Are you ready for the new accounting standards for Revenue recognition and Leases?

Shipping industry alert

The countdown to the effective date of the new Revenue recognition\(^1\) and Leases\(^2\) accounting standards issued by IASB\(^3\) and FASB\(^4\) has begun. But are you ready?

There is a presumption that revenue transactions in the shipping industry are typically not complex or would not include features such as multiple deliverables (e.g. goods and services), variable selling prices, non-standard clauses in contracts, principal vs agent considerations, etc., as compared to other industries. This presumption may lead ship owning or operating companies to underestimate the demands of implementing the new Revenue recognition standards.

Furthermore, since the effective date of the new Leases standards for calendar year-end public entities is one year later than the effective date of the new Revenue recognition standards, those same companies may feel that there will be sufficient time to address any new lease accounting implementation issues even if the potential effects on initial application may be significant.

While some companies will be able to implement these new standards with limited effort, others may find implementation to be a significant undertaking. Successful implementation will require an assessment and a plan for managing the change.

We encourage you to challenge your understanding of the new standards by considering how you would answer the questions on the following pages. It may be time to take action sooner than you thought.

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\(^{1}\) IFRS 15, Revenue from Contracts with Customers; Accounting Standards Codification (ASC) 606, Revenue from Contracts with Customers

\(^{2}\) IFRS 16, Leases; ASC 842, Leases

\(^{3}\) International Accounting Standards Board (IASB); International Financial Reporting Standards (IFRS)

\(^{4}\) Financial Accounting Standards Board (FASB); US Generally Accepted Accounting Standards (US GAAP)
Questions about Revenue recognition

When should revenue from services be recognized under the new standards?
Shipping cargo takes time to complete. A majority of spot voyages and contracts of affreightment (COA) are currently commonly accounted for using the percentage of completion method or the discharge-to-discharge basis. Under the new standards, an entity recognizes revenue only when it satisfies a performance obligation by transferring a promised good or service (over time or at a point in time) to a customer. A good or service is considered to be transferred when the customer obtains control. Recognizing revenue upon a transfer of control is a different approach from the “risks and rewards” model in legacy GAAP.

A performance obligation is satisfied over time if any one of the following criteria is met:
• The customer simultaneously receives and consumes the benefits of the entity’s performance as the entity performs.
• The entity's performance creates or enhances an asset (work-in-progress) that the customer controls as the asset is created or enhanced.

Transportation services will likely meet the criteria for revenue recognition over time as the customer simultaneously receives and consumes the benefits as the entity performs. The IASB and FASB observed that the customer benefits from the entity's performance as it occurs if another entity would not need to substantially reperform the entity’s performance (for example, distance already travelled) to date.

How should voyage expenses (i.e. canal dues and bunkers), operating expenses (i.e. crew cost and lubricants) or address commissions be treated under the new standards?
Freight fulfillment costs will continue to be expensed as incurred unless (a) they can be capitalized under another standard; or (b) they relate directly to a contract, generate or enhance resources of the entity that will be used in satisfying performance obligations in the future, and are expected to be recovered.

Where revenue is recognized over time, it is unlikely that fulfillment costs will be capitalized under the new standard.

How is the recognition of demurrage and dispatch affected by the new standards?
Demurrages and dispatch contractual payments would constitute variable consideration under the new standards.

What transition method will you select?
The standards permit a full retrospective or modified retrospective approach.

Is early adoption of the new Leases standards concurrently with application of the new Revenue recognition standards appropriate for you?
Given the interaction between the new revenue and leases guidance, it may be more efficient to adopt both standards concurrently.

What new disclosures are required?
The majority of the new standards’ disclosure requirements relate to an entity’s contracts with customers. These disclosures include disaggregation of revenue, information about contract asset and liability balances, and information about an entity’s performance obligations.

Disclosing contract assets and liabilities and the revenue recognized from changes in contract liabilities and performance obligations satisfied in previous periods will likely be a change in practice for most entities. Entities will need to make sure they have appropriate systems, policies and procedures and internal controls in place to collect and disclose the required information.

How would a cancellation clause affect timing of revenue recognition under the new standards?
Voyage charters typically include a cancellation clause which is triggered in the case the vessel will not reach the designated loading port on time. Such cancellation clause does not result in compensation by the charterer.

Revenue recognition - the new standards:
IFRS 15, Revenue from Contracts with Customers
ASC 606, Revenue from Contracts with Customers

In May 2014, the IASB and FASB (the “Boards”) issued converged new Revenue recognition standards that will supersede virtually all existing revenue guidance under US GAAP and IFRS.

