



THE HONG KONG SHIPOWNERS ASSOCIATION LTD.

12th Floor, Queen's Centre, 58 Queen's Road East, Wanchai, Hong Kong.
Phone : (852) 2520-0206 Fax : (852) 2529-8246 Email : hksoa@hksoa.org

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

14th December 2010

Lease Accounting Standard Exposure Draft ED/2010/9 of August 2010 ("**Paper**")
Basis for Conclusions Exposure Draft ("**Basis for Conclusions**")

Dear Sirs,

The Hong Kong Shipowners Association is a trade association representing the interests of shipowners, ship managers and ship operators resident in Hong Kong, as well as the various companies supplying services to those companies.

The Association is grateful for the opportunity to make the following submission.

IASB has proposed that the distinction between finance leases and operating leases be abolished and has proposed new rules as to how all leases are to be accounted for in financial statements in the future.

The reasons for proposal are explained in the first paragraph of the Paper. These words bear repeating because shipping and its basic contractual instruments, charterparties, do not appear to have been considered.

The paper begins

"Leasing is an important source of finance. Therefore, it is important that lease accounting should provide users of financial statements with a complete and understandable picture of an entity's leasing activities."

Charterparties in General

Voyage charterparties are NOT sources of finance; time charterparties are almost NEVER sources of finance, many demise charterparties will be sources of finance, but not all will be.

Legal Descriptions

Lord Hobhouse of Wood-borough in *BP Exploration Operating Co Ltd v Chevron Transport (Scotland)* reported in [2001] UKHL at page 50 says in paragraph 79:-

*"79. A bareboat demise charter differs from the common kinds of charterparty, such as time charters and voyage charters. They [time charters and voyage charters] involve no transfer of the possession of the vessel to the charterer; they are simply contracts for services to be provided by the "owner" (who may or may not be the actual owner and frequently is just another charterer higher up the line) to the charterer. A voyage charter can be a contract of carriage. A time charter normally includes an express or implied indemnity for the consequences of complying with the charterer's orders but the vessel remains under the command and control of the owner's master and crew as if she was being traded for the owner's own account. A bareboat demise charter by contrast is truly a contract for the hire of the vessel and involves the delivery of the vessel into the possession of the charterer and the control of the vessel resting with the charterer's employees. The vicarious liability in **personam** for the delictual or tortious acts of the master and crew rests with their employer, the demise charterer."*

IASB defines a lease as a contract in which the right to use a specified asset or assets is CONVEYED for a period for time in exchange for consideration.

The word "**conveyed**" means there is a transfer of possession of the asset. Lord **Justice MacKinnon** in the case, "The *Airesford* ([1942] 1All E.R. 503 at page 504) described the difference between charterparties which convey possession and those that do not.

"The respective rights and obligations of the two parties to this time charterparty must depend upon its written terms, for there is no special law applicable to the particular form of contract known as a time charterparty. A time charterparty is, in fact, a document which is of a very misleading nature, because the real nature of what is undertaken by the shipowner is disguised by the use of language dating from a century or more ago - language which was then appropriate to a contract of a totally different character. A century ago a time charterparty, then known as a demise charterparty, was an agreement under which the charterer was handed over the possession of the ship of the shipowner to put his servants and crew upon her and to sail her for his own benefit. That form of charterparty, which, as I say, was called a demise charterparty, has long since been obsolete. The modern form of time charterparty is, in essence, one under which the shipowner agrees with the time charterer that, during a certain named period, the shipowner will render service as a carrier by his servants and crew to carry the goods which are put on board his ship by the time charterer."

Demise Charterparties

Whatever might have been the case in 1942, in 2010, the demise charterparty is not obsolete. It is often used today as a vehicle for the financing of ships, and is sometimes called a lease, a bareboat charter or a charter by demise. It may take the form of a finance lease or an operating lease.

