

06 May, 2011

IFRS Foundation/ International Accounting Standards Board  
30 Cannon Street  
London EC4M 6XH  
United Kingdom

## Comments on the Exposure Draft of Leases

Dear Sir/ Madam,

The Korea Shipowners' Association (hereinafter "KSA") believe that the exposure draft of leases (hereinafter "ED") could potentially influence the financial environment of global shipping industry. And we are pleased to have the opportunity to submit our comments on the ED.

The KSA is a nation-wide organization of owners and operators of vessels engaged in ocean transportation on the basis of free activities. The KSA is founded with 12 shipping company in 1960, and became a member of the International Shipping Federation in 1980. As of 31 Dec., 2010, the KSA has grown as a global organization in which 181 member companies own and operate a total of 760 vessels with aggregate tonnage of 37,363,522 dead weight tons. The KSA strives to promote fair and free shipping activities, contributes toward sound development of Korean shipping industry, and represents the opinion of Korean shipping companies.

We are deeply considering that the Korean shipping companies have serious concern and confusion about applying the ED. And we submit the review on the ED for shipping industry how to reflect substances in the economics of shipping industry.

We generally agree that the ED is reasonable and could solve the problems of existing accounting models for leases, omitting relevant information about rights and obligations of operating lease.

However, we believe that the characteristics of shipping industry could not be reflected on the ED. When IASB define the lease, the characteristics of service industry, especially shipping industry, should be considered deeply.

Shipping companies offer transportation services either by using their own vessels or chartering of vessels owned by other ship owners. Some chartering of vessels is the service contract, by which shipping company can receive the transportation service by ship owner (refer to appendix 2).

There exist various contracts with various characteristics in shipping industry, and each contract has different substance in the economics. If shipping company should apply the ED identically to all of the contracts, the financial statement of shipping company would fail to reflect the substances in the economics. It will cause the misjudgment of users of financial statement and the negative effect on the growth of shipping industry.

Also, we believe that there is inconsistency between lessor's accounting model and lessee's accounting model on the ED. We hope that IASB should review on the lessee's accounting model and develop the lessee's accounting model consistent with lessor's.

We will suggest our opinion about definition of lease, accounting model of lessee, short-term lease and the effective date of the leases standard, relating to shipping industry (refer to appendices). And we strongly require that IASB would further review on the ED.

- **Definition of Lease**

The ED does not define the lease sufficiently, so it is difficult to distinguish a service contract and a lease. The time charter contract, transportation service contract in the shipping industry, is a service contract which has to be combined with an asset. However, the definition of lease is so vague that shipping company is hard to apply the lease standard on the time charter.

Even if the service must be combined with an asset, if the service is trade like a commodity in a perfectly competitive market, it should be regarded as a service contract entirely. For instance, the time charter arrangement in shipping industry is a service contract that shipping company purchases the transportation service in the time charter market, perfectly competitive market of transportation service.

In other words, when an entity makes a contract that he asks a counterparty to perform a specific service, which must be combined with an asset and is same as the entity's primary operation activity, the contract is for using the specific service, not using the asset.

Also, when an entity needs an asset for providing a specific service, the entity's primary operation activity, if a counterparty only provide the asset, the contract should be regarded as lease. However, if the counterparty provides an entire specific service using the asset to the entity, the contract should be regarded as a service subcontract, and the Revenue from Contracts with Customers should be applied on this contract.

Also, while the IASB prefers principle-based approach on the IFRS, the conditions in paragraph B4 of the ED seems a rule-based guidance, excluding the opportunity for entities to reflect their own

industrial characteristics in applying the standard. It seems unreasonable that a contract should be regarded as a lease, if only one of three guidance would be satisfied.

So, The IASB should instead suggest various indicators for entities to be used in judging how to apply the lease standard considering their own industrial characteristics.

And "right to direct others to operate the asset" is a limited measure in providing a clear classification for a time charter between a service contract and a lease in the shipping industry, and it should be developed further.

"Even when the entity has a right to direct others to operate the asset, if the owner of asset operates the asset by the entity's direction and the owner retains the risks related with the operation, it may not be considered a lease.

