Singapore Shipping Association

Ref: SSA/302/10

8 December 2010

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sirs

IFRS EXPOSURE DRAFT ("ED") ON LEASES (AUGUST 2010)

The Singapore Shipping Association (SSA) is a national trade association that represents almost 400 companies drawn from a wide spectrum of the shipping industry comprising mainly shipowners, charterers, operators and ship managers – collectively, they control over 2,500 vessels which are principally Singapore flag and totaling some 100 million deadweight tons, as follows:

- Owned by SSA members - 1220 vessels, 37.5 million dwt
- Managed by SSA members - 958 vessels, 43.1 million dwt
- Chartered/Operated by SSA members - 554 vessels, 21.7 million dwt

In addition, the Association also counts ship agents and various other ancillary companies such as shipbrokers, marine insurers, marine lawyers, ship financiers and financial accounting firms among its members.

Formed to promote the interests of its members and to enhance the competitiveness of Singapore as an International Maritime Centre, the SSA supports the International Accounting Standards Board's (IASB) and the US Financial Accounting Standards Board's (FASB) stated goal of reducing diversity in accounting treatments and complexity of lease accounting.

SSA maintains, however, that the proposed standard to remove the distinction between finance and operating leases is incompatible with operational practices of the shipping industry, and will in fact increase the complexity of lease accounting.

In summary, we are of the strong opinion that the proposed standard should not be introduced.

1. An Introduction to Charters

Chartering of ships is one of the foundations of the entire shipping industry, an industry that carries over 90% of the world's trade.

Whilst there are many forms of charter of varying lengths, for the purpose of this paper, the SSA will focus on summarising main types of charter relating to whole ships. For clarity's sake, the phrases "*charterer-in*" and "*charterer-out*" will be used to describe the two parties in the transaction.

- ***Voyage Charter***

  The charterer-in pays a fixed sum for the ship to carry a cargo from Point A to Point B. As operational control remains with the charterer-out, all costs and risks of delay incurred as a result of the vessel being employed on the voyage will be paid by the charterer-out.

- ***Time Charter***

  The charterer-in charters a vessel on time basis, the duration of which could be restricted to the length of the intended voyage itself, or for a prolonged period such as a minimum of six months, with options to extend the charter for a longer period. Remuneration to the charterer-out takes the form of "charter hire", which is a sum per day or pro-rated. In addition, under a time charter, the charterer-out's commercial involvement in the voyage is minimal, as the charterer-in assumes operational control of the ship on the voyage, as well as the risks of voyage performance upon themselves.

- ***Bareboat Charter***

  Under specific circumstances, the charterer-in enters into a time charter with the charterer-out, whereby in addition to a time charterer's duties, he assumes all other aspects of ownership such as crewing, repair and maintenance, but excluding repayments on the ship back to the financial institution(s) responsible for the ships' financing. For all intents and purposes, the charterer-in operates the vessel as if he owns it for the duration of the charter, which may vary from a month or to several years.

2. Our views and comments

- **General Comments**

Ship owning and ship operating companies act as both lessors and lessees, and in some cases, intermediate lessees/lessors.

Furthermore, in shipping, debt financing and leasing are important aspects of business and key to business growth. The recognition of lease liabilities under the proposed standard will have a detrimental impact on gearing for many of our ship owning and operating companies, resulting in potential breaches or renegotiation of many financial covenants associated with debt agreements.

As such, from the perspective of the shipping industry, the SSA is extremely concerned – as growth models for the shipping industry revolve solely around the purchase and/or charter of new vessels, the SSA cannot accept a situation where its ship owning and ship operating members are forced to focus on financial engineering instead of the acquisition of new vessels, growth will be stifled.

- **Ship Financing**

The proposed standard, if adopted in its current form, will deter the lease of assets.

Traditionally, it is common for ship financiers (including leasing companies) to extend credit facilities by entering into sale and leaseback arrangements associated with ships with ship owners or ship operators.

The recognition of a lease liability by the ship owners or operators (the lessee) will lead the lessee to reconsider the use of a sale and leaseback arrangement as an attractive financing scheme.

The traditional use of sale and leaseback of asset, as an alternative financing tool available to the shipping industry, will therefore become less attractive and curb credit financing activities in the shipping industry.

