



cutting through complexity

TRANSPORT

Impact of IFRS: Shipping

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A large industrial crane stands prominently in the foreground, its long jib extending towards the top right. The crane is silhouetted against a bright, hazy sky at sunset or sunrise. In the background, other cranes and industrial structures are visible along a waterfront. The overall scene is industrial and atmospheric.

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Introduction

In 2011 we reported that it was difficult to obtain comparable financial reports for the biggest shipping companies in the world. We struggled to find any relevant reporting for about a third of those we looked for, and beyond this, we found comparability difficult with ten different accounting bases used for the remaining two thirds.

But the picture is getting better. Our 2011 findings, published in Shipping Insights 4: Keeping Ahead, recognised that many countries are swiftly adopting International Financial Reporting Standards (“IFRS”) and that local GAAPs were likely to be superseded in the next couple of years. Compared with a similar KPMG survey in 2008, more accounts were publically available and less accounting GAAPs were being used. Other than the US, we can expect companies based in all the major shipping countries to be reporting on a consistent basis as IFRS adoption continues at a pace.

The challenge remains for preparers and users alike, as to how to adopt the principles of IFRS in the world of shipping – where choices exist, or judgment is required, differences in interpretation or application are inevitable.

In this publication, we assess the impact of IFRS on the shipping industry – looking in some detail at the key areas that company Boards and their finance teams have to grapple with.

The key areas

Based upon the frequent conversations we have with shipping companies and KPMG member firms’ experience of undertaking GAAP conversions to IFRS, the following topics are the key areas to consider:

1. Cost capitalisation
2. Depreciation and residual value
3. Impairment of non-financial assets
4. Leasing
5. Consolidation and joint arrangements
6. Revenue and costs
7. Financial instruments
8. Segment reporting
9. First-time adoption

In our experience, these areas are most sensitive to the operational reality of the shipping industry – be it the nature of the assets and liabilities or the contractual arrangements most commonly entered into. This publication sheds light on these issues by considering how shipping companies are dealing with the complexity in practice and by providing specific examples to illustrate the application of IFRS.

In doing this, we have referred to our survey of publically available financial information of the world’s largest shipping companies. This sample was first selected from the 2010/11 reporting season to support our analysis for our recent Shipping Insights 4 publication, amended to focus on only those companies using IFRS. A list of these companies is provided in the Appendix. We have not updated our analysis to consider more recent financial announcements and reports.

The International Accounting Standards Board (“IASB”) – the organisation that develops new IFRSs – is incredibly busy at the moment. At the time of issuing this publication there are fundamental changes proposed to leasing and revenue recognition and we expect further clarity around financial instruments. As we consider each key topic, we have looked forward to how new proposals may affect the balance sheets and income statements of shipping companies in the future.

We hope both current users of IFRS and those planning a conversion in the near term find this publication helpful and informative. KPMG’s global shipping network has the breadth and depth of resource to provide clients with support and advice on all aspects of current and future international financial reporting issues. I would encourage you to keep in touch with your normal KPMG contact, or link up with our network.

John Luke
KPMG, Global Head of Shipping

1.

Cost capitalisation

Vessels are recognised at cost, being the directly attributable costs incurred by a company in bringing the asset to the location and condition necessary for its intended use.

Cost typically equates to the contract price agreed with the shipyard and includes:

- cost of any option purchased to secure a future slot in the yard (but see later);
- stage payments to the yard over the build phase (which may include incremental or variation costs associated with design changes, price escalation etc. during the construction);
- borrowing costs eligible for capitalisation and costs associated with hedging future stage payments;
- initial inspection and certification costs; and
- potentially some repositioning costs (including first fill of lube-oil and bunker fuel).

In KPMG firms experience, owners rarely incur significant internal direct costs associated with the build; however some internal costs associated with an in-house team managing the build contract may be eligible for capitalisation if they are directly attributable to the project.

Non-specific or operating costs are expensed as incurred, including costs associated with crew training.

Borrowing and hedging costs

Borrowing costs that are directly attributable to the construction are capitalised, as it generally takes a substantial period of time to build a vessel. Borrowing costs may include certain finance charges and foreign exchange differences that are regarded as an adjustment to interest costs. In our view, borrowing costs also may include payments and accruals made under interest rate swaps used for hedging of eligible borrowing costs (but not the mark-to-market change in the fair value of the interest rate swap).

Identifying borrowing costs on general (as opposed to specific) borrowings can be challenging. A weighted average interest cost approach is applied, making sure to exclude any interest on specific borrowings. The objective is to capitalise borrowing costs that would have been avoided had the asset not been constructed. The amount capitalised may not exceed the actual interest incurred by the company. The period during which interest is capitalised should broadly match the period over which other costs are eligible for capitalisation.

Some vessel construction contracts may be in currencies other than the functional currency of the company. To mitigate its exposure to fluctuations in exchange rates a company may use hedging. If certain conditions are met, the company may apply hedge accounting under IAS 39 *Financial Instruments*:

Recognition and Measurement. In that case the company may designate certain vessel construction contracts as hedged items. For cash flow hedges, the effective portion of the exchange gains or losses is initially recognised in other comprehensive income, rather than in the income statement. IAS 39 permits an accounting policy choice to either capitalise these amounts within the initial cost of the investment or to recycle them to profit or loss in the same period during which the vessel affects profit or loss over the depreciation period or when the vessel is impaired or sold.

Repositioning costs

Generally start-up and pre-operating costs are not eligible for capitalisation unless those costs are necessary to bring the asset to its working condition. Therefore, costs incurred up to the moment when the vessel is capable of operating in the intended manner (including moving it to a required location) do meet the definition of an eligible cost.

In our experience, companies seeking to capitalise costs in this area generally consider repositioning costs from the yard to the nearest major port, rather than the actual costs incurred in moving the vessel to a port of choice (or port determined under a charter agreement). In some instances, the vessel generates an operating loss in its first days at sea, as it moves from the yard to the commencement of its first laden voyage. The operating loss is expensed as incurred.



Subsequent expenditure and dry-docking

When an item of property, plant and equipment ("PPE") comprises individual components for which different depreciation methods or rates are appropriate, each component is depreciated separately. A separate component may be either a physical component or a non-physical component that represents a major inspection or overhaul. PPE is separated into parts (components) when those parts are significant in relation to the total cost of the item.

Component accounting is compulsory, but this does not mean that a company should necessarily split its assets into an infinite number of components if the effect on the financial statements would be immaterial.

Broadly vessels comprise a hull, engine, superstructure, navigation system and other fit-out assets. In our experience, companies are pragmatic in the approach to componentisation with the base assumption that these elements have approximately the same engineering lives and therefore depreciable lives. Companies only move away from this assertion if persuasive evidence exists to the contrary which would result in a material impact. One area of challenge is around navigation equipment, where the operational service life may be longer than the period up to which the technology becomes obsolete.

In most cases a company acquires a vessel (either new or second-hand) for a fixed sum without necessarily knowing the cost of the individual components, and accordingly these should be estimated either by reference to current market prices, in consultation with the contractor or by some other reasonable method of approximation such as relative values.

Dry-docking (as the major overhaul) is identified and accounted for as a separate component. For example, an owner acquires a new vessel for 400 and the useful life of the ship is 20 years and the next dry-docking is due in three years. At the acquisition date the dry-docking costs for similar ships that are three years old are approximately 80. Therefore, the cost of the dry-docking component for accounting purposes is 80 and this amount would be depreciated over the three years to the next dry-docking. The remaining carrying amount, which may need to be split into further components, is 320. Component accounting for inspection or overhaul costs is intended to be used only for major expenditure that occurs at regular intervals over the life of an asset. Costs associated with routine repairs and maintenance are expensed as incurred including routine maintenance performed whilst the vessel is in dry dock.

IFRS is silent with regards to the specific costs that should be included in measuring the component attributable to major inspection or overhaul costs (i.e. whether they should be incremental and/or external costs). Expanding the example above where the owner's in-house ship management team carry out most of the dry-dock work and the external costs incurred is only 30. In our view, the company should attribute the entire 80 to the component on the basis that the cost of an item of PPE includes internal as well as external costs, and there is no requirement for the costs to be incremental.

In our view, borrowing costs associated with a dry-docking need not be capitalised, assuming the dry-docking periods are relatively short.

Owners may also incur subsequent expenditure to enhance the operating capability of the vessel or extend its life (such as raising the bridge or significantly replacing the hull). Such costs are eligible for capitalisation provided future economic benefits are associated with them. Finally costs incurred in meeting new or changing regulation may be eligible for capitalisation even though the expenditure itself does not give rise directly to future economic benefits.

Assets leased under an operating lease

Accounting for dry dock and other subsequent asset expenditure is more complex for an asset leased under an operating lease because the asset and future obligations under the lease are not reflected in the lessee's statement of financial position. There is no guidance in IFRS on whether component accounting is appropriate when the principal asset is not recognised in the financial statements.

Regular dry-docking is essential for the owner or operators to maintain the vessel classification and insurance. Accordingly, certain lease arrangements may require the lessee to incur the dry-dock cost. In our view, the nature of the transaction will determine the accounting treatment and it may be appropriate for the lessee to:

- apply the component approach and recognise major repair or overhaul costs as a leasehold improvement; or
- apply the liability approach and build up a provision for the dry-docking cost over the period of the lease. The provision would be measured at the expected cost of the dry-docking based on the condition of the vessel at each reporting date.

If a vessel could be handed back part-way through its dry-dock cycle (rather than being handed back only after a full dry dock had been undertaken), then the component approach may be appropriate.

Alternatively, a liability approach may be appropriate if the lease agreement specifies that the lessee should return the vessel in its original condition or compensate for costs required to restore the vessel to its original condition.

Purchase of second hand vessels

Second hand vessel sales are usually arranged by a ship broker. The purchaser recognises the vessel as PPE at the contract price (which includes an element of broker fees and transaction costs such as legal and inspection).

Sale and purchase contracts typically specify at which port ownership transfers. Costs associated with moving the vessel after the sale are unlikely to be eligible for capitalisation and therefore would be an operating cost of the purchaser.

Disclosure

IFRS financial statements are required to disclose the gross carrying amount of PPE, the accumulated depreciation and the impairment losses at the end of the period and a reconciliation from the opening balance sheet (and comparative).

A distinction is made between assets purchased and those acquired through a business combination. Assets classified as held for sale in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* are disclosed separately.

Disclosures are made by separate asset classes. This does not mean an analysis by asset component, but rather groupings of assets that are similar in nature. IAS 16 *Property, Plant and Equipment* provides "ships" as an example of an asset class. We would encourage companies that are engaged in different types of shipping activity (e.g. dry-bulk, container and tanker) to provide disclosure at this level, as this provides users of accounts with more insightful information, particularly when considering impairment risks, and may better align with segmental disclosures.

Additional footnote disclosure is required for the:

- existence and amounts of restriction on title and PPE pledged as security for liabilities;
- amount of borrowing costs capitalised in the period;
- amount of expenditure recognised in the carrying amount of an item of PPE that is in the course of construction; and
- amount of contractual commitments for the acquisition of PPE.

The last point is relevant for investors to understand the entity's exposure to new tonnage.

Experience in practice?

Companies in our survey provided little insight into the types of costs being capitalised. Some policies included "costs of bringing the asset into use" but the narrative was unclear as to the specific approach being adopted to issues such as repositioning.

Almost all companies stated that they were capitalising interest or borrowing costs. In instances where non-specific funding was being used to build new ships, some companies provided guidance on the rate at which interest was capitalised.

The majority of the sample categorised all ship sub-classes (e.g. dry-bulk, container and tanker) as one class of PPE.

2.

Depreciation and residual value

Subsequent to initial recognition, items of PPE are depreciated on a systematic basis to the income statement over their useful economic lives to a residual value.



IFRS requires companies to reassess the useful economic lives and residual values of assets at each reporting date, with a change in either being accounted for prospectively as a change in accounting estimate.

Commencement of depreciation

Depreciation commences once the asset is complete and in a condition and location ready for use. In the shipping industry, there is perhaps less ambiguity regarding this judgment than in other sectors and given our comments in the previous section depreciation usually commences when the vessel is delivered.

