

# European Community Shipowners' Associations



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Dear Sir,

## **International Accounting Standard Board International Financial Reporting – IFRS Exposure Draft ED/2010/9 on Leases**

### **IFRS Exposure Draft ED/2010/9 on Leases**

ECSA is the professional association representing the interests of the shipowners of the EU and Norway. The ECSA membership controls 41 % of the global merchant fleet and is active in all kinds of maritime services: intra Europe, in the trade between the EU and third countries and in so called cross trades between non EU trading entities.

ECSA refers to its letter of 26 June 2009 on the discussion paper leases (DP/2009/1) – that expressed the concerns in respect of the impact of the envisaged standard on the shipping industry in general – and to your letter of 3 September 2010 inviting ECSA's views on the IFRS Exposure draft ED/2010/9 on Leases. As mentioned in the letter of 26.6.2009, ECSA would reiterate that for the shipping industry Operating Leases are like a commodity. ECSA would therefore highly appreciate that the specific position of "time chartering" is taken into consideration when developing the final standard on lease accounting.

### **Introduction**

A large number of respondents to ED/2010/9 *Leases* ("the ED") have articulated their comments around the complexity of the ED, the lack of reliability of the estimate of the lease term and several components of the lease payments (contingent rentals, residual value guarantees, and term option penalties), the expected difficulty in periodically reassessing the lease term and the lease payments and, in general, the cost of complying with the proposed new standard.

We share these concerns and strongly believe that the benefits of the ED do not outweigh the considerable efforts that are likely to be expended in adopting the new approach mandated by the ED.

We are particularly concerned about the adverse impact on financial covenants in general and on debt-to-equity ratios in particular and the possible reaction of lenders, especially in the current economic environment where credit is scarce. Furthermore, the front-loading of expenses in the lessee's profit or loss is also seen as a negative.

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In addition, we also believe that a number of proposals included in the ED conflict with guidance included in other standards or exposure drafts that are currently outstanding. Details are as follows:

### Comments

- **Use of “bright lines”**

IAS 17 *Leases* currently does not use “bright lines” to distinguish between operating leases and finance leases, as opposed to the standard applicable under US GAAP. Instead, IAS 17 uses terminology such as “*the major part of the economic life of an asset*” and minimum lease payments that amount to “*at least substantially all of the fair value of a leased asset*”. The joint IASB and FASB project on leases aims among other things at eliminating the use of “bright lines” in US GAAP.

The ED introduces at least two cases of “bright lines”, one in the definition of short-term leases, the other in the determination of the lease term. These two “bright lines” interact one with another in a way that reinforces their combined effect:

- **First “bright line”: short-term leases = not more than 12 months**

Paragraph 64 of the ED defines a short-term lease as a lease for which the longest possible lease term is not more than 12 months. The accounting treatment available for short-term leases under paragraph 65 of the ED (measuring the lease liability and the right-of-use asset at the undiscounted amount of the lease payments) differs markedly from that required under paragraph 12 (a) of the ED (measuring the lease liability at the present value of the lease payments).

As a result, a difference of one day in the lease term could cause significant differences in the measurement of the lease liability and the right-of-use asset.

Distinguishing between short-term and other leases should be a matter of accounting policy. Paragraph B18 of the ED lists a number of factors (contractual, non-contractual, business, and specific to the lessee) which can be used by an entity to determine whether the alternative treatment under paragraph 65 of the ED would be appropriate in the circumstances.

- **Second bright line: determining the lease term = 50% + probability of occurrence**

The difficulty addressed in the previous paragraph in relation to the definition of a short-term lease is compounded by the fact that the determination of the lease term – which is used for defining short-term leases – also uses a “bright line”. Under paragraph 13 of the ED, the lease term is the longest possible term that is more likely than not to occur. “More likely than not” refers to a probability in excess of 50%.

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Determining at the inception of a lease the likely lease term will require predicting the likelihood of events that could take place after a considerable period of time, particularly for those leases with a long initial non-cancellable term. Subjecting this determination to a “more likely than not” test would not only add to the complexity of this determination, but, in addition, is inconsistent with a principles-based approach that should ban the use of “bright lines”, e.g., 50%.

