from three

ports creates value for the charterer. Generally, such flexibility would create value. Accordingly, if the charterer's decision-making rights are substantive, the charterer will most likely direct how and for what purpose the vessel is used.

Further, determining when the charterer controls the right to use the asset is critical because it determines when the lease commences. For example, if the charterer can make substantive decisions about how to direct the use of the vessel from the time the vessel is located in the prior discharge port, the lease would most likely commence at the prior discharge port.

However, this issue continues to evolve, and it is possible that the FASB and SEC will want to share perspectives, which may include implementation guidance. Shipowners and charterers should consult with their accounting advisers and monitor developments on this topic.



Connecting the Dots — Interaction With Example 6 in ASC 842

ASC 842 includes implementation guidance in Example 6, which describes two cases involving contracts to use a vessel (ASC 842-10-55-79 through 55-91, Case A and Case B). Case B describes a time charter (discussed in more detail below) and concludes on the basis of the case facts that the contract contains a lease.

Conversely, Case A describes a voyage charter and concludes on the basis of the case facts that the contract does not contain a lease. Specifically, this conclusion is reached because the charterer does not control how and for what purpose the vessel is used. The implementation guidance further notes that how and for what purpose the vessel is used is predetermined in the contract — namely, the delivery of specific cargo to a specified location within a certain period. The case example continues by stating that the charterer has no other decision-making rights about how and for what purpose the vessel is used over the contract period.

However, as noted above in [Industry Perspective — Whether a Voyage Charter Contains a Lease](#), charterers may have additional decision-making rights in voyage charters. Therefore, the FASB may not have been aware of these additional decision-making rights (and therefore did not contemplate them) when arriving to the conclusion in Case A for a voyage charter. As a result, conclusions regarding whether a voyage charter contains a lease may differ from that cited in Case A.

Accordingly, because voyage charters may provide the charterer with decision-making rights, such that those rights enable the charterer to direct the use of the vessel throughout the period of use, the shipowner and charterer must evaluate whether the contract contains a lease. That is, an entity cannot default to accounting for the contract under ASC 606, nor is it optional. The parties must determine whether the entire contract is a service or whether it contains a lease that would therefore include lease and nonlease components (e.g., crew services). The result of the contract containing a lease would be a requirement to account for the lease components in accordance with ASC 842 and the nonlease components in accordance with ASC 606, unless the contract contains a lease and certain practical expedients are elected. That is, the charterer elects the practical expedient in ASC 842 (and the shipowner elects an expected practical expedient in ASC 842) to treat the lease and nonlease components as lease components. See [Connecting the Dots — Practical Expedient for Lessors to Not Separate Lease and Nonlease Components](#) and [Connecting the Dots — Allocation for Lessees](#)).

Considerations Related to the New Revenue Standard

As noted above, accounting for a voyage charter in accordance with ASC 606 and ASC 842 is not a free election. Therefore, the parties will need to determine whether such a contract is a service in its entirety or whether it also contains a lease and account for the contract in accordance with ASC 606 and ASC 842. Key considerations under the new revenue standard that shipowners should evaluate relative to voyage charters include, but are not limited to, the following:

Identifying Performance Obligations

Assuming the arrangement does not contain a lease, our general view is that a contract for a voyage charter consists of a single performance obligation to provide the charterer with an integrated transportation service within a specified time period. This conclusion appears relatively straightforward when the shipowner has been contracted to transport the charterer's cargo in a single voyage.

However, the shipowner should evaluate all of the promises in the contract to determine whether there are other distinct performance obligations. For example, in some cases, the charterer contracts the shipowner to transport a specific amount of cargo that may require multiple voyages from the same port of loading to the same destination, such as in a contract of affreightment. Typically, in these arrangements, the shipowner is only transporting cargo from the port of loading to the port of discharge. The vessel's return voyage from the port of discharge to the port of loading to pick up additional cargo is often referred to as the "ballast leg." Shipowners will need to apply judgment to determine whether such contracts comprise a single performance obligation consisting of multiple deliveries or multiple distinct deliveries (i.e., more than one distinct performance obligation) with ballast legs in between the voyages. See the [Timing of Revenue Recognition](#) section below for additional considerations related to ballast legs.

Variable Consideration

As noted above, contracts for voyage charters often include provisions whereby the charterer is required to pay demurrage. Demurrage represents damages paid to the shipowner for exceeded laytime (i.e., the charterer exceeds the amount of time specified in the contract for loading or discharging the cargo from the vessel, or both). Conversely, the shipowner may be required to pay despatch (also referred to as "dispatch") to the charterer as a bonus for loading or discharging cargo in less time (i.e., for reducing the time a vessel must spend in port loading or discharging cargo). Currently, diversity in practice exists regarding the point at which shipowners begin to recognize demurrage.

Under the new revenue standard, the demurrage and despatch represent forms of variable consideration (that increase or lower the contract consideration), which a shipowner will need to estimate at contract inception using either the expected value or most likely amount approaches (and consider whether some of the estimate of variable consideration should be constrained). The shipowner would also need to update its estimate of variable consideration over the contract period.



Industry Perspective — Variable Consideration Related to Despatch and Demurrage

Under legacy U.S. GAAP, shipowners generally do not adjust revenue for despatch and demurrage amounts until the contingency underlying such amounts is resolved (i.e., until the cargo is actually loaded or unloaded and the amount by which the laytime is exceeded or achieved is known). Such amounts may or may not be material, and oftentimes the contract terms may be designed such that the shipowner does not expect to receive or pay any demurrage or despatch. Thus, shipowners have questioned whether it would be acceptable to continue current practice and wait until the contingency is resolved to adjust revenue for demurrage and despatch (i.e., fully constraining estimates of demurrage or despatch). However, while fully constrained estimates of revenue (or reductions of revenue) until the variability is resolved may be appropriate because of the inherent uncertainty of incurring despatch or demurrage at contract inception, an entity should not default to fully constraining variable consideration because doing so is not consistent with the principles in ASC 606. Therefore, shipowners will need to apply judgment when estimating and constraining variable consideration related to despatch and demurrage, including updating estimates of variable consideration throughout the contract period as required by ASC 606. That is, an entity would be required to update its estimate over the voyage period for changes in facts and circumstances that make it more or less likely that it will incur despatch or demurrage.

