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New leasing standard & the shipping community

Shipping

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After almost ten years of joint deliberations between the International and the US standard setting bodies (IASB and FASB respectively), the new standards on leasing were issued in the first months of 2016. The article below attempts to identify and summarise the impact on the shipping industry.

Why does this development affect the shipping community?

Time charter, bareboat charters and other arrangements that are widely used in the shipping industry will typically fall under the definition of a lease.

Unlike the current practice, any lease arrangement with a term of more than 12 months will have to be recognized on the balance sheet in the manner explained below.

The main impact of the change affects lessees (charterers) that use operating leases, which are currently not recognized on the balance sheet, with only a disclosure of lease commitments required in the notes.

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What is the position of the international shipping community vis-à-vis the new standard?

The International Chamber of Shipping ('ICS') strongly opposed the changes in the lease reporting standards.

ICS submitted comments to the International Accounting Standards Board ('IASB') on behalf of the international shipping industry on 14 December 2010, had a meeting with the IASB on 30 March 2011 and submitted further comments and their position again on 11 July 2011 and 20 September 2013. The reasons for the ICS's opposition are examined below.

Effective date

International Financial Reporting Standard ('IFRS') 16 is effective in 2019.

New definition of a lease and contracts used in shipping

Briefly, a contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration.

There is detailed guidance and a flowchart in IFRS 16 on how this definition is applied.

Key considerations in applying the definition:

- Does the customer have (a) the right to obtain substantially all of the economic benefits from use of the identified asset; and (b) the right to direct the use of the identified asset?
- Even if an asset is specified, a customer does not have the right to use an identified asset if the supplier has the substantive right to substitute the asset throughout the period of use.
- It is presumed that the customer has the right to direct use of an asset even if the relevant decisions about how and for what purpose the asset is used are predetermined.
- The 'right to control the use' of a vessel might be evidenced by the exclusive use of the ship by the charterer, where the charterer has the right to decide what cargo will be transported and when and to which ports the ship will sail throughout the period of use (even if the owner has protective rights, such as restrictions in the contract that prevent the charterer from sailing into waters at a high risk of piracy or carrying hazardous materials as cargo).
- Also, the 'right to control the use' of the vessel may be evidenced in cases where the charterer's cargo occupies substantially all of the capacity of the ship, thereby preventing

others from obtaining economic benefits from use of the ship during the period specified in the contract.

- Based on the above, the following contracts are likely to be treated as follows (but this does not mean that significant judgement will not be required):
  - Bareboat charters will typically meet the definition of a lease, as the charterer controls use of the vessel during the period of the contract
  - Time charters are likely to contain both a lease component and a service component (the operation and maintenance of the ship by the owner) – refer to the 'Service component' peculiarity below for the required treatment.
  - Pool agreements are also likely to contain a lease and a service component
  - Voyage charters are not likely to meet the definition of a lease, as the charterer does not have the right to direct the use of the ship, i.e. how and for what purpose the ship is used
  - Contracts of affreightment are not likely to meet the definition of a lease, as they are contracts for the provision of services.

It is interesting to note that the ICS notes in their comment letter to the IASB on 20 September 2013 that 'while the customer (charterer) is given the right to decide which cargoes to carry and for whom and at what price, the economic benefit that he can expect to derive from the time or voyage charter service will be limited by the way in which the ship is operated (its flag state, insurer, crew nationality, etc.) – control of which is retained by the ship-owner.'

In their comment letter of 11 July 2011, the ICS puts forward 12 arguments why, in their view, a time charter is not a lease but a contract for services to perform Charterer's instructions for the carriage of goods. The IASB addressed certain of these concerns by adding the 'service component' characteristic (described in the following paragraph) and adding certain clarifications to the definitions of control. But obviously the IASB was not convinced that the right to use the ship and the corresponding lease liability should not be presented at all on the balance sheet.

'Service component' peculiarity

This is particularly relevant to shipping. Why?

IFRS 16 stipulates that for a contract that contains a lease component and a non-lease component, a lessee shall allocate the consideration in the contract on the basis of the relative stand-alone prices of the components. If an observable stand-alone price is not readily available, the lessee shall estimate the stand-alone price, maximizing the use of observable information.

As a practical expedient, a lessee may elect not to separate non-lease components and instead account for them as a single lease component.

The ICS expressed their concern in their comment letters to the IASB stating that time charters and similar contracts for transportation services utilized by international ship operating companies could fall within the definition of a lease, when in fact such arrangements should not be treated as leases for accounting purposes. The ICS accepts that bareboat charter arrangements fall within the new definition of a lease.

The ICS asked for a clear definition of 'services'; no such definition was included in the standard.