- **Lessee accounting**

We are generally supportive of the IASBs' proposal, the "right-of-use" model, that lessee should recognize all asset and liability arising from all leases. However, in applying the "right-of-use" model, there should be consistency for both of lessor and lessee.

Depending on the extent to which a lessee undertakes exposure to risks or benefits associated with the underlying asset, lessee also should apply the "right-of-use" model differently to reflect differences in the economics of the business models for different lessees just as lessor does.

In other words, it is reasonable that lessee should present the lease as linked-presentation method when lessor applies the performance obligation approach to the lease.

We believe that lessee could have the following advantages by applying the linked-presentation method.

- i. It reflects and shows interdependency of the right-of-use asset and the liability to make lease payments as a result of totaling those amounts to a net lease asset or lease liability
- ii. By presenting the right-of-use asset as contra-liability account, lessee may show that underlying asset in relation to lease transaction is not owned by lessee.
- iii. Similar to the case of lessor, adjusted right-of-use model used by lessee alleviates the concern that presenting separately the right-of-use asset and the liability to make lease payments inappropriately overstates both total assets and total liabilities in the statement of financial position.

- **Short-term lease**

We do not agree with the asymmetry of short-term lease accounting between lessor and lessee. Just as lessor would recognize lease payments in profit or loss over the lease term, lessee should recognize lease payments in profit or loss over the lease term. This approach will make consistency between lessor and lessee. If it would be needed, lessee could provide sufficient information to users by disclosing the entire lease payments over the lease term on notes.

- **Effective date of lease**

We hope that the ED would be revised reflecting the characteristics of shipping industry. And the Korean shipping companies could have negative effect in highly competitive business of shipping industry by adopting IFRS earlier. Because of the vagueness of definition of lease, if the time charter would be regarded as a lease, it will cause the high debt to equity ratio of the Korean shipping companies. It could be unfair comparing to other country's shipping companies such as Japan or China. And it could lead to a lack of comparability between IFRS shipping company and Non-IFRS shipping company.

So, we strongly insist that the effective date of lease standard should be postponed until other countries adopt the IFRS.

For additional details, please refer to the responses in appendices below, in which we address items particularly relevant to the shipping industry.

We would be happy to further discuss these matters with you.

Yours sincerely,



Jong Chul, LEE

Chairman

Korea Shipowners' Association

## Appendix 1

### **Question 3: Short-term leases**

*The exposure draft proposes that a lessee or a lessor may apply the following simplified requirements to short-term leases, defined in Appendix A as leases for which the maximum possible lease term, including options to renew or extend, is twelve months or less:*

*(a) At the date of inception of a lease, a lessee that has a short-term lease may elect on a lease-by-lease basis to measure, both at initial measurement and subsequently, (i) the liability to make lease payments at the undiscounted amount of the lease payments and (ii) the right-of-use asset at the undiscounted amount of lease payments plus initial direct costs. Such lessees would recognise lease payments in profit or loss over the lease term (paragraph 64).*

*(b) At the date of inception of a lease, a lessor that has a short-term lease may elect on a lease-by-lease basis not to recognise assets and liabilities arising from a short-term lease in the statement of financial position, nor derecognise any portion of the underlying asset. Such lessors would continue to recognise the underlying asset in accordance with other IFRSs and would recognise lease payments in profit or loss over the lease term (paragraph 65).*

*(See also paragraphs BC41-BC46.)*

*Do you agree that a lessee or a lessor should account for short-term leases in this way? Why or why not? If not, what alternative approach would you propose and why?*

We agree with a lessor's accounting model for short-term lease. However, we do not agree with the asymmetry of short-term lease accounting between lessor and lessee. The lessee's accounting model for short-term lease, recognition of undiscounted amount of the lease payments, is inconsistent with the lessor's.

No entity would make a short-term lease for the primary operating asset. Even if it would do, it will recognize the lease payments in a profit or loss within 12 months.

Just as lessor would recognize lease payments in profit or loss over the lease term, lessee should recognize lease payments in profit or loss over the lease term. This approach will make consistency between lessor and lessee. If it would be needed, lessee could provide sufficient information to users by disclosing the entire lease payments over the lease term on notes.

