

December 15, 2010

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

Dear Sir or Madam:

Exposure Draft: "Leases"

The Japanese Shipowners Association' ("JSA" or "we"), a trade organization representing the interests of shipowners and ship operators in Japan, is writing this letter to request your attention to our concerns about a proposed standard included in the exposure draft "Leases" (" the ED") issued by the IASB ("the board"). This letter summarises the views of Japanese shipping interests about this proposed standard.

1. Overall comments

We agree conceptually that a lessee should recognise an asset representing the right to use an underlying asset during the lease term and a liability to make lease payments. However, the ED does not appear to define the scope of a lease clearly enough, and maintaining a vague definition might result in inconsistent interpretations and arbitrary accounting practices.

In our opinion, a lease should be recognized as an asset by the lessee, even under the right-of-use model, only when a benefit arising from the asset is fully under the lessee's control and is not dependant on the lessor's capability in fulfilling his obligation under the contract. Otherwise, the definition of asset under the Conceptual Framework is not met, and there cannot be a clear distinction between a lease and a service. As for the liability, it needs to be a present obligation and arise from a past event, if it is recognized in the lessee's balance sheet. Otherwise, the definition of a liability under the Conceptual Framework is not met.

In the context of the shipping industry, the ED may be comprehended as requiring time-charter contracts to be accounted for as a combination of lease and service contract,

although they are, in our opinion, virtually pure service contracts. For this specific point, please see "Accounting for Time-Charter Contracts" in the appendix.

2. Responses to the questions in the ED

2.1 Definition of a lease ( Question 4(a) )

The definition of a lease should be further clarified so that consistency with the basic concept of assets and liabilities is maintained. Specifically, we suggest, among others, the below changes.

1) The definition of lease in appendix (A) should read as follows:

"A contract in which the unconditional right to use a specific asset (the underlying asset) is conveyed, for a period of time, in exchange for consideration that is a present obligation of the lessee."

2) Paragraph B1(b) should read as follows:

"the contract conveys the unconditional right to control the use of a specified asset for an agreed period of time, to the extent that the benefit arising from the asset is no longer dependant on the lessor's capability in fulfilling his obligation under the contract. (paragraph B4)"

2.2 Contracts that contain service components and lease components ( Question 6 )

We have concern about paragraph B5(a). In our opinion, a contract containing a non distinct lease component, however the primary economic function of which is recognized as a service rather than a lease between the contracting entities, should be recorded as a service as a whole. Accounting for such a contract as a lease would unnecessarily gross up the balance sheet and spoil the comparability and the decision-usefulness of the financial statement. Paragraph B5(a) should be amended to add such a guidance accordingly.

### 2.3 Lease Term ( Question 8 )

We do not believe that including an optional period in the lease term meets the definition of a liability, and believe that the lease term should only include optional lease periods that are reasonably certain to be exercised. Besides, from a practical viewpoint, it is quite doubtful that the entities can reasonably estimate lease terms considering an optional extension exercisable in the distant future (or even in near future), especially for industries like shipping that are subject to extremely volatile markets.

Sincerely yours,



Mitsuo Nakamoto  
Director General  
The Japanese Shipowners' Association

<Appendix >

### Accounting for Time-Charter Contracts

#### 1 Summary

We are of the opinion that chartered vessels under typical time-charter contracts do not share the key characteristics of a lease contract assumed in the exposure draft "Leases" issued by the International Accounting Standards Board in August 2010 (the "exposure draft") and that time-charter contracts should be construed as transportation service contracts. Accounting for as such best reflects the economic substance of the time-charter contracts.

In addition, there could be negative economic impacts, such as the below effects on shipping companies, when a time-charter contract is accounted for as a combined lease and service contract.

##### a) Finance

Even with no change in the economic substance, including the financial risks that a shipping company is exposed to, the incremental lease obligation to be recorded may lead to violation of debt covenants with financial institutions and cause difficulty in financing for investments and overall corporate business operations. This negates management's efforts to isolate the risks associated with the fluctuation of the market value of vessels by choosing time charters.