Other forms of variable consideration may also exist in these contracts, including payments that vary based on a market rate. In a manner consistent with the considerations presented above, shipowners will be required to apply judgment to appropriately estimate and constrain variable consideration in the contract.

Timing of Revenue Recognition

Our general view is that a contract for a voyage charter meets the criteria to recognize revenue over time because the charterer simultaneously receives and consumes the benefits of the shipowner's performance as the shipowner performs. This is because another shipowner would not need to substantially reperform the transportation services performed to date if the contract was cancelled during the voyage from the load port to the destination port.



Connecting the Dots — Discharge to Discharge

Often, the port of discharge from one voyage charter will be different than the port of loading in a subsequent voyage charter. Therefore, the shipowner must move the vessel to the next port before it can obtain the cargo to be shipped in the next contract ("mobilization"). This portion of a vessel's voyage is typically called the ballast leg, as noted above.

Currently, many shipowners recognize revenue ratably on a discharge-to-discharge basis and therefore recognize revenue over the ballast leg. In accordance with legacy U.S. GAAP, such recognition has been limited to situations in which the shipowner has a legally binding contract in place for the subsequent charter. In other words, revenue related to the subsequent contract begins at the previous port of discharge if the next contract has already been executed before the vessel leaves the previous port of discharge. If a contract has not yet been executed, then revenue recognition begins once a contract is executed (which may be in route to the port of loading that is specified in the subsequent contract).

ASC 606 would require the shipowner to evaluate the distinct performance obligations in the contract with a charterer. In addition, evaluation of the performance obligations in the contract should be considered from the customer's perspective. A customer contracts with the shipowner to move cargo from the load port to the discharge port. Accordingly, the shipowner needs to determine whether the efforts involved in the mobilization of the vessel to the load port represent a fulfillment activity (i.e., a set-up activity) related to the performance obligation to move the customer's cargo or a distinct service that provides a benefit to the customer. If the mobilization efforts satisfy a promise to the customer by delivering a distinct service, it should be accounted for as a separate performance obligation.

We believe mobilization of a vessel from a previous port of discharge to a subsequent port of loading does not result in a separate benefit for charterers and that the activity is thus incapable of being distinct. That is, the customer hires the shipowner to move its cargo from the load port to the discharge port and receives benefits as the cargo is loaded and moved. Therefore, mobilization from a previous discharge port to a load port (regardless of whether a subsequent contract is executed) is a set-up activity necessary to fulfill the shipowner's promise to deliver cargo from the named port of loading to the named port of discharge in the contract. Consequently, the shipowner should not begin to recognize revenue until the shipowner's service begins at the subsequent port of loading.⁸

Accordingly, revenue recognition for voyage charters will most likely represent a significant change for shipowners that currently recognize revenue on a discharge-to-discharge basis when they adopt ASC 606.

Contract Costs

Costs incurred by the shipowner related to a voyage charter should be evaluated to determine whether such costs represent incremental costs to obtain a contract or costs to fulfill a contract under ASC 340-40. Once an entity identifies the population of its voyage costs that represent either incremental costs to obtain or costs to fulfill the contract, the entity should consider whether such costs meet the criteria to be capitalized.

Assuming the criteria to capitalize costs under ASC 340-40 are met, the timing and pattern of recognition of costs in the income statement is dependent on the type of costs. For example, incremental costs to obtain a contract such as a commission are amortized over the period of benefit (unless such costs are expensed in accordance with ASC 340-40-25-4 because "the amortization period of the asset that the entity otherwise would have recognized is one year or less"). Conversely, costs to fulfill a contract are recognized when or as the related performance obligations are satisfied.



Connecting the Dots — Capitalization of Fulfillment Costs Over the Ballast Leg

As discussed in the [Timing of Revenue Recognition](#) section above, under the new revenue standard, revenue related to voyage charters would not be recognized over the ballast leg (assuming that the contract does not contain a lease). However, shipowners would need to evaluate whether to record an asset (i.e., related to costs to fulfill a customer contract) to the extent fulfillment costs meet the three criteria in ASC 340-40-25-5. If all of the criteria are met, an entity would be required to defer (i.e., capitalize) such costs and recognize them in the income statement when, or as, the related performance obligations are satisfied.

⁸ In the event that the shipowner concludes that a voyage charter contains a lease for the vessel, then the shipowner will need to use judgment to determine the commencement of the lease term, and thus the commencement of recognizing lease revenue under the contract.

ASC 340-40-25-5 requires an entity to recognize an asset for costs incurred in the fulfillment of a contract if the costs (1) are directly related to the contract, (2) enhance the resources that the entity will use to perform under the contract, and (3) are expected to be recovered. Often a shipowner will have a contract in place with a charterer before it mobilizes its vessel to the load port. In such a situation, the first two criteria are most likely met because (1) the vessel (and therefore the related transportation costs) is directly related to the contract and (2) relocating the vessel enhances the entity's resources (i.e., the vessel) since it puts the vessel in a location that allows the entity to satisfy its performance obligation(s) under the contract. Consequently, a critical assessment for the shipowner to make is whether the transportation costs are expected to be recovered. We believe that this assessment is very dependent on the specific facts and circumstances and could vary across entities and within an entity across its contracts.

In addition, assuming the criteria for capitalization are met, a shipowner may be required to capitalize costs in addition to voyage costs (e.g., crew costs in addition to fuel costs). ASC 340-40-25-7 and 25-8 provide the following guidance regarding costs that should be capitalized and should be expensed as incurred:

25-7 Costs that relate directly to a contract (or a specific anticipated contract) include any of the following:

- a. Direct labor (for example, salaries and wages of employees who provide the promised services directly to the customer)
- b. Direct materials (for example, supplies used in providing the promised services to a customer)
- c. Allocations of costs that relate directly to the contract or to contract activities (for example, costs of contract management and supervision, insurance, and depreciation of tools and equipment used in fulfilling the contract)
- d. Costs that are explicitly chargeable to the customer under the contract
- e. Other costs that are incurred only because an entity entered into the contract (for example, payments to subcontractors).