IAS 16 outlines different methods of depreciation, encouraging companies to adopt a policy that best reflects the consumption of economic benefits. In our experience, the straight-line method is almost exclusively used within the shipping industry.

Depreciation of the major components of the vessel could be suspended, e.g. whilst in dry dock, but this practice does not appear commonplace, presumably on the grounds of materiality.

Useful economic lives

The useful economic life of a vessel component is judgmental, and can be complicated by:

- the long engineering lives of vessels;
- the uncertainty over the future market conditions in which the vessel will operate;
- fleet deployment and operating cycles;
- future technological changes, including the impact of regulations and constraints and new engine design; and
- the repairs and maintenance policies.

In our experience, owners typically adopt a prudent approach and consider the most likely utility of the asset. This is frequently shorter than the theoretical engineering life of the hull and engine.

Residual value

Residual value is the amount that a company could receive for the asset at the reporting date if the asset were already of the age and in the condition that it will be in when the company expects to dispose of it. Residual value does not include expected future inflation. The estimated residual value is based on similar assets that have reached the end of their useful lives at the date that the estimate is made.

In the shipping industry, the residual value can be relatively material because of the scrap value of steel and the considerable scrapping market that exists. Accordingly, today's market price for scrap steel can be used as a basis for determining a vessel's residual value.

Depending on the market conditions, the residual value of a vessel can potentially be higher than its net book value. At this point, the company suspends depreciation until such time as the residual value falls again.

Using steel price to determine a residual value is not without challenges. Given the volatility of the steel price over the past five years. We do not suspect that the standard setters envisaged companies having to mark residual values to market each year. However, when a change in market conditions is material, we would expect owners to update the estimates.

Disclosure

IAS 16 requires companies to disclose:

- the depreciation charge and accumulated depreciation;
- the basis for estimating residual values;
- the useful economic lives; and
- depreciation method.

If a company changes its assessment of useful economic lives or residual value during the year, the effect to net income is also disclosed.

In our experience, shipping companies tend to disclose broad ranges rather than specific rates, which makes it difficult to assess the quality of the fleet in operation. This contrasts with companies in the airline industry, which often describe in more detail the nature and age of the aircraft fleet they are operating.



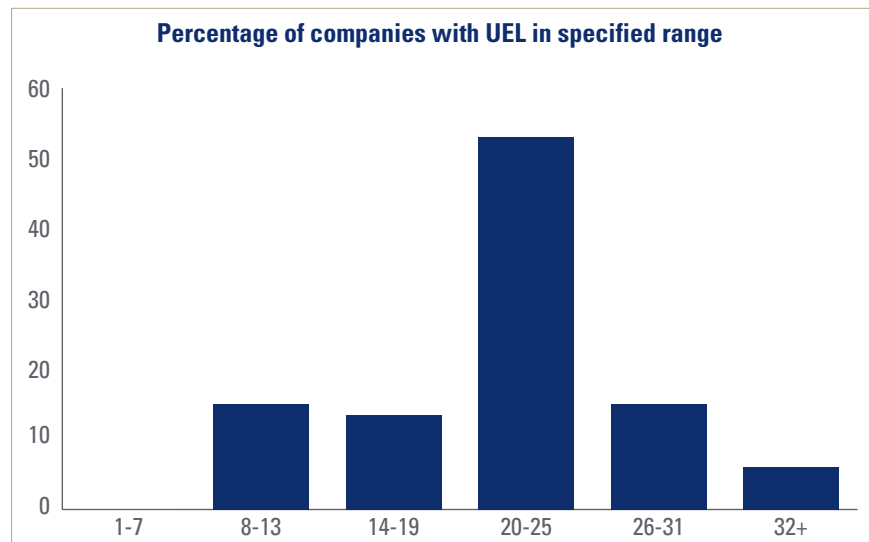
Experience in practice?

Overall, there was consistency in the selection of useful economic lives.

One or two companies provided very broad ranges of lives (for example, one quoted 10-25 years), which presented a challenge in assessing the age and long run depreciation charge of the company. Outliers in the analysis above were likely to have asset-specific reasons for shorter or longer lives. In particular, for FPSOs this judgment is likely to be driven by the remaining reserves associated with the oil field. It did however appear that companies were being prudent in their estimates, as the engineering lives of vessels were, generally, longer than 20-25 years. This appears to indicate that companies expect vessels to become economically impaired before the end of their engineering lives due to technological evolutions or regulatory requirements.

Just less than one third of our sample did not provide information on how residual values were determined. Several used a percentage of the original cost price as a proxy (with a range of 5% to 20%) and others used average steel prices (lightweight tonnes – LWT). Of these, some went

Figure 1: UELs disclosed by shipping companies



Source: KPMG LLP (UK) 2012

further and stated that three year average scrap steel prices were used – obviously to address the volatility point identified above.

Of our sample, we did not identify any company that disclosed a change in estimate of either useful economic life or residual value in the latest financial year. Accounting standards require the

impact of such change in estimate to be disclosed if material.

The level of detail in disclosures made it difficult to identify the impact of different depreciation rates on the net profit of companies in the industry. However, it was possible to identify those that were more prudent (and charged higher depreciation) year on year.



3.

Impairment of non-financial assets

Impairment is one of the most critical judgments in considering the strength of the balance sheet and something that debt holders, equity owners and the supply chain are intently focussed on.

Notwithstanding the cyclical nature of the shipping industry, the level of impairments recognised historically has been relatively low – in our 2011 Shipping Insights publication we noted that less than a half of one percent of our sample’s aggregate net book value of vessels had been impaired during the 2010 reporting cycle – and there are a number of factors which may be underpinning this, which we consider below.

Cash generating units

Wherever possible, the assessment of impairment is performed on an individual asset basis. However, this is not possible if an asset generates cash flows only in combination with other assets as part of a larger cash-generating unit (“CGU”) which cannot be larger than an operating segment as defined by IFRS 8 *Operating Segments*. In our experience, many single assets in the shipping industry do not qualify for independent impairment testing, because they are operated as part of an integrated fleet.

Accordingly assets need to be grouped in the smallest asset pool, which generates independent cash flows. The identification of CGUs requires judgment and can be one of the most difficult areas of impairment testing. Whilst the key test is the identification of independent cash inflows, IAS 36 *Impairment of Assets* also refers to other factors such as the manner in which management monitors operations and makes decisions about continuing or disposing of assets and/or operations. In our view, these additional factors are intended to assist in identifying parts of the business that

have independent cash inflows, and are not alternative tests.

In identifying groups of assets that have independent cash inflows, in our view two considerations, neither of which is likely to be determinative in isolation, are particularly useful in the analysis:

- Revenue separation – are the streams of revenue derived from these groups of assets independent of one another; and
- Asset separation – are the assets operated together to such an extent that they do not generate independent revenue streams?

Liner companies, in particular, usually find that inter-relationships between operating assets make specific allocation of all cash flows to individual vessels challenging if not impossible. Some companies may group assets by a particular trade that they operate, but even that can sometimes be difficult given the ability of operators to switch vessels between trades.

Individual asset testing is more commonplace where specific or specialist vessels are in operation or are chartered to an individual counterparty on specific terms.

Impairment triggers

IAS 36 provides a number of example indicators of possible impairment, such as:

- a significant adverse change in the market and economic environment in which a company operates or to which an asset is dedicated; and

- evidence being available from internal reporting that indicates economic performance of an asset is worse than expected.

Practical triggers therefore include:

- general downturn in global economy (which drives demand for vessel movements);
- depressed freight rates;
- depressed new build prices or resale prices;
- vessels being laid up;
- higher than normal scrapping rates;
- substantial physical damage to the vessel;
- technological obsolescence (e.g. driven by regulatory change); and
- operating losses.

Impairment model

Where an impairment test is performed, the carrying amount of an asset or group of assets is compared to its recoverable amount, which is the higher of:

- Fair value less costs to sell (generally based on the market price); or
- The value expected to be generated from the continuing use of the asset – its value in use.

If the carrying value is greater than the recoverable amount then the asset is written down.

Identifying fair value

The best evidence of fair value is a binding sale agreement in an arm's length transaction. In the absence of liquid markets, entities use the best information available to estimate the amount that could be obtained through the disposal of the asset at the reporting date. The use of one or more independent brokers may be appropriate and the recently introduced on-line valuation tools can also provide supporting evidence.

Assessing value in use

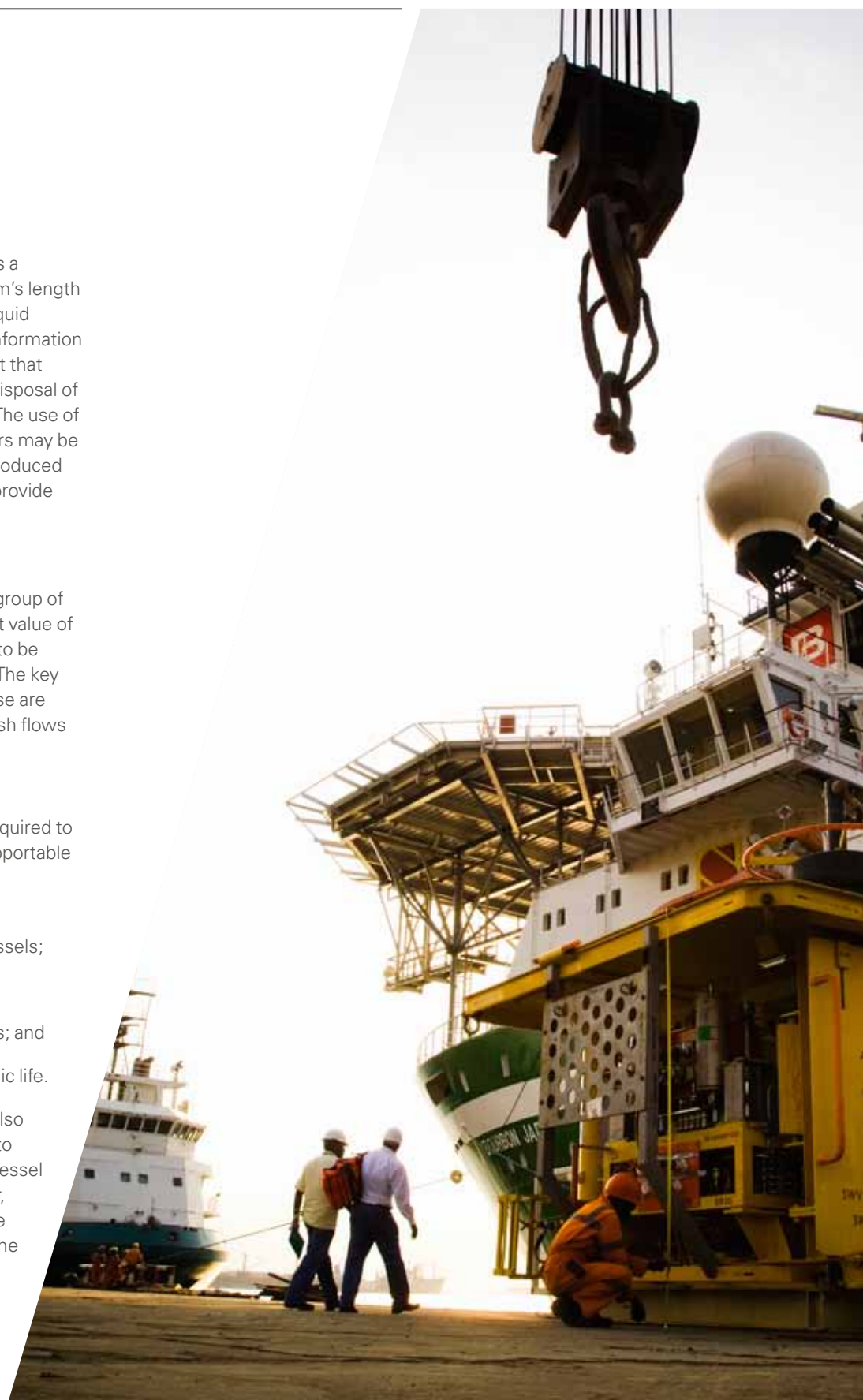
The value in use of an asset (or group of assets) is defined as the present value of the future cash flows expected to be derived from the asset or CGU. The key factors in assessing a value in use are therefore the composition of cash flows and the discount rate applied.