The author of this paper does not propose to argue against the application of the proposed lease accounting rules for demise charterparties. Under a demise charterparty, possession of the ship concerned is conveyed to the charterers for the

duration of the charterparty. There could be very minor problems only in dealing with demise charterparties, which are used to enable a ship to be registered in two jurisdictions, so that the flag is chosen by the demise charterer, which problems are explained in an Appendix to this submission, but they will have to be dealt with on an ad hoc basis.

This Submission

This submission deals with voyage charterparties and time charterparties and it is submitted that the accounting rules proposed for leases by IASB should not apply to such contracts.

Shipping

Shipping is often perceived by the public as the highly visible business of the liner trade and passenger trade (especially cruises). Liner trade today is largely containerised. How such trade is operated has little bearing on the debate over lease accounting rules. Most containerships are owned by the shipowner or leased by the shipowner from another on terms where the proposed rules are appropriate. The contract of carriage is a bill of lading or a similar document.

The liner and cruise trade is what is seen in major waterfront cities, such as Los Angeles, New York, London, Hong Kong, Shanghai, Singapore, Tokyo and so forth. Such picture misses the trades engaged in the carriage of bulk cargoes, such as oil, oil products, LNG, LPG, iron ore, coal, grain, steel, timber, fertiliser etc, which are not visible to a city dweller's eye. Nonetheless, significant bulk trades use the ports such as Singapore, Amsterdam and Longbeach for oil and other commodities.

Voyage Charterparties

Voyage charterparties are contracts of affreightment. The shipowner (who may itself charter the ship from another party) agrees to carry a certain specified cargo from one port to another. The shipowner is paid "freight" for that service, which may be expressed as a rate per ton or a lump sum. The shipowner is responsible for paying

for fuel, port charges and other voyage costs. The officers and crew are paid by the shipowner and remain under his control and directions. The rate of freight is not referable to applicable rates of interest or the financing costs for the ship or indeed its operating costs. Rates of freight are referable to the market rates that are applicable at the time the fixtures are made and the availability and suitability of ships to load the cargo that is to be transported. Shipping markets are open and free to an extent that hardly exists elsewhere. They are global markets.

Voyage charterparties may be made for a number of voyages at the prescribed rate of freight. The shipowner may engage to carry a million tons of iron ore from one place to another, using the same ship or a number of ships. The rate of freight will be a fixed rate per ton of cargo loaded, but may include escalation for fuel costs.

Such charterparties are not in the nature of leases, they are contracts under which the shipowner undertakes to provide the services of the ship and its officers and crew to carry the cargo needed. The contract cannot be and should not be divided into financing element and service elements and in no sense can be described as an unconditional right to use the ship so as to become an "*asset*" of the charterer of the ship or the shipper of the cargo.

A distinction from the proposed lease rules must be made for contracts of affreightment and voyage charterparties. They are not finance vehicles. They should be accounted for as they are at present, namely as expenses to the charterer or shipper appearing in the profit and loss account of the relevant person and revenue for the shipowner in its profit and loss account. If necessary, a note should be made to the accounts explaining what are the transactions to which the enterprise concerned is a party. Such note may be necessary if the period of the contract extends over more than one accounting period.

Time Charterparties

Time charterparties are contracts where a charterer receives services for a period of time to have cargo carried from one port to another. Time charterparties are a form of contract of affreightment. Hire under a time charterparty is usually expressed as a

rate per day, which rate is to apply for the period of the charterparty. The time charter period may be for a single trip between two ports, but may extend to 20 years or more. Hire commences when the ship is placed under charterer's orders and continues until the ship is redelivered, which is usually a date fixed by the charterer within one month, more or less, of date on which the charterparty is expressed to end. The time charter period may also be extended to allow the ship to complete its then voyage. Under charterer's orders means that the ship will sail to a port nominated by the charterer and load cargo at such port for carriage to another port nominated by the charterer. The charterer pays for the fuel consumed and port charges. The shipowner remains responsible for the navigation and safety of the ship. For the purposes of liability, the shipowner, not the charterer, is the carrier of the cargo and is normally liable for loss or damage to the cargo. The shipowner not the charterer, is vicariously liable for the delictual or tortious acts of the officers and crew. The shipowner insures the ship and crew. The carrier's liabilities in respect of the cargo are likewise insured by the shipowner.