## Appendix 2

### **Question 4**

*(a) Do you agree that a lease is defined appropriately? Why or why not? If not, what alternative definition would you propose and why?*

*(c) Do you think that the guidance in paragraphs B1-B4 for distinguishing leases from service contracts is sufficient? Why or why not? If not, what additional guidance do you think is necessary and why?*

(a) We generally agree that a lease is defined appropriately. However, we believe that the IASB should provide further guidance for entities that apply the definition to their lease. For example, even if the service must be combined with an asset, if the service is traded like a commodity in a perfectly competitive market, it should be regarded as a service contract entirely.

In other words, when an entity makes a contract that he asks a counterparty to perform a specific service, which must be combined with an asset and is same as the entity's primary operation activity, the contract is for using the specific service, not using the asset.

Also, when an entity needs an asset for providing a specific service, the entity's primary operation activity, if a counterparty only provide the asset, the contract should be regarded as lease. However, if the counterparty provides an entire specific service using the asset to the entity, the contract should be regarded as a service subcontract, and the *Revenue from Contracts with Customers* should be applied on this contract.

See our response to question 4(c).

(c) We believe that the guidance provided in paragraphs B1-B4 relating to distinguishing leases from service contracts is not sufficient.

The above guidance is not sufficient because, in the shipping industry, complex contracts that cannot be clearly classified between lease and service contract exist, such as the "time charter" arrangements.

### ***The Characteristics of Contracts:***

Shipping companies offer transportation services either by using their own vessels or chartering of vessels owned by other ship owners. When providing transportation services using chartered vessels, there are the following three types of contracts: 1) voyage charter, 2) time charter, and 3)

bareboat charter.

Each contract has obviously distinguishable from each other. Characteristics of each type of contracts are summarized in the below table:

	Voyage Charter	Time Charter	Bare Boat Charter
Control of vessel	Owner	<b>Owner</b> : Control of and responsibility for operation <b>Charterer</b> : Give orders	Charterer
Period of contract	Single voyage or multiple voyages	<b>Multiple months to years</b>	Multiple years
Responsibility of maintaining fully-operable condition	Owner	<b>Owner</b>	Charterer
Captain and Crew	Owner	<b>Owner</b>	Charterer
Off-Hire	Yes	<b>Yes</b>	No

A voyage charter is a onetime transportation service contract made between a shipping company and a vessel owner to transport the cargo from the designated port of loading to the designated port of unloading. Therefore, the shipping company enters into voyage charter contracts to use the vessel owner's ocean transportation capability achieved through possessing vessel and employing captain/crews.

The vessel owner retains the responsibility to maintain its vessel in an appropriate, fully operable condition by managing captain/crew on board, insuring the vessel, etc.

On the other hand, a bareboat charter meets the definition of the lease. The shipping company only leases the vessel and operates the underlying asset to its own operating activity (transportation) with the captain/crew employed by the shipping company. The shipping company has the responsibility to maintain its vessel in the appropriate, fully operable condition by managing captain/crew on board, insuring the vessel, etc.

In case of a time charter, the classification as a service contract or a lease might not be clear in accordance with the ED. However, time charter contracts can be considered an extension of voyage charter contracts. Whereas a voyage charter is a onetime transportation service contract, time charter is a transportation service contract for a specific period.

***Why We Consider Time Charter to Be a Service Contract, Not a Lease:***

*Time Charter Market*

The time charter market, primarily developed in London, New York, Tokyo, and Singapore, is a perfectly competitive market for transportation service between suppliers (vessel owners) and buyers (shipping companies). There are numerous suppliers and buyers in the market.

When a buyer needs transportation service capability, it submits the specifications (size and type of the vessel, minimum speed, appropriate number of captain/crew, maximum payment, etc.) to brokers, who then provide a list of suppliers with transportation service capability to satisfy the requirements. After assessing the suppliers' transportation service capabilities internally generated through the vessel, captain/crew, experience of suppliers, etc., the buyer enters into a time charter contract with the supplier deemed to have the appropriate transportation service capability.

As such, the time charter market is **a perfectly competitive market for transportation service**. A time charter is the contract to purchase a service.