- **Compatibility with Actual Industry Practice**

The removal of the differences between operating and finance leases in the proposed standard may have "simplified" lessee lease accounting, but the introduction of the "performance obligation" and the "derecognition" approaches to be assessed by the lessors, on a lease-by-lease basis, has increased complexity in financial reporting and may potentially distort the financial statements of lessors.

In shipping, the consideration as to whether a ship owner or operator (or lessor) retains exposure to significant risks or benefits associated with the ship can never be an easy one. Given the cyclical nature of freight rates across the different market segments commonly found in the shipping industry and the highly volatile market for ship valuation, an accurate assessment of the factors such as estimated period of lease, the extent of contingent rentals embedded in lease payments, as well as the options to extend or terminate the lease, can never be objectively and easily made, thereby making the evaluation of a suitable approach for lessor to adopt in lease accounting, ie "performance obligation" or "derecognition" model to be extremely difficult.

Furthermore it is common for ship owner and operator to act as intermediate lessee/lessor, using one of the chartering methods listed above.

The application of the proposed lease accounting model to the head lease and the proposed lessor accounting to the sub-leases, which also has the potential effect of rendering economically identical head lease and sub-lease being measured differently, will cause confusion to users of the intermediate lessee/lessor's financial statements – this will be explained further in **Annex 1**, which is an illustration of the accounting impact on the Income Statement, Balance Sheet and the Cash Flow Statement for container shipping.

An illustration of the impact of the proposed standard from the perspective of the offshore sector is also attached for reference as **ANNEX 2**.

In practice, subleases are common and there are some arrangements that intermediate lessors treat as a pass-through. The ED does not discuss the possibility that an intermediate lessor may act as agent, and does not comment on whether the guidance in the Revenue ED would apply to lease contracts, or on whether the guidance in IAS 39 on offsetting financial assets and liabilities would apply to an intermediate lessor's leases asset and lease liability.

Under current practices, the SSA assumes that *voyage charters*, (where there is no effective control of the ship by the charterer-in and the transaction is essentially the same as booking cargo space) will not be considered as leases rather than as purchase of service, we do not foresee any additional complications.

It also raises the question about the usefulness of lessor accounting when it was merely created to avoid inconsistencies with the proposal on lessee lease accounting. Since the proposed standard provides simplified lease accounting for short-term leases less than 1 year, and allows ship owners (lessors) to derecognise assets and liabilities associated with the lease contract, the structuring of shorter term leases under 1 year may become more common and therefore challenges the practical application of lessor accounting as prescribed in the proposed standard.

The situation is further complicated for time charters – whilst time charters are leases, the charter rates could incorporate service elements (eg. technical management support, crewing etc) that are outside the scope of IAS 17. Under the ED, the lessee and lessor would need to assess whether the service component is distinct and whether it is practicable to allocate the payments between the service and lease components.

As such, separation of the charter rates into payments for the lease (ie. the right to use the asset) and service elements could involve considerable judgment and whether the process is auditable is yet untested. Failure to perform such segregation is likely to overstate the liabilities associated with the lease obligations on the balance sheet

- **Inconsistent Treatment for Lessor and Lessee**

Although a single accounting model has been adopted for the lessee, a dual model has been granted to the lessor. Lessors have to assess whether they retain exposure to significant risks or benefits of the underlying assets in order to make a decision as to whether to what extent they recognize the asset (ie the ship) on their books, whereas lessees only have to recognize right of use assets on their books.

Furthermore, there is a distinct possibility that the lessee and lessor will both record a specific asset in their books resulting in a "doubling-up effect" (physical asset and right-to-use asset). In addition, the requirement of both lessee and lessor to estimate contingent rentals and renewal options may lead to inconsistent measurement effect by the two companies involved.

The SSA cannot accept a proposal where a standard for lessee accounting has been established without a complete lessor accounting model that is conceptually consistent and aligned with the proposed model for lessees. As it stands, the proposals put forward by the IASB and FASB will not provide an accurate, faithful representation of a shipping company's financial position and operations.