Bills of lading are usually issued by the owner on charterer's instructions to the shipper of the cargo. A bill of lading will identify the amount of cargo loaded and its destination. A bill of lading is often a document of title and sets out the terms on which the carriage of the cargo by the shipowner is effected so far as the consignor and consignee of the cargo are concerned. The charterer's name may not be mentioned in the bill of lading.

Time charter rates are market rates. There are free and open markets for ships of different kinds. The rate of hire is not referable to the financing costs of the ship or to interest rates. So far as the charterer is concerned, a time charterparty is NOT a financing transaction. Moreover such transaction may be effected at a loss to the owner of the ship, which is not consistent with a finance transaction. The ship may be moved from the Atlantic to the Pacific at a loss because freight rates are better in the Pacific.

Daily rates of hire and time charter equivalent rates

The daily rate of time charter hire for a standard capesize bulk carrier of between 170,000 and 180,000 Dwt over the past three years has varied from US\$150,000 to zero. For tankers carrying crude oil, market rates are described as World Scale; which determines a time charter equivalent rate for the tanker concerned, based on fuel prices. Huge fluctuations have occurred in the rates applicable to the tanker market. No service element in the "**charge**" can be allocated or identified, because the hire or freight is the whole of the service charge. The shipowner knows his operating costs per day, but that is not the service "**increment**" that is provided under a voyage charterparty or a time charterparty.

Time charterparties should be dealt with as they are now in the profit and loss accounts of both parties, but could perhaps be supplemented by notes to the accounts describing the transactions concerned.

Basis for Conclusion

Twice in the Basis of Conclusions (in paragraphs BC50 and BC53) the board refers to service elements. In paragraph BC53 the board says "*.....it would be rare that a lessor will not be able to identify service components within a contract which contains service and lease components*"; while in BC 50 it says "*However in the board's view, it would be rare to be able to identify a distinct service component and yet not be able to allocate the payments between the components*". As described above no allocation between the service and lease components can be made for time or voyage charterparties. The whole of freight or hire is a service charge because the contracts are service contracts, not finance transactions disguised as charterparties.

Specific Charterparty Terms

Demurrage, Delay, Despatch and Deadfreight

Under a voyage charterparty, the shipper of the cargo compensates the owner of the ship, if the quantity of cargo loaded is below that for which the contract of affreightment was concluded. Such compensation is deadfreight. Freight is a function of the quantity of cargo loaded multiplied by the freight rate, so if there is short loading, the shipowner suffers a loss.

If the ship is unable to proceed to the appropriate berth and load or discharge its cargo, the owner will be compensated by being paid demurrage for the delay. Despatch may compensate the shipowner for speed.

Such concepts are alien to leases which are financing transactions or operating leases, but are consistent with a voyage charterparty being a contract of services.

Offhire

In all time charterparties, if the ship is unable to perform the services required of it, whether through breakdown, absence of crew, damage to the ship or otherwise, the ship is offhire. No hire is paid from the time the ship ceases to be available until it is again available for service. It does not matter what caused the damage to the ship or whether there was fault on the part of the owner. If the ship is not available, the ship is offhire. Until it is fit to resume service (in some cases at the place that it would have been if it had continued in service) no hire will be paid. Moreover, while the ship is offhire the shipowner pays for all fuel consumed by the ship. Fuel charges are not insignificant.

