

Case 19-1c

The Terminator

Trans Ocean Shipping (“Trans Ocean”) provides domestic and international transportation and logistics services to customers. The company contracts shipping vessels, trucks, and aircraft to provide regional, long-haul, and international shipments of customer goods. Trans Ocean has entered into the following contracts:

In March 2019, Trans Ocean entered into a shipping contract with a customer, Asia Manufacturing (“Asia”), in which Trans Ocean is the exclusive shipper of Asia’s products between Shanghai and Los Angeles. Trans Ocean’s contract with Asia is effective on July 1, 2019. Before signing the contract with Asia, Trans Ocean did not operate the Shanghai-Los Angeles route. To satisfy the contract with Asia, in April 2019, Trans Ocean leases a cargo ship from Heavy Vessel Manufacturing (“Heavy”), which commences on July 1, 2019. Trans Ocean had no other customers on July 1, 2019 to deliver goods on the Shanghai-Los Angeles route.

Trans Ocean adopted ASC 842, *Leases*, on January 1, 2019.

The following are relevant facts about Trans Ocean’s shipping contract with Asia and Trans Ocean’s lease with Heavy.

Trans Ocean’s Shipping Contract With Asia

- The shipping contract’s stated term with Asia is for one year.
- Asia can renew the contract annually for up to four additional years. Therefore, the revenue contract can extend to include a total of five years.
- Asia pays a significant up-front nonrefundable fee for the initial one-year term; the same amount is due at the beginning of every renewal period.
- Asia can cancel at any time without incurring a penalty other than forfeiting any up-front nonrefundable fees already paid or owed at the beginning of the initial contract term and any nonrefundable fees paid or owed at the beginning of each renewed period.
- Although the contract is new, Trans Ocean and Asia have entered into similar arrangements with similar terms and routes, and, historically, Asia has renewed for one or more years.
- Trans Ocean appropriately concludes that (1) the shipping contract with Asia meets the scope of and criteria in ASC 606, *Revenue From Contracts With Customers*, and (2) the contract term for its shipping contract with Asia is one year.

Trans Ocean’s Lease With Heavy

- The contract between Trans Ocean and Heavy contains a lease under ASC 842.
- Rental payments are fixed, aligned to market prices each year.
- To mitigate risks, Trans Ocean negotiated the lease period and renewal options to mirror those of Trans Ocean’s revenue contract with Asia. As a result, the fixed, noncancelable term of the lease is one year, and Trans Ocean can renew annually for four additional years (i.e., up to five full years).

Trans Ocean believes that since Asia can terminate the revenue contract after one year (even though Asia may need to ship products for longer than a year and has historically renewed under other similarly structured contracts), it is uncertain whether Asia will renew the revenue contract. Because of this uncertainty, Trans Ocean believes that the renewal options related to the lease are not reasonably certain at the commencement date of the lease.

As a result, Trans Ocean concludes that the lease term for its lease contract with Heavy is also one year.

Required:

1. Do you agree with Trans Ocean's conclusion that the lease term for the cargo vessel is one year because the revenue contract is for one year?
2. What factors should Trans Ocean consider in supporting its conclusion related to the lease term?

Additional Facts

On December 1, 2019, Trans Ocean entered into a shipping contract with Eastern Manufacturing Company ("Eastern") to ship Eastern's products between Shanghai and Los Angeles. The contract with Eastern commences on January 1, 2020, and, on the basis of Trans Ocean's evaluation of its enforceable rights and obligations in the contract with Eastern, Trans Ocean concludes that term of the revenue contract with Eastern is for a period of two years. Further, Trans Ocean concludes that (1) the cargo vessel will have sufficient capacity to service both Asia and Eastern; and (2) the leased asset is needed for Trans Ocean to perform under its revenue contract with Eastern (because of economic reasons that would not allow Trans Ocean to use another vessel).

Required:

3. Should Trans Ocean reassess the lease term of the cargo vessel? If so, why?