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IFRS industry insights
Shipping industry implications of the revised leasing exposure draft

The Bottom Line

- A revised exposure draft on lease accounting has been published by the IASB and FASB with a comment deadline of 13 September 2013.
- Leases that could extend beyond 12 months will come on-balance sheet for lessees, potentially impacting key performance indicators, gearing and lending covenants.
- The definition of a lease will only capture contracts that convey control of specific identifiable assets.
- For lessees, many leases of vessels will have a front-loaded expense profile, whereas most property leases will have an overall straight-line expense profile.
- For lessors, income from most vessel leases will be front-loaded as well as recognising the profit or loss related to the leased portion of the asset, on commencement. Most property leases will have a straight-line income profile.

What's happened?

On May 15. 2013 the IASB and FASB published a revised proposed standard on lease accounting with comments requested by 13 September 2013. The IASB has published it as a revised exposure draft (the 'ED') whilst the FASB has published a revised proposed Accounting Standards Update (ASU). The leases project is a joint project of the IASB and the FASB, and the proposals of the FASB and IASB are nearly identical.

Whilst a number of problems identified by respondents to the exposure draft published in 2010 (such as the definition of lease term and the treatment of variable lease payments) have been addressed, in some instances they have been replaced by new issues that will require careful consideration and complexities undoubtedly remain.

What is clear is that accounting for leases may prove time consuming and will inevitably require judgements to be made.

Implications for the shipping industry

In this publication we look specifically at the implications of the ED on shipping entities. Of course many more complexities exist and, as described below, Deloitte has produced further guidance, exploring these in greater detail.

Leases coming on balance sheet for lessees

Lessees would recognise an asset and corresponding liability on their balance sheets for their fixed future lease payments, similar to existing finance lease accounting. Aside from a few specific scope exclusions, the only other leases that could stay off-balance sheet would be those that have a maximum possible term of 12 months, including a presumption that extension options will be exercised. This gross-up in the balance sheet, resulting from lease assets and liabilities being recognised, is likely to be significant, particularly for leases of vessels running several years.

Definition of a lease

A lease will exist where a contract conveys a right to control an identifiable asset. This is designed to capture specific assets, such as a specific vessel rather than assets of a particular specification, such as a particular type of vessel.

- Bareboat charters are expected to continue to meet the definition of a 'lease' as they typically convey the right of use of an identified vessel. Consistent with existing standards, freight agreements and contracts of affreightment (COA) would typically not meet the definition of a lease as they are contracts for the provision of a service rather than the use of an identified asset.

- Time charter agreements are more complex and assessing whether they meet the definition of a lease under the ED will hinge on the degree to which the 'right of use' results in control of the asset over the contract term. The specific contact terms would need to be evaluated to determine if the time charter agreement contains a lease component under the proposed guidance. In their deliberations the IASB acknowledged that whether time charters meet the definition of a lease will come down to facts and circumstances.

- Time charter agreements which contain a lease would require payments to be allocated based on the relative observable purchase price of the individual components: the lease and the service (which could be measured by reference to, for example, the bareboat charter rate and management fee rate). If lessees are unable to obtain observable purchase prices they would account for all the payments as a lease, rather than a lease and a separate service.

Lessees with straight-lined expense for properties but front-loaded for many other assets

Unless a property (building/land) is leased for the "major" part of its remaining economic life or the lease payments are "substantially all" of its fair value (such cases are expected to be rare) the subsequent measurement of the asset and liability would yield a straight-line single lease expense over the lease period.

The same tests would be applied for assets other than property, such as vessels, but a lower threshold of "insignificant" would need to be met and the asset's total economic life considered. Otherwise, the expense profile would be front-loaded because the lease asset would be amortised on a straight-line basis, whilst the lease liability would be amortised using the effective interest rate method. Reassessing existing leases using these tests may prove time consuming, although a transition relief means that existing finance leases could be automatically classified under the model that produces a front-loaded expense.

Lessors derecognise most non-property assets and have front-loaded income

Property lessors would typically retain the entire underlying asset on their balance sheet and recognise income on a straight-line basis. For most leases other than property, the lessor would derecognise the leased asset and recognise a receivable for the lease payments along with a residual asset. The residual asset represents the lessor's claim to the residual value of the leased asset at the end of the lease term. The residual asset on balance sheet would be measured as the net amount of (a) the gross residual asset, being the present value of the estimated residual value at the end of the lease term, and (b) deferred profit, if any. Any profit on the residual asset would be deferred until sale or re-lease of the underlying asset. Although the two components of the net residual asset would be presented as a single amount, entities must calculate the two components to apply the subsequent accounting requirements. Lessors would be required to recognise upfront any resulting profit or loss related to the leased portion of the asset.

The lessor would subsequently account for the lease receivable at amortised cost under the effective interest method, recognising interest income at the rate the lessor charges the lessee. In addition, the lessor would subsequently accrete the gross residual asset over the lease term to an amount equal to the expected residual value of the leased asset at the end of the lease also using the rate the lessor charges the lessee in the lease contract.

Areas impacted by the proposals	
Banking covenants	Initial recognition of an asset and liability may not have an impact on a lessee's net assets, but it could affect key balance sheet ratios, particularly if the liability is treated as a financing item. For leases with front-loaded expense profiles, any interest expense beyond that on existing finance leases could impact covenants based on interest cover. Renegotiations could be required.
Key performance indicators	Key metrics of a business' performance could be impacted by the proposals. Depending on how they are calculated, measures such as return on capital may be affected or need redefining. For those operating lease expenses that would be replaced with a front-loaded interest and amortisation charge, adjusted measures of lessees' earnings which strip out the effect of interest, such as EBIT, may increase and those that strip out amortisation and depreciation as well, such as EBITDA, could increase by a greater amount.
Reporting systems	Systems would need to capture all information required by any new standard – the ED proposes extra disclosures beyond those currently required. Closer relationships between finance teams and the operations teams entering into leases may be advisable to avoid undesired accounting consequences.
Remuneration schemes	Performance related pay schemes could be impacted due to changes in key performance indicators. Again, renegotiating or redefining such schemes may be advisable.
Earnouts	Where acquisitions have included contingent consideration that is dependent on the acquiree's future performance the effects of any new lease accounting would need to be assessed carefully.

Resources

More detailed information on the revised ED can be found in Deloitte's IFRS in Focus publication available from www.iasplus.com and Deloitte's Heads Up publication (for a US GAAP perspective) is available **here**.

The revised ED and ASU drafts can be accessed on the on the IASB and FASB websites.

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