This is contrary to the concept that applies in leases, whether they be operating leases or finance leases. No aircraft owner entering into an operating "*lease*" will take responsibility for the performance of the aircraft in such fashion. That risk and responsibility passes to the operator of the service in which the aircraft is used. There is no concept of "*offhire*". But a "*wetlease*" under which an aircraft complete with a

full crew is supplied to another person is akin to a time charterparty and is neither a finance lease nor an operating lease. Wet leases are used in the air cargo industry and when there are emergencies, such as the engine problems with the A380 aircraft, so as to enable an airline to maintain its scheduled services.

This reinforces the concept that charterparties are NOT financing transactions. This is true for all time charterparties, from trip charters to long term time charterparties.

Charterparties are not "**unconditional**" obligations as described in BC7, there is neither an unconditional obligation to use the ship (it can be left idle) or any unconditional obligation to pay hire or freight.

Withdrawal

It is in the nature of lease or loan financing transactions, in relation to equipment such as aircraft, that in the event of default in payment by the user of the equipment, the user compensates the owner for the rental for the full period of lease, albeit such amount will be discounted and may be mitigated through the equipment being placed under a new lease.

Under a time charterparty, if hire is not paid in full and on time, the owner may withdraw the ship from service and thereby bring the time charter to an end. Unless the conduct of the charterer amounts to repudiation of the contract, there are no damages payable for such termination. The owner can claim unpaid hire, but no more.

Owners often withdraw ships under a charterparty simply to take advantage of an improvement in market rates. In adverse markets, where the time charter rate paid is higher than can be obtained in the market, Charterers may force the shipowner to withdraw the ship from service, by the expedient of not paying hire.

Advance Payments

Freight under a voyage charterparty is often paid in two instalments, one on loading and the other on or before completion of discharge of the cargo. It is usual for all freight be earned upon loading the cargo, and, in some cases, freight is paid in full on loading.

Hire under a charterparty is usually paid monthly in advance, so that on commencement of service under the charterparty, 30 days of hire becomes payable immediately.

Such basis for payment is contrary to that of a financing transaction, where interest is typically paid in arrears.

Speed, Fuel consumption, Boil Off and other warranties.

Most time charterparties include provisions for the owner to pay damages in the event that the ship does not perform in accordance with the fuel consumption, speed, boil off rates and other warranties.

This reinforces the motion that a charterparty is a contract of services and not a financing contract.

Multiple parties

It is not uncommon for a ship to be time chartered to one party, who time charters it to a second party, who in turn time charters it on. Provided the term of each subcharter is less than or the same as the head charter and there was no prohibition against sub-charters in the head charter, this is acceptable. The failure of a subcharterer to pay hire, does not excuse payment of hire by the charterers further up the chain. The Bills of lading will be issued by the master of the ship to evidence receipt of the cargo. The master issues the bill of lading on instructions of the last subcharterer in the chain, a person with whom the shipowner may have no relationship at all. Yet the shipowner

is the carrier of the cargo and is liable for loss of or damage to the cargo to the consignor/consignee. The shipowner may be obligated to deliver the cargo to the consignee, if the bill of lading has been issued freight paid, even though hire has not been paid throughout the chain of charterparties. No financier puts itself at the mercy of people it does not know in such way.

Long Term Charterparties

On the face of it, the long term charterparties such as those which are entered into for LNG carriers or containerships might be deemed to be leases. They are not. The sponsors of an LNG project or the charterer of a containership need a reputable shipowner to operate the ship required to carry its LNG or its customers' cargo, as the case may be, to its designated markets. Hire inevitably has two components, one, the capital element and the other the operating cost element. There is a simple explanation for this division, the cost of providing the officers and crew, covering the ship and its obligations by insurance, repair and maintenance costs, drydocking costs etc may vary considerably over the term of the charterparty. The charterer cannot allow the owner to become insolvent because of its operating costs eat into its margins. The charterer needs the service of the ship to enable its cargoes to be delivered for the end user, who, for example, may need the LNG to run its electricity plants and so light a city.