- **Industry Volatility**

The shipping industry is extremely dependent on the state of the global macroeconomy and is susceptible to volatility in charter rates, vessel values and industry profitability. Whilst the dry bulk trade is typically cited as an example of industry volatility, the same applies to other sectors such as the container and tanker markets.

As such, the SSA is extremely concerned that the ED's proposal that a lessee should recognise a right-of-use asset and a liability to make payments will force lessees to make use of best-guess estimates for which a great deal of uncertainty exists, and the initial recognition of amounts for contingent rentals that may not occur.

Furthermore, the lease arrangements reached at inception may subject to further changes in response to changes in the market conditions that would also make the re-estimation of the right of use asset and the associated liability to be more confusing to users of the entity's financial statements.

In addition, the liability recognised by lessees might include amounts that do not represent present obligations of the lessee or meet the definition of a liability. The burden that would be borne by lessees in preparing financial statements under the proposed model would, in many cases, outweigh the benefits of providing this information.

Under the proposed model, we believe that situations could arise where the right-of-use asset recorded by the lessee exceeds the fair value of the underlying asset, in which case the company will have an impairment issue and may need to write down to the recoverable amount. This may cause confusion to users of financial statements when the right-of-use asset is subject to re-assessment of the estimates involved.

- **Cost of Compliance**

The industry is also extremely concerned that the complexity of the proposed standard will place an increased compliance burden, especially if large numbers of charter transactions were to be effected.

The situation would be even more unacceptable if the computations potentially require reassessment each year, such as for contingent rentals and lease-term periods. For contingent rentals, we would prefer a "best estimates" approach of the cash flows which would not include probability imputation. For lease-term periods, we disagree with the definition of "lease term" under para. 13 of the ED, and that it should not take into account the effect of any options to extend or terminate the lease.

Furthermore, shipping companies may also have to consider the effect of exchange differences in circumstances where the functional currency of the company is not aligned with the currency in the charter contract. In this scenario, it would be impractical for companies to consider the fluctuation in the exchange rate used to compute the lease-projections at every reporting period-end.

Whilst shipping companies may not be classed as "small and medium sized enterprises" as a result of the large transaction values, many ship operators, especially those who are solely charterers-in and have no other ship operating activity, would find such complexity both burdensome and expensive to satisfy.

The assessment of the lease term, renewal options and contingent rents, in particular, will add considerable complexity to lease accounting, especially in the year of transition, and on an ongoing basis in the case of vessels engaged on short-term charters (e.g offshore support vessels) of not less than 12 months.

While the standard seeks to provide investors with a better understanding of the leasing activity, the ED requires both the lessees and lessors to make use of best-guess estimates. The lessors are put in a more onerous position as they would in fact, have to second guess the proposed actions of the lessees in order to assess the lease term, contingent rentals and renewal options. With so much uncertainty involved, it is natural that these estimates may not materialise at the end of the day. From this perspective,despite the increase in compliance burden for companies, the new standard may confuse users of the financial statements instead of providing them with a better understanding of the activity

In addition, users of the financial statements are already familiar with the current standards and have devised their own methodology to analyse the existing leasing information on the financial statements. With the revision in the standard, the users would need to reconfigure their methodology to take into account the new assumptions inherent in the new standard.

3. Conclusion

The SSA believes that the international shipping industry as a whole shares our serious concerns.

It is the Association's considered opinion that the proposed standard, whilst technically ideal from the perspective of an academic or analyst, cannot be practically applied to actual contracts.

Whilst the Association cannot support the proposed standard in its current draft, we, and our international colleagues, remain ready to assist you in your efforts to develop an accounting standard that is suitable for adoption by the industry.

Yours faithfully
SINGAPORE SHIPPING ASSOCIATION

DANIEL TAN
Executive Director

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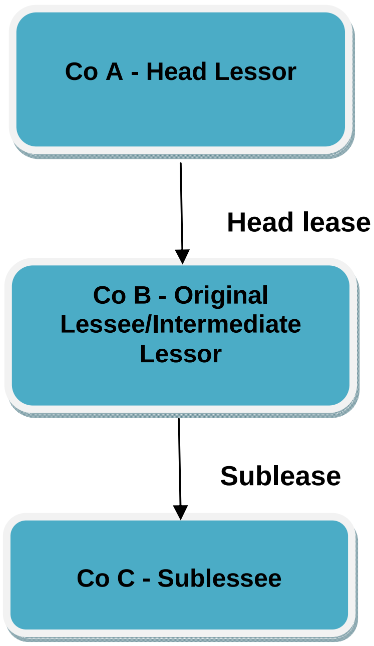
ANNEX 1

SUBLEASES

In the shipping industry, the reporting entity (Co B) will sometimes act as both a lessor and a lessee of the same asset (i.e vessel). For example, a reporting entity may lease a vessel from one party (Co A - the Head lessor) and then sublet the same vessel to another party (Co C - the Sublesee).

