



International Accounting Standards Board
Working Group on Leases
30 Cannon Street
London EC4M 6XH
United Kingdom

29 December 2010

Dear Sirs,

IFRS Exposure Draft on Leases (August 2010)

We are responding to your invitation to comment on the Exposure Draft on Leases, as published in August 2010 by the International Accounting Standards Board (the “Board”), on behalf of The China Navigation Company Pte. Ltd.

Based in Singapore, The China Navigation Company Pte. Ltd. owns and operates 24 vessels – 17 owned and 7 chartered in on a time charter basis. The vessels are used as part of a liner shipping service. The vessel charters are currently accounted for as operating leases, which we believe reflects the commercial substance of the charter agreements (i.e. essentially renting cargo space).

Whilst we agree that the existing standard on lease accounting (IAS 17) requires further improvement, we do not support the proposed changes made by the Board outlined in the Exposure Draft. In our view, the proposed changes may not achieve the desired effect of comparability but could instead lead to misleading information being provided as well as place a significant administrative burden on companies in the shipping industry. We will elaborate these issues in more detail below.

Implications of the proposed treatment

I. Impact on lessee accounting

a) Operating lease versus finance lease – now one model

Our company charters in vessels and leases containers and these are treated as operating leases, i.e. these transactions are ‘off balance sheet’. With the proposed lease accounting standard, all leases (charter in) within scope will be ‘on balance sheet’ for lessees and will cause an increase in assets and liabilities in the balance sheet. This will impact our key ratios and covenants.



b) New Measurement basis for lease liability

The lease liability will be different from the finance lease liability calculated under IAS 17:

- Proposals regarding lease term and contingent rentals will tend to increase lease payments compared to IAS 17; and
- Proposals regarding purchase options and residual value guarantees will tend to decrease lease payments compared to IAS 17.

The new proposals will therefore increase the use of judgment and estimates while potentially reducing the clarity of the financial statements on inception and throughout the term of lease(s). Additionally it will increase volatility in reported assets and liabilities as lease liabilities are reassessed throughout term of lease potentially distorting the financial statements.

c) Recognition and measurement of right-of-use asset

The new proposals will cause the front-loading of income in the profit and loss account due to the amortization of the asset and the interest charge on the liability.

The impact will be to increase in EBITDA (earnings before interest, depreciation and amortization) and similar measures, as a result of removing the operating lease expense from the EBITDA calculation (whereas amortization is included). This may have a material impact on company performance measures.

II. Increase in compliance cost and complexity in measurement

The assessment of the lease term, renewal options and contingent rents are some of the areas which will add complexity to lease accounting if adopted. The additional work involved in these assessments, both for the year of transition and on an ongoing basis, will be significant for the lessee of charter in vessels.

The new proposed standards could be a time-consuming and costly exercise.

III. 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 perceive that they retain exposure to significant risks or benefits of the underlying assets in order to make a decision as to whether to recognize the asset on their books. Lessees, however, will definitely have to recognize the assets on their books.

There is a possibility that the lessee and lessor would have both recorded the assets in their books resulting in a “doubling-up effect”. In addition, the requirement of both lessee and lessor to estimate contingent rentals and renewal options may lead to inconsistent presentation by the two companies involved.



IV. Distortion of financial parameters

The key financial parameters of the organization will be greatly affected by the new proposals. An increase in assets and liabilities is highly likely to result in lower asset turnover ratios, lower return on capital, and an increase in debt to equity ratios, which could cause non-compliance with loan covenants and affect the credit risk of the organization.

The argument that users of the financial statements (such as analysts) will benefit from the proposals appears weak given that IFRS 7 already requires extensive disclosure of liquidity and the maturity profile of liabilities. Analysts already make their own adjustments to the financial statements using the information disclosed.

V. Non-core and low value leases

The proposal for short-term leases of less than 12 months to be exempted from the full requirements does not go far enough. In reality, certain non-core and low value leases (for instance, photocopier leasing) would exceed the 12-month cut off and have to be accounted under the proposed treatment. The inclusion of such leases has limited benefit to the users of the financial statements and will be very time consuming for the preparers of the financial statements.

VI. Presentation in Financial Statements

IAS 17 does not contain detailed presentation requirements. For example, there is no requirement for a lessee in a finance lease to present the assets and liabilities (arising from lease contracts) separately from other assets and liabilities in its statement of financial position. For many entities, the new proposals would increase the number of line items in their statement of financial position.

The new proposals indicate that a lessee present the asset and liability arising from a lease contract. The presentation changes will be included in the:-

- 1) Statement of financial position
- 2) Statement of comprehensive income
- 3) Statement of cash flows*

*The presentation in the statement of cash flows is more prescriptive than current requirements and may represent a change in practice for many entities.

VII. Withdrawal of existing guidance

There is no specific guidance proposed regarding:-

- 1) Lease incentives
- 2) Re-negotiation of lease assets and liabilities
- 3) De-recognition of lease assets and liabilities



Suggested alternative treatments

I. Adoption of a principal based standard to remove structuring opportunities

The Boards should consider removing the structuring opportunities that are possible under the existing standard. We recognize that one of the criticisms of the existing standard is that some leases may be structured to avoid the recognition of assets on the balance sheet. A principal-based standard focusing on the difference in substance for “in substance purchases” and “other leases” should help to ensure that all “in substance purchases” are recognized as assets.

II. Exclusion of factors which requires arbitrary estimates

The inclusion of options and contingent lease period rents in computing lease payments and the lease term should be removed as it adds complexity and is open to manipulation since these require estimates to be made by management.

Should it be necessary to include these factors, we propose that the Boards include more specific criteria on the assessment of such factors. For instance, optional lease periods should be included only if the incentives granted for the extension of the lease period will significantly enhance the probability of the lessee extending the lease. In this way, the level of management judgment required in assessing the probability will be reduced.

III. Broaden the definition for non-core and low value leases

The inclusion of non-core and low value leases provides limited benefit to the users and increases the workload of the preparers significantly. As such, we recommend that the Boards consider redefining these non-core leases using a broader basis instead of a time bar of 12 months or less.

The Boards could consider enhancing the disclosure requirement for such leases to enable users to extract relevant information if they require them.

We would welcome the opportunity to discuss these views in further detail with you. If you have any questions regarding our comments, please do not hesitate to contact the undersigned on +65 6603 9484 or at amyon.chaffey@chinanav.com.

Yours sincerely,
For and on behalf of The China Navigation Company Pte. Ltd.

Amyon Chaffey
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