Cash flow composition

The cash flow projections are required to be based on reasonable and supportable assumptions and are built up by considering:

- spot or chartered rates for vessels;
- utilisation;
- operating costs of the vessels; and
- the estimated useful economic life.

Cash flows for dry-docking are also included as they are necessary to maintain the performance of a vessel in its current condition; however, discretionary capital expenditure that could enhance or improve the vessel's performance or life is excluded from the calculation.



IAS 36 states that a maximum of a five-year horizon is appropriate for the cash flows to be based upon company's budgets and forecasts, and thereafter a growth rate is applied. Long-term charter agreements could be a reason to rebut this time horizon (especially for bare boat arrangements). Absent such arrangements a terminal growth rate is usually applied.

Complexity arises in the shipping industry because of the cyclical nature of its operations. This also may be a factor for lowering a long-term growth rate.

Discount rate

The discount rate to be applied to the projected cash flows reflects the current market assessment of the risks specific to the asset or CGU and the time value of money. The key point to highlight is that the discount rate for impairment purpose is unlikely to equal the weighted average cost of capital ("WACC") of the asset holder, because it may not represent the rate of return that a market participant would require if it were to choose to invest in the vessel(s) in question.

It is generally rare that a discount rate is observable directly from the market, and therefore one needs to be derived. The most common method in practice is to start with a company's WACC which is then adjusted to build up a market participant discount rate.

Factors to consider to arrive at an appropriate rate include the:

- nature of the chartering arrangement – in the case of spot and time charters the owner is exposed to both operational and credit risk, whilst for bareboat charters only credit risk may be relevant;
- terminal value – risks associated with vessel scrapping are likely to be different to re-sale and/or a purchase option; and the
- nature of the asset(s) – forecasting and liquidity risk associated with the different types (dry-bulk, container, tanker etc) and different sizes (cape, panamax, handy etc) of vessels.

A further complication is that WACC is a post-tax discount rate, whilst IAS 36 requires using a pre-tax discount rate for impairment testing purposes. However, this may not cause an issue for a shipping company operating in a tonnage tax regime. The tonnage tax is not based on taxable profits and is not considered to be an income tax under IAS 12 *Income Taxes*. Therefore, in our view the cash flows in a value in use calculation should be determined net of the tonnage tax cash outflows.

Differences between fair value and value in use

In principle, and in a perfect market, there should be very few differences between a fair value and value in use, as both are calculating the long-term earnings potential of the vessel. However, in practice, value in use may be higher as it takes into account entity specific factors and information that may not be readily available to market participants.

Example factors include:

- charter arrangements for the individual assets, which could have more favourable terms than current market rates;
- a more optimistic view of daily running costs;
- high residual values and different views on useful economic lives;
- different views on discount rates;
- a more bullish view of market sentiment; and
- the level of liquidity in the market (a discount may be applied when there is a lack of liquidity).

Reversal of past impairments

If there is an indication at a reporting date that the recoverable amount of the impaired vessel or CGU increases, the impairment of the vessel or CGU is reversed. The amount of the reversal is the lower of:

- the amount necessary to bring the carrying value of the asset to its recoverable amount; and

- the amount necessary to restore the assets of the CGU to their pre-impairment carrying value less subsequent depreciation that would have been recognised.

Reversals are recognised in the income statement (unless the assets were revalued).

A reversal does not arise due to the impact of the unwinding of the discount used in determining value in use.

Part-completed new builds

Some vessels under construction may be subject to impairment if the agreed costs to build a vessel become higher than its estimated value in use or fair value. This issue has been especially relevant in the past couple of years as new build prices have dropped by up to 40% from the 2007/8 peak.

If this is the case and the contract with the shipyard cannot be cancelled without a penalty, then it is necessary to consider whether the contract is onerous under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. In assessing whether a contract is onerous, a shipping company compares the expected benefits from the vessel with the lower of the cost to fulfil the contract and any compensation or penalty to cancel the contract. If the expected costs to fulfil or cancel the contract are higher than the expected benefits from the vessel, then the contract is onerous. Before a separate provision for an onerous contract is established, the shipping company recognises an impairment loss on the vessel under construction.

Parent and subsidiary considerations

It is not uncommon for a parent to charter a vessel from its subsidiary and then onward charter (either for a long or a short-term) to its customers. In such instances, different assessments of CGU's and different estimates of cash flows may be used for impairment testing purposes at the Group (consolidated) level compared to the subsidiary level. For example; in a one-ship vessel owning company, cash inflows from the parent's charter and the daily running costs may be easily determinable, whereas at a

consolidated level, such transactions are eliminated and replaced by external exposures. Accordingly the impairment test at the group and subsidiary could yield a different outcome.

High-level “sense” checks

When the recoverable amount of a CGU is determined on the basis of value in use and substantial parts of the company are being tested for impairment, a high-level comparison between market capitalisation, adjusted for the market value of debt and any surplus (or specific) assets, and the total value in use for all CGUs provides some support that the assumptions and discount rate used are appropriate for the cash flows.

Disclosure

IAS 36 requires a number of specific disclosures, but perhaps most importantly:

- a description of the cash-generating units;
- whether the recoverable amount is based on fair value or value in use; and
- the assumptions underpinning the recoverable amount (such as discount rates).

Experience in practice?

A market participant discount rate is difficult to calculate and therefore the divergence of disclosed rates is perhaps not surprising.

About half the sample clearly disclosed discount rates, with the lowest at 5% and the highest at 13% (post tax). Only one indicated a significant difference between pre and post-tax rates presumably because this company was operating outside tonnage tax.

Only three companies disclosed a range of rates being used – presumably reflecting their belief that the market rates for separate asset classes were different.

Just under a half of our sample disclosed indicative growth rates used for impairment calculations. Here the range was even wider, with one

applying an inflation increase of 1.8% and the highest rate being 13.4%.

About half of these disclosures were based upon market measures (seaborne container indices, Baltic indices, etc) and others were based upon internal management business plans. The extent of this spread is perhaps surprising, but we would expect different vessels operating in certain geographies to have specific growth rates.

About a quarter of our sample identified cash-generating units, and these were generally on a fleet basis.

Very few in the sample provided sensitivity analysis in sufficient detail that aid users of accounts to assess the strength of long-term forecasts.





4.

Leasing

Leases are commonplace in the shipping industry – both as a source of capital to fund new build programmes and second-hand purchases and also as a regular way to do business through bare-boat and time-charter arrangements.

Lease accounting issues have focussed on the judgment of whether arrangements are “on” or “off” balance sheet. As we will see later in this section, new accounting proposals mean that this distinction is likely to be removed, and perhaps accounting for both lessors and lessees is about to get far more complex.

Operating vs finance leases

Under existing accounting standards (IAS 17 *Leases*) the assessment of whether a lease is a finance or operating lease depends on whether substantially all of the risks and rewards incidental to ownership of the leased asset have been transferred from the lessor to the lessee.

Under a finance lease, the lessor recognises a finance lease receivable and the lessee a finance lease liability for future lease payments. Under an operating lease both parties treat the lease as an executory contract with rentals being recognised in the income statement over the term of the lease on a straight line basis. Under a finance lease of a vessel the lessee recognises an asset on its balance sheet, and under an operating lease, the asset remains on the balance sheet of the lessor.

Distinguishing between a finance and operating lease can be challenging in some circumstances. The following are key indicators of a finance lease:

- **Transfer of ownership** – if legal ownership of the asset transfers to the lessee either during or at the end of the lease, then the agreement usually will be classified as a finance lease;
 - **Purchase options** – the existence of a purchase option that is expected (at the start of the lease term) to be exercised means that legal title is expected to transfer. If the option price is expected to be below market, this may indicate that the lessee will exercise it;
 - **Major part of economic life** – if the lease term is for the major part of the asset’s economic life, then the agreement would normally be classified as a finance lease;
 - **Present value test** – if at the start of the lease the present value of the minimum lease payments amounts to substantially all of the fair value of the leased asset, then the agreement is normally classified as a finance lease; and
 - **Specialised nature of the asset** – if the asset is customised in such a way that only the lessee can use it without major modification, then this is a factor in concluding on a finance lease arrangement.
- Supplemental indicators that suggest a finance lease include:
- the lessee can cancel the lease but the lessor’s losses are borne by the lessee;
 - gains and losses on the residual value fall to the lessee; and
 - the lessee can extend the lease at below market rent.
- IFRS requires companies to assess the relative weight of evidence given the above factors, and KPMG believe an overall assessment of the transfer of risk and reward should be made.

Economic vs useful life

An asset’s economic life may be longer than its useful life. The economic life is the period over which the asset is expected to be usable. The useful life is the period over which the economic benefits of the asset are expected to be consumed by the lessee.

Present value test and minimum lease payments

Minimum lease payments are those payments that the lessee is, or can be, required to make to the lessor over the lease term and include:

- **Residual value payments** – from the lessee’s perspective, this includes any amount guaranteed by the lessee or a party related to it and from the lessor’s perspective this includes any residual guarantees of an unrelated third party; and
- **The exercise price of a purchase option** – to the extent it is reasonably certain at the inception of the lease that it will be exercised (and would also include a put option under which the lessor can require the lessee to purchase the asset at the end of the lease as this functions economically as a residual value guarantee).

Contingent rents are excluded from the minimum lease payments. Costs for services and taxes to be paid by and reimbursed to the lessor (including amounts for repairs and maintenance) are also excluded. If payments due under a lease include charges that are reimbursements for expenditures paid by the lessor on behalf of the lease, then such elements are separated from the minimum lease payments based on the relative fair values of the components of the arrangement.

IFRS has no bright line for its present value test (unlike US GAAP which uses a threshold of 90% or more of the fair value of the leased asset).

Residual value guarantees

The definition of minimum lease payments for a lessor also includes any residual value guaranteed by a financially capable independent party, whereas the lessee includes only amounts guaranteed by the lessee and the parties related to the lessee.

Initially the lessor records a finance lease receivable at the amount of its net investment, which comprises the present value of the minimum lease payments and any unguaranteed residual value accruing to the lessor. The present value is calculated by discounting the minimum lease payments due and any unguaranteed residual value, at the interest rate implicit in the lease. Initial direct costs are included in the calculation of the finance lease receivable, because the interest rate implicit in the lease, used for discounting the minimum lease payments, takes initial direct costs incurred into consideration.

Subsequent changes to leases

Leases are not reclassified for changes in estimate (e.g. of the economic life or residual value) or changes in circumstance (e.g. default of the lessee or the likelihood that the lessee will renew a lease), but modification of key terms may result in the company having to account for a new lease.

When modifying terms, a company is required to test whether the lease would have been classified differently if the modification had been in effect at the inception of the lease. If the modified terms would have resulted in a different classification based on the original estimates and circumstances, then the modified agreement is regarded as a new lease, and is classified in accordance with the modified terms, based on estimates at the modification date.

In the scenario where the lessee gives notice of its intention to exercise a renewal option (which it did not anticipate making at the inception of the lease), it may be acceptable to account for the secondary lease period as a new lease either from the date of notice or the first day of the new lease. The classification of the new lease may be different from the original lease classification. In certain circumstances, a secondary lease period or option may be added to the original lease part way through the initial lease term. In such cases, it may be acceptable to reconsider the classification of the lease based on the new provisions, either at inception of the original lease or at the date the change is made.