*In-Transit Loss*

A typical time charter contract contains an "in-transit loss" clause such as below:

In Transit Loss :

Vessel is to be allowed maximum 0.5 percent of in transit loss which shall be the difference between the gross quantity agreed and measured by an independent surveyor who is mutually acceptable for both parties on board vessel after loading and gross quantity agreed and measured by an independent surveyor who is mutually acceptable for both parties on board prior to discharge, less any or all free water on board prior to loading. Any loss exceeding the said 0.5 percent is to be reimbursed by vessel owner to shipping company at an amount equal to the FOB port of loading value of such cargo plus freight and insurance due with respect thereto.

According to this clause, the vessel owner has responsibility to transport the cargo safely to the destination. Should any cargo loss exceeding the normal loss incur, the vessel owner is required to reimburse the loss exceeding the normal amount. This indicates that the vessel owner retains the risk relating to cargo transportation, which is the shipping company's operating activity. As such, time charter should be considered the contract of using vessel owner's transportation service capability.



*Vessel Owner Has a Lien on Cargo.*

A typical time charter contract contains a "Lien" clause such as below:

Lien :

Owners shall have a lien upon all cargoes and all freights, sub-freights and demurrage for any amounts due under this charter; and Charterers shall have a lien on the vessel for all monies paid in advance and not earned, and for all claims for damages arising from any breach by Owners of this charter.

According to this clause, if the shipping company does not make payment for the time charter, the vessel owner can exercise a lien upon all cargoes. A lien is a right to retain possession of another's property to secure the payment of a debt where the property must be related to the debt. In a time charter, the cargoes are the objects of transportation and the payment of a debt is a the payment for using the vessel owner's transportation service capability. In other words, the payment is the cost of vessel owner's transportation service.

Considering these characteristics, the economic substance of a time charter is a transportation service contract for using the asset (vessel).

***Exposure Draft of Leases:***

Under the ED, it is not clear whether a time charter is to be classified as a service contract or a lease.

The guidance provided in B4 (a) is not sufficient to determine time charter's classification as a service contract, not a lease. The shipping company has the ability or right to direct the vessel owner to voyage the vessel from the designated port of loading to the designated port of unloading for a specific period.

On the other hand, the vessel owner is responsible for keeping the vessel in a fully-operable condition. Such responsibilities include hiring a competent captain/crew and maintaining the vessel in an appropriate working condition to comply with the rules and regulations of international treaties and the laws of registered country.

Further, the captain on board, employed by the vessel owner, makes decisions for the safety of the vessel and for navigation which includes the route of voyage, supervision for proper cargo loading, permission of loading of hazardous materials and control of cargoes during the voyage. All of these decisions relate to operating the vessel.

As such, “right to direct others to operate the asset” is a limited measure in providing a clear classification for a time charter between a service contract and a lease in the shipping industry, and it should be developed further as below:

“Even when the entity has a right to direct others to operate the asset, if the owner of asset operates the asset by the entity’s direction and the owner retains the risks related with the operation, it may not be considered a lease.

Also, while the IASB prefers principle-based approach on the IFRS, the conditions in paragraph B4 of the ED seems a rule-based guidance, excluding the opportunity for entities to reflect their own industrial characteristics in applying the standard. It seems unreasonable that a contract should be regarded as a lease, if only one of three guidance would be satisfied.

So, The IASB should instead suggest various indicators for entities to be used in judging how to apply the lease standard considering their own industrial characteristics.

### Appendix 3

**Question 12: Statement of financial position**

*(a) Do you agree that a lessee should present liabilities to make lease payments separately from other financial liabilities and should present right-of-use assets as if they were tangible assets within property, plant and equipment or investment property as appropriate, but separately from assets that the lessee does not lease (paragraphs 25 and BC143-BC145)? Why or why not? If not, do you think that a lessee should disclose this information in the notes instead? What alternative presentation do you propose and why?*

(a) We are generally supportive of the IASBs' proposal, the "right-of-use" model, where the lessee should recognize all assets and liabilities arising from all leases. However, in applying the "right-of-use" model, we believe there needs to be consistency in the lessor and lessee's accounting.