This can be illustrated in the following diagram:



For illustration:

Company B leases Vessel X from Co A with a five-year time-charter at a rate of US$300 per day. Company B then subleases the same vessel to Co C at a rate of US$500 per day for 5 years.

Assumptions

1) **Co B incremental borrowing rate is 3%;**
2) **The rate that Co B charges Co C is 5%.**
3) **No contingent rent in both cases.**

Please refer to Appendix A for the treatment under the current lease accounting and the proposed lease accounting. The performance obligation approach for lessor accounting is being applied.

Impact to income statement:

Under current accounting standard, the profit remains constant over the years.

With the new propose accounting standard, the Co A's profit increases at the beginning of the years and reduces in subsequent years. And charter hire income will

now split into lease revenue and interest income whereas charter hire payment split into interest expense and amortisation of the right of use asset.

Impact to balance sheet:

Under current accounting treatment, this is almost certainly an operating lease. In Co B's book, Co B does not record any assets or liabilities, and deals with charter income (from Co C) as they are due & receivable and charter payments (to Co A) as they are due and payable.

Under the new proposals, in Co B's book, these will give rise to both an asset and a liability. Under head lease, the asset is the right to use the vessel for five years. The liability is the present value of the charter payments. Whereas under sublease, the lease receivables is the right to receive lease payments from Co C at present value of the lease payments discounted using the rate the intermediate lessor(Co B) charges the sublessee(Co C). And the lease liability is for its obligation to permit the sublessee to use the lease asset, i.e Vessel X.

To avoid the 'double gross-up' in the balance sheet that would otherwise result under the performance obligation approach, under new proposal, all assets and liabilities arising from both the head lease and sub-lease, except for the obligation to pay rentals to the head lessor, would be presented together at the gross amounts in the balance sheet with a net subtotal; the obligation to the head lessor would be presented separately in liabilities.

While, initially, this makes little difference to net assets (as they are the same) it will increase the reporting entity (Co B) borrowings and change the ratios.
Over time, there will be changes in both profits and net assets from those currently reported. Depreciation and financing charges will follow a slightly different pattern to that under the current model.

Impact to cash flow:

Under current accounting, the charter hire income and charter hire expense are classified as operating activities.

Under the new propose accounting, interest expense arising from lease contracts would be classified as financing activities separately in the statement of cash flows. However, for lessors, repayments, collections of the lease receivable and interest income arising from that receivable would be presented as operating activities in the statement of cash flows.

Other than this, the amortisation of right-of-use, changes in the right to receive lease payment from sublease, changes in the lease liability from sublease and changes in the liability to make lease payment under head lease will create more confusion and complexity in interpreting/reading the cash flow statement!

Conclusion:

Based on the existing accounting treatment with the disclosure of the operating lease commitments, the user of the financial statements can easily analyse/dissect the result of the shipping company.

Shipping is a global and dynamic industry and its operating results are closely tied to the level of economic activity in the world. A higher level of economic growth would generally lead to higher demand for industrial raw materials, which in turn will boost

imports and exports. The shipping market is cyclical in nature and charter rates generally tend to be volatile.

Charter rates and earnings of the shipping companies are primarily a function of demand and supply in the markets. While demand drivers are a function of trade growth and geographical balance of trade (which determines the length of haul required), the supply drivers are a function of new ship building orders as well as scrapping of existing tonnage.

All the above are easily be analysed under current (operating-lease) accounting treatment.

With the new proposed lease accounting, the removal of the distinction between finance leases and operating leases, which mean that all chartered-in tonnage would appear on the company's balance sheet, together with a liability for the obligations under the lease. The resulted changes have major impact on gearing and of course on any financial covenants.

