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International Accounting Standards Board 30 Cannon Street London EC4M 6XH BY EMAIL ONLY

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**Dear Sirs** 

## **LEASES EXPOSURE DRAFT ED/2013/6 - SHIPS**

Your exposure draft ED/2013/6 invited comments on your proposed International Financial Reporting Standard relating to leases. The UK Chamber of Shipping, as the trade association for the UK shipping industry, with some 140 member companies who operate a total of approximately 1,000 ships, is pleased to respond to that invitation.

Our response focuses on the effect of your proposals on ship charters – you may find it helpful to refer to our letter of 17 July 2009 (in response to your discussion paper DP/2009/1) for descriptions of the charter market and of the different types of charters that are used to meet the various requirements of merchants and shipowners. In short, we believe that your proposals will create particular difficulties with accounting for time charters.

As a preliminary point, however, we do not recognise the criticism – as stated in your snapshot document – that the current practices for accounting for charters are "misleading". (We make no comment in relation to the transparency of accounting for leases in other business sectors.) No such criticism has been raised in discussions among our membership. The long-established practice of disclosing charters in notes to financial statements is transparent and well-understood.

The UK Chamber of Shipping is concerned that your proposed standard would cause three particular problems for companies that charter-in ships:

- It would cause serious damage to their balance sheets, by describing charter costs as liabilities. In every case, this will affect the company's gearing, by making it appear less well capitalised, and may put it in breach of its covenants with its bank. This will necessitate the renegotiation of those covenants. We highlighted the associated risks in our letter of 17 July 2009 and, with developments in the credit market since then, the effect is likely to be even more prejudicial to the shipping company now than four years ago.
- It would distort their profitability, as the requirement to amortise a charter will cause "interest payments" in the early years of a charter to be stated in a manner that does not reflect the outflow of cash under the charter. This artificial depression of a shipping company's profitability is undesirable and there are few grounds for supposing that the prospect of greater apparent profitability several years hence at the end of the charter will offset the immediate damage to the company's apparent health now.

It would be difficult to administer, because single payments under the charter would need to be
disaggregated so as to identify the cost of the supply of the ship itself separately from the supply
of services of ship-management, crew, etc.

A further problem is foreseen if your proposal is not adopted as a global standard, as the accounts of comparable businesses will appear very different depending on whether they are based in a country that observes your standard or not. Shipping companies in the UK and other countries that observe your standard will appear to be in a much weaker financial position than their competitors overseas. This distortion will impair their ability to access finance or, at least, increase its relative cost – thereby placing UK shipping companies at a competitive disadvantage in global markets.

We would expect that the consequences of preparing accounts in accordance with your proposed standard would be so damaging that any shipping company in a position to do so would seek to avoid it. PLCs may have no choice, but we would expect private companies not to elect to follow your standard. It would also be unsurprising if companies that currently rely on time charters to provide the shipping capacity they require for their business were to opt instead to use contracts of affreightment, which would provide the same tonnage but without identifying the vessel (and, therefore, without creating a large liability on their balance sheet). In our view, the prospect that an accounting standard would be regarded as such a threat to their business that companies would take active steps to avoid using it wherever possible ought to be grounds for reconsidering it.

The introduction, in this latest version of your proposal, of a 12-month threshold, so that short-term charters would not need to be shown as liabilities on a balance sheet, would undoubtedly mitigate the damage that the standard would otherwise cause. Short-term charters are appreciably more common than long-term ones, and charters of 60-120 days duration are not unusual. In the current market, long-term charters are unpopular, because they deny charterers the flexibility they need in order to respond to challenging conditions. It should be noted that they are also unpopular in strong market conditions, as they preclude the ship's owner from taking advantage of rising market rates.

At the moment, the charter market is characterised by optionality, with charterers favouring short-term charters (of, typically, three or six months) with options for one or two extensions. These arrangements provide the flexibility that is vital in current market conditions: providing charterers with capacity to meet immediate cargo demands, with continued access to the tonnage if that is required, but without being saddled with surplus tonnage if the cargo demand comes to an end. In deeming such optional extensions to be integral parts of the original charter term, your proposed definition puts a false construction on such charters and disregards the commercial reality.

Indeed, given that the effect of a charter being classified as other than a "short-term lease" would be so punitive for the charterer, we would see a risk that your definition could actually determine market behaviour, and cause charterers to avoid writing-in options that could extend the term of a charter beyond 12 months. Plainly, this would be unsatisfactory: an accounting standard ought not to drive business decisions. The definition of a "short-term lease" ought to be concerned solely, as the account themselves would be, with the contractual term of the charter; we would accordingly urge that it be modified so as to remove the reference to options for extensions.

Your proposed standard would also create corresponding problems for shipowning companies that charter-out their ships on time charters. Firstly, their profitability would be distorted by being inflated in the early years of a charter and depressed in its later years, by "interest payments" that bear no relation to cash receipts. Secondly, they would face significant additional administrative work, being required to value the debt and residual elements of the charter at initial recognition (which would in practice be a complex exercise, reliant on estimates), rather than simply recording income on a straight line basis. Again, no obvious value would be added to the business by any of this work.

Overall, the UK Chamber of Shipping considers that your proposal would be damaging, problematic and costly for shipping companies, while yielding no business benefits in return. These undesirable

impacts would be reduced by modifying the definition of a "short-term lease", to bring it into line with the accounts themselves and disregard optional extensions that do not comprise an integral part of the charter. The UK Chamber would advocate such a modification in any event, but this would merely mitigate the problem. It would be preferable by far to avoid creating the problem in the first place, and the UK Chamber would, therefore, strongly urge that ships be removed from the scope of your proposal, and that time charters continue to be accounted for in the long-established and well-understood manner through disclosure in notes to financial statements.

Yours faithfully

Tim Reardon

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