

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

6 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 Swire Pacific Offshore Operations Pte Ltd.

Based in Singapore, Swire Pacific Offshore Operations Pte Ltd owns and operates over 70 offshore support vessels which are chartered to customers in the oil and gas industry. The vessel charters are currently accounted for as operating leases, which we believe reflects the commercial substance of the charter agreements.

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 an a significant administrative burden on companies in the offshore support vessel industry . We will elaborate these issues in more detail below.

Implications of the proposed treatment

I. Assessment of lease term and reassessment of renewal options and contingent rents

The determination of the lease term based on the probability of the renewal option being exercised makes the estimation of the length of the lease term very arbitrary. The probability of the lease term extension may vary from period to period and may be greatly affected by industry demand and supply.

Under the existing accounting framework, the estimated lease payments to be received from renewal and contingent rents typically do not meet the definition of assets. They are not a resource controlled by the company and the company may not derive future economic benefits from them. As such, they are not currently included in the value of the minimum lease payments. If, as is suggested by the Exposure Draft, such optional lease receivables and contingent rents are included, the lease receivable may be overstated and not reflect the commercial substance of the charter hire agreement.

In addition, the inclusion of contingent rentals using an expected outcome approach would require companies to develop different scenarios for different leases. This not only increases compliance costs, but also allows the preparers of the financial statement to make arbitrary estimates when calculating the value of leases. This could lead to manipulation of companies' results to achieve desired outcomes.

As the nature of the offshore industry is cyclical, companies within the industry will have difficulty in accurately estimating the length of the expected lease term and the certainty of renewal options and contingent rents. According to the Exposure Draft, reassessment of the lease term, renewal options, residual value guarantees and contingent rents is required when there is a significant change in the circumstances. Readjustments to the financial statements will have to be made on a regular basis and this could cause significant fluctuations in the profitability reported by companies. It also reduces the comparability of financial statements across financial periods.

Many charter hire agreements are for periods of 12 months or less. The inclusion of option periods may result in charter hire agreement extending beyond one year, resulting in companies not being able to qualify for the simplified treatment. The industry may face pressure from customers to structure charter hire agreements to be of a shorter length in order for customers to qualify for the simplified accounting treatment. A situation where accounting treatment dictates commercial behavior is one we would wish to avoid.

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 lessors of offshore support vessels.

III. Compliance with local tax and cabotage rules

Where vessels are on long-term charters and hence derecognized from the lessor's balance sheet, there may be unfavorable tax consequences. These include the possibility of not being able to qualify for capital allowance claims. Furthermore, derecognition of the assets may make it more difficult to comply with local cabotage rules, especially those which require the vessels operating in the local region to be owned by the company and hence reflected in the company's audited accounts.

IV. 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.

V. 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.

VI. Front-loaded lease interest income

Rather than recording charter hire revenue on a constant basis, under the Exposure Draft proposal the lease income received will be front-loaded resulting in higher revenue at the start of the lease term. This may not reflect the pattern of the economic benefits arising from the assets, for example the economic benefits from vessel chartering do not usually differ materially throughout the lease period.

VII. 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.

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 6309 3618 or at nigel.gribble@swire.com.sg.

Yours sincerely,

For and on behalf of Swire Pacific Offshore Operations Pte Ltd
Nigel Gribble
Finance Director