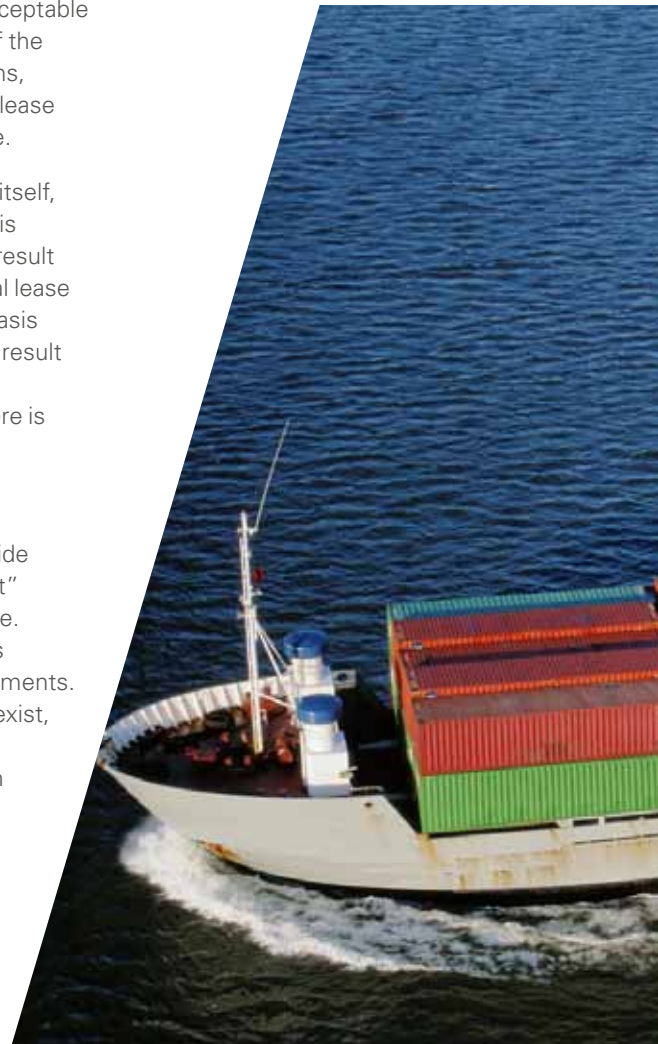
Renewing the lease does not, in itself, result in a modification. But care is needed when the renewal does result in changes to some of the original lease terms (which could include the basis of rental payments) as this could result in a modification. The area of modifications is complex and there is little specific guidance available.

Profit share arrangements

Certain charter agreements provide for the parties to share the "profit" between the charter and spot rate. This is to compensate the parties for locking in longer-term arrangements. Where such contingent clauses exist, these may be recognised when certain and in the period to which they relate.

Tax variation clauses

Some leases outside a tonnage tax regime allow the lessor to obtain a tax benefit that is passed to the lessee in the form of reduced rentals. Most of these arrangements contain a variation clause so that any tax disadvantage suffered by the lessor as a result of changes in tax law or rates will be compensated by an increase in future lease payments. IFRS does not contain specific guidance on whether to account for amendments retrospectively or prospectively and in our view, the method applied should reflect the nature of the clause and whether the effect of the tax change is retrospective or prospective.



Sale and leaseback transactions

When a sale and leaseback results in a finance lease, any gain on the sale is deferred and recognised as income over the lease term.

If the leaseback is classified as an operating lease then any gain or loss is recognised immediately if the agreement terms are clearly at fair value. If the sale price is above fair value, then any gain is deferred and amortised. If the sale price is below fair value then the gain or loss is recognised immediately, unless it is compensated by below-market future rentals. In these scenarios, gains are deferred and amortised.

Special purposes entities

Under some lease arrangements vessels can be transferred to special purpose entities ("SPEs"), and then leased back. These SPEs usually have limited activity other than the lease of the vessel and the servicing of debt finance, and therefore may be operating on "auto-pilot". Determining whether such SPEs are subject to consolidation requires judgments that take into account specific facts and circumstances (see section 5).

Service concession arrangements or arrangements that contain a lease

In our experience certain port operating agreements fall within the scope of IFRIC 12 *Service Concession Arrangements*. IFRIC 12 does not define public-to-private service concession arrangements, but it describes typical "features" of such arrangements. The scope of IFRIC 12 is

defined by reference to control of the infrastructure. An agreement between "Grantor" (typically a government authority or agency) and "Operator" (the private-sector entity using the infrastructure) is within the scope of IFRIC 12 if:

1. The Grantor controls what services the operator must provide with the infrastructure;
2. The Grantor controls to whom it must provide the services;
3. The Grantor controls (or regulates) at what price services are charged; and
4. The Grantor controls through ownership, beneficial entitlement or otherwise, any significant residual interest in the infrastructure at the end of the concession term.



Certain arrangements may contain some of the characteristics of a public-to-private service concession arrangement but be outside of the scope of IFRIC 12. For example, this may be a case if the Grantor does not control prices charged by the Operator or any significant residual interest in the infrastructure.

For the purposes of IFRIC 12, it is sufficient for the price to be regulated by the Grantor – either through a capping mechanism or an approval process. We find that price control is often retained by the Grantor where it is exposed to volume risk (i.e. is taking a variable fee).

Accounting under IFRIC 12 is complex, and may result in the recognition of intangible assets (being the “right to use”) and a liability for the payments to the Grantor. Port concession rights may also relate to certain items of PPE which are classified as intangible assets.

Where an arrangement is outside the scope of IFRIC 12, companies need to consider the requirements of IFRIC 4 *Determining whether an Arrangement contains a Lease* and IAS 17.

Disclosure

IAS 17 requires that lessors and lessees disclose the following for operating leases:

- The future minimum lease payments (or receipts) under non-cancellable operating leases in aggregate for each of the following periods:
 - not later than one year;
 - later than one year and not later than five years;
 - later than five years;
- Total contingent rents recognised as an expense (or income) in the period; and
- A general description of the company’s leasing arrangements.

Experience in practice?

Four companies mentioned service concession arrangements (or similar) and noted that these may give rise to financial assets (i.e. the companies recognised financial assets rather than PPE). No company in our sample specifically referred to IFRIC 4 within accounting policy sections as policy issue.

Some basic disclosure around the companies as lessors was available, however it was not possible to assess the consequential impact of any adoption of the new leasing proposals.



On the horizon

But all of this is about to change...

The IASB and the US FASB (the Boards) continue their deliberations over a new accounting model for lease accounting. The Boards remain committed to bringing all leases on balance sheet, but the finer points of the proposals are still being fleshed out, with another comment period expected sometime in late 2012.

The key proposals at the time of issuing this publication are outlined below. The broad principles are likely to remain and will have significant ramifications for shipping companies in the future.

Area	Consequence
Identifying leases and embedded leases... being a contract that: <ul style="list-style-type: none"> • Conveys the right to use a specified asset; and • Conveys the right to control the use of the underlying asset 	<p>All leases (operating and financing) would be brought on balance sheet for lessees.</p> <p>Short leases (less than 12 months) are likely to be scoped out, but longer term arrangements and bare-boat charters are likely to be within scope.</p> <p>Distinguishing between a lease and a service and the interchangeability of assets to fulfil contracts would become key judgments. Contracts of affreightment may continue to be off-balance sheet.</p>
Lease classification test	<p>The proposed test is based upon the extent of consumption of the underlying asset (ie whether the lessee acquires more than an insignificant portion of the utility of the underlying asset). For assets other than investment property, the lessee will apply the accelerated model and the lessor will apply the receivable and residual model, unless consumption is insignificant. If consumption is insignificant, then the lessee will apply a straight-line model and the lessor will apply an approach similar to current operating lease accounting.</p>
Accounting for lessees	<p>A lessee would recognise a right of use ("ROU") asset and a lease liability.</p> <p>For the straight-line model, lessees would measure the lease liability at amortised cost, recognise the total lease expense on a straight line basis as a single-line income statement item and adjust the carrying amount of the ROU asset by the difference between the total lease expense and the interest expense on the lease liability.</p> <p>Those applying the accelerated model would measure the lease liability at amortised cost, recognising interest expense in the income statement, amortise the ROU asset generally on a straight-line basis, recognising amortisation expense in the income statement, and thereby recognise the total lease expense on an accelerated basis.</p>
Accounting for lessors	<p>Under the receivable and residual model, the lessor would recognise a lease receivable and a residual asset on lease commencement, measure the lease receivable initially at the present value of the lease payments, measure the residual asset as an allocation of the carrying amount of the underlying asset, and recognise interest income over the lease term, resulting in an accelerated income recognition.</p> <p>Under the operating lease model, the lessor would continue to recognise the underlying asset and recognise lease payments on a straight line basis.</p>
Determining the discount rate	<p>The rate would be that implicit in the contract, which would result in a contract specific (rather than portfolio) approach.</p>
Variable lease payments	<p>Variable lease payments based upon indices would be calculated at the spot rate on commencement of the lease.</p> <p>Actual variable lease payments arising in the year but not included in the initial assessment would be recognised as an expense as incurred and the lease liability would be reassessed to reflect the closing spot rate.</p>
Initial direct costs	<p>These would be included in the carrying amount of the ROU asset.</p>
Transition	<p>Companies would need to decide whether to apply the requirements fully retrospectively or prospectively from adoption date.</p>



5.

Consolidation and joint arrangements

A new suite of standards issued in 2011 may have a significant impact on shipping companies. IFRS 10 *Consolidated Financial Statements*, IFRS 11 *Joint Arrangements* and IFRS 12 *Disclosure of Interests in Other Entities* set out requirements for consolidation, joint arrangements and relevant disclosures.

These standards are effective for periods beginning on or after 1 January 2013, with early adoption possible. The effective date for companies applying IFRSs as adopted in the EU may be on or after 1 January 2014, subject to finalisation of the endorsement process. Rather than looking backwards this section focusses solely on the new requirements.

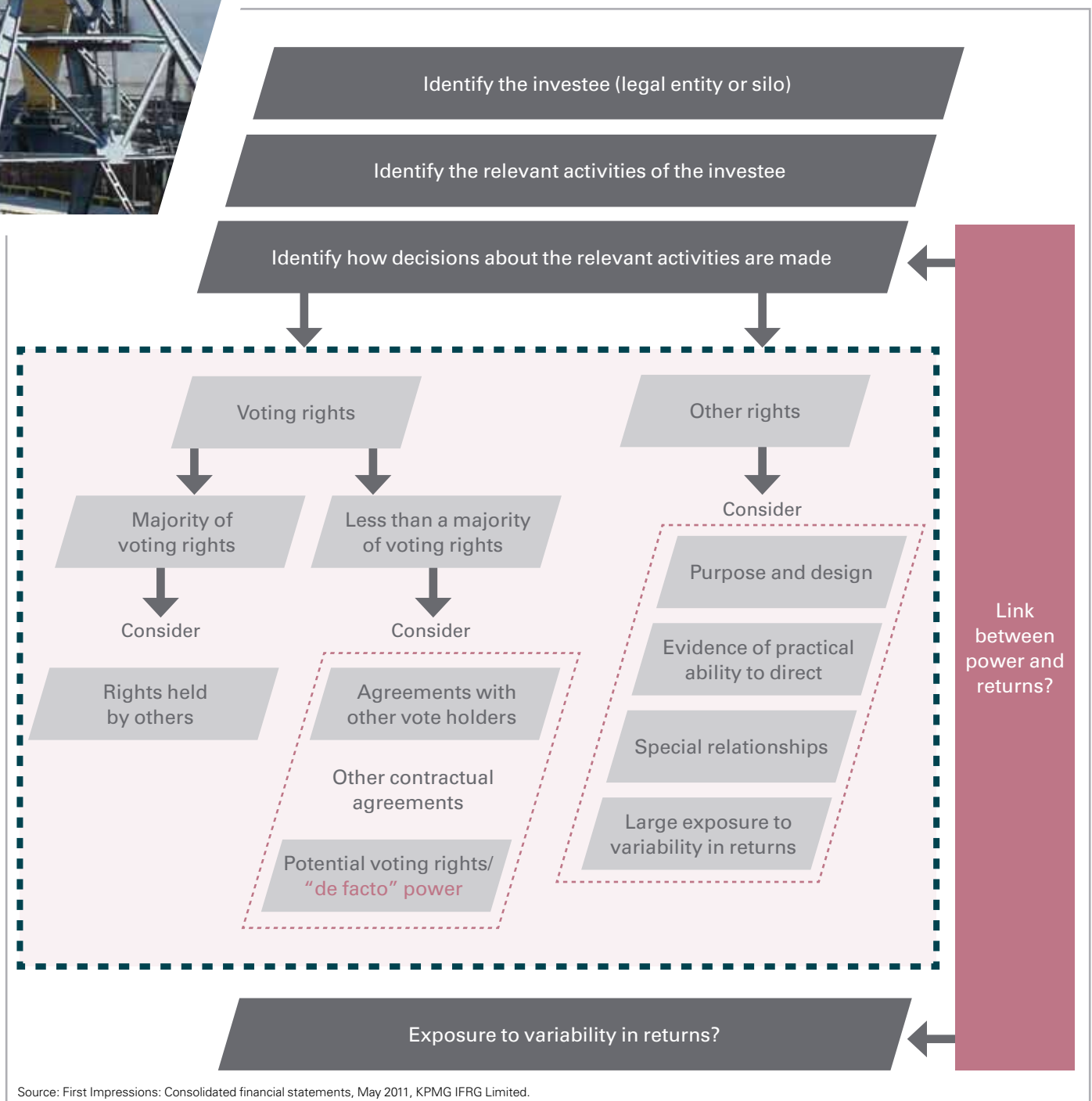
The concept of control under IFRS 10 is not identical to the definition of control under current standards. An investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.