25-8 An entity shall recognize the following costs as expenses when incurred:

- a. General and administrative costs (unless those costs are explicitly chargeable to the customer under the contract, in which case an entity shall evaluate those costs in accordance with paragraph 340-40-25-7)
- b. Costs of wasted materials, labor, or other resources to fulfill the contract that were not reflected in the price of the contract
- c. Costs that relate to satisfied performance obligations (or partially satisfied performance obligations) in the contract (that is, costs that relate to past performance)
- d. Costs for which an entity cannot distinguish whether the costs relate to unsatisfied performance obligations or to satisfied performance obligations (or partially satisfied performance obligations).

Accordingly, a shipowner should exercise significant judgment when determining:

- Whether an anticipated contract exists (because capitalization of fulfillment costs is not limited to when a contract is in place but also applies when there is a specific anticipated contract).
- Whether costs are expected to be recovered.
- The nature and amounts of the costs related to transportation of the vessel over the ballast leg. For example, in its evaluation of crew costs, a shipowner may exclude payroll related to certain crew members who are required for the delivery of the cargo for the customer but not required for transportation over the ballast leg.

Time Charters

In a time charter, a shipowner gives the charterer exclusive use of a vessel for a given time period — which could range from one month to multiple-year arrangements — in exchange for consideration. The charterer has full discretion over the ports visited, routes taken, vessel speeds (within the limits established in the charter party agreement), and number of trips the vessel makes during the contract term. Contractual restrictions may permit the charterer to send the vessel only to safe ports and carry only lawful cargo. In time charter arrangements, the shipowner is responsible for certain costs such as insurance, crew, and lubricants, while the charterer bears the voyage costs, such as fuel and port charges, during the contract term.

Determining Whether a Contract for a Time Charter Contains a Lease

In a manner similar to the analysis for voyage charters above, an entity should first consider whether the fulfillment of the contract for a time charter depends on an identified asset by assessing whether (1) the vessel is a specified asset and (2) the shipowner has a substantive substitution right. An identified asset may be explicitly specified in the contract or implicitly specified (e.g., implicit identification may occur because of limited assets that can fulfill the specifications in the contract or the customer takes substantially all of the asset's capacity). For a substantive substitution right to exist, the shipowner (1) must have the practical ability to substitute the asset with an alternative asset throughout the period of use and (2) would benefit economically from its right to substitute the asset. Generally, substitution rights for warranty and maintenance reasons are not substantive substitution rights.

1. Is the vessel a specified asset?

Generally, yes. Similarly to a voyage charter, the name of the vessel to be used in a time charter is explicitly specified in the contract.

2. Does the shipowner have a substantive substitution right?

Generally, no. The shipowner must have the practical ability to substitute the vessel and would obtain an economic benefit from substituting the vessel for the substitution right to be substantive. The contractual provisions may explicitly prevent the shipowner from substituting the vessel unless the vessel is damaged. Substitution for damages or repairs is not considered substantive. In addition, the shipowner may not have the practical ability to substitute the vessel being used in a time charter during the period of use because the asset is at sea. However, assuming the shipowner does have the practical ability to substitute the asset, the shipowner would also need to obtain an economic benefit (e.g., the benefit of doing so would exceed the costs of substitution). Given a ship is at sea, it is likely that the costs to substitute the vessel would exceed the benefits related to substitution. Therefore, we would generally expect that it would be rare for shipowners to have substantive substitution rights.

However, while situations in which a substantive substitution right exists in time charter arrangements are expected to be rare, the evaluation is dependent on each arrangement's facts and circumstances. Accordingly, the parties to time charter arrangements should evaluate each contract to determine whether (1) a substitution right exists and (2) the substitution right is substantive.

On the basis of the general assumptions above, it appears that a time charter contract depends on the use of an identified asset. In these cases, the next step is to evaluate whether the charterer has the right to control the use of the vessel during the term of the contract. In doing so, the parties to the time charter should assess whether, throughout the period of use, the charterer (1) has the right to obtain substantially all of the economic benefits from using the vessel and (2) has the right to direct how and for what purpose the vessel will be used.

1. Does the charterer obtain substantially all of the economic benefits from using the vessel?

Generally, yes. In a time charter, the charterer receives the right to substantially all of the economic benefits from using the vessel because it has exclusive right to use the vessel for the term of the time charter. Therefore, the charterer can decide whether to use the vessel to transport its own cargo or allow third parties to transport cargo on the vessel in exchange for consideration.

In addition, if the charterer decides to transport third-party cargo on the vessel, then consideration should be given to whether the arrangement between the charterer and third party represents a lease (which may represent a sublease for which the charterer may be the sublessor) or a service provided by the charterer to the third party.

2. Does the charterer have the right to direct how and for what purpose the vessel will be used?

Generally, yes. In a time charter, the charterer typically directs how and for what purpose the vessel is used because it has full discretion over the ports visited, routes taken, vessel speeds, and number of trips the vessel makes during the contract term. However, because the evaluation is dependent on judgments, the facts and circumstances (including the contractual provisions) need to be examined carefully.

Although the shipowner can prevent the charterer from carrying certain types of cargo (e.g., hazardous or unlawful materials) and transporting the vessel through certain areas (e.g., those prone to piracy), as well as contractual speed limitations, these restrictions would be protective rights because they are protecting the shipowner's interest in the asset. Protective rights generally do not result in the charterer's inability to direct the use of the asset. However, because judgment is needed to assess whether contractual restrictions are protective, restrictions on the charterer's ability to use the asset should be evaluated individually and in the aggregate to determine whether such restrictions are protective rights or restrictions that prevent the charterer from directing the use of the vessel.

On the basis of the facts assumed above, the charterer obtains substantially all of the economic benefits from using the vessel and has the right to direct how and for what purpose the vessel will be used during the contract term. In addition, the vessel is an identified asset. Therefore, the contract for a time charter generally contains a lease.

Considerations Under the New Revenue Standard

Nonlease Components

Although a contract for a time charter generally contains a lease for the vessel, ASC 842 requires the identification of lease and nonlease components. Accordingly, the charterer and shipowner should consider whether the contract contains nonlease components that the parties should account for separately from the lease of the vessel (i.e., goods or services that should be accounted for under ASC 606 for the shipowner or other cost guidance for the charterer).

