DANMARKS REDERIFORENING Comment Letter No. 474

2013-270

(DANISH SHIPOWNERS' ASSOCIATION)

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

By ordinary mail and email: info@ifrs.org

13 September 2013

Dear IASB Board Members,

Exposure Draft: Leases - Proposed changes to lease accounting

The Danish Shipowners' Association appreciates the opportunity to respond to the revised Exposure Draft regarding leases ("hereinafter the "ED") of May 2013.

We acknowledge the significant efforts done by the International Accounting Standard Board (hereinafter the "Board") to respond to the concerns raised by constituent to the original exposure draft issued in August 2010 to which the Danish Shipowners' Association responded on 15 December 2010.

Furthermore, we acknowledge that the Board has specifically addressed one of our main concerns as set out in our comment letter of 15 December 2010 and also presented at a video conference held on 26 November 2010, namely the front load issue. We also note that the Board has decided to address other issues raised by us, namely

- Full relief from the provisions for lessees in respect of short-term leases.
- · Relief from separation of lease elements from service elements for lessees if there are no observable market prices
- Elaboration of the definition of a lease to ensure that only arrangements under which the buyer truly obtains control over a specified asset are classified as lease contracts.

Our main comments relate to the following issues:

- 1. Lease classification proposal to base classification between type A and B on the criteria in IAS 17
- 2. Purchase options for type B leases
- 3. Lessor accounting

These items are further elaborated below. The Danish Shipowners' Association's reply to the individual questions raised by the Board is included as an appendix.

Lease classification

We do not find that that the model proposed by the Board to distinguish between leases for which the lease expense is recognized on a straight line basis (type B) and those for which the expense recognition pattern is similar to a purchase (type A) is the right one. First of all we notice that the extent of consumption of the underlying asset is a continuum, and cannot meaningfully be expressed by an "either/or" model, i.e. the type A vs. type B distinction. Especially, we notice that the presumption that in a property lease, the lessee does not consume a significant part of the asset while a lessee does this in a vessel lease, is not conceptually based. This is because the economic life of a vessel is often not significantly lower than that of a building.

We do not agree with the Board – as set out in BC 45 - that merely because the lessee consumes more than an insignificant portion of the underlying asset, the lease should be accounted for similar to a purchase of the underlying asset. In our view, the nature of a lease generally differs significantly from a purchase of an asset. In the shipping industry, the background for entering into a lease and not into a purchase of the underlying vessel is usually to manage the exposure to the market, i.e. to match the number of ship days with the contracted or expected coverage over the term of the lease. Entering into leases establishes much more scalability to the operations and reduces the risk compared to purchasing the vessel. This is because a purchase effectively exposes the owner to the market over the economic life of the vessel regardless of whether the owner expects to dispose of the vessel before the end of the economic life of the vessel. Should the owner decide to sell the vessel before the end of the economic life of the vessel, the market's expectations to the future rates in the market is fully reflected in the sales price in the market. Therefore, we find that the appropriate dividing line between leases should be treated similar to purchases of the underlying assets and those to be treated differently, is whether the lease is in substance purchase of the underlying asset. This is in fact the underlying principle of current IAS 17.

Therefore, we propose that only those leases which would be classified as finance leases under IAS 17 are classified as type A leases. All other leases should be classified as type B leases, resulting in a straight line expense recognition pattern. Similar to the model proposed in the ED, classification should be made on initial recognition and retained, unless the contract is subsequently amended.

Straight line recognition of the lease expense reflects the typical shipping company business model described above. This is because each individual vessel earns revenue while consequently, managing the fleet is based on comparison between the lease expense and revenue obtained on an on-going basis.

We see the below mentioned advantages of this approach while still meeting the overall objective that rights and obligations arising from lease contracts shall be reflected in the financial statements:

- 1. The classification is based on a well-known concept while the classification criteria proposed by the Board are complex.
- 2. The risk of significant diversity in measurement of lease obligations and hence periodic interest expense due to the inability to determine the "true" discount rate for time charters is eliminated because the lease expense is recognized straight

line in the income statement. Due to the inability to determine the discount rate inherent in a time charter contract (see Lessor Accounting for a further elaboration).

We also see a number of complexities on application of the type A model, which would effectively be eliminated because most leases would be classified as type B leases. Hence, they would be subject to more simplified accounting because the profit/loss impact is the same in all periods.

For recognition of type B on the balance sheet of the lessee we suggest a methodology whereby the right-of-use asset is amortised straight-line with a corresponding reduction of the lease liability, i.e. that § 41 (a) is not applied to Type B leases. We suggest no changes to the recognition in the income statement.