The other characteristics of a time charterparty exist in such long term charterparties: there are terms such as offhire, a right to withdraw as a consequence of the failure to pay hire, warranties and so forth. Moreover the capital element of hire may be less than the financing costs of the ship. The obligation to use the ship is not unconditional and obligation to pay hire is not unconditional.

With one exception which is noted below, there is no adverse consequence of treating such charterparties by expensing the hire paid, and requiring a note in the accounts as to the existence of the charterparty and its term. There is no justification for treating the hire earned as a service component and an interest component and putting the asset in the balance sheet of the owner at its residual value and in the charterer as "a right to use". Those who finance LNG projects understand what they are doing and

those who finance such ships understand quite clearly what the obligations are. There is no disadvantage accruing to any person from not treating such charterparties as contracts of affreightment or services, and not as leases.

Impact of the New Rules

It is proposed that a charterer of a ship might book the charterparty as an "*asset*" which is identified as a "*right to use the asset*" which will be depreciated (not necessarily at the rate implied by the hire) and that the hire payments will be divided into interest components and service components. This gives rise to the possibility that the full amount of the hire payments may not be deductible for tax. The introduction of an asset will inflate the balance sheet of the charterer. The owner of the ship has problems, the ship may need to be booked at its residual value, not its full value and the hire the shipowner receives divided into separate components, of which one is interest.

Tax

Shipowners who pay tax on their shipping profits are not common phenomena. For many years tax has been assessed on shipping profits on the basis that the revenues derived by the ship owner from the uplift of cargo or passengers in the taxing jurisdiction are compared with its shipping revenues from world-wide sources and the fraction thus created is used to multiply the actual worldwide shipping profits of the shipowner to determine the taxable profits in the taxing jurisdiction. UK, USA, Hong Kong, Australia, Israel, Egypt and other countries have all had or have variations on such tax models. They arise because shipping is an international business and most of the activity is carried on in international waters. Many countries now have double tax treaties which exempt shipping profits earned by an enterprise of one country from tax in the other country.

Moreover today many states recognize that shipping is an international business, which should be exempt from tax and shipping income is now often completely exempt from tax.

If charterparty income is deemed to be derived from a financing contract, the income (or more especially the interest) is NOT derived from shipping, it is derived from financing activities and could become taxable as interest, not as shipping income. Thus a hard earned exemption of shipping profits from taxation may become redundant. Shipping income may become interest income to satisfy the requirements of the accounting rules to reclassify charterparties as leases.

It is idle to say that this has not happened in respect of airlines. Airlines are often expressions of national identity, while shipowners are mostly entrepreneurs for whom governments and taxation authorities have little or no sympathy. The risk may be small, but it is one which ought to be recognised. It cannot be the intention of the board to change the commercial nature of a transaction; but surely that is what will happen if as is proposed the new lease accounting rules are to apply to charterparties.

Problems

In the author's experience, the failure to account for charterparties in the way suggested by the board has seldom, if ever, led to problems with the owner or charterer. However, there is always an exception and, perhaps inevitably, it involves Enron. But the problem was the opposite of what the board is seeking to protect against. Before Enron collapsed in a heap of accounting irregularities, it chartered an LNG carrier from a European owner by a long term charterparty. It booked the ship as if it were an asset, i.e. on the basis now recommended by the board, and thereby inflated Enron's balance sheet. The liabilities were not visible because they were submerged in a host of other liabilities. Enron went into Chapter 11 so that the charterparty was not enforceable by the shipowner.

At such time, market for such ships was thousands of dollars per day below the rate at which the ship had been fixed to Enron. The owner was not a banker, it was a shipowner operating with a relatively small capital and low cash reserves and on thin margins. It was essential the ship was released from Enron's grip, so that the ship could start earning for the shipowner. However, the trustee in bankruptcy of Enron had a significant asset on his books. The liability under the charterparty was, in effect, discharged, because it was unenforceable. In the end, the owner was required

to pay a significant sum to have the ship released from the contractual obligations under the charterparty. Treating such charter as an asset of Enron, gave an opportunity for Enron and its creditors to profit from what was a significant liability, which at the time could not be covered by the potential revenues for such ship.