For example, in time charters, the shipowner is generally responsible for operating and maintaining the vessel. When the shipowner is responsible for these services, the shipowner should separately account for the vessel lease under ASC 842 and the operation and maintenance services under ASC 606 because the shipowner is providing the charterer a benefit apart from the use of the asset.



Connecting the Dots — Practical Expedient for Lessors to Not Separate Lease and Nonlease Components

The January 2018 proposed ASU would amend the new leases standard to provide lessors with an election not to separate lease and nonlease components when the only effects of doing so would be limited to presentation and disclosure differences under ASC 606 and ASC 842. Specifically, application of the practical expedient is expected to be subject to both of the following conditions: (1) the pattern of revenue recognition for the lease and nonlease components must be the same, and (2) the combined, single unit of account must be classified as an operating lease. If either of these conditions are not met, then a lessor would not be able to apply the practical expedient. Further, in applying the practical expedient, the lessor would be required to disclose (1) that it has elected the expedient and (2) the nature of the items being combined.

Comments on the January 2018 proposed ASU are due by February 5, 2018, and will then be subject to redeliberation by the FASB. Shipowners should stay tuned for updates that are expected to occur during the first half of 2018.

However, in anticipation of the FASB's ratification of such change, shipowners that engage in time charters should consider whether they would meet the conditions to apply the proposed practical expedient and, if so, whether the benefits of applying the practical expedient (e.g., reduced complexity) would outweigh the related costs. In addition, shipowners that elect to apply the practical expedient should consider the need to implement appropriate controls to ensure that they apply the election consistently to all classes of underlying assets.

Assuming that a lessor does not elect, or does not meet the conditions to apply, the proposed practical expedient to not separate lease and nonlease components (as discussed above), the lessor (i.e., a shipowner) would allocate the consideration in the contract to the separate lease components (i.e., the vessel) and the nonlease components (i.e., the operation and maintenance services) on the basis of the relative stand-alone selling prices of the components by applying the guidance in ASC 606-10-32-28 through 32-41. In addition, as stated in ASC 842-10-15-38, a lessor would "allocate any capitalized costs (for example, initial direct costs or contract costs capitalized in accordance with [ASC] 340-40 . . .) to the separate lease components or nonlease components to which those costs relate." See the [Transition Considerations for Shipowners](#) section for additional information on how a shipowner would allocate consideration to the lease and nonlease components because ASC 606 and ASC 842 have different effective dates.⁹



Connecting the Dots — Allocation for Lessees

A lessee would allocate the consideration in the contract to the separate lease and nonlease components on a relative stand-alone price basis by using observable stand-alone prices when available. When observable stand-alone prices are not available, a lessee can estimate the stand-alone price by maximizing the use of observable information. However, lessees (i.e., charterers) are permitted to elect, as an accounting policy by class of underlying asset, not to separate lease components from nonlease components and instead account for the entire contract as a single lease component. If a charterer elects not to separate the lease and nonlease components in the contract, this would effectively result in a gross-up of its right-of-use asset and lease liability. This practical expedient was granted to reduce the implementation costs for lessees. In addition, the effects of applying the practical expedient will result in higher right-of-use assets and lease obligations for lessees, which is consistent with the objective of the new leases standard (i.e., for lessees to

⁹ For public companies, ASC 606 is effective for annual reporting periods beginning after December 15, 2017, and interim periods therein. For public companies, ASC 842 is effective for annual reporting periods beginning after December 15, 2018, and interim periods therein (i.e., one year after the effective date of ASC 606).

reflect lease obligations on their balance sheets). As noted above, the FASB tentatively agreed to provide lessors with a similar practical expedient if certain conditions are met.

Variable Consideration

Similarly to a voyage charter, a time charter contract may include variable consideration — for example, (1) market-based time charters, whereby the rates are based on published indices, or (2) profit sharing arrangements, which are sometimes part of a fixed-rate time charter arrangement that enables the shipowner to earn additional consideration if an established market index exceeds a predetermined rate. In addition, to the extent that the vessel does not meet specified performance criteria, there could be a reduction to the contract consideration through performance claims. The charterer and shipowner should consider whether those variable payments relate to the lease or nonlease components in the contract. If the payments relate to the lease components (i.e., the payments are not distinct from the leased vessel), such amounts would represent variable lease payments. Variable lease payments that do not depend on an index or rate are excluded from the calculation of lease payments (and the right-of-use asset and lease obligation that the charterer would recognize on its balance sheet) and recognized in the period in which the variability is resolved.

Conversely, if variable consideration relates to nonlease components, the shipowner should apply ASC 606 (assuming that it does not elect the proposed practical expedient to not separate lease and nonlease components). That is, the shipowner should estimate the variable consideration (subject to the constraint) and update its estimate each period.

See [Variable Consideration](#) in the Voyage Charter section for additional information.

Contract Costs

Because a time charter would generally be viewed as a lease and would typically include nonlease components related to the operation and maintenance of a vessel, shipowners would need to consider the capitalization and allocation of costs related to obtaining the contract. That is, a lessor would need to consider both initial direct costs (defined in ASC 842 as “incremental costs of a lease that would not have been incurred if the lease had not been obtained”) and costs to obtain a contract in accordance with ASC 340-40 for revenue contracts. Specifically, in accordance with ASC 842-10-15-38, a lessor should allocate initial direct costs to all lease components and allocate other capitalized costs under ASC 340-40 to nonlease components. However, such an allocation may not be necessary if the FASB finalizes the amendments in its January 2018 proposed ASU that would permit lessors that meet certain conditions to not separate lease and nonlease components. For more information, see [Connecting the Dots — Practical Expedient for Lessors to Not Separate Lease and Nonlease Components](#).

In addition, because a shipowner provides operating and maintenance services and such services typically meet the conditions to recognize the related revenue over time, fulfillment costs related to nonlease components are generally recognized in the income statement as the related revenue is recognized.



Connecting the Dots — Lessor Costs to Ready the Asset Under Lease

ASC 842 provides guidance on accounting for initial direct costs of a lease. Paragraph BC222 of ASU 2016-02 explains that initial direct costs are generally limited to commissions or payments made to existing tenants to obtain a lease. Because certain costs incurred by a shipowner to ready the vessel for its intended use are not incremental to obtaining a lease, such costs would not meet the definition of an initial direct cost. Because the cost accounting guidance in ASC 842 is limited to initial direct costs, questions have arisen about how a lessor (e.g., shipowner) would account for certain costs to ready the asset subject to the lease (e.g., the vessel) for its intended use before the lease commences.