The new Revenue recognition standards provide accounting guidance for all revenue arising from contracts with customers and affect all entities that enter into contracts to provide goods or services to their customers unless the contracts are in the scope of other IFRS or US GAAP standards, such as leases. They also specify the accounting for costs an entity incurs to obtain and fulfill a contract to provide goods and services to customers and provide a model for the measurement and recognition of gains and losses on the sale of certain nonfinancial assets, such as property and equipment.

As a result, the Revenue recognition standard, will change the way many companies measure and recognize revenue and will expand disclosure requirements. More judgments and estimates may be required across multiple business functions than in the past.

Shortly after issuing the standards, the Boards formed the Transition Resource Group to help them determine whether more guidance was needed to address implementation questions and to educate stakeholders. Since then, the Boards amended their respective standards. While the Boards did not agree on the nature and breadth of all of the changes to their Revenue recognition standards. The Boards expect the amendments to result in similar outcomes in many circumstances.

Effective date
IFRS 15 is effective for annual reporting periods beginning on or after 1 January 2018 and interim periods within that year. Early adoption is permitted, provided that fact is disclosed.

ASC 606 is effective for public entities for annual reporting periods beginning after 15 December 2017, including interim reporting periods within that year. Non-public entities are required to apply the standard for annual reporting periods beginning after 15 December 2018, and interim reporting periods within the following year. Early adoption is permitted by both public and non-public entities as of the original public entity effective date (annual reporting periods beginning after 15 December 2016, and interim periods therein). Early application prior to that date is not permitted.
Leases - the new standards: IFRS 16, Leases
ASC 842, Leases

After joint deliberations, the IASB and FASB each issued a new accounting standard for leases in early 2016. Both standards require lessors to recognize most leases on their balance sheets as lease facilities with corresponding right-of-use assets.

Under both IFRS 16 and ASC 842, leases are accounted for based on a ‘right-of-use model’. The model reflects that, at the commencement date, a lessee has a financial obligation to make lease payments to the lessor for its right to use the underlying asset during the lease term. The lessor conveys that right to use the underlying asset at lease commencement, which is the time when it makes the underlying asset available for use by the lessee. Therefore, under both IFRS and US GAAP, entities will need to focus on whether an arrangement contains a lease or a service agreement because there are significant differences in the accounting.

However, while many requirements are similar, there are significant differences between the IASB and FASB standards. For example, under IFRS 16, lessees do not classify leases, while under ASC 842, dual classification was not eliminated and lessees are still required to classify leases as finance or operating leases. IFRS 16 also provides options not to recognise right-of-use assets and lease liabilities for short-term leases and leases of low-value assets, while such exemptions are not available under ASC 842. These, and other differences will result in certain lease transactions being accounted for differently under IFRS and US GAAP.

Effective date
IFRS 16 is effective for public and non-public entities with annual reporting periods beginning on or after 1 January 2019 and interim periods within that year. Early adoption is permitted for entities that apply IFRS 15 at or before the date of initial application of this standard, provided that fact is disclosed.

ASC 842 is effective for public entities with annual reporting periods beginning after 15 December 2018 and interim periods within that year. Non-public entities are required to apply the standard for annual reporting periods beginning after 15 December 2019 and interim periods the following year. Early adoption is permitted.

Questions about leases

Are your shipping contracts leases considered under the new standards?
As legacy accounting for operating leases and service contracts is similar under IFRS and US GAAP, determining whether an arrangement is a lease or service contract might not have been a focus for many entities. Given the consequences of the new standards, the effects of treating an arrangement as a service instead of a lease may be material when it may not have been material in the past. This may require some entities to revisit the assessments made under current standards.

How are shipping contracts for bareboat and time charters treated under the new standards?
Bareboat charters and time charters would be considered lease contracts while voyage charters are not considered in scope under the new Leases standards, as illustrated by examples¹ in both IFRS 16 and ASC 842.

Do your shipping contracts include non-lease components?
Many contracts contain a lease coupled with an agreement to purchase or sell other goods or services (non-lease components). Under the new standards, activities or lessor costs such as a lessor providing services (e.g., maintenance) or operating the underlying asset (e.g., vessel charter) would generally represent non-lease components.

How are non-lease components treated under the new standards by lessees? By lessors?
IFRS 16 and ASC 842 will require both lessees and lessors to identify and account for non-lease components separately from the lease component under their shipping contracts in accordance with other guidance. For example, the non-lease components may be accounted for as executory arrangements by lessees (customers) or as contracts subject to IFRS 15 or ASC 606 by lessors (suppliers). Only lessees are allowed a practical expedient to account for the lease and non-lease components as a single lease component.