##### a) Incremental cost for lease accounting

Given the large amount of long-term and short-term time-charter contracts, shipping companies worldwide may be required to modify their existing accounting systems significantly if the time charters are classified as combined lease and service contracts under the new accounting standard. Burdensome accounting practices are also anticipated. As discussed later in this paper, we believe the assets and liabilities derived from time-charter contracts under lease

accounting are different in nature from owned assets and relevant financial liabilities. Therefore, we doubt that readers of our financial statements could benefit from recording lease assets and liabilities on time-charter contracts.

## 2 Time Charter

There are two ways for shipping companies to secure vessels to provide marine transportation services to customers: either to own vessels or to hire vessels from others. There are three contract types utilized to hire vessels: 1) bare-boat charter, 2) time charter, and 3) voyage charter.

We have no doubt that the bare-boat charter falls under the definition of a lease, and the voyage charter is a pure transportation service contract. Our question is therefore whether the time charter is a combined lease and service contract or a pure service contract under the new lease standard.

Under a time charter, the voyage of a vessel is managed by the captain and crew on board, who are employees of the vessel owner, while the sailing instructions are given to the captain by the charterer (a shipping company). It is the responsibility of the vessel owner to keep his vessel in a seaworthy condition (a condition in which the vessel can complete safe voyages) by maintaining the vessel in a fully operable condition, deploying a qualified captain and crew, and through other necessary measures. The characteristics of the time charter are quite different from the bare-boat charter, which is a straight-forward lease of an asset, and it is the charterer (lessee) that is responsible for keeping the vessel seaworthy and fully controlling the vessel. We are therefore of the opinion that the time charter is a pure service contract to render a transportation service.

A voyage charter is a cargo transportation contract to transport cargo between a designated port of loading and unloading in a specified quantity and over a designated time. The charterage of the voyage charter is calculated by multiplying freight rate per ton by cargo quantity.

|   | Bare-boat Charter          | Time Charter   | Voyage Charter  |
|---|----------------------------|--|---|
| Legal Classification                        | Lease contract             | Service contract or transportation contract  | Transportation contract   |
| Charterage                                  | Consideration for lease    | Consideration for services rendered by the vessel kept seaworthy by the owner                        | Consideration for transportation of cargo                                     |
| Charter period                              | Multiple years (long-term) | Multiple months to years (medium-term)   | Single voyage or multiple consecutive voyages (short-term)                    |
| Manning                                     | Charterer                  | Owner  | Owner   |
| Possession of Vessel                        | Charterer                  | Owner  | Owner   |
| Responsibility of Maintaining Seaworthiness | Charterer                  | Owner  | Owner   |
| Off-Hire                                    | No                         | Yes  | No  |
| Speed Claim                                 | No                         | Yes  | No  |
| Cost borne by Owner                         | Capital cost of vessel     | Capital cost of vessel and cost for crew, maintenance, etc.  | Capital cost of vessel, cost for crew, maintenance, etc., and cost for voyage |
| Control of Vessel                           | Charterer                  | Owner operates and possesses a vessel while vessel's deployment orders are given by the charterer to | Owner   |

|  | Bare-boat Charter | Time Charter   | Voyage Charter |
|--|-------------------|--|----------------|
|  |                   | the captain, who makes the ultimate decision and thus delivers the services. |                |

### 3 Why a Time-Charter Contract Does Not Contain a Lease

#### 3.1 Economic benefit from the use of the asset can only be realized through delivery of services by the owner

The economic benefit derived from the use of the chartered vessel can be secured by the charterer only when the vessel owner delivers the promised services as per the time-charter contract. Despite the fact that a vessel is designated under a time-charter contract, the economic benefit from the use of the vessel is fully dependent on the owner's capability, which is beyond the control of the charterer. Therefore, the right to control the use of the vessel is always maintained by the owner, not conveyed to the charterer under the time-charter contract.

Because of the same reason provided in the previous paragraph, the charterage under the time-charter contract does not become due unless the promised services are delivered by the owner. In addition, when a time-charter contract is cancelled for a reason either by an owner or charterer before the time-charter expiration date, a cancellation charge is to be generally agreed upon through negotiations between the owner and the charterer in consideration of the time-charter market at the time of the cancellation; namely, the charge is not determined until the cancellation takes place.