Assuming that the activities to ready the asset before lease commencement are not separate nonlease performance obligations (i.e., distinct services), we generally believe that costs incurred by a lessor to ready an asset are akin to contract fulfillment costs because the lessor is required to incur such costs to fulfill its obligation under the contract. However, the new leases standard does not include specific guidance that addresses the accounting for fulfillment costs related to leases. That is, while ASC 340-40 addresses fulfillment costs for an entity that provides a good or service in a revenue contract (or a nonlease component in a lease contract), it does not include leases (or lease components) in its scope.

Accordingly, because (1) costs to ready lease assets before lease commencement (e.g., ballast costs to bring a ship to the lessee) are akin to contract fulfillment costs for a shipowner as the party earning revenue (i.e., lease revenue) in the arrangement and (2) there is no other explicit guidance that addresses costs a lessor incurs to ready an asset under lease, it is our opinion that it would be appropriate for a shipowner to consider the contract fulfillment guidance in ASC 340-40 to account for such costs, including initial and subsequent recognition and measurement. For example, a shipowner would begin by analyzing the criteria in ASC 340-40-25-5 to determine whether the costs meet the criteria to be capitalized, which include assessing whether the costs (1) relate directly to a contract or an anticipated contract, (2) generate or enhance resources that the shipowner will use to satisfy its future performance obligation(s), and (3) are expected to be recovered.

However, this issue continues to evolve, and it is possible that the FASB and SEC will want to share perspectives, which may include implementation guidance. Shipowners should consult with their accounting advisers and monitor developments on this topic.

For additional considerations about fulfillment costs related to the ballast voyage, see [Connecting the Dots — Capitalization of Fulfillment Costs Over the Ballast Leg](#).

Bareboat Charters

A bareboat charter, also known as a demise charter, is an arrangement for the hiring of a vessel in which the shipowner provides no administration or technical maintenance services. Under these arrangements, the charterer obtains possession and full control of the vessel and bears responsibility for the vessel's operation (including crew), maintenance, and voyage costs. Restrictions similar to those noted above for time charters also commonly exist in bareboat charter agreements.

Determining Whether a Contract for a Bareboat Charter Contains a Lease

A typical bareboat charter is a lease for the following reasons:

- There is an identified asset. The agreement typically names the vessel, and therefore the asset is explicitly specified. Further, the shipowner has no legal right to substitute the asset. Consequently, the assessment of whether the shipowner has a substantive substitution right is not applicable.
- The charterer has the right to control the use of the identified asset.
 - The charterer's exclusive use of the vessel during the period of use is evidence of the charterer's right to receive substantially all of the economic benefits from the vessel during the period of use.
 - The charterer has the right to direct the use of the asset because it has full discretion over how often and where the asset can sail. In addition, the charterer is responsible for providing the crew and maintaining the vessel. In doing so, the

charterer controls the crew regarding its activities in operating and maintaining the vessel. While there are contractual restrictions regarding the locations to which (or through which) the vessel can sail and the cargo it can carry, these are protective rights that do not prevent the charterer from having the right to direct the use of the vessel.

Although our general view is that a bareboat charter represents a lease, each contract should be evaluated on the basis of the contract's facts and circumstances.

Considerations Under the New Revenue Standard

Unlike the charterer in a time charter, the charterer in a bareboat charter has control over all of the operating and maintenance activities. For example, the charterer has the ability to operate the vessel on its own, but may also contract with a third party to operate the vessel. In either situation, the charterer retains control over the operations of the vessel, such as directing the captain of the vessel to maintain specific speeds. Certain protective rights may exist, such that the charterer cannot direct the captain of the vessel to exceed a certain speed; however, these protective rights generally would not affect the charterer's ability to direct the use of the vessel.

Because the charterer in a bareboat charter controls the operations and maintenance of the vessel and does not pay the shipowner to receive those services under the contract, the contract generally does not contain any nonlease components. Thus, it does not appear that any portion of the contract would be within the scope of the new revenue standard. Rather, in the absence of the identification of other obligations or services in the agreement, the contract as a whole would generally be accounted for within the scope of the new leases standard.

Contract Costs

Because the contract for a bareboat charter will generally be accounted for entirely within the scope of the new leases standard, any costs incurred by the shipowner and the charterer (e.g., commissions paid to brokers) should be analyzed to determine whether they meet the definition of an initial direct cost under the new leases standard. Accordingly, such costs may include commissions, but also may include payments made to an existing tenant (e.g., existing charterer of the vessel) to incentivize the tenant to terminate its lease. Initial direct costs should be capitalized and amortized over the lease term.

In addition, a shipowner should assess whether there are fulfillment costs that should be capitalized (e.g., costs to deliver the vessel to the lessee before the lease commences). For more information, see [Connecting the Dots — Lessor Costs to Ready the Asset Under Lease](#).

Transition Considerations for Shipowners

Separation of Lease and Nonlease Components Upon the Adoption of ASC 606

As stated in ASC 606-10-15-2, the new revenue standard does not apply to lease contracts within the scope of ASC 840 (or ASC 842, upon adoption of the new leases standard). Although lease contracts are generally outside the scope of the new revenue standard, ASC 606-10-15-4 states that a "contract with a customer may be partially within the scope of [ASC 606] and partially within the scope of other Topics listed in paragraph 606-10-15-2." An example of a contract that may be partially within the scope of ASC 606 and partially within the scope of another ASC topic is a lease contract entered into by a lessor that contains both lease and service elements.¹⁰

¹⁰ Note that this would not apply to lessees because a lessee does not perform services or generate revenue under a lease contract.