In our view the advantages of the approach proposed are the following:

- 1. The approach is simple to apply.
- 2. Less risk of impairment of the right of use asset.

Purchase options for type B leases

It seems that the guidance in respect of purchase options for type B leases will have an unintended impact to the extent that the lessee determines that there is a significant economic incentive to exercise the option. The amortization period for type B leases will, as a result of paragraph 50 and 42b be equal to the lease term. Hence, the exercise price under the option will be expensed over the lease term because it forms part of the cost of the lease per B15 and B16 while the lease liability as of the expiry date will be equal to the exercise price under the option. On exercise this liability is settled but no asset is recorded.

Because the underlying principle of type B is straight line expense recognition, we find that purchase options should be excluded. Alternatively, the allocation period under paragraph 42 b should be the higher of the remaining lease term or the remaining useful life of the asset similar to the last sentence in paragraph 48 for type A leases. This model will lead to unnecessary complexity and not align in full with the straight line concept.

Lessor accounting

The proposed lessor accounting model for type A leases is complex and associated with a significant degree of judgment, especially in determining the value of the residual asset. While this approach may reflect the business model of certain lessors, this is not necessarily the case for the shipping industry. Entering into a 5 year time charter contract would, under the ED, most likely be classified as a type A lease. Hence, the lessor has to determine the fair value of the vessel on expiry of the time charter and determine an appropriate discount rate. Due to the fact that time charter rates are set in a fairly active market, the lessor would not be able to set the rate on the basis of expectations about the residual value and determination of a discount rate. The lessor

would rather consider whether the rate that could be obtained in the market is attractive compared to alternative coverage.

Further, for the reasons set out under "Lease classification" in respect of lessees, entering into a lease out, which is classified as an operating lease under IAS 17, is not comparable to a sale of the underlying vessel. We are therefore not convinced that it is appropriate to recognize any gain on entering into a lease out, unless the transaction is an in substance sale of the underlying asset.

By moving the dividing line between type A and B leases as proposed by us, the partial de-recognition model will only apply to leases which are in substance sales. The judgments required to apply the model proposed by IASB would by nature be significantly less critical because the residual value is low.

We acknowledge that for most leases there is no symmetry between lessee and lessor accounting. We do, however, find that the advantages, first of all the simplicity of the approach, outweight this disadvantage. We also notice that the IASB in the place has accepted lack of symmetry between lessor and lessee in type B leases.

If you have any questions or wish us to further elaborate on the comments made in this letter, please do not hesitate to contact Stinne Taiger Ivø (+45 33 48 92 85)

Yours faithfully,

Danish Shipowners' Association

Stinne Taiger Ivø

Appendix

Response to the ED questions

Question 1

This revised Exposure Draft defines a lease as "a contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration". An entity would determine whether a contract contains a lease by assessing whether:

- (a) fulfillment of the contract depends on the use of an identified asset; and
- (b) the contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration.

A contract conveys the right to control the use of an asset if the customer has the ability to direct the use and receive the benefits from use of the identified asset.

Do you agree with the definition of a lease and the proposed requirements in paragraphs 6–19 for how an entity would determine whether a contract contains a lease? Why or why not? If not, how would you define a lease? Please supply specific fact patterns, if any, to which you think the proposed definition of a lease is difficult to apply or leads to a conclusion that does not reflect the economics of the transaction.

Response

Overall, we agree with the proposed definition, and we acknowledge the work done by the Board to ensure that only arrangements under which the buyer truly has control over the asset are classified as leases. There may be doubt about how to perform the test set out in paragraph 14 in respect of deriving economic benefits from the asset in cases where both the supplier and the buyer are involved in operating the asset during the term of the arrangement, for instance time charter contracts for vessels. This is because both parties will take relevant decisions in respect of the total profitability of the vessels during the term of the arrangement. The Board should explain the relationship between magnitude and variability, as total operating expenses may be significant to the total profit but not necessarily be subject to significant risk of variability compared to variability in revenue and hence profit.

We also notice that determination of whether a lease exists to a wide extent is based on supplier specific information such as substantive substitution rights; information which is not necessarily available to the customer.

Question 2

Do you agree that the recognition, measurement and presentation of expenses and cash flows arising from a lease should differ for different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

Response

We agree that measurement and presentation should differ for different types of leases. We do, however, not find that the dividing line should be the one proposed in the ED. In our view, the dividing line should be whether the lease is an in substance purchase or whether it is a "true" lease. Only in substance purchases should be classified as type A leases while all other leases should be classified as type B leases. The "in substance purchase" concept is equal to the well known concept of IAS 17.

As set out in our cover letter, we find that this is the appropriate because leases which are entered into with the view of obtaining availability of assets over a period shorter than the expected remaining life of those assets rather than obtaining alternative financing of asset purchases should not be treated as purchases of assets.