Returns are defined broadly and include not just the ownership benefits such as dividends but also fees, remuneration, tax benefits, economies of scale and cost

savings. The investor needs to have exposure or rights to variable returns from its involvement. Power considers the existing rights that give the ability to direct relevant activities, i.e. those that significantly impact the investee's returns. IFRS 10 explicitly includes the concept of de facto control which can result in consolidation of entities with less than majority of voting rights. An investor needs to have the ability to use its power over the investee to affect its returns.



Figure 2: Control model



Source: First Impressions: Consolidated financial statements, May 2011, KPMG IFRG Limited.

Voting and other rights

There is a gating question in the control model, which is to consider whether voting rights or rights other than voting rights are relevant when assessing whether the investor has power over the investee. This judgment needs to consider the substantive rights exercisable when decisions about the relevant activities need to be made and whether the holder has the practical ability to exercise the rights.

An investor can have power over an investee when the relevant activities are directed through voting rights in the following circumstances:

- the investor holds the majority of the voting rights and these are substantive; or
- the investor holds less than half the voting rights but has arrangements which allow unilateral direction of the relevant activities of the investee.

When holder of voting rights as a group do not have the ability to significantly affect the investee’s returns, the investor considers the purpose and design of the investee as well as the following factors:

- evidence that the investor has the practical ability to direct the relevant activities unilaterally (this being the factor with the greatest weight);
- indications that the investor has a special relationship with the investee; and
- whether the investor has a large exposure to variability in returns.

In considering special relationships, IFRS 10 requires companies to consider (amongst other factors) whether the investee’s operations are dependent upon the investor and a significant proportion of the investee’s operations are conducted on behalf of the investor.

These considerations are likely to touch on a number of industry issues, including terminal activities that are conducted through a joint venture whilst one of the investor is responsible for a considerable amount of the terminal traffic. Any analysis will be specific to the facts and circumstances of the agreements and activities of the investee.

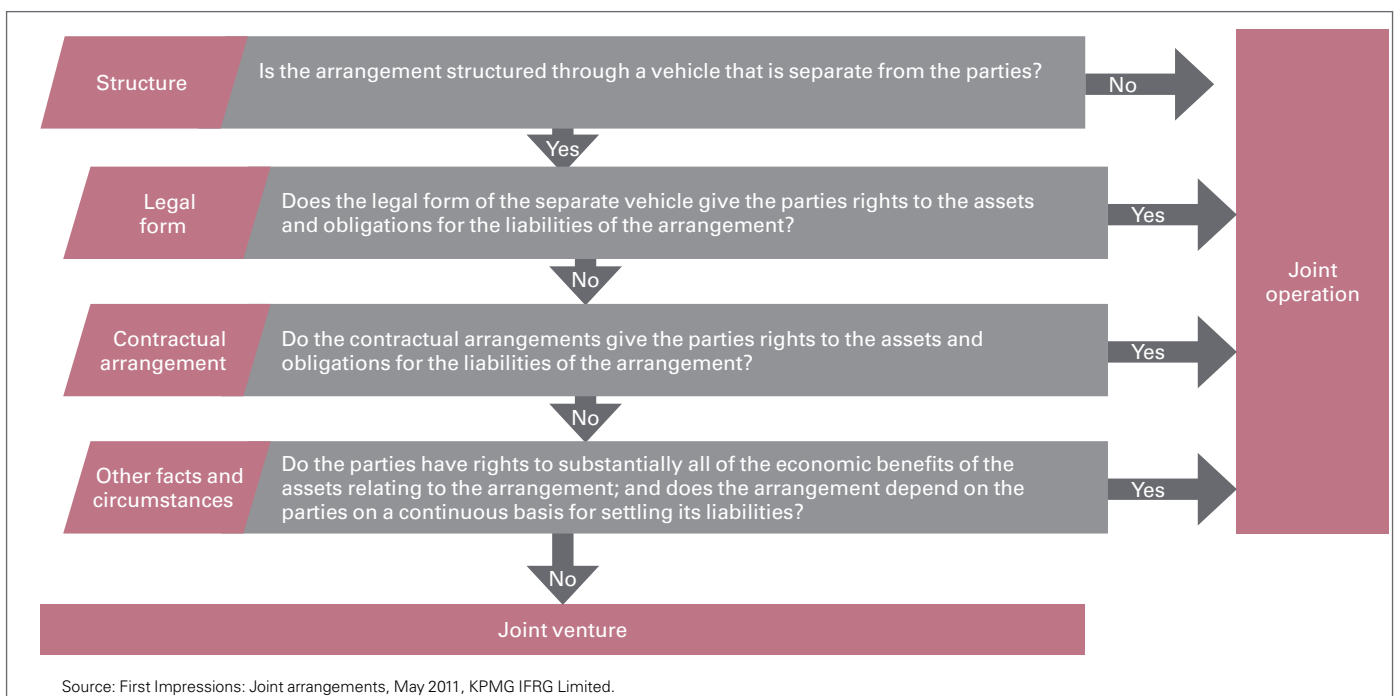
Joint arrangements

Under IFRS 11, joint arrangements are essentially defined in the same way as under IAS 31 *Interests in Joint Ventures*; however, the classification of joint arrangements, which affects the accounting, has changed to:

- Joint operations, whereby the parties with joint control have rights to the assets and obligations for the liabilities, relating to the arrangement; and
- Joint ventures, whereby the parties with joint control have rights to the net assets of the arrangement.

The key to determining the type of the arrangements, and therefore the subsequent accounting, is the rights and obligations of the parties arising from the arrangements in the normal course of business. If a joint arrangement is determined to be a joint operation, then the joint operator accounts for its own assets, liabilities and transactions, including its share of those incurred jointly. If a joint arrangement is determined to be a joint venture, then the joint venture accounts for its investment using the equity method; the free choice between using the equity method or proportionate consolidation has been eliminated.

Figure 3: The decision tree for classifying a joint arrangement



Pool arrangements

Pool arrangements are commonplace in the shipping industry – they provide a mechanism for sharing risk, by operating contributed assets as a cohesive fleet and collecting and distributing earnings under a pre-arranged points-weighting system.

Typically there are three types of pool structure that are accounted for differently. The company:

- controls the pool – the pool is consolidated;
- is a joint operator of the pool – the company's share of revenue, costs, assets and liabilities is recognised; or
- is chartering the vessel into a pool operation, and recognises the net income from this charter arrangement.

Different pool arrangements require a careful consideration of all specific terms, facts and circumstances, as their classification would affect the accounting outcome.

Most pools in the shipping industry are not structured through a separate legal entity (or an entity recognised by some other form of statute) and therefore would more likely be classified as joint operations rather than joint ventures. The accounting outcome will reflect the aim of pooling – revenue and cost sharing that protects the return on the company's asset.

Frequently, the pool participants appoint a pool manager. Power to control arises from rights – these include current and potential voting rights and decision-making rights arising from a management contract. Here, the critical aspect is whether the manager is permitted to use these additional rights to its own benefit. If the manager is merely as an agent (i.e. is using the delegated powers for the benefit of all), its remuneration is "at market" (i.e. is commensurate with services provided) and has no unusual decision-making authorities it is unlikely that being the pool manager will affect the accounting outcome.

Disclosure

The increased level of disclosures required by IFRS 12 (as compared to current practice) has been driven, in part, by the IASB's review of the impact of the 2008 financial crisis. Stakeholders were concerned about off-balance sheet SPEs and a lack of transparency over critical accounting judgements. The objective of IFRS 12 is to help users of accounts evaluate the nature of, and risks associated with, an entity's interests in other entities and the effects of those interests on financial position, performance and cash flow.

IFRS 12 requires:

- disclosures about significant judgments and assumptions made in determining control, significant influence or joint control, in particular where a company holds more than half the voting shares of another and does not consolidate, it needs to explain why;
- disclosures about interests in subsidiaries, joint ventures, joint arrangements and associates such as name, nature of interest, dividends and summarised financial information;
- nature and extent of significant restrictions on investor's ability to access or use assets and settle liabilities; and
- specific disclosures for structured entities (whether consolidated or unconsolidated).

The disclosures may be aggregated for interests in similar entities with the method of aggregation being disclosed. Suitable characteristics for aggregation may include nature or geography. However, joint arrangements cannot be aggregated with associates.

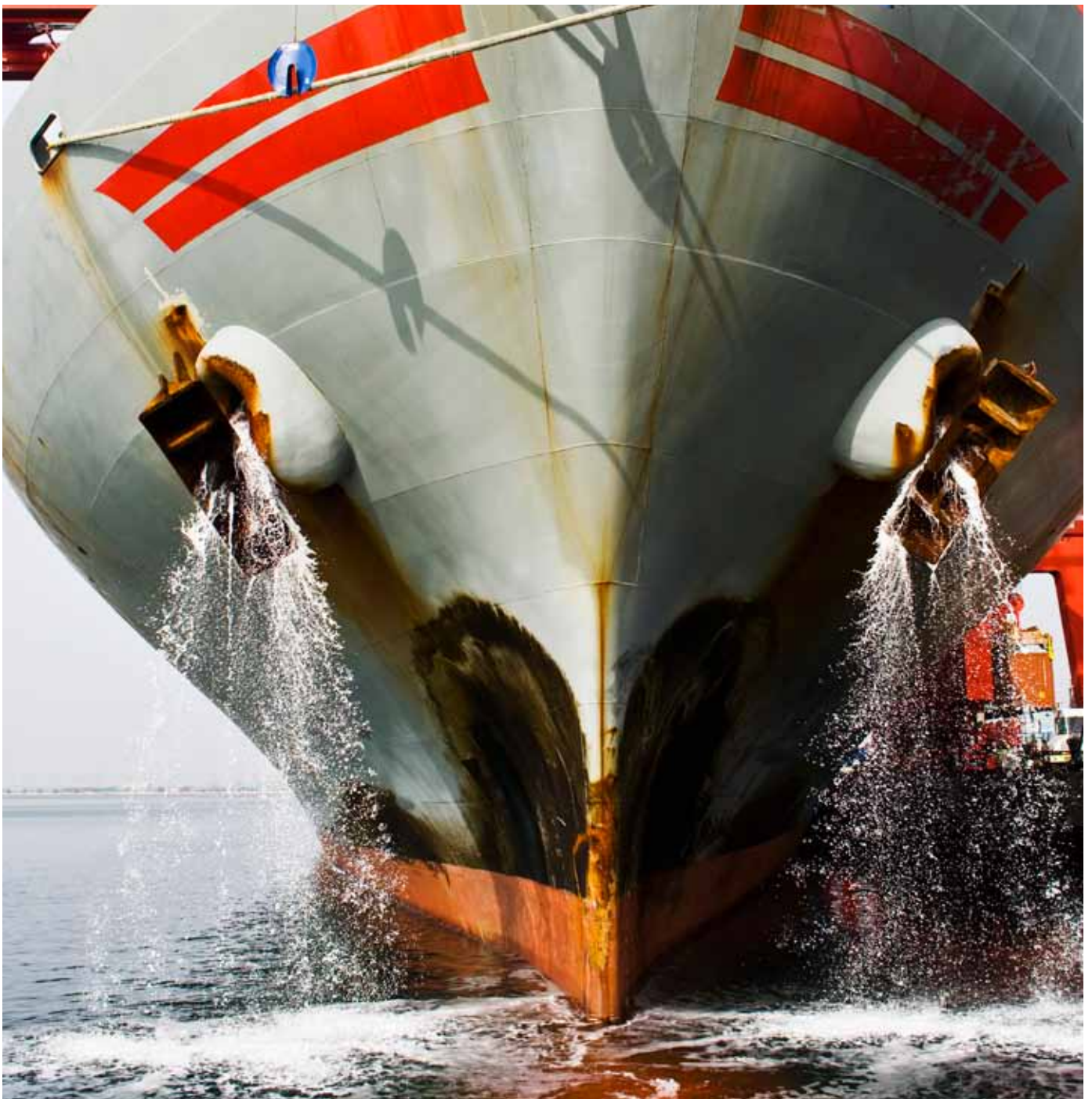
Experience in practice?