Under current lease accounting guidance, the scope guidance in ASC 840-10-15-19 states the following (pending content effective upon adoption of the new revenue standard {in braces}):

For purposes of applying this Topic, payments and other consideration called for by the arrangement shall be separated at the inception of the arrangement or upon a reassessment of the arrangement into:

- a. Those for the lease, **including the related executory costs and profits thereon**
- b. Those for other services on a relative fair value basis {relative standalone selling price basis}, consistent with the guidance in paragraph 605-25-15-3A(b) {paragraph 606-10-15-4 and paragraphs 606-10-32-28 through 32-41}. [Emphasis added]

ASC 840 further states that executory costs (such as a lessor's property taxes, insurance, and maintenance) are excluded from the lessor's minimum lease payments for lease classification and measurement. Although these costs are excluded from the lessor's minimum lease payments, the costs are generally still considered part of the lease contract in accordance with ASC 840-10-15-19(a) rather than "other services" or substantial services¹¹ that are separated and excluded from the scope of ASC 840 and therefore typically within the scope of revenue recognition guidance (historically, under ASC 605 or industry guidance). That is, executory costs are not separately accounted for under legacy revenue recognition guidance in ASC 605. In vessel charter arrangements, other or substantial services would include crew services provided by the shipowner. Crew services typically encompass activities necessary to navigate and operate a vessel during a contract period. However, crew members typically also perform maintenance activities that an entity may view as executory costs. Therefore, an entity's evaluation of whether activities performed by crew members are executory costs or substantial services often requires judgment.

In addition, ASC 605-25-55-3 clarifies, through an example, when the ASC 605 allocation guidance should be applied and when the ASC 840 allocation guidance should be applied as follows:

For example, leased assets are required to be accounted for separately under the guidance in Subtopics 840-20 and 840-30. Consider an arrangement that includes the lease of equipment under an operating lease, the maintenance of the leased equipment throughout the lease term (executory cost), and the sale of additional equipment unrelated to the leased equipment. The arrangement consideration should be allocated between the deliverables subject to the guidance in Subtopic 840-20 and the other deliverables using the relative selling price method. (Although Topic 840 does not provide guidance regarding the accounting for executory costs, it does provide guidance regarding the allocation of arrangement consideration between the lease and the executory cost elements of an arrangement. Therefore, this example refers to the leased equipment and the related maintenance as deliverables subject to the guidance in that Topic.) The guidance in Topic 840 would then be applied to separate the maintenance from the leased equipment and to allocate the related arrangement consideration to those two deliverables. This Subtopic would be applied to further separate any deliverables not subject to the guidance in Topic 840 and to allocate the related arrangement consideration.

In accordance with the illustrative example above, deliverables within the scope of lease guidance (including both the leased asset and executory costs) would be within the scope of ASC 840 and subject to the allocation guidance in ASC 840. However, the separate deliverable of the sale of additional equipment would not be covered by ASC 840 and would instead be subject to the accounting and allocation guidance in ASC 605.

In contrast to this approach under ASC 840, upon adoption of the new leases standard, a lessor will be required to separate lease and nonlease components in a contract (unless it elects the proposed practical expedient to not separate lease and nonlease components). As illustrated above, a common example of a nonlease component under ASC 842 is maintenance services performed by the lessor, which may be currently accounted for as an

¹¹ "Substantial services" is a term used in EITF Issue No. 01-8, "Determining Whether an Arrangement Contains a Lease," to differentiate services not accounted for under lease accounting from executory costs accounted for under lease accounting. This distinction between maintenance services, which are executory costs that historically have been accounted for under ASC 840, and substantial services, which historically have been accounted for under ASC 605, was raised in EITF Issue No. 08-2, "Lessor Revenue Recognition for Maintenance Services," but was not further clarified.

executory cost under ASC 840. That is, upon a lessor's adoption of ASC 842, maintenance services will be considered a service within the scope of ASC 606 rather than an executory cost accounted for under lease accounting guidance. Because the effective dates of ASC 606 and ASC 842¹² are not the same, questions have been raised about whether and, if so, when a lessor would be required to separate nonlease components currently accounted for as executory costs (e.g., maintenance services) and account for those activities as services within the scope of ASC 606. Specifically, stakeholders have questioned whether a lessor would be required to separately account for maintenance services under ASC 606 (1) upon the adoption of ASC 606, (2) upon the adoption of ASC 842, or (3) in some other manner.

After these questions were raised, we participated in informal meetings with both the FASB staff and the SEC staff to discuss the interaction between ASC 606 and ASC 842 and how adoption of the new revenue and new leases standards will affect the accounting for nonlease components (e.g., maintenance services). On the basis of our discussions with both parties, our understanding is that a lessor would not be required, upon adoption of the new revenue standard, to separate existing executory costs accounted for under ASC 840 that will meet the definition of a nonlease component under ASC 842 (e.g., maintenance services) and account for those activities as services within the scope of ASC 606. However, we believe that while a lessor would not be required to separate nonlease components, it would be acceptable for a lessor to elect to separate nonlease components and account for them as revenue-generating activities upon adoption of ASC 606.

Upon adoption of ASC 842, a lessor's accounting for executory costs that historically have been accounted for under ASC 840 will depend on whether the lessor's lease classification changes under ASC 842. Specifically, a lessor should consider the following:

- *Lease classification does not change* — If a lessor's lease classification does not change upon adoption because the lessor either (1) elects to apply the practical expedients in ASC 842-10-65-1(f) and (g) (collectively, the "practical expedients"), which allow an entity not to reassess lease classification on its existing contracts, or (2) does not elect to apply the practical expedients and instead elects to reevaluate classification, but the lease classification does not change (or changes only from sales-type to direct finance) upon reassessment at transition, the lessor should account for the remaining periods of the lease as if it were "running off" its current lease accounting treatment. As a result, the lessor should continue to account for all executory costs under ASC 840, including maintenance services, as part of the lease component. That is, the lessor should not separate maintenance services from the lease component and, accordingly, should not account for maintenance services under ASC 606.
- *Lease classification changes* — If a lessor's lease classification changes upon adoption of ASC 842, the lessor must apply the guidance in the new leases standard on separating components of a contract as of the beginning of the earliest period presented under ASC 842, which, for calendar-year public entities, is January 1, 2017. Accordingly, the lessor would be required to separate, and allocate consideration to, nonlease components, which would most likely include maintenance services activities. These nonlease components would be accounted for under the revenue recognition guidance in ASC 606 (assuming that the lessor does not elect the practical expedient to not separate lease and nonlease components).

In contrast to the discussion above on executory costs (including maintenance services), an entity should account for "other services" or substantial services that are not within the scope of ASC 840 in accordance with the guidance in the new revenue standard as of the effective date applicable to the entity.