Furthermore, the introduction of new items "the amortisation of right-of-use, interest income and interest expense" added complexity and difficulties for users to analyse the performance of the shipping company and caused unnecessary confusion to the reader of the financial statements.

APPENDIX A

Current accounting					
Income statement	Year 1	Year 2	Year 3	Year 4	Year 5
Charter hire income	$182,500.00	$182,500.00	$182,500.00	$182,500.00	$182,500.00
Charter hire expense	($109,500.00)	($109,500.00)	($109,500.00)	($109,500.00)	($109,500.00)
(A)	$73,000.00	$73,000.00	$73,000.00	$73,000.00	$73,000.00
New Propose lease accounting					
Lease revenue	$158,025.90	$158,025.90	$158,025.90	$158,025.90	$158,025.90
Interest income	$39,506.47	$32,356.80	$24,849.64	$16,967.12	$8,690.48
Interest expense	($15,044.34)	($12,035.47)	($9,026.60)	($6,017.74)	($3,897.92)
Amortisation of right-of-use	($100,295.59)	($100,295.59)	($100,295.59)	($100,295.59)	($100,295.59)
(B)	$82,192.45	$78,051.64	$73,553.35	$68,679.70	$62,522.87
Different (A) - (B)	$9,192.45	$5,051.64	$553.35	($4,320.30)	($10,477.13)

Presentation in financial position					
	Year 1	Year 2	Year 3	Year 4	Year 5
Right-of-use asset under head lease	**$401,182.35**	**$300,886.76**	**$200,591.17**	**$100,295.59**	$0.00
Lease receivables from sublease	**$647,135.97**	**$496,992.77**	**$339,342.40**	**$173,809.52**	$0.00
Lease liability from sublease	($632,103.59)	($474,077.70)	($316,051.80)	($158,025.90)	$0.00
Net lease asset (AA)	$416,214.72	$323,801.83	$223,881.78	$116,079.21	$0.00
Liability to make lease payment under head lease (BB)	($407,022.28)	($309,557.75)	($209,084.35)	($105,602.08)	($0.00)
Net(AA) - (BB)	$9,192.45	$14,244.09	$14,797.43	$10,477.13	($0.00)

Cash flow	Year 1	Year 2	Year 3	Year 4	Year 5
Current accounting					
Profit before tax/Net increase in cash and cash equivalents	**$73,000.00**	**$73,000.00**	**$73,000.00**	**$73,000.00**	**$73,000.00**
New Propose lease accounting					
Profit before tax	$82,192.45	$78,051.64	$73,553.35	$68,679.70	$62,522.87
Add/(Less):					
Amortisation of right-of-use	$100,295.59	$100,295.59	$100,295.59	$100,295.59	$100,295.59
Interest income	($39,506.47)	($32,356.80)	($24,849.64)	($16,967.12)	($8,690.48)
Interest expense	$15,044.34	$12,035.47	$9,026.60	$6,017.74	$3,897.92
Operating income before working capital changes	$158,025.90	$158,025.90	$158,025.90	$158,025.90	$158,025.90
Changes in the right to receive lease payment from sublease	$142,993.53	$150,143.20	$157,650.36	$165,532.88	$173,809.52
Changes in the lease liability from sublease	($158,025.90)	($158,025.90)	($158,025.90)	($158,025.90)	($158,025.90)
Changes in the liability to make lease payment under head lease	($94,455.66)	($97,464.53)	($100,473.40)	($103,482.26)	($105,602.08)
Cash generated from operations	$48,537.86	$52,678.67	$57,176.96	$62,050.62	$68,207.44
Interest income	$39,506.47	$32,356.80	$24,849.64	$16,967.12	$8,690.48
Net cash flows from operating activities	$88,044.34	$85,035.47	$82,026.60	$79,017.74	$76,897.92
Cash flow from financing activities					
Interest expense	($15,044.34)	($12,035.47)	($9,026.60)	($6,017.74)	($3,897.92)
Net increase in cash and cash equivalents	**$73,000.00**	**$73,000.00**	**$73,000.00**	**$73,000.00**	**$73,000.00**

ANNEX 2

Performance obligation

Company A leases a newbuild vessel for 10 years from 1 Jan 20x1 at a daily rate of US$8,000. The vessel is subleased out for 4 years at a day rate of US$20,000. A fixed discount rate of 10% is used and all transactions are paid or received in cash at the end of each year. There are no renewal options and no residual value guarantees.