Nearly one half of our sample had some involvement in pool arrangements and the majority of these were treated as joint arrangements.

6.

Revenue and costs

Revenue is recognised only if it is probable that future economic benefits will flow to the entity and these benefits can be measured reliably.



In general, the IFRS tests for recognition are:

- **it is probable that the economic benefits of the transaction will flow to the company;**
- **the revenue can be measured reliably; and**
- **the costs (both incurred and future costs) are identified and can be measured reliably.**

Unbundling of contracts

Many end-customer contracts include a full start-to-end service, whereby the shipping company takes responsibility for collection, holding at port and on-sea transportation. IFRSs require entities to consider whether such full-service contracts should be unbundled for revenue recognition purposes.

Routine transactions are usually not unbundled if:

- the contract was negotiated as a single package;
- the service will be performed in a continuous sequence; and
- the risks associated with delivering each element are similar.

Certainly, routine transactions in the sector do not meet the separation criteria, however unbundling may be acceptable (certainly if a customer request is more unusual) and that this may result in a more appropriate accounting treatment.

How much revenue to recognise

Time and bare-boat charters are generally recognised on a daily basis over the term of the charter (although consideration should be given to some of the more complex aspects outlined later). Revenue is not generally recognised when the vessel is off-hire.

The majority of spot voyages and contracts of affreightment are accounted for using a percentage of completion method, under which revenue is recognised over the period of the voyage.

Complexity arises in estimating the stage of completion (and therefore the amount of revenue to be recognised), and practice does differ in this area. Most adopt a total cost or total time basis for estimating the stage of completion; however, judgment is needed when defining the 'voyage', with consideration of:

- whether a round-trip or leg-to-leg basis is more appropriate;
- the actual number of days it takes to complete a voyage when a large proportion of ocean freight is delivered late;
- whether the contracts for affreightment contain several destination ports.

Revenues and costs in the shipping industry are often based on 'standard' voyage estimates at each balance sheet date, with changes in estimates adjusted prospectively.

Bunker or currency adjustments

It is common for charter contracts to include currency or bunker adjustments, such that price is adjusted when either move outside a predetermined range. The challenge of such arrangements is to determine whether the contract contains an embedded derivative and whether this would need to be accounted for separately.

An embedded derivative is part of a non-derivative host contract that affects some or all of the cash flows under the contract in a manner similar to a stand-alone derivative instrument. For example, cash flows under the contract change following a change in a market variable or index.

IAS 39 requires an embedded derivative to be separated from the host contract and accounted for as a derivative if the following conditions are met: its characteristics are not closely related to the economic characteristics and risks of the host contract; a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and the hybrid instrument is not measured at fair value with changes in fair value recognised in profit or loss.

An embedded feature may contain significant leverage. However, in our experience, most charter contracts have features which are closely related to the host contract (such as currency and fuel price escalators) and with no significant leverage. Therefore, in these circumstances, no separate accounting is required. Instead the effect of the feature is considered in the host contract.

Charter renegotiations

Renegotiations of charter agreements are more common in challenging markets. The charterer may seek amendments to the terms of the contract if they are significantly above market. Frequently these renegotiations can alter the profile of the cash flows within the charter agreement (through either delaying payments to the end or lengthening the period of the overall charter).

Onerous charter agreements

Onerous charter arrangements can arise if the cost of a 'charter-in' exceeds the income from a 'charter-out'. Such issues are more prevalent in a downwards market where the charter-in may have been arranged at higher prices than the prevailing market rate today. However, care should be taken in distinguishing between overall loss-making operations and onerous contracts. In our view, a provision should not be recognised for the contracts, unless the cash flows

related to them are clearly distinguishable from the operations as a whole.

A contract is onerous (under IAS 37) when the unavoidable costs of meeting the obligations under a contract (the lower of the net costs of fulfilling the contract or the cost of terminating it) exceed the benefits to be derived. Where this is the case a provision may be required.

An alternative approach is for a company to apply the IAS 11 *Construction Contracts* requirements to service contracts accounted for using the percentage of completion method. In this instance, the full costs - i.e. directly attributable variable costs and fixed allocated costs - are considered in assessing whether a contract is onerous. Companies have an accounting policy choice to account for losses in accordance with IAS 11 or IAS 37, but such a choice should be consistently applied.

When considering whether a contract is onerous, a company should assess whether or not a contract can be terminated. It may be that cancelling a charter-in will result in a lower net cash outflow than continuing with the agreement.

Entities should also consider alternative uses. It may be that the company operates a fleet of vessels on a range of charter agreements, for which in total the economic benefits exceed the costs. Accordingly, care would need to be taken when matching costs and revenue streams – perhaps an alternative vessel could be used to fulfil the contract which is either owned or chartered-in on lower rates.

Sharing or “swap” arrangements

Some operators “swap” slots with other companies as a way of maximising vessel utilisation and minimising costs. For example, shipping Company A swaps 50% of its capacity on one ship and gains 50% capacity on Company B’s ship. Company A and B then sell this capacity to the market (shippers).

IAS 18 *Revenue* highlights instances where goods and services are exchanged for goods or services that are similar in nature and value and in such instances the exchange is considered to be a transaction that does not generate revenue. Accordingly Company A will only record as revenue the sales of slots it has achieved to shippers (in this example the sales from 50% of its own ship and 50% from B’s ship) and not account for the swap between it and B. This avoids any double counting of revenue.

Disclosure

Accounting policies adopted for revenue recognition are required to be disclosed, including disclosure of the methods used to determine contract revenue and the methods used to determine the stage of completion.

Experience in practice?

All our sample recognised some revenue streams on a percentage of completion (“POC”) basis and several companies provided some useful disclosure as to how POC was determined.

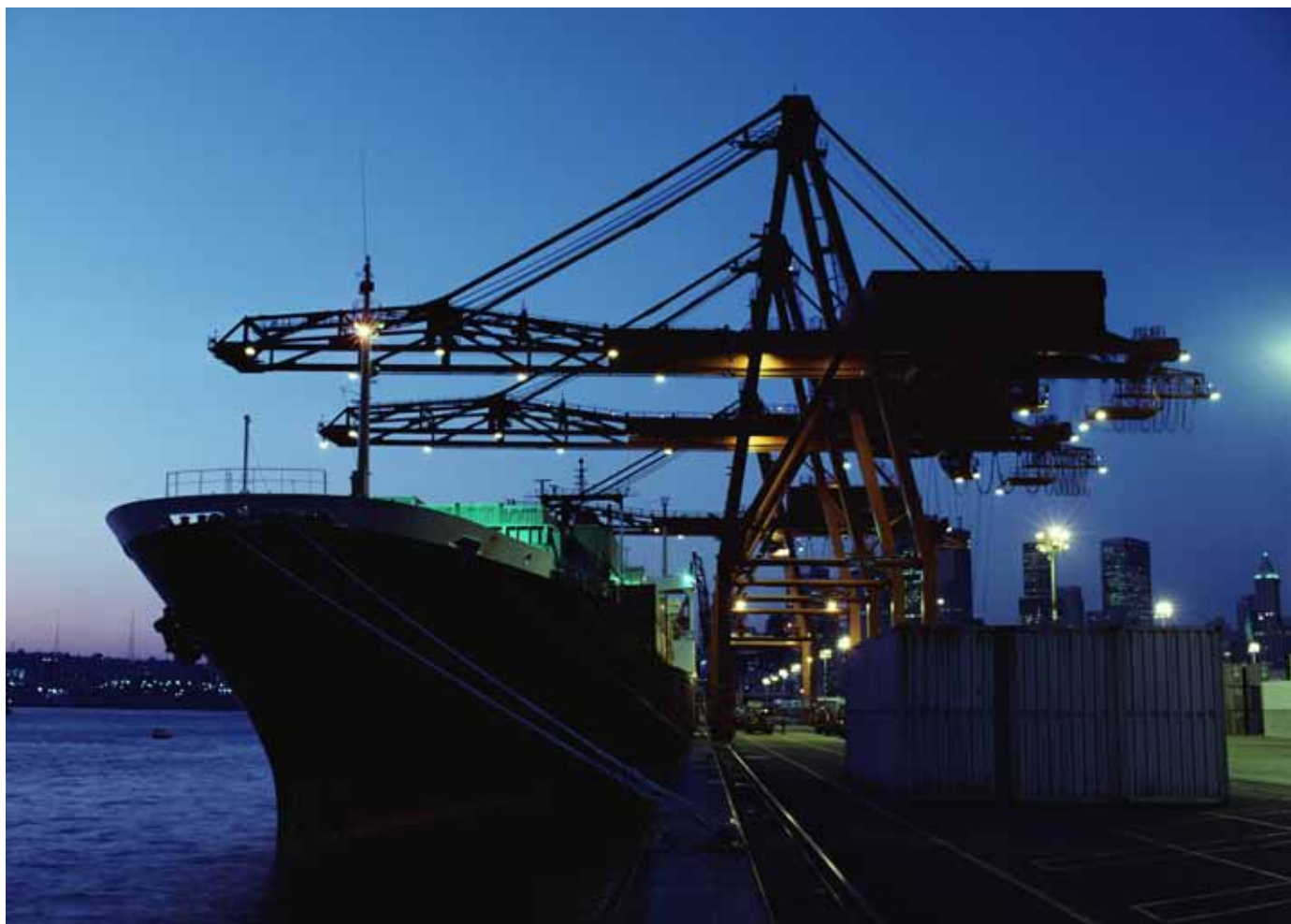
At least four companies used a discharge-to-discharge basis for measuring the service rendered. Some used the number of days in the contract, expected cost, others used an assessment of the operating capability of the asset (together with the route) and others used model or standard voyages.

At least three companies provided for losses where the forecast to complete indicated that the voyage would result in a loss.

One company discussed its approach to idle time or ballast days and in these scenarios revenue was not apportioned unless a relevant contract was in place.

One company discussed its approach to specifically identified revenue streams for vessel upgrades and mobilisation. In these instances this revenue was recognised over the period of the underlying service.

A significant minority of our sample outlined their revenue recognition policy in one or two lines of text. Companies may need to disclose more detailed information under new proposals for revenue recognition.

