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TRANSPORT

Shipping insights briefing

A view of the future:
2017 – bigger balance sheets!

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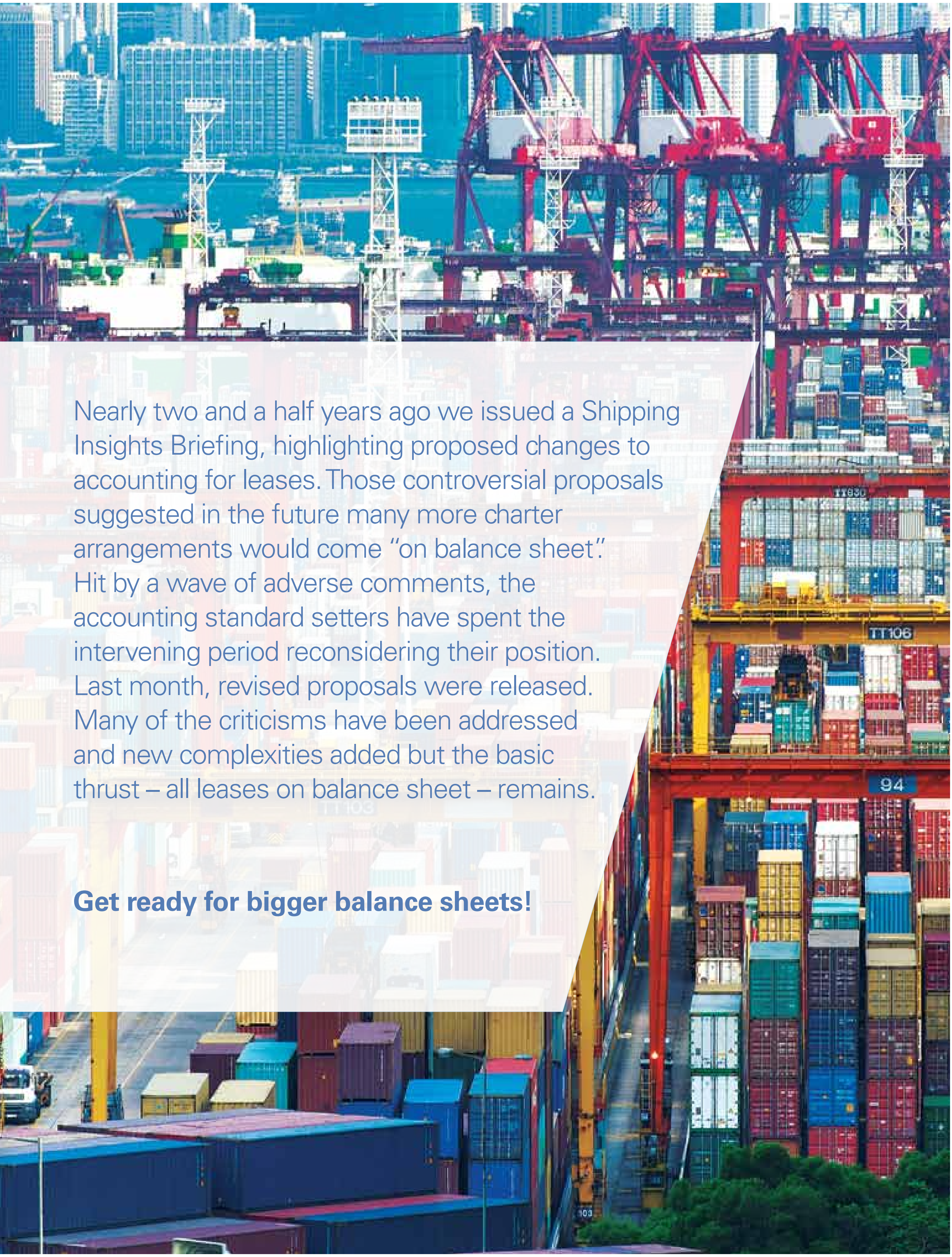


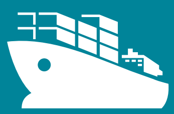
Nearly two and a half years ago we issued a Shipping Insights Briefing, highlighting proposed changes to accounting for leases. Those controversial proposals suggested in the future many more charter arrangements would come "on balance sheet". Hit by a wave of adverse comments, the accounting standard setters have spent the intervening period reconsidering their position. Last month, revised proposals were released. Many of the criticisms have been addressed and new complexities added but the basic thrust – all leases on balance sheet – remains.