How are variable lease payments affected under the new standards?
Variable lease payments that depend on an index or rate would be included in lease payments; other variable lease payments would not.

How should ballast voyages be treated under the new standard?
Ballast voyages for positioning a vessel under a time charter may or may not be compensated.

How would lessees and lessors classify leases under the new standards?
IFRS 16 would have lessees apply a single recognition and measurement model for all leases (with certain exemptions), while lessors, would classify all leases as either finance and operating. While ASC 842 would have lessees classify all leases (with certain exemptions) as either finance or operating leases, and lessors would classify all leases as sales-type, direct financing or operating leases. Lease classification under ASC 842 could differ from current guidance because the classification tests are not identical.

How would vessel sale and leaseback transactions be affected under the new standards?
The requirement to consider the control criteria in IFRS 15 or ASC 606 in order to determine whether a sale has occurred in a sale and leaseback transaction would be a significant change from current practice for seller-lessees, and such transactions may no longer provide seller-lessees with a source of off-balance sheet financing.

¹ IFRS 15 Illustrative example 6; ASC paragraphs 842-10-55-79 to 99.

For further information, visit the following websites:

- IFRS 16: http://www.ifrs.org/standards/leases/
- ASC 842: https://www.fasb.org/standards/leases/
Additional considerations:

Adoption date
The IASB and FASB aligned several concepts in its new Leases standards with concepts in its new Revenue recognition standards (e.g., determining whether the transfer of an asset is a sale in a sale and leaseback transaction), and in some cases required lessors to apply specific guidance in the new Revenue recognition standards to their leasing transactions (e.g., for a lessor’s allocation of the consideration in the contract). Given the interaction of the new standards, some entities may consider it more efficient to early adopt the new Leases standards concurrently with the application of the new Revenue recognition standards, in order to have one transition date for both standards.

Transition method selection
Revenue recognition - All entities will be required to apply the standards retrospectively under IFRS and US GAAP, using either a full retrospective or a modified retrospective approach.

Leases - Under IFRS, lessees will be permitted to use either a full retrospective or a modified retrospective approach for leases existing at the date of initial application of IFRS 16, with options to use certain transition reliefs, while lessors will not be required to make any adjustments on transition for leases in which it is a lessor and will account for those leases from the date of initial application. Under US GAAP, lessees and lessors are required to apply ASC 842 using a modified retrospective approach for all leases that exist at or commence after the beginning of the earliest comparative period presented, and have an option to use certain practical expedients. Lessees and lessors are prohibited from using a full retrospective transition approach.

Transition disclosures prior to adoption
Some entities still may not know, or be able to make, a reasonable estimate of the impact the new standards will have on their financial statements and will make a statement to that effect. However, regulators like ESMA¹ and the SEC² expect an entity’s disclosures to evolve in each reporting period as more information about the effects of the new standards become available.

In July 2016, ESMA made a public statement regarding the implementation of IFRS 15 which highlighted the need for consistent and high-quality implementation and for transparency on the impact of IFRS 15 to assist users of financial statements. In relation to the requirements in IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors³, ESMA commented that an entity should gradually be able to provide more entity-specific quantitative and qualitative information. The public statement also provides, the types of information ESMA expects to be disclosed for each interim and annual reporting for 2016 and 2017 when an entity expects the standard to have a significant impact.

The SEC has said that in the coming year it will monitor Staff Accounting Bulletin (SAB) Topic 11.M (SAB 74) disclosures which require public companies to disclose the effects a recently issued accounting standard will have on their financial statements when they apply it in a future period. The SEC has stated several times that it expects an entity’s disclosures to evolve as more information about the effects of the new standards become available. That is, the SEC expects that an entity’s transition disclosures will increase as a company progresses in its implementation plans. Entities that don’t yet know how they will be affected should disclose that the effect is unknown, along with information about when they plan to complete their assessment of how they will be affected.

ACTIONS TO TAKE NOW...

- Use the time prior to adoption to prepare
- Evaluate the potential effects
- Prepare transition disclosures and update them as adoption nears
- Prepare updated required disclosures
- Implement and sustain new processes and controls
- Consider whether the company has adequate resources for an effective implementation
- Explore different views within the industry on how to implement the standards

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¹ European Securities and Markets Authority (ESMA)
² U.S. Securities and Exchange Commission (SEC)
³ International Accounting Standard (IAS)