Existing IAS 17 - Operating lease

Profit and loss

(US$'M)	20x1	20x2	20x3	20x4
Lease income	7.30	7.30	7.30	7.30
Lease expense	(2.92)	(2.92)	(2.92)	(2.92)
Profit	4.38	4.38	4.38	4.38
EBIT	4.38	4.38	4.38	4.38

Balance Sheet

(US$'M)	1 Jan 20x1	31 Dec 20x1	31 Dec 20x2	31 Dec 20x3	31 Dec 20x4
Cash	0	4.38	8.76	13.14	17.52
Net Assets	**0**	4.38	8.76	13.14	17.52

Proposed ED – Performance obligation

Profit and Loss

(US$'M)	20x1	20x2	20x3	20x4
Lease income	4.99	5.48	6.03	6.64
Interest income	2.31	1.82	1.27	0.66
Interest expense	(1.79)	(1.68)	(1.56)	(1.42)
Amortisation of asset(i)	(1.79)	(1.79)	(1.79)	(1.79)
Profit	3.71	3.82	3.95	4.08
EBITDA	7.30	7.30	7.30	7.30

Balance Sheet

(US$'M)	1 Jan 20x1	31 Dec 20x1	31 Dec 20x2	31 Dec 20x3	31 Dec 20x4
Cash	0	4.38	8.76	13.14	17.52
Right of use - leased asset	17.94	16.15	14.35	12.56	10.77
Obligation to pay	(17.94)	(16.82)	(15.58)	(14.22)	(12.72)
Lease receivable	23.14	18.15	12.67	6.64	-
Performance obligation	(23.14)	(18.15)	(12.67)	(6.64)	-
Net Assets	-	3.71	7.54	11.48	15.57

Remarks

(i) Straight line amortisation of leased assets.

Journal Entries to be posted under new proposed ED

At inception	US$'M
Dr Leased Asset	17.94
Cr Obligation to Pay	(17.94)
(To record the vessel leased from third party)	
Dr Lease receivable	23.14
Cr Performance obligation	(23.14)
(To record the lease payment for the 4 year sublease)	

At year 1

Dr Amortisation of asset	1.79
Cr Lease Asset	(1.79)
(To account for depreciation of leased asset)	

Journal Entries to be posted under new proposed ED

At year 1

Dr Lease receivable	2.31
Cr Interest income	(2.31)
(To record interest income arising from 4 year sublease)	
Dr Cash	7.30
Cr Lease receivable	(7.30)
(To record payment received for the 4 year sublease)	
Dr Perf obligation	4.99
Cr Lease revenue	-4.99
(To record principal payment for the 4 year sublease)	
Dr Obligation to pay	1.12
Dr Interest expense	1.79
Cr Cash	2.91
(To record interest and principal payment for leased asset)	

Lease repayment schedule (US$'000)

Main lease	Lease payment	Principal	Interest	Total
				7,942.14
x1	2,920.00	1,125.79	1,794.21	16,816.35
x2	2,920.00	1,238.37	1,681.63	15,577.98
x3	2,920.00	1,362.20	1,557.80	14,215.78
x4	2,920.00	1,498.42	1,421.58	12,717.36
x5	2,920.00	1,648.26	1,271.74	11,069.10
x6	2,920.00	1,813.09	1,106.91	9,256.01
x7	2,920.00	1,994.40	925.60	7,261.61
x8	2,920.00	2,193.84	726.16	5,067.77
x9	2,920.00	2,413.22	506.78	2,654.55
x10	2,920.00	2,654.55	265.45	(0.00)
Sublease	**Lease payment**	**Principal**	**Interest**	**Total**
				23,140.02
x1	7,300.00	4,986.00	2,314.00	18,154.02
x2	7,300.00	5,484.60	1,815.40	12,669.42
x3	7,300.00	6,033.06	1,266.94	6,636.36
x4	7,300.00	6,636.36	663.64	(0.00)