Get ready for bigger balance sheets!

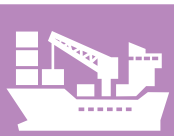
Commenting on the revised accounting proposals[1], Brian O'Donovan, partner in KPMG's International Standards Group, said:

> Bringing leases on-balance sheet is a cherished goal of the standard setters. These proposals would achieve that goal, but I question whether they represent a sufficient improvement over current lease accounting standards to satisfy financial statement users, or justify the considerable cost and complexity of implementation.

Key facts:



Many lessee companies would see an increase in reported assets and liabilities



Proposals affect 'big-ticket' ship leases and smaller items such as company cars and office space

New 'dual models' for both lessees and lessors, with property leases retaining the straight-line expense method

Remaining leases will result in amortization and interest expense (similar to today's finance leases), which could adversely affect net profit

John Luke, KPMG's Global Head of Shipping believes that:

> People's gearing will look higher, their debts will look higher. They will have quite a different-looking balance sheet and that will have an impact on their banking covenants. It may also affect their tax situation and their ability to pay dividends.

1 Issued jointly by the International Accounting Standards Board (responsible for developing International Financial Reporting Standards) and the Financial Accounting Standards Board (responsible for developing US GAAP).

In this updated Shipping Insights Briefing, KPMG's Global Shipping Practice reflects on what these proposals will mean for the shipping sector – a sector currently struggling to attract sufficient sources of finance, and one where balance sheet stresses have meant the recent failure of several significant shipping owners and operators.

Proposal headlines

- A new dual model for lease accounting along with different classification tests for property and non-property leases
- A front loaded profile of total lease expense on most non-property leases
- Lease definition based on the use of an identified asset when the contract conveys a right to control the use of the asset
- A new requirement to monitor leases throughout the lease term and re measure assets and liabilities even if there is no change to the agreement
- Transition will require all existing and potential lease contracts to be reanalyzed

Identifying a lease

The proposals define a lease as *"a contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration".* A lease would exist when both of the following conditions are met:

- fulfilment of a contract depends on the use of an identifiable asset; and
- the contract conveys the right to control the use of the identifiable asset for a period of time in exchange for consideration.

A contract would convey the right to use the identified asset if the customer has the ability to direct the use of the asset and derive benefits from its use throughout the term of the contract.

Under this definition, contracts of affreightment are unlikely to be considered leases because the underlying asset is not identifiable. A single agreement might contain multiple lease elements that would be accounted for separately. For example, it might be necessary to account separately for the different elements of lease of a port facility, though a lease of a ship may be a single component.

If a single contract contains multiple lease and/or non-lease components, then the company would be required to account separately for each component (this is consistent with the current requirement to split out service and maintenance elements from charter agreements). To separate the contract and allocate consideration between the components, the company would apply guidance similar to that applied on separation of performance obligations in the Boards' proposed revenue recognition standard.

Determining the lease term

A company would determine the lease term as the non-cancellable period of the lease, together with periods covered by:

- renewal options, if the lessee has a significant economic incentive to renew; and
- termination options, if the lessee has a significant economic incentive not to terminate.

Introduction of this new threshold – 'significant economic incentive' – will require close inspection of the option price. Given the volatility of the shipping market, determining whether an option creates a significant economic incentive will be complex.

Classifying the lease

The biggest change since the previous version of the proposals is the introduction of dual lease accounting models – and a new lease classification test to assess whether a lease is a Type A lease or a Type B lease (please see table below).

For the purposes of this test, a ship will be non-property. Therefore many leases of ships will be Type A.

Some in the shipping industry may question the distinction the new lease classification test makes between, e.g., ships and buildings. Suppose a company leases a brand new asset for 10 years. The asset has a useful life of 30 years. The lease is at a market rate and does not contain a purchase option. In this case:

- if the asset is a ship, the lease will be a Type A lease; but
- if the asset is a building the lease will be a Type B lease.