¹² See footnote 9.

Reallocation of Consideration Upon the Adoption of ASC 606

At its June 21, 2017, Board meeting, the FASB addressed another transition question about whether (1) the application of ASC 606 to prior periods in transition should have an impact only on the revenue components of a contract or (2) a lessor is required to reassess the accounting for the entire contract, including lease components. The accounting for the lease components could change if the transaction price is allocated on a relative stand-alone selling price basis and the amount allocated to the lease components is affected by the adoption of ASC 606 (e.g., the lease classification could change).

The Board decided that an entity is not required to reallocate contract consideration between revenue and lease components when it adopts ASC 606. That is, application of the new revenue standard should affect only the accounting for the revenue components of contracts and should not affect the accounting for the lease components.

For example, assume that a five-year contract includes a lease component accounted for under ASC 840 (or ASC 842, if early adopted) and a substantial service accounted for under ASC 605. Consideration for the contract is \$150,000 (or \$30,000 per year), of which \$100,000 was allocated to the lease component and \$50,000 was allocated to the service. In addition, assume that the contract provides the right to renew the substantial service at a significant discount and that this right would be identified as a material right under ASC 606 but was not identified as a separate unit of accounting under ASC 605. Upon transition to ASC 606, the entity determines that there are three components or performance obligations in the contract: (1) the lease component, (2) the substantial service, and (3) the material right. On the basis of the FASB's view expressed above, only the \$50,000 that was previously allocated to the substantial service would be reallocated between the two revenue elements (the substantial service and the material right). The \$100,000 that was originally allocated to the lease component under ASC 840 would not be reallocated as a result of adopting ASC 606.

Vessel Pool Arrangements

In addition to contracting directly with customers for the chartering of a vessel, shipowners may enter into pooling arrangements, which provide the benefits of a large-scale operation and chartering efficiencies that might not be available to smaller fleets.

Under a pool arrangement, a group of shipowners pool their vessels together and authorize a third party (the "pool manager") to negotiate and manage the chartering of the vessels to customers. Unlike a typical spot or time charter, in which the shipowner contracts directly with the customer for the use of a vessel, the charter (i.e., revenue) negotiations for a pooled vessel are conducted by the pool manager. Vessels contracted under a pool arrangement are generally chartered to customers in the spot market, but the pool manager may charter the vessels under short- or longer-duration time charters as well, depending on the pool arrangement between the shipowner and the pool manager.

Shipowners in a pool arrangement share in the revenue generated by the entire group of vessels in the pool, regardless of the performance of the individual vessel, as long as the vessel is available for hire. Pool members generally receive a proportionate share of the pool revenue in accordance with a point system that allocates a certain number of points to each vessel in the pool. The number of points are assigned (or allocated) to each vessel on the basis of the vessel's performance, age, consumption, speed, and other factors on a competitive basis compared to other vessels in the pool. When the vessel is not available for hire (such as when a vessel is in drydock), the shipowner generally is not entitled to payment.

A vessel pool arrangement is similar to a time charter arrangement in that the voyage costs, such as cost of bunkers and port expenses, are borne by the pool, and operating costs including crews, maintenance, and insurance are typically borne by the shipowner for its vessels in the pool.

Considerations for Shipowners and Pools

Some have questioned how a shipowner should account for its participation in a pooling arrangement. Specifically, questions have arisen about whether an arrangement between the shipowner and the pool (and the pool manager) contains a lease. We believe that the determining factor for whether the contract contains a lease depends on whether (1) the shipowner considers its customer in the arrangement to be the pool or the end charterer and (2) the pool is the principal or the agent in the arrangement to contract the vessel to the end charterer.

Therefore, a shipowner and the pool in an arrangement to contract a pool vessel to an end charterer should assess who is the principal and agent in the arrangement (i.e., perform an assessment in a manner consistent with the principal-versus-agent guidance in ASC 606 or ASC 605 as applicable for the entity). Such evaluation should consider the rights and obligations of both parties to determine whether their rights under the arrangement are indicative of control of the vessel or protective rights. For example, a shipowner may have certain protective rights that do not affect the pool's ability to control the vessel.

The following are additional factors a shipowner and pool would likely consider when evaluating who the principal is in the arrangement with the end charterer; that is, whether:

- The contract with the end charterer specifically names the pool, rather than the shipowner (i.e., the shipowner is not a party to the contract with the end charterer).
- The pool is responsible for managing issues that may arise during the end charterer's use of the vessel (i.e., the end charterer expects the pool, rather than the shipowner, to resolve any issues).
- The pool has the power to decide which vessel in the pool it will use to fulfill the contract with the end charterer.
- The pool sets the prices that the end charterer will pay to use the vessel.

After performing a principal-versus-agent analysis, the shipowner and the pool should consider whether the contract between the shipowner and the pool (i.e., for the use of the shipowner's vessel) contains a lease. Assuming the pool is the principal in the arrangements with end charterers, we believe that a contract between the shipowner and the pool will generally contain a lease, in part, because:

- There is a specified asset. That is, the vessel is named in the arrangement between the shipowner and the pool and generally, there are no substitution rights.
- The pool has the right to receive substantially all of the economic benefits of the use of the asset.
- The pool (through the pool manager) directs the use of shipowner's vessel. The shipowner does not contract directly with the end customer; rather, it contracts with the pool and the pool, in turn, contracts with the end customer. As a result, the shipowner has limited visibility into whether, when, and to whom the vessel is chartered, and the customer has limited visibility into the shipowner of the vessel being used to transport its cargo.



Connecting the Dots — Implications of Leases Contained in a Contract Between a Shipowner and a Pool

In accordance with ASC 842, when a contract between a shipowner and a pool for the pool's use of the shipowner's vessel contains a lease, the parties will need to bifurcate lease components and nonlease components (e.g., for crew services), unless certain practical expedients are elected. (See [Connecting the Dots — Practical Expedient for Lessors to Not Separate Lease and Nonlease Components](#) and [Connecting the Dots — Allocation for Lessees](#)). The parties will also need to determine the classification and measurement for any lease components in the contract.