In accordance with the ED, depending on the extent to which the lessor retains exposure to risks or benefits associated with the underlying asset, the lessor would apply either a performance obligation approach or a derecognition approach. Relating to this, comments on the discussion paper and feedback received as a part of the boards' outreach activities indicate that the majority of constituents supported using the derecognition approach only. However, the board deemed that a single approach to lessor accounting would not be appropriate for all leases because of differences in the economic substance of the business models for different lessors.

Likewise, in our opinion, the lessee also should apply the "right-of-use" model differently to reflect differences in the economics of the business models for different lessees just as the lessor does, dependent on the extent to which a lessee undertakes exposure to risks or benefits associated with the underlying asset

However, on the ED, the IASB proposes that the lessee should apply the "right-of-use" model to all leases regardless of the lessee's exposure to risks or transfer of benefits associated with the underlying asset. Under such arrangements, the lessee and the lessor would have differing approaches on accounting for the same transaction.

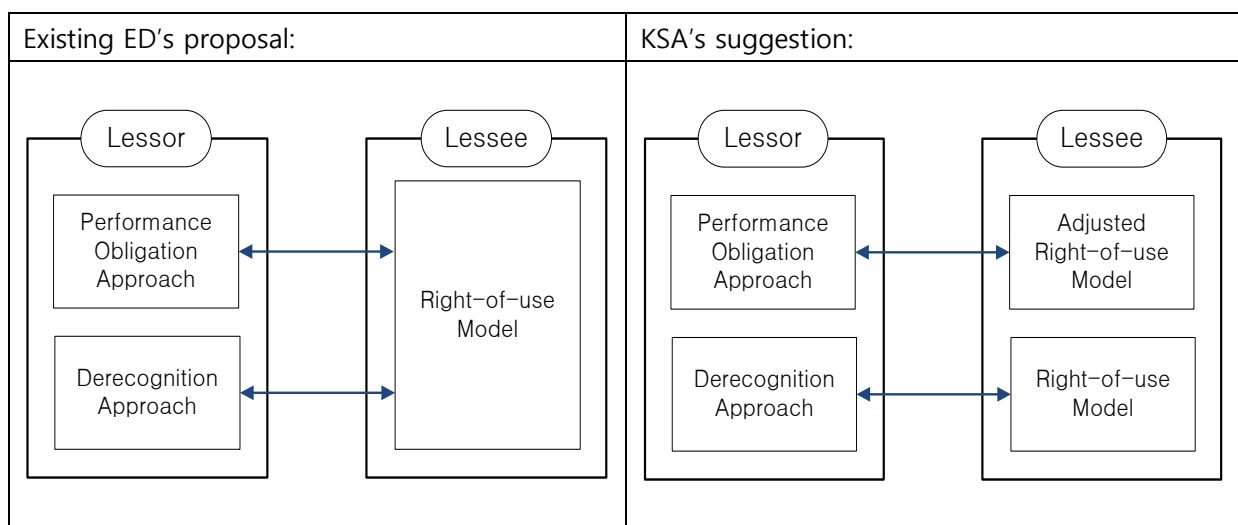
We propose following alternative measures:

1. Since the lessor accounts for lease transactions by using either performance obligation approach or derecognition approach dependent on whether the economic risk or benefits associated with underlying assets have been transferred or not, the lessee would also need to account for the lease transactions by using the accounting approach dependent

on the approach undertaken by the lessor.

2. For lease transactions accounted under the performance obligation approach, the lessee should presents gross in the statement of financial position the liability to make lease payments (liability) and right-of-use asset (asset) while totaling those amounts to net lease asset or lease liability.

We propose the lessees to recognize lease transactions shown as below charts dependent on whether the economic risk or benefit associated with underlying assets have been transferred to the lessee or not.



While performance obligation and derecognition approaches are used depending on whether the economic risk or benefits associated with underlying assets have been transferred or not, the right-of-use model approach used by the lessee does not reflect the differences in economic substance. Accordingly, as a result of applying different lease accounting models, the lease transaction recognized by the lessee may not appropriately reflect the corresponding lease transaction accounting by the lessor.

Therefore, we propose the lessees to use the adjusted right-of-use model when performance obligation approach is used by the lessor, while using right-of-use model approach when derecognition approach is used by the lessor.