Economically, these seem like similar transactions. But the lease classification will be different – and so the lease accounting will be different.

Although Type A leases and Type B leases are both on balance sheet for lessees, the profile and presentation of lease expense may be significantly different, as explained below.

The Proposals do not define what is meant by 'significant' or 'insignificant', and for a US$150 million ship expected to operate for 25 years, judging what is insignificant will clearly be a matter of interpretation.

Underlying asset	Lease classification
→ Non-property*	Type A, unless: • the lease term is for an insignificant part of the total economic life of the underlying asset; or • the present value of the lease payments is insignificant relative to the fair value of the underlying asset.
→ Property*	Type B, unless: • the lease term is for the major part of the remaining economic life of the underlying asset; or • the present value of the lease payments accounts for substantially all of the fair value of the underlying asset.

* i.e., land and/or a building

Recognition and initial measurement for lessees

Lease liability

A lessee would recognise a lease liability representing its obligation to make lease payments.

The lessee would initially measure the lease liability at the present value of the future lease payments – discounted using:

- the rate that the lessor charges the lessee, if readily determinable; or
- the lessee's incremental borrowing rate.

Future lease payments include:

- fixed payments less any lease incentives receivable from the lessor;
- variable lease payments that depend on an index or a rate, or are in-substance fixed payments;
- amounts expected to be payable by the lessee under residual value guarantees;
- the exercise price of a purchase option if the lessee has a significant economic incentive to exercise that option; and
- payments for penalties for terminating the lease, if the lease term reflects the lessee exercising a termination option.

Lease asset

A lessee would recognise a right-of-use (ROU) asset representing its right to use the underlying asset. A lessee would measure the ROU asset initially at cost, comprising:

- the amount of the initial measurement of the lease liability;
- any lease payments made to the lessor at or before the commencement date, less any lease incentives received; and
- any initial direct costs incurred by the lessee.

Impact to the income statement

A lessee in a Type A lease would present amortization of the ROU asset and interest on the lease liability as separate expenses. The profile of total lease cost (amortization plus interest) would generally be front-loaded. This is likely to be the case for many leases of ships. This will result in earlier expense recognition than for current operating leases. However, it may result in higher EBITDA[2], as lease expense would now be presented as amortization and interest.

Lessee accounting for Type B leases would follow the approach for Type A leases, except that:

- a lessee would calculate amortization of the ROU asset as a balancing figure, such that the total lease cost (amortization plus interest) would be recognized on a straight-line basis over the lease term; and
- the lessee would present total lease cost (amortization plus interest expense) as a single line item.

The dual model approach may introduce particular complexity when accounting for leases of ports. For example, the property element of the lease may be Type B with straight line expense recognition – but the non-property element of the lease may be Type A with front loaded expense recognition.

2 Earnings before interest, taxes, depreciation and amortisation

Lessor accounting – Type A lease

On lease commencement, a lessor would de recognize the underlying asset and recognize:

- a lease receivable, representing its right to receive lease payments; and
- a residual asset, representing its interest in the underlying asset at the end of the lease term.

The lessor would initially measure the lease receivable at the present value of the estimated future lease payments (similar to the way in which a lessee measures its lease liability), discounted at the rate that the lessor charges the lessee, plus any initial direct costs.

The lessor would initially measure the residual asset as:

- the present value of the amount that the lessor expects to derive from the underlying asset at the end of the lease term, discounted at the rate that the lessor charges the lessee; adjusted for
- the present value of expected variable lease payments (if the lessor has included an expectation of variable payments in the discount rate but not in the lease receivable) and unearned profit arising on lease commencement.

A lessor would present the profit or loss arising on lease commencement in a manner that reflects the lessor's business model:

- as revenue and cost of sales, if the lessor enters into leases to realize value from goods that it would otherwise sell; or
- as a single line item, if the lessor uses leases to provide finance.

Ship owners may be surprised to see that they would be required to remove their ships from their balance sheets when the ships are put on lease – even for lease terms of only a couple of years. Instead, ships owners will account for the receivable and residual assets described above.