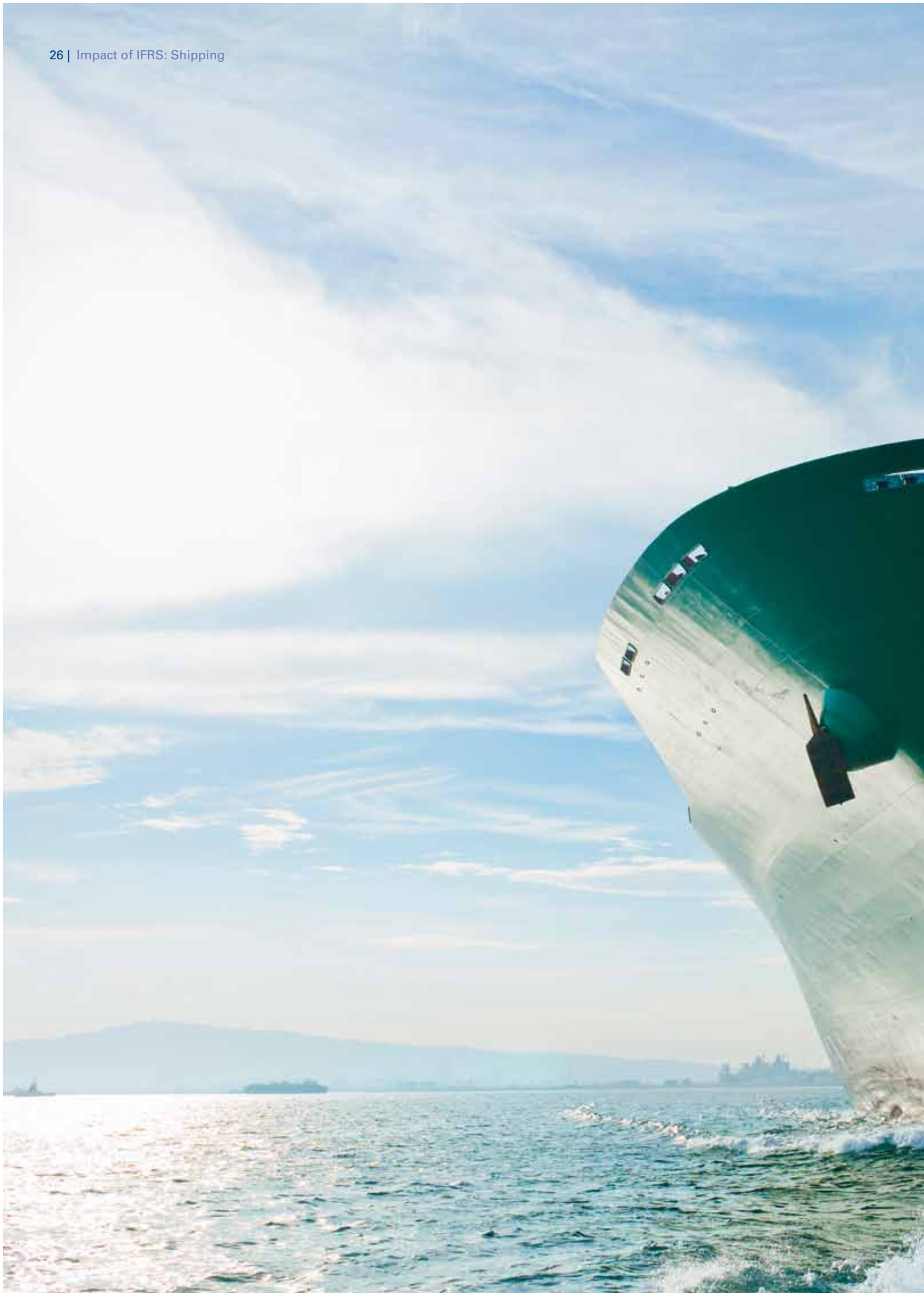


On the horizon

In November 2011, the IASB issued an exposure draft (“ED”) to replace existing revenue recognition standards and interpretations. The ED – Revenue from contracts with customers – proposed a single revenue model that would be applied to all contracts with customers. It proposes a five-step analysis, to:

- identify the contract with a customer – combine contracts in specific circumstances but no requirement to segment and a contract modification may be treated as a separate contract when specific criteria are met;
- identify the separate performance obligation – account for ‘distinct’ performance obligations separately unless the obligations are satisfied at the same time;
- determine the transaction price – including variable amounts;
- allocate the transaction price to the separate performance obligations – allocate based on the stand-alone selling prices; and
- recognise revenue as each performance obligation is satisfied – recognise revenue when the customer obtains control of the goods or services over, or at a point in time. Recognition of variable consideration as revenue is limited to the amount that a company is ‘reasonably assured to be entitled’.

The ED introduces a number of new concepts which will require detailed work through. In general, we believe that shipping companies will be able to continue with a percentage of completion basis for revenue recognition for many transport contracts as control from operator to customer continuously passes over the voyage. However, companies will need to go through the five-step analysis to identify any problem areas. Undertaking this analysis sooner, rather than later, may help with the structuring of key commercial terms as new business is undertaken. In preparing financial statements, companies will be required to provide extensive additional disclosures (some may require investment in systems to generate the information).



7.

Financial instruments

Companies enter into a range of strategies to offset the potential negative impact of increasing fuel (or bunker) prices on profitability.

Contracts frequently have bunker adjustment clauses that allow the operator to pass on certain increases in bunker prices.

Beyond this, companies frequently enter into derivative contracts (options, futures or forwards) to hedge the price risk. Such contracts often fall within the scope of IAS 39, under which they are recognised on the balance sheet at fair value with changes in fair value recorded through profit or loss.

Some companies focus on the economic hedge (cash) and therefore are less concerned by profit and loss volatility, accordingly gains and losses on fair value changes on the derivative contracts are recognised in the

income statement each period. Others seek to apply cash flow hedge accounting which defers recognition of the fair value changes on the derivatives in profits or loss until the hedged item – e.g. the transaction with the bunker adjustment feature – affects profit or loss.

Other entities may forward purchase and take physical delivery of bunkers. Where physical delivery is expected to be taken for the company's own use, IFRS allows these contracts to be treated as executory and held off balance sheet and accounted for at the settlement date.

Freight forwarding agreements

Freight forwarding agreements ('FFAs') offer owners and operators a means of protecting themselves against freight rate volatility. Trading FFAs require the company to take a position in a futures (or 'paper') market, rather than a physical forward market. Such contracts are net settled and accordingly the own use exemption cannot be used. FFAs are becoming a more popular risk management tool, especially in today's volatile market. Operators are seeking to counterbalance the risk associated with the physical position.

Such contracts are derivatives and are required to be measured at fair value in the balance sheet with changes in fair value recognised in profit or loss. Hedge accounting may be achievable, however, this may in practice be difficult to achieve. FFA contracts are an emerging product, and accordingly are only priced on certain 'model' voyages (a certain size and type of vessel, transporting goods from standard ports). Getting key terms to match is likely to be difficult and therefore a significant amount of ineffectiveness is likely.

New build options

New build slots are usually secured in yards through the signing of a build option. Such options can be very valuable, and indeed were at the height of the last shipping boom just before the 2008 economic crisis.

IFRS permits an exemption from the requirements of IAS 39, where the contract is for the company's 'own-use'.

In most instances, such down payments are therefore capitalised as part of the cost of building the vessel, and do not fall foul of the financial instrument accounting standards.

Normally the entities entering into new build option contracts expect the build to complete – the contract is defined as executory, being one in which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent. Normally, the seller has the obligation to deliver the completed vessel and the buyer has the right to receive the equipment and the obligation to pay the full price, accordingly cannot be net settled for cash.

Practically, an owner and builder may – at a later stage – agree to cancel a contract that requires the owner to pay some compensation. The possibility of a subsequent agreement to cancel a contract that is initially expected to complete does not impact the initial accounting treatment.

Disclosure

The requirements under IFRS 7 *Financial instruments: Disclosures* are extensive and include both qualitative and quantitative disclosures.

Companies are required to provide commentary of their exposure to and management of liquidity, currency, credit and interest rate risk. This commentary is required to be supported by numerical analysis of the current exposures of the company and its sensitivity to changes thereon.



Experience in practice?

Our sample used a broad range of derivative instruments to hedge economic risk.

Just under 90% of the sample used derivatives to hedge interest rate risks, and almost all of these sought to apply hedge accounting.

Similarly popular was forward currency hedging – just shy of 80% used these derivative instruments. Here it was less

clear whether companies applied cash flow hedge accounting or were taking fair value gains and losses on the derivatives immediately to the income statement. But at least three-quarters of those holding foreign exchange derivatives were applying some form of hedge accounting.

Only about one half of our sample indicated some form of commodity

hedging – most commonly through bunker swaps and futures. But only two of these were seeking to hedge account, illustrating the difficulty of meeting the current qualifying requirements.

Three companies indicated that they were using freight forward agreements to hedge against freight rates. Here, hedge accounting was universally applied.



On the horizon

The IASB has been reviewing the financial instruments accounting standards for some time, with a phased release of new proposals for the accounting of financial instruments. The changes proposed aim to respond to criticisms around complexity and the burden of hedge accounting and the artificial mismatch between risk management and accounting.

The proposals would remove some of the operationally onerous requirements such as the 80-125 percent threshold and retrospective assessment for hedge effectiveness testing. Additional proposals would allow companies to rebalance and continue certain existing hedging relationships that have fallen out of alignment instead of having to restart the hedge in a new relationship. Another benefit of the proposals – particularly relevant in fuel procurement strategies – would make the use of purchased

options as hedging instruments more attractive. Finally, the proposals would make hedge accounting possible for components of non-financial items – e.g. the crude oil component of bunker purchases.

Therefore, shipping companies that have been put off by hedge accounting complexity may seek to apply hedge accounting more widely under the forthcoming requirements.

8.

Segment reporting

IFRS 8 *Operating Segments* sets out requirements for segment disclosures by entities whose debt or equity instruments are traded in a public market. The requirements are based on a 'management approach' both in regard to the identification of reportable segments and the measures disclosed for those segments.

The practical approach to segment reporting under IFRS 8 includes five steps:

Operating segments are identified based on the way in which financial information is reported to the Chief Operating Decision-Maker ("CODM"). An operating segment is defined as a component of a company:

- that engages in business activities from which it may earn revenues and incur expenses;
- whose operating results are reviewed regularly by the company's CODM in order to allocate resources and assess its performance; and
- for which discrete financial information is available.

Two or more operating segments may be aggregated into a single operating segment when the segments have characteristics so similar that they can be expected to have essentially the same future prospects. IFRS 8 permits aggregation if it is consistent with the core principle of IFRS 8, the segments have similar economic characteristics and are also similar in each of the following respects: the nature of product/service, the processes, the type of customer, the distribution methods and the regulatory framework.

In this regard, companies that engage in a number of different aspects of shipping – perhaps offshore, port operations, or even dry and wet may need to consider whether aggregation is appropriate.

1.

Identification of the chief operating decision maker (CODM)

2.

Identification of operating segments

3.

Aggregation of operating segments

4.

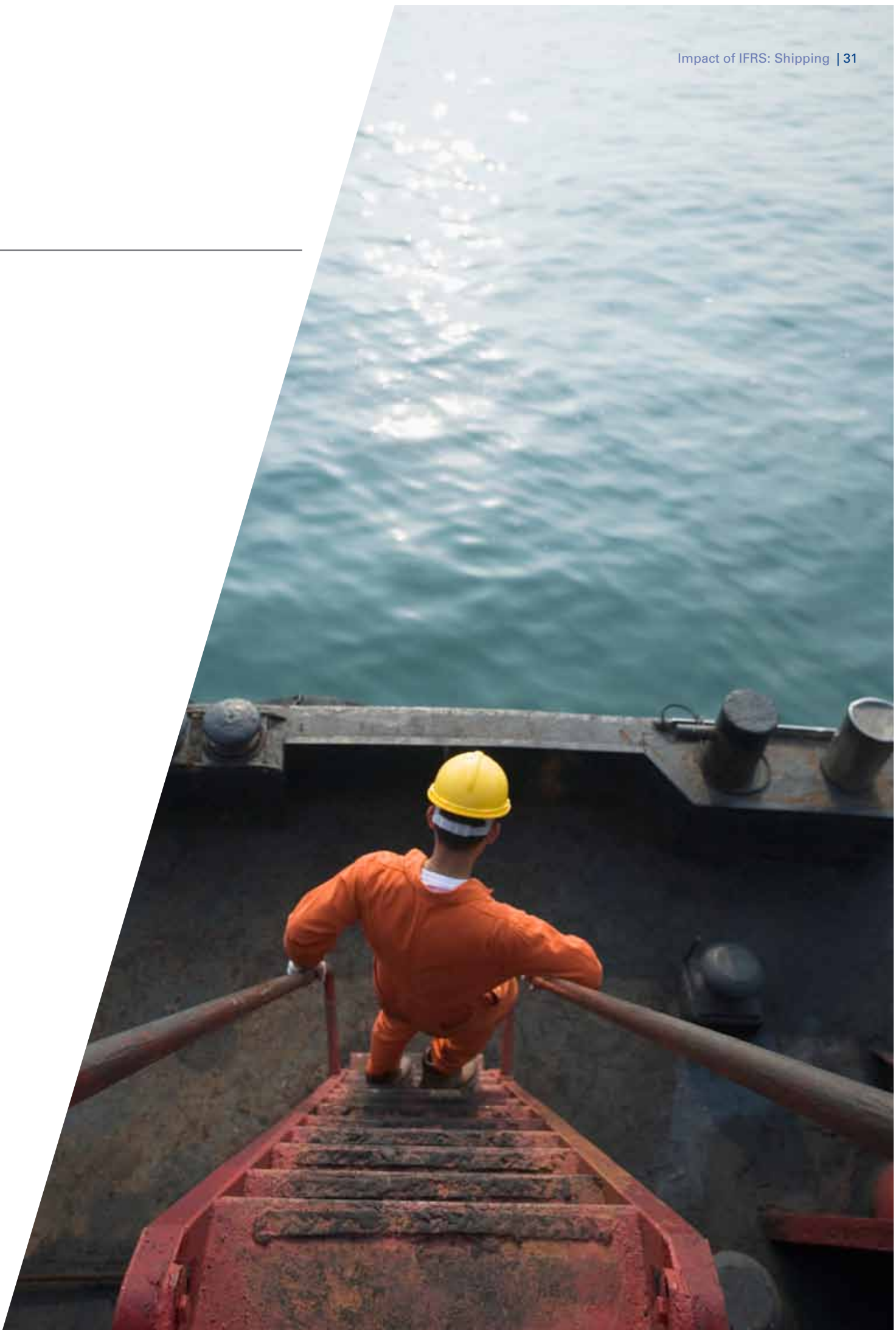
Determining reportable segments

5.