Under IAS 17, the lease term is the non-cancellable contracted period plus any additional periods for which the lessee has the right to extend the lease and for which, at inception of the lease, it is reasonably certain that the lessee will exercise its option. Determining that a future event is reasonably certain does not require the use of a probability threshold. The ED should retain the existing guidance under IAS 17.

- **Contingent rentals**

Under paragraph 14 (a) of the ED, contingent rentals are included in lease payments when determining the lease liability, based on a probability-weighted estimate of contingent rentals payable, using a reasonable number of outcomes for which a probability distribution is estimated. This approach is questionable in two respects:

- **Definition of a liability**

It is not clear whether contingent rentals create an unconditional present obligation – and, therefore, a liability – since the payment of contingent rentals is triggered by external factors that are not within the control of the lessee (e.g., volume of sales or number of products manufactured).

- **Expected present value – Probability-weighted approach**

A probability-weighted approach (“expected present value”) is normally associated with the determination of the fair value of an asset or liability. For example, FASB ASC subtopic 410-20 *Asset Retirement Obligations* requires entities to measure asset retirement obligations initially at fair value and states that an expected present value technique will usually be the only appropriate technique with which to estimate fair value.

Under paragraph 16 (a) of the ED, a lessee would not be permitted to measure its lease liability at fair value. Therefore, the use of a probability-weighted approach (“expected present value”) in the determination of contingent rentals is inconsistent with the measurement base of the lease liability adopted in the ED.

Contingent rentals should be recognised in profit or loss, as and when the related contingencies are resolved.

- **Consistency with ED 2010/6**

The satisfaction of a performance obligation is central to the proposed revenue recognition model under ED/2010/6 *Revenue Recognition from Contracts with Customers*.

Since lease accounting from the perspective of the lessor is entirely a matter of revenue recognition, it is not clear why the ED should retain two alternative approaches, i.e., the performance obligation approach and the derecognition approach.

A dual model of accounting for the lessor (performance obligation approach vs. derecognition approach) is counterintuitive and is apt to create confusion. In addition, since ED 2010/6 uses a performance obligation approach – and lease accounting from the perspective of the lessor is a matter of revenue recognition – we believe that a single model – the performance obligation approach – should be mandated in all cases.

- **Changes in lease payments – Reassessment of facts and circumstances**

Paragraph 17 of the ED requires that contingent rentals, residual value guarantees and term option penalties be reassessed if facts or circumstances indicate that there could be a significant change to lease assets or lease liabilities since the previous reporting period.

Paragraph 7 of IFRIC 9 *Reassessment of Embedded Derivatives* requires that an entity assess whether an embedded derivative should be separated from the host contract when the entity first becomes a party to the contract. Subsequent reassessment is prohibited, unless there is a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract. Paragraph BC6 of IFRIC 9 further concludes that reassessment is not appropriate for changes in external circumstances (emphasis added).

Changes in contingent rentals, residual value guarantees and term option penalties are similar to changes in external circumstances, since they are driven substantially by market, product and/or technological factors. As a result, paragraph 17 of the ED is inconsistent with the accounting treatment of embedded derivatives under IFRIC 9.

We recognise that the underlying in contingent rentals, residual value guarantees, and term option penalties is a non-financial variable specific to a party to a lease contracts and, therefore, these instruments do not meet the definition of a derivative under IAS 39. As a result, analogizing the ED with IFRIC 9 may not be appropriate. Nevertheless, except for the difference in this characteristic of the underlying, these instruments are in every respect similar to derivatives (underlying, notional amount or payment provision, no or small initial investment, and settlement at a future date).

Although contingent rentals, residual value guarantees, and term option penalties are not derivatives, there is no reason why the guidance regarding the reassessment of the need to separate embedded derivatives, on the one hand,

and the reassessment of contingent rentals, residual value guarantees, and term option penalties, on the other hand, should be different.

The resolution of a rental contingency, the change in the residual value of a leased asset and the change in the penalty for lack of exercise of an option to extend a lease do not change the contractual terms of a lease, but instead arise from external facts and circumstances. For the sake of simplicity and consistency with accounting guidance dealing with similar issues, these changes should be reflected in the financial statements only as and when they occur.