This model is essentially a development of current finance lease accounting. However, the model is more complex than current finance lease accounting, in part to address additional issues that arise in accounting for the residual asset.

Lessor accounting – Type B lease

A lessor would follow an accounting model similar to operating lease accounting under IAS 17 Leases – i.e., it would recognize:

- lease payments as lease income, on a straight-line basis or another systematic basis if that basis is more representative of the pattern in which income is earned from the underlying asset;
- initial direct costs as an expense on the same basis as it recognizes lease income; and
- variable lease payments as income when earned.

Other issues most relevant to the Shipping industry

Issue	Proposal
→ Variable lease payments	Indexed rentals would be factored into the initial measurement of the lease asset/liability based on the current value of the index, but other variable elements (such as certain bunker escalators) would be accounted for as incurred.
→ Foreign currency revaluation	The lessee s lease liability and lessor s lease receivable would be recognized on the respective balance sheets as monetary items and therefore within the scope of IAS 21 for foreign currency translation. This could create income statement volatility if the company's functional currency is different to the currency of the lease.
→ Re measurement of the lease following reassessment	A company would be required to reassess the lease for changes in certain circumstances including whether there is a change in an incentive to exercise a renewal option. In shipping, where charter rates are volatile, this requirement could be particularly onerous to apply. A reassessment by a lessee would typically require an adjustment to the ROU asset and lease liability.
→ Short-term leases	A company can elect not to apply the proposed lease models to short-term leases. Short-term means less than 12 months, including any extension options, and a lease is not short-term if it includes a purchase option. Short-term spot deals and voyage charters are therefore likely to fall outside the scope of the proposals – instead entities may apply a version of current operating lease accounting so such contracts.
→ Transition	A company would be able to adopt the new standard retrospectively or apply a modified retrospective approach, and take advantage of specified reliefs.

What are the wider implications of these proposals?

Key financial metrics would be affected by the recognition of new assets and liabilities, and by changes in the profile and presentation of lease income and expense. Increased volatility can be expected on the balance sheet as arrangements are continually reassessed. All of this will need careful communication with providers of finance and wider stakeholders. There could also be impacts on:

- compliance with debt covenants;
- employee compensation arrangements;
- tax balances (if the company is outside a tonnage tax regime); and
- the company's ability to pay dividends.

Additionally these proposals could influence sale and leaseback arrangements. A traditional, economical and popular financing option will no longer deliver the benefits. This could add further pain to the shipping industry where sources of finance remain tight.

All to play for?

The Exposure Draft is open to comment until 13 September 2013. No effective date for the final standard has been set although it seems unlikely that this would be before 1 January 2017 – the date that the new revenue standard comes into force.

Certainly with such compromise in the proposals around concepts, cost and most critically whether the proposals enhance the understanding of a company's financial position and performance, we would encourage shipping companies to respond to these proposals.

KPMG member firms' Shipping specialists have been assisting companies assess the likely consequences of the leasing proposals ever since changes were first suggested.

How KPMG firms can help

→ Initial and immediate impact	Providing lease education and training. Performing calculations for you to quantify the possible impact of the changes. Reviewing your calculations, providing assurance to the board on the detail of the calculations and/or the methods used. Provide assistance on the data used to renegotiate banking covenants or restructuring debt obligations.
→ Impact and consequence of transition	Working with you to develop the data required to perform the analysis. Reviewing the forecasts you prepare and providing assurance on the methodology used to generate them. Providing tax assurance services on the possible consequences of the changes. Performing the detailed calculations to prepare the transition adjustments.
→ Ongoing monitoring of impact	Working with you to design processes and controls for collecting and updating data at each reporting date. Helping you to design, procure, select and implement IT systems to deal with the changes. Providing assurance on 'dry runs' used to test the process to perform the calculations.

Contact us

Please speak with your local KPMG team or contact:

John Luke
Global Head of Shipping
T: +44 20 7311 6461
E: john.luke@kpmg.co.uk

Ian Griffiths
Shipping Practice
T: +44 20 7311 6379
E: ian.griffiths@kpmg.co.uk

Shazar Dhalla
Transport KPMG Global Executive
T: +44 20 7694 8242
E: shazar.dhalla@kpmg.co.uk

www.kpmg.com

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