Classification and measurement will depend on the term of the lease and the lease payments during the term. Generally, the term related to a pool's use of a shipowner's vessel is less than a year because the shipowner is able to remove its vessel from the pool at any time subject to a notice period that is typically between 90 and 180 days. In addition, there are no lease payments (i.e., no fixed payments) because the pool will pay a variable amount to each shipowner on the basis of the pool's performance and the allocation of points to each shipowner.

As a result, the shipowner (as lessor) would classify the lease as an operating lease. Accordingly, the shipowner would continue to account for the vessel as an asset in its financial statements and would record lease revenue each period as the variability associated with the lease payments is resolved. The pool, as lessee, could elect to apply the short-term lease exemption; this would result in the pool accounting for the lease in a manner similar to an operating lease in accordance with ASC 840. That is, the pool would not record a right-of-use asset and lease obligation and would record lease expense each period, as the variability associated with the lease payment is resolved.

Considerations for Pools and End Charterers

A pool should perform a separate evaluation to determine whether its contract with an end charterer is or contains a lease. An end charterer should also assess whether its contract with a pool contains a lease. Because the form of the contracts between a pool and end charterer may vary, different conclusions may result. Consequently, we encourage pools and end charterers to analyze the specific terms and conditions of their contracts to determine the appropriate accounting in accordance with ASC 842 and ASC 606.

Other Implementation Considerations

The requirements of the new revenue and leases standards may present significant implementation challenges for entities during the period of transition and beyond, including the following:

- Evaluating new requirements that will involve the use of significant judgment, including estimates related to recognition on the balance sheet and income statement.
- Selecting and applying the transition requirements in the new revenue and leases standards.
- Managing the complexities of data collection, storage, and maintenance for a potentially large population of contracts.
- Enhancing information technology systems to perform the necessary calculations and reporting requirements.
- Refining internal controls and other businesses processes related to the identification and capture of contracts subject to the new accounting and disclosure requirements.

- Determining whether debt covenants will be affected and, if so, working with lenders to avoid violations.
- Identifying and addressing income tax effects.

Increased Use of Judgment

Management will need to exercise significant judgment in applying certain of the requirements in ASC 606 and ASC 842, including those related to the identification of lease and nonlease components and allocation of consideration to each component. An entity's judgment in distinguishing between leases and services becomes more critical under the new guidance, since almost all leases will be recognized on balance sheet. In addition, judgment is often required in the assessment of a lease term and commencement of revenue recognition. It is important for shipping entities to consider how the new standards specifically apply to them so that they can prepare for any changes in the timing, pattern, and classification of revenue recognition.

Retrospective Application

The new revenue standard requires entities to apply the standard either on (1) a full retrospective basis or (2) a modified retrospective basis to the latest period presented. The new leases standard, as originally issued in ASU 2016-02, required entities to apply the standard on a modified retrospective basis to the earliest period presented in the financial statements. However, the amendments in the FASB's January 2018 proposed ASU would provide entities with an election not to restate their comparative periods in the period of adoption when transitioning to the new leases standard, which we believe would be similar to the modified retrospective transition method under the new revenue standard. Both new standards provide optional practical expedients that entities can use at their discretion. As a result, entities in the shipping industry may need to review contracts that commenced several years before the effective date of both new standards. In addition, entities in the shipping industry will most likely be required to perform dual tracking of balances during the retrospective period given the potential difficulty of retroactively recalculating such balances when the new standards become effective.

Data Management, Systems, Processes, and Controls

To comply with the new accounting and disclosure requirements required by ASC 606 and ASC 842, entities in the shipping industry will have to gather and track information that they may not have previously monitored. The systems and processes associated with such information may need to be modified to support the capture of additional data elements that may not currently be supported by legacy systems. Further, to ensure the effectiveness of internal controls over financial reporting, management will want to assess whether it should implement additional controls. Entities in the shipping industry may also need to begin aggregating essential data from new and existing contracts since many of these contracts may be subject to the new standards.

Note that the above are only a few examples of changes entities in the shipping industry may need to make to their systems, processes, and controls. These entities should evaluate all aspects of ASC 606 and ASC 842 to determine whether any other modifications may be necessary.

Getting Started

Entities in the shipping industry should develop a robust plan and establish a cross-functional implementation team to ensure an efficient and timely approach to implementation. In developing such a plan, they should consider:

- Performing a current-state assessment of their revenue and lease portfolio, including product, service, and lease volumes and types, availability of electronic data and data gaps, and any potential changes related to accounting, taxes, or processes.
- Establishing a granular project plan and roadmap to manage the effort across multiple functions, business units, and countries, as necessary.
- Developing an approach to, and the resources to perform, the gathering and abstraction of the data.
- Determining their specific system requirements and developing a plan for enhancing system capabilities to satisfy the new storage, calculation, and reporting requirements while keeping in mind the associated internal control implications.
- Assessing the impact on their key metrics and debt covenants.

Time is truly of the essence. For calendar-year-end public business entities, the new revenue standard is now effective. However, as the effective date of the new revenue standard (for nonpublic entities) and the new leases standard (for all entities) quickly approaches, the most important action an entity can take is to start the efforts related to this accounting change now. It can be a challenge to anticipate the data gaps and overcome the data abstraction hurdle, but with adequate support and sufficient time, it can be achieved. By planning properly, entities in the shipping industry can help ensure that their transition to the new revenue and leases standards is smooth and successful.

How Deloitte Can Help

Deloitte Expertise

Deloitte professionals both in the United States and globally across the member firms of Deloitte Touche Tohmatsu Limited are equipped with the latest tools and technology to help you develop and execute an action plan for implementing the new revenue and leases standards.

Our services include help with accounting interpretations, process revisions, system changes (including development of system business requirements), new system implementations, and tax analysis. Specific areas of assistance include but are not limited to:

- *Contract assessment* — Reviewing existing contracts to determine the new standards' effect.
- *Data challenges* — Gathering data from various locations (both physical contracts and system information) and creating a standardized gathering framework.
- *Process challenges* — Implementing a standardized process for consistent reporting and application throughout an entity.

Deloitte Tools

Deloitte has developed a suite of user-friendly, Web-based tools to help shipping entities maintain lease data and perform lease calculations under the new leases standard. These tools can help automate the process of analyzing and abstracting lease contracts; manage a centralized, secure repository; and identify and address key data deficiencies associated with leases.

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