Segment disclosure information

Experience in practice?

From reviewing the accounts of our sample, it would appear that shipping companies have identified fewer segments than we see in other industries. Without granular segmental disclosure it remains difficult for readers of accounts to get under the skin of organisations and truly understand performance and outlook.



9.

First-time adoption

Selecting accounting policies at the time of preparing the opening IFRS balance sheet not only affects the first IFRS financial statements but also the financial statements for subsequent periods.

IFRS 1 *First-time Adoption of IFRS* provides a company converting to IFRS a number of reliefs from the retrospective requirements that otherwise would apply. Without any relief, a company would be required to retrospectively implement IFRS from the start of its corporate history.

IFRS 1 seeks to ensure that a company's first IFRS financial statements contain high-quality information that is transparent for users and comparable over all periods presented. The guidance in IFRS 1 aims to provide a suitable starting point for subsequent accounting under IFRS that can be generated at a cost that does not exceed the benefits. Shipping companies will need to go through each of the optional exemptions in IFRS 1 and decide which are the most appropriate for them. We note some examples to consider below.

Business combinations

One of the most commonly used IFRS 1 exemptions is the choice not to restate pre-IFRS business combinations. Acquisitive companies will not wish to revisit previous acquisition accounting under previous GAAP, unless there is a significant benefit, such as a downward adjustment to goodwill on IFRS transition so as to avoid impairment write-offs to profit or loss in the future.

Accounting for vessels

Components

There are no exemptions available from identifying components of property, plant and equipment that are required to be depreciated separately under IFRSs. The identification and separate recognition of the depreciation of components are required in the opening IFRS statement of financial position. For example, IFRSs require major inspections and overhauls to be identified and depreciated as a separate component of the asset. Component depreciation affects the subsequent accounting for both cost and depreciation. Accordingly, both cost and accumulated depreciation are allocated to identified components separately. When the original cost of a major inspection or overhaul is not available, the expected cost of the next overhaul may be used as the best estimate of the cost of the component. In our view, a similar approach is acceptable for measuring major inspection and overhaul costs in the opening IFRS statement of financial position.

Interest capitalised

The transitional rules of IAS 23 can be applied, such that interest is only capitalised prospectively.

Deemed cost election

Another exemption choice that some shipping companies review, but do not always take, is the deemed cost election under IFRS 1. Historic cost assets can be brought onto the company's first IFRS balance sheet at deemed cost at the date of transition. The exemption applies to individual items of property, plant and equipment, investment 'property and intangible assets, subject to meeting certain criteria. Deemed cost may be (1) fair value at the date of transition; (2) a previous GAAP revaluation broadly similar to fair value under IFRS, or cost or a depreciated cost measure under IFRS adjusted to reflect, for example, changes in a general, or specific price index; or (3) an event-driven fair value. Unlike other optional exemptions, the event-driven fair value exemption under IFRS may be applied selectively to the assets and liabilities of a first-time adopter if specific criteria are met.



Accounting for leases

With respect to finance leases, a lessee recognises, at the date of transition:

- the carrying amount of the leased asset determined as if IFRSs had been applied from inception of the lease, subject to the requirements and/or optional exemptions of IFRS 1. For example, in our view the deemed cost exemption for property, plant and equipment may be applied to an asset acquired under a finance lease; and
- the carrying amount of the lease liability as a progression of the amount that would have been recognised at commencement of the lease, taking into account accrued interest and repayments.

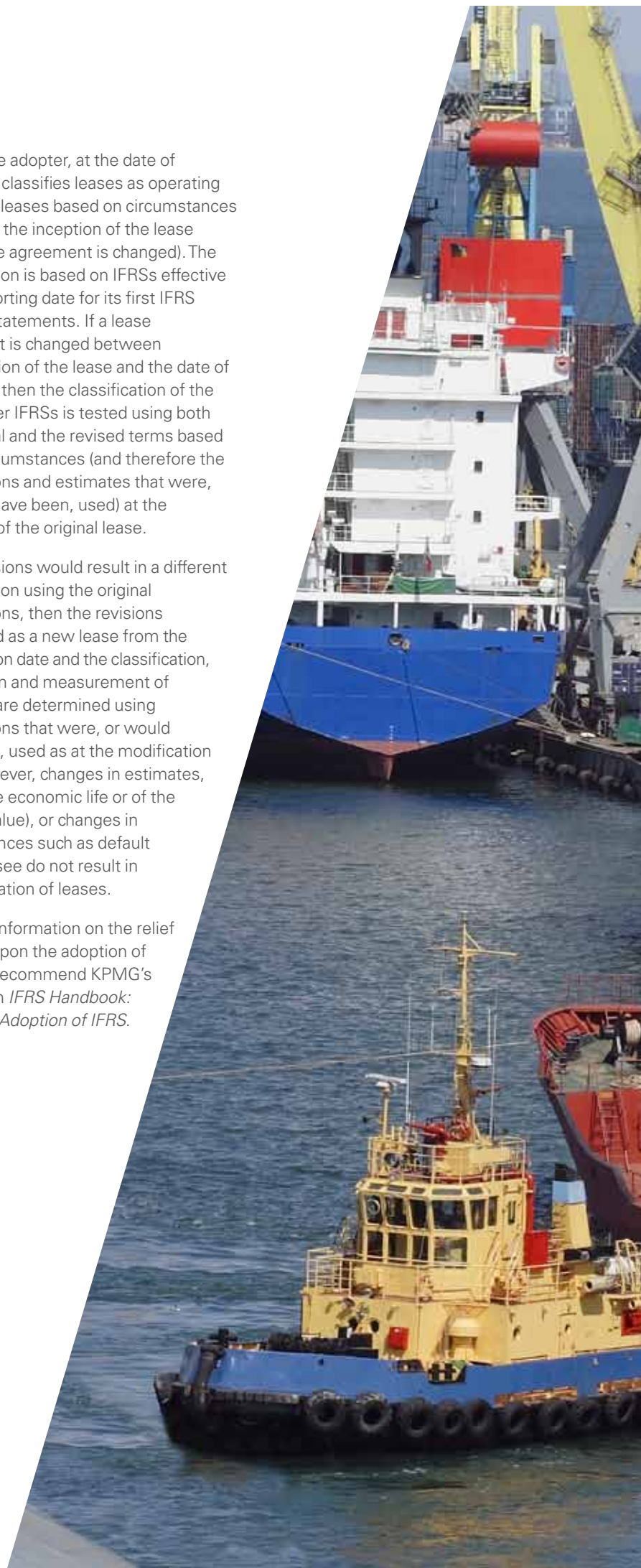
A lessor recognises a finance lease receivable in the statement of financial position at the amount of its net investment, which comprises the present value of the minimum lease payments and any unguaranteed residual value accruing to the lessor. If the lessor recognised the leased asset under previous GAAP, then it is derecognised at the date of transition. The carrying amount of the lease receivable at the date of transition is a progression of the amount that would have been recognised at commencement of the lease, taking into account accrued interest and repayments.

With respect to operating leases, a lessee (lessor) recognises rent expense (income) on a straight-line basis over the lease term, or on another systematic basis if appropriate. Lease incentives are taken into account in determining the total lease expense (income) that is spread over the relevant period.

A first-time adopter, at the date of transition, classifies leases as operating or finance leases based on circumstances existing at the inception of the lease (unless the agreement is changed). The classification is based on IFRSs effective at the reporting date for its first IFRS financial statements. If a lease agreement is changed between the inception of the lease and the date of transition, then the classification of the lease under IFRSs is tested using both the original and the revised terms based on the circumstances (and therefore the assumptions and estimates that were, or would have been, used) at the inception of the original lease.

If the revisions would result in a different classification using the original assumptions, then the revisions are treated as a new lease from the modification date and the classification, recognition and measurement of the lease are determined using assumptions that were, or would have been, used as at the modification date. However, changes in estimates, (e.g. of the economic life or of the residual value), or changes in circumstances such as default by the lessee do not result in reclassification of leases.

For more information on the relief available upon the adoption of IFRS, we recommend KPMG's publication *IFRS Handbook: First-time Adoption of IFRS*.





10.

Appendix

Who informed our “Experience in Practice”?

To supplement the technical analysis, we reviewed the Annual Reports of some of the largest shipping and port companies reporting under IFRS.

Companies were chosen based upon size (market capitalisation and/or size of fleet). We restricted our analysis to companies that applied IFRS (or EU adopted IFRS) in 2010, ignoring countries that are moving to IFRS.

We did not contact any company directly in preparing this publication. No comment is made by KPMG member firms in regard to the adequacy or otherwise of the policies and disclosures adopted by companies in our survey.

Companies in our survey

Aegean Marine Petroleum Network	Grindrod
AP Moller-Maersk	Hapag Lloyd
Bonheur	James Fisher & Sons
Cie Maritime Belge	Mitsubishi Heavy Industries
Cia Sud Americana de Vapores	Odfjell
Condordia Maritime	Petroleum Geo-Services
d’Amico International Shipping	Premuda
DPWorld	Rickmers Maritime
D/S Norden	Solstad Offshore
Euronav	Stolt Nielsen
Farstad Shipping	STX Pan Ocean Co
Golden Ocean Group	Wilh Wilhelmsen Holding



Other ways KPMG member firms' professionals can help

A more detailed discussion of the accounting issues that arise from the application of IFRS can be found in our publication *Insights into IFRS*.

In addition, we have a range of publications that can assist you further, including:

- IFRS compared to US GAAP;
- Illustrative financial statement ;
- IFRS Handbooks, which include extensive interpretative guidance and illustrative examples to elaborate or clarify the practical application of a standard;
- New on the Horizon publications, which discuss consultation papers;
- Newsletters, which highlight recent accounting developments;

- IFRS Practice Issue publications, which discuss specific requirements of pronouncements;
- First Impressions publications similar to this, which discuss new pronouncements; and
- Disclosure checklist.

IFRS-related technical information also is available at kpmg.com/ifrs.

For access to an extensive range of accounting, auditing and financial reporting guidance and literature, visit KPMG's Accounting Research Online. This web-based subscription service can be a valuable tool for anyone who wants to stay informed in today's dynamic environment. **For a free 15-day trial, go to aro.kpmg.com and register today.**

Additionally, each year, KPMG's Global Shipping Practice publishes "Shipping Insights", which analyses emerging trends and issues affecting the sector.



Acknowledgements

We would like to acknowledge the authors and reviewers of this publication, including:

- Ian Griffiths and Tom Eve, KPMG in the UK
- Kenny Tan, KPMG in Singapore
- Brian O'Donovan and Irina Ipatova, KPMG's International Standards Group

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