Similar to right-of-use model, the adjusted right-of-use model recognizes lease transactions in the statement of financial position as asset and liability. However, the model presents gross in the statement of financial position the liability to make lease payments(liability) and the right-of-use asset (asset) while totaling those amounts to the net lease asset or lease liability (similar to performance obligation approach).

Under Basis for Conclusion (BC) paragraph 148, the ED proposes linked presentation in which the lessor presents gross in the statement of financial position the underlying asset, the right to receive lease payments and the lease liability, totaling those amounts to a net lease asset or lease liability. The boards believe that such a presentation has the following advantages:

- i. It reflects the interdependency of the underlying asset, right to receive lease payments and lease liability, while acknowledging that the criteria for offsetting that would permit the right to receive lease payments and the lease liability to be presented net are not met..
- ii. It reflects that the lessor continues to own the leased asset.
- iii. It alleviates the concern that presenting separately the underlying asset, a right to receive lease payments and an offsetting lease liability would inappropriately overstate both total assets and total liabilities in the statement of financial position.

Adjusted right-of-use model that we propose is similar to the right-of-use model in that the model presents gross in the statement of financial position the right-of-use asset and the liability to make lease payments while totaling those amounts to a net lease asset or lease liability. We believe that such presentation has the following advantages:

- i. It reflects the interdependency of the right-of-use asset and the liability to make lease payments as a result of totaling those amounts to a net lease asset or lease liability
- ii. By presenting the right-of-use asset as contra-liability account, the lessee may show that the underlying asset in relation to the lease transaction is not owned by the lessee.
- iii. Similar to the case of the lessor, the adjusted right-of-use model used by the lessee alleviates the concern that presenting separately the right-of-use asset and the liability to make lease payments inappropriately overstates both total assets and total liabilities in the statement of financial position.

When the lessor and the lessee account for the lease transactions using the performance obligation approach, the lessor continues to include the underlying asset under the property, plant and equipment of statement of financial position, when the lessee would also account for the right-of-use asset (underlying asset) as property, plant and equipment in its statement of financial position. As shown in the below chart, accounting of the same underlying asset both by the lessor and the lessee will overstate the statements of financial position as a whole:

	Performance obligation approach			Derecognition approach		
FS	A			B		
	Underlying asset	Right-of-use asset	Lease liability	Remaining underlying asset	Right-of-use asset	Lease liability
	1,000	400	400	600	400	400
	Lease payment receivable 400			Lease payment receivable 400		
	1,000	400	400	1,000	400	400
PP&E	Before lease transaction : Underlying asset (A) = 1,000			Before lease transaction : Underlying asset(A) = 1,000		
	After lease transaction: Underlying asset(A) 1,000 + right-of-use asset (B) 400 = 1,400			After lease transaction: Remaining lease asset (A) 600 + right-of-use asset (B) 400 = 1,000		

Additionally, under the performance obligation approach, if lessees were to sub-lease the same underlying asset, the property, plant and equipment account for the same underlying asset will further continue to overstate.

**Adjusted Right-of-Use Model**

	Performance obligation approach		Derecognition approach		
FS	A		B		
	Underlying asset		Lease liability	Remaining underlying asset	Right-of-use Asset
	1,000		400	600	400
	Lease payment receivable		Right-of-use asset (400)	Lease payment Receivable	
400			400		
Lease payable (400)					
1,000		0	1,000	400	400
PP&E	Before lease transaction :		Before lease transactions :		
	Underlying assets (A) 1,000		Underlying assets (A) 1,000		
PP&E	After lease transactions :		After lease transactions :		
	Underlying assets (A) 1,000		Remaining underlying asset (A) 600 + right-of-use asset (B) 400 = 1,000		

The use of the adjusted-right-of-use model will solve problems related to operating lease accounting, which does not recognize the lease transaction in the statement of financial position, and will increase the effectiveness and uniformity of lease accounting approach used by the lessor and the lessee.

Therefore, the lease accounting approach used by the lessee also needs to account for the lease transactions in accordance with economic substance of the lease transaction, and thereby, the financial information between the lessor and the lessee would be uniform and interdependent.