Straight line recognition of the lease expense reflects the typical shipping company business model described above. This is because each individual vessel earns revenue while, consequently, managing the fleet is based on comparison between the lease expense and revenue obtained on an ongoing basis.

From an operational view, this proposal has significant advantages. First of all, classification of leases is already provided by the lease classification performed under IAS 17, and expense recognition for operating leases is to a wide extent also provided by IAS 17. Hence, the only significant change required to be implemented would be to "bring the operating lease note to the balance sheet".

Finally, the arbitrary distinction between property and other assets would be eliminated.

Question 3

Do you agree that a lessor should apply a different accounting approach to different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

Response

We generally find the proposed type A lessor model very complex to apply. Further, we are not convinced that recognition of an up-front gain properly reflects the business model of most lessors. Similar to lease in, lease out is part of managing the fleet rather than a partial sale of a vessel.

We propose to retain the type B lessor model, and hence, all leases other than in substance purchases should be treated similar to current IAS 17 operating lease accounting. We notice that this approach also resolves the complexities of sub-leases as it ensures that the income statement impact from the lease in and lease out respectively is symmetrical.

Question 4

Do you agree that the principle on the lessee's expected consumption of the economic benefits embedded in the underlying asset should be applied using the requirements set

out in paragraphs 28–34, which differ depending on whether the underlying asset is property? Why or why not? If not, what alternative approach would you propose and why?

Response

We do not agree. As set out in our response to question 2 we propose application of the current finance vs. operating lease guidance in IAS 17 to determine whether a lease is classified as a type A or type B lease.

Question 5

Do you agree with the proposals on lease term, including the reassessment of the lease term if there is a change in relevant factors? Why or why not? If not, how do you propose that a lessee and a lessor should determine the lease term and why?

Response

In our 2010 comment letter, we proposed that term extension options should only be included in the lease term if extension is virtually certain. We acknowledge that the threshold for inclusion of term extension options has been raised by the proposed "significant economic incentive" notion. As the concept seems to be similar to the "reasonably certain" notion of IAS 17 we would expect it to be operational for most preparers, and consequently, we agree with the proposal.

Question 6

Do you agree with the proposals on the measurement of variable lease payments, including reassessment, if there is a change in an index or a rate used to determine lease payments? Why or why not? If not, how do you propose that a lessee and a lessor should account for variable lease payments and why?

Response

As set out in our comment letter, it seems that purchase options for which the lessee has a significant economic incentive to exercise has unintended implications in type B leases. We therefore propose that for type B leases, purchase options are excluded from the measurement of the right of use asset and lease liability.

Question 7

Paragraphs C2–C22 state that a lessee and a lessor would recognize and measure leases at the beginning of the earliest period presented using either a modified retrospective approach or a full retrospective approach. Do you agree with those proposals? Why or why not? If not, what transition requirements do you propose and why? Are there any additional transition issues the boards should consider? If yes, what are they and why?

Response

We agree.

Question 8

Paragraphs 58–67 and 98–109 set out the disclosure requirements for a lessee and a lessor. Those proposals include maturity analyses of undiscounted lease payments; reconciliations of amounts recognized in the statement of financial position; and narrative disclosures about leases (including information about variable lease payments and options). Do you agree with those proposals? Why or why not? If not, what changes do you propose and why?

Response

Overall, we support comprehensive disclosures to support users of financial statements to better understand the financial performance and position of the reporting entity. We are, however, not sure that all disclosures proposed are really necessary. For instance, reconciliation of lease liabilities separated into type A and type B leases seems unnecessary because the measurement method is the same. For the benefit of preparers – but also for the benefit of users in respect of avoiding confusion - we find that specific disclosures should not be required if the items in question are already in the scope of other disclosure standards. This is true for lease liabilities as they are in the scope of IFRS 7. Hence, we prefer that all disclosures in respect of lease liabilities are governed by IFRS 7.

Question 12

The IASB is proposing amendments to other IFRSs as a result of the proposals in this revised Exposure Draft, including amendments to IAS 40 *Investment Property*. The amendments to IAS 40 propose that a right-of-use asset arising from a lease of property would be within the scope of IAS 40 if the leased property meets the definition of investment property. This would represent a change from the current scope of IAS 40, which permits, but does not require, property held under an operating lease to be accounted for as investment property using the fair value model in IAS 40 if it meets the definition of investment property.

Do you agree that a right-of-use asset should be within the scope of IAS 40 if the leased property meets the definition of investment property? If not, what alternative would you propose and why?

Response

We do not express any opinion on this issue as this is specific to an industry different from ours.

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