Listed companies

There are a number of shipping companies listed in stock markets such as New York, Belgium, Oslo, Hong Kong and Singapore. Those that follow such companies understand the shipping market and the nature of charterparties. They do not need the protection that the board proposes.

Projects which use LNG ships are financed by banks who understand clearly the nature of the contract, and the liabilities that charterparties create. There is no need to protect such banks. These are not businesses in which the obligations are hidden from view. The charterparties are identified in notes to the accounts. The risk of misinterpretation is zero.

On the other hand, adding in the books of a shipping company, chartered in ships as "*assets*" with corresponding liabilities, does distort the balance sheet and could lead to a breach of the debt equity ratios and similar covenants. The business model of shipping is transparent, those who lend to shipping are not naive, and the risks are apparent and clearly recognized.

The proposals by the Board thus protect an illusion as an interested party.

Summary

One of the disappointing characteristics of the Papers is that the Board appears to have focused almost exclusively on the financing industry and, in particular, the aircraft industry. It is as if shipping does not exist.

Shipping is a huge industry. Its particular way of doing business is adversely affected by the proposals. The board is therefore urged to make the appropriate exemptions to

its one-size-fits-all proposal. Above all, the board must recognize that the need to add liability to a balance sheet, if no corresponding asset truly exists, means that another solution has to be found. Charterparties have to be listed in the notes to the accounts, if a ship is chartered in. The liabilities should be recognized in the profit and loss account as appropriate. For the owner of such a ship, it may be appropriate to describe the charterparty in notes to its accounts, but it is not acceptable to distort the economic and legal effect of such a contract by classifying the income into non shipping components. The function of accounting is to record the effects of a contract in the accounts of an enterprise: accountants should not become alchemists to transform the nature of what is before them.

From a practical perspective, and without derogating from the fundamental principles referred to above, change in the accounting treatment of time charters would give rise to significant implementation hurdles and economic cost to owners and charterers, and a comprehensive study of these consequences should be undertaken before any change in the rules is implemented.

For example, the proposal to ‘gross up’ a lessee’s balance sheet for a lease liability and right-of-use asset and to account for a lease as a financing will likely have an adverse impact on at least certain of a lessee’s financial ratios even though a lessee’s financial condition or financial performance has not changed. We are concerned that, without corresponding contemporaneous changes to financial covenants, certain financial covenants could be breached solely due to a change in accounting policy because the financial covenants were designed and written with existing lease accounting rules in mind.

The IASB and FASB should coordinate with the financial institutions industry to determine how financial covenants should be recalibrated to result in the same measure of risk, ability to service debt, etc. for the same entity under the proposed accounting standards.

The Association would be grateful if the Board would take this submission and the recommendations of the Association into account in the development of the proposed Standard.

Yours faithfully

A handwritten signature in black ink that reads "Arthur Bowring". The signature is written in a cursive style with a large initial 'A'.

Arthur Bowring
Managing Director

(This submission kindly prepared for the Association by Mr. Daniel R. Bradshaw,
Meyer Brown JSM, Hong Kong)

Appendix

The flags of a ship confer its nationality, but registration of the ship also records the ownership and the mortgages on that ship. Because leases of aircraft are common, aircraft are usually registered in the disponent ownership of the lessee, and registration records the lease (and may record mortgages over the aircraft granted by the owner) and confers nationality.

In the 1980s, a number of countries, such as Germany, the Philippines, Panama, and Cyprus devised a dual registration system whereby the ownership of the ship will be recorded in one shipping register, together with the mortgages, but the obligation to fly the flag of that jurisdiction will be excused for so long as the ship is demise chartered to a person who registers the ship in its disponent ownership in another country's register and flies the flag of that country. Such demise charters are very often transactions under which little or no value flows as the ship may be time chartered back to an associate of the owner.