- **Presentation in the statement of comprehensive income of the lessor – Performance obligation approach**

The ED proposes that under the performance obligation approach the lessor present separately from other interest income, income, and depreciation expense, the interest income on the lease receivable, the income from satisfaction of the lease liability, and the depreciation of the underlying asset.

The ED also proposes that the lessor classify the cash receipts from the recovery of both the principal and interest as cash flows from operating activities, again, separately from other operating cash flows.

If the lessor uses leases as an alternative to selling, an entity should be permitted to report both the interest income on the lease receivable and the income from the satisfaction of the lease liability as one amount in a single line of the statement of comprehensive income, with a breakdown of the amount in the notes to the financial statements. This would align the presentation of lease income in the income statement under the two approaches, i.e., the performance obligation approach and the derecognition approach. Moreover, the classification of lease income as one single line item in the statement of comprehensive income would be consistent with the classification of lease cash receipts in the statement of cash flows.

- **Presentation in the statement of financial position of the lessor – Performance obligation approach**

The ED proposes that under the performance obligation approach the statement of financial position of the lessor present a net total – as a lease asset or a lease liability – of the underlying asset, the right to receive lease payments (lease asset), and the liability to permit the lessee to use the underlying asset (performance obligation).

The statement of financial position would better reflect the economics of the transaction, if the underlying asset were reported separately in the statement of financial position, and the lease asset and performance obligation as one single item – as a lease asset or a lease liability.

- **Derecognition of the lease asset and the lease liability (and derivatives embedded in leases)**

The ED does not provide guidance on derecognition of lease assets and lease liabilities (and derivatives embedded in leases).

Paragraph 2 (b) of IAS 39 *Financial Instruments: Recognition and Measurement* contains a scope exclusion for rights and obligations under leases to which IAS 17 *Leases* applies, except for issues of derecognition and impairment of lease receivables (paragraph 2 (b) (i)), derecognition of lease payables (paragraph 2 (b) (ii)), and derivatives that are embedded in leases (paragraph 2 (b) (iii)). In all of these three cases, the relevant provisions of IAS 39 apply. IFRS 9 *Financial Instruments* did not change the scope of IAS 39.

In the absence of indications to the contrary, it can be assumed that the existence guidance on derecognition of financial assets and financial liabilities, and embedded derivatives, under IAS 39 will continue to apply to leases under the ED. However, this matter should be clarified.

- **Lease incentives**

The ED would replace IAS 17 *Leases*, and three IFRIC interpretations, including SIC 15 *Operating leases – Incentives*.

The ED does not provide guidance on accounting for lease incentives. It is not clear why the ED does not require that lease incentives be included in the initial measurement of the present value of lease payments for the lease liability (lessee) and the lease asset (lessor), since lease incentives are a form of initial direct costs. The ED should clarify whether lease incentives should be accounted for in the same manner as initial direct costs.

- **Short-term-leases**

- **Accounting by the lessee**

Paragraph 64 of the ED states that “... *such (i.e., short-term) lessees shall recognise lease payments in profit or loss over the lease term*”.

We believe that this statement is inaccurate.

Paragraph 64 of the ED states that the lessee under a short-term lease is permitted on a lease-by-lease basis to measure the lease liability at the undiscounted amount of the lease payments and the right-of-use asset at the amount of the lease liability plus initial direct costs (emphasis added).

As a result, lease payments derecognise the lease liability over the lease term, but lease payments are not recognised in profit or loss. In contrast, profit or loss captures the amortisation of the right-to-use asset, which includes not only the lease payments but also the initial direct costs.

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- **Accounting by the lessor and the lessee**

Paragraph 65 of the ED provides that for short-term leases a lessor is permitted on a lease-by-lease basis not to recognise additional assets and liabilities arising from the lease contract in the statement of financial position and not to derecognise any portion of the underlying asset. In other words, the ED permits a lessor to continue accounting for short-term leases under the operating lease model under current IAS 17.

For the sake of consistency, we believe that the same option should be available to the lessee under a short-term lease (as defined). In other words, the lessee under a short-term lease should be permitted not to record a lease liability and a right-of-use asset, and to record lease payments under the operating model under current IAS 17.

Yours faithfully,



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