Therefore, we believe that the charterage to be paid in the future does not meet the definition of a liability in the conceptual framework for financial reporting (para. 4.16 of the framework for 2010).

#### 3.2 Vessel owner controls the operation of the asset

Under the time-charter contract, the vessel owner is responsible for keeping the vessel seaworthy. These responsibilities include hiring a competent captain and crew, and maintaining vessel and machinery on board in a proper working condition to comply with the rules and regulations of international treaties and the laws of the country in which the vessel is registered. The captain on board is fully responsible for vessel safety and navigation, which includes the routing of voyages, determining whether ports of call are safe, supervising proper cargo loading, giving permission to load hazardous materials, and controlling cargo during the voyage. The charterer has no control over these decisions, which are indispensable for the voyage. The instructions that the charterer can give to the captain are limited to those for the purpose of the voyage while the vessel is always operated and controlled by the captain and his crew in the best interest of the owner throughout the time-charter contract.

It is legally acknowledged that the charterer has no ownership interest in the vessel, or the right of possession of the vessel, and if a third party negligently damages a vessel under the time charter, the charterer generally has no legal right to claim damages against the third party in tort (*The Mineral Transporter [1985] 2 Lloyd's Rep. 303 (P.C.)*). This is another indication that the right to control the use of the vessel cannot be deemed to be conveyed to the charterer by the time-charter contract.

#### 3.3 Payment of a charterage is based on output/performance

The charterage of the time charter is only paid to the vessel owner while the chartered vessel is on hire, being kept seaworthy, and performing the transportation services. The charterage is calculated based on the number of days of the charter; however, when the vessel becomes unseaworthy or is out of business for some reason, for which the vessel owners have responsibility — such as failing to maintain the vessel in a fully-operable condition, failing to employ legally required crew, or dry docking for class inspection and repair — the charterage for those periods will be deducted from the regular hire payments to the vessel owner by the charterer (defined as off-hire). In addition, if the services are not offered in a proper manner specified in the time-charter party

due to a defect or deterioration of the vessel, engine, or other equipment, the charterage will be reduced to compensate for the extra operation cost incurred by the charterer (defined as a speed claim or bunker claim). If the performance of the vessel is extremely poor, the charterer has the right to cancel the time-charter contract without any compensation to the vessel owner. These conditions indicate that the payment of the charterage is based on the performance of the vessel and is not simply based on the number of days that the vessel is available to the charterer.

3.4 Nominating a specific vessel is not meant to be requiring a designated asset

The purpose of the time charter is to secure a desired cargo carrying capacity (panamax, capesize, etc.,) at a suitable position in time and geographical location for a desired duration in the time-charter market. The chartered vessel does not have to be customized for each charterer. The economic benefit to the charterer cannot be realized without the performance of services by the captain and crew. As such, the charterer's act of designating a specific vessel in the time-charter contract is usually not meant as a specification for a unique vessel that cannot be replaced by another vessel similar in size.

3.5 The objective of utilizing a time charter is to properly isolate risks associated with owning a vessel in the highly volatile shipping market

By utilizing time charters, the management of shipping companies can hedge risks — such as the residual value of vessels and mismatches of currencies for revenue and associated costs — take competitive advantage of manning and maintenance cost, and more importantly, manage the carrying capacity of cargo to respond agilely to the fluctuation of cargo transportation demand. Active time-charter markets exist for chartering vessels for short terms and long terms. Charterage is agreed upon based on the supply and demand of suitable vessels in the market according to size rather than based on the accumulation of the capital cost of vessels, prevailing interest rates, and human services. The volatility of these markets is extremely high and affected by political, economic, and social events around the world.

On financial statements, to best reflect the time-charter activities of shipping companies, we are of the opinion that time-charter contracts, irrespective of the length of the contract term, should be accounted for as transportation services and a new lease standard should be drafted to read that time-chartered vessels are to be distinguished from owned vessels and bare-boats charters.

3.6 The legal nature of time charters is determined as not being a lease

Under UK laws, the standard time-charter contract has been generally construed to be a transportation services contract, as far as we understand.