They emphasize that reporting the lease element in a time/voyage charter arrangement is an impossible exercise and a meaningful result will not be obtained. This is because there is no open market for ships to be marketed separately from the crew and other services on a time charter contract basis. The only market for a ship to be marketed separately from the crew and related services is on a bareboat basis and this form of charter operates in an entirely separate market from the time charter and the two cannot be likened.

A lessee may elect not to separate non-lease components and instead account for them as a single lease component.

The ICS warned that this requirement will trigger significant cost and training to enable the assessment of each contract, but the results would not be meaningful to users of financial statements, being based on theoretical and subjective models of prices. They recommended to the IASB that where a contract contains both a lease and a service component, this should be regarded as not containing a lease at all. The IASB did not follow this recommendation in its final standard.

In their comment letter to the IASB dated 11 July 2011 the ICS supported the view that the service and use components in a time charter contract are inseparable. One interesting argument included in this letter is that owners are unlikely to provide sensitive cost data to charterers; thus charterers will be left with estimating the ship values and service components (such as manning, repair and maintenance, insurance, etc.) The accuracy of the final calculation will depend on the charterers' knowledge

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of ship values and experience in ship management activities and involve decisions which are highly subjective.
A counter argument regarding the measurement of service component is that there are market surveys by type of vessel that provide a reliable estimate of these services each year.
We need to follow how the practice of separating the service component from the lease component will evolve over time and whether a 'shipping practice' will emerge.

Recognition and measurement

At the commencement date, the lessee will recognize a right-of-use asset and a lease liability; these are calculated as the present value ('PV') of the lease payments.
The lease payments shall be discounted using the interest rate implicit in the lease (defined as the interest rate that causes the PV of lease payments and the unguaranteed residual value to equal the fair value of the asset). If this rate cannot be readily determined, the lessee shall use the lessee's incremental borrowing rate.
Lease payments shall include a purchase option if the lessee is reasonably certain to exercise that option.
Lease payments shall also include variable lease payments that depend on an index (such as the Baltic Dry Index), initially measured using the index at the commencement date.
The right-of-use asset shall be depreciated over the lease term; the entire useful life of the asset will be used if it is reasonably certain that the lessee will exercise a purchase option.
The lease liability will subsequently be increased by interest on the lease liability and reduced by lease payments made.
The effect of the above is that, although total lease expenses to be recognized over the entire charter period will be the same as before, they will be more front-loaded, with higher charges in the earlier years and lower in the later years.
The most significant impact of the new requirements is that there will be a significant increase in lease assets and lease liabilities.

Treatment of service component:
In response to feedback received and to provide cost relief, IFRS 16 permits a company to choose either to:

a. Separate the amounts paid for the lease and the services and then capitalize only the amounts paid for the lease; or
b. not separate lease and service components and instead account for them together as a lease.

Presentation

The right-of-use asset will be presented either separately in the statement of financial position, or within Vessels and disclosed in the notes.
Similarly, lease liabilities will be presented either separately in the statement of financial position, or within some other line and disclosed in the notes.
In the statement of profit or loss, a lessee shall present interest expense on the lease liability (which is part of finance costs) and depreciation on the right-of-use asset.
In the statement of cash flows:

a. Cash payments for the principal portion of lease liabilities shall be disclosed within financing activities;
b. Cash payments for the interest portion either in operating or financing activities.

Lessor accounting

IFRS 16 substantially carries forward the lessor accounting requirements of the previous standard (IAS 17). Accordingly a ship-owner (lessor) continues to classify its leases as operating leases or finance leases and to account for those two types of leases differently. Certain additional disclosures are required which relate to information about how the lessor manages its risks relating to residual interests in leased assets.

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The effects analysis below discusses the effects of the new leasing standard mainly from a lessee perspective.

This is because the accounting for a lessor is largely unchanged with certain enhanced disclosures required for lessors.

Effects on the income statement

[IFRS does not define terms such as EBITDA and operating profit].
The following affects lessees with off balance sheet leases: IFRS 16 will bring an increase in EBITDA and Operating profit, because lease rentals are shown as Depreciation and interest expense.

Effects on the cost of borrowing

Information received by the IASB indicates that most sophisticated users of financial statements (including lenders) already estimate the effect of off balance sheet leases on financial leverage. One academic research, which examined interest rates charged by 5,812 commercial loans over the period 2000-2009, concluded that: ''These results support our hypothesis that sophisticated credit market participants incorporate information about off balance sheet operating leases into their credit assessments'.
The IASB is of the view that changes to the cost of borrowing (if any) will result from improved decision-making which will in turn be based on improved transparency about a company's financial leverage.

Effects on debt covenants

The IASB noted that the changes to lease accounting could affect some debt covenants. They could also result in some companies no longer complying with debt covenants when IFRS 16 is applied.
A public survey conducted in 2015 by the European Financial Reporting Advisory Group (EFRAG), the IASB and national standard-setters in five EU countries covered 11 per cent of the European banking market and concluded that banks expect to reconsider the terms and conditions of debt covenants when IFRS 16 becomes effective.
We believe that shipping companies should be prepared to follow the requirements of the new standard and where breaches of covenants are likely, or reasonably possible, it is crucial that they discuss with lenders in advance.

Effects on key financial metrics

For leases previously classified as finance leases, there will be no significant change.
For leases previously classified as operating leases, significant changes are expected and summarized in the table below.

Metric	What it measures	Common method of calculation	Expected effect of IFRS 16	Explanation
Leverage (gearing)	Long-term solvency	Liabilities/Equity	⇧ Increase	Increase because financial liabilities increase (and equity is expected to decrease)
Current ratio	Liquidity	Current assets/ Current liabilities	⇩ Decrease	Decrease because current lease liabilities increase while current assets do not.
Interest cover	Long-term solvency	EBITDA/ Interest expense	Depends	EBITDA will increase applying IFRS 16 as will interest expense. The change in the ratio will depend on the characteristics of the lease portfolio.
EBITDA	Profitability	Profit before interest, tax, depreciation and amortization	⇧ Increase	Increase because expenses for off balance sheet leases are excluded.

Extract from "IFRS 16 Effects analysis" issued by IASB, January 2016.

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Sub-leases

This impacts all companies chartering-in vessels that are subsequently chartered-out (intermediate lessors).

If the charter-out is made on a spot basis, this does not constitute a lease.

Otherwise, the intermediate lessors shall classify a sublease as a finance lease or an operating lease by reference to the right-of-use asset arising from the head lease.

Transition simplifications

It is very interesting that upon initial application, IFRS 16 allows (but does not require) not to restate comparative information; the cumulative effect of initially applying this standard shall be recognized as an adjustment to the opening balance of retained earnings at the date of initial application.

When first applying IFRS 16, companies are not required to reassess existing contracts to determine whether they contain a lease applying IFRS 16.

There are certain other important transitional reliefs.

Illustrative Examples

The Illustrative Examples of IFRS 16 include two examples for a Ship (examples 6A & 6B).

Effects analysis by industry

The IASB presented the quantified impact of the new standard on ten industry sectors, including Transport. The sample used by IASB for Transport included 51 companies in five continents. Based on the comment letter of ICS of 20 September 2013, there is a reminder to IASB that over 90% of the world's trade is transported by sea.

IFRS and US GAAP: a comparison

There are many similarities and significant differences as well between IFRS and the US standard (Topic 842).

Briefly Topic 842 requires that:

- There continues to be a differentiation between finance leases and operating leases even for lessees – in contrast with IFRS.
- The principal difference from current guidance is that the lease assets and lease liabilities arising from operating leases should be recognized in the statement of financial position (similarly with IFRS).
- For operating leases, a lessee will:
  1. Recognize a right-of-use asset and a lease liability, initially measured at the PV of the lease payments (similarly with IFRS).
  2. Recognize a single lease cost, calculated so that the cost of the lease is allocated over the lease term on a straight line basis (in contrast with IFRS).
  3. Subsequently, the lease liability is measured at the PV of the lease payments not yet paid (in line with IFRS). The right-of-use asset shall be measured at the amount of the lease liability (unlike IFRS). Yet the amortization of the Right-of-use asset is the balancing figure after deducting the interest element from the total lease rental expense (unlike IFRS).
- Balance sheet presentation is similar to IFRS, except that Finance lease right-of-use assets shall not be presented in the same line as operating lease right-of-use assets; also finance lease liabilities shall not be presented from in the same line as operating lease liabilities.
- The income statement presentation is different to IFRS. For finance leases, a lessee shall present amortization of the right-of-use asset and interest expense. For operating leases, a single lease expense shall be included in the lessee's income from continuing activities.
- Service components: the treatment is similar to IFRS, including the election to account for the non-lease component together with the related lease component as a single lease component.
- Lessor accounting: the accounting applied by a lessor is largely unchanged from that applied under previous GAAP. The new guidance modifies the accounting for sales-type and direct financing leases to a certain extent.

How we can help

This summary does not cover all the changes required under the new standard and we are happy to help provide guidance on the changes that will affect your business.

Shipping businesses come to Moore Stephens because of our specialist sector knowledge and the wide-ranging advice and assistance we can give them.

For more information or to discuss how we could help you with the transition, please contact us.

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