



TRANSPORT

Shipping insights

Issue 2

Insights arising from
the economic downturn

ADVISORY



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Introduction

We are pleased to present KPMG's second "Shipping Insights" publication. The world has changed since we issued our first Insights in 2008, and the shipping sector is suffering as much as anyone. Survival is now the strategy, as sector participants fight to maintain volumes, cash and earnings. In this publication, we highlight some of the financial accounting and reporting issues that many shipping companies face in these uncertain times





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When we released our first Shipping Insights publication in the autumn of 2008, the effects of the economic downturn were only just starting to materialize. In this second installment of Shipping Insights we look to see how the financial reporting of the shipping industry has responded to this change and what lies in store for the future. This time, we have elected to focus on International Financial Reporting Standards ("IFRS"), recognizing (as we identified last time) the similarities between this and other accounting regimes make our observations relevant for all.

Against a backdrop where ship owners are debating whether or not to lay-up ships amongst other things, we discuss the impact on the financial statements – particularly around impairment and going concern. We revisit accounting for property, plant and equipment, focusing on the nature of costs which can be capitalized – an area of some judgment. We also touch upon some new topics – accounting for embedded derivatives and tonnage tax.

Finally we look ahead to proposed changes to new accounting standards. The international accounting landscape is set to change – again! Some of the proposed changes may have a significant impact on your earnings and strength of balance sheet.

The challenge faced by the shipping sector is probably unparalleled. It's a tough market, where it's survival of the fittest – we think some will fail, but for others there is an ocean of opportunity.

What do you think?

Many of the topics we cover in this issue are in response to feedback we received on our first publication last year.

We want to ensure KPMG's contribution to your sector remains relevant and insightful, and therefore welcome your input and feedback.

Economic downturn and industry response

For the shipping industry the economic downturn has led shipowners and carriers being faced with a very different climate compared to just a few years ago. Freight rates have collapsed as demand has plummeted at a time when the global fleet is expanding.

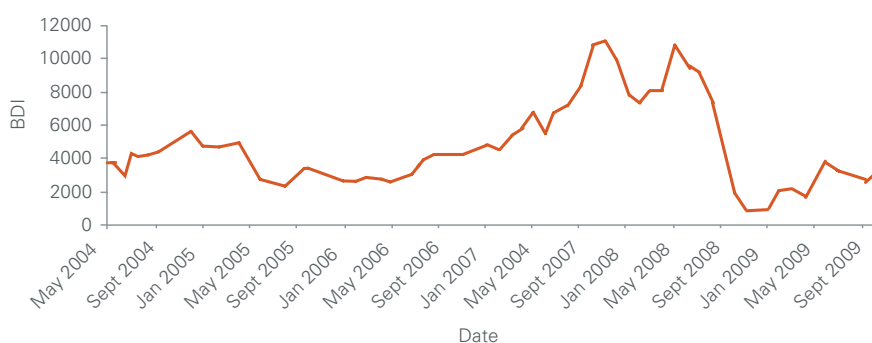
Perhaps the biggest topic for debate in the sector at the moment is whether or not to lay up. It's a huge operational decision, as the engineering and maintenance requirements are significant – it might mean the difference between failure and survival.



The impact on freight rates

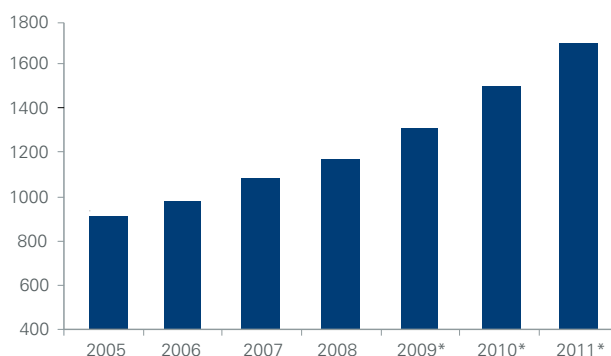
Demand for ship moves has dropped off just as record new build orders are being delivered. These factors, coupled together, have driven the sharp decline we have witnessed in freight rates.

Baltic Dry Index



The race to buy new ships was fuelled by expected growth and strong demand including strong cash flows and a willingness of financiers to put up the cash (often in the past 2-5 years at hugely attractive rates). We are now in the midst of a capacity explosion

Actual and predicted* world fleet size



Now that the cash flows are disappearing owners are now left with spare capacity. Undeniably the industry is facing huge concerns – what will it do if rates do not recover?

What should you do?

Some estimates are that up to 10 percent of the world fleet is currently laid up. However, laying up isn't the only option, and many shipowners are deferring this decision. On new orders it may still be possible to cancel, substitute or delay. Shipbuilders, mindful of empty yards, may be willing to renegotiate. Some are accepting delays to the schedule, as long as they have received a down payment. Others may offer short term docking facilities after completion (within the order price) and some yards are offering raw material rebates, recognizing that making lower margins over a longer period is better than taking huge profit today and being idle tomorrow. Shipowners should be thinking of negotiating over contract modification, some might find willingness to compromise.

Scrapping is always an option. Many will use the downturn to refresh fleets – retire older, inefficient and smaller ships, and make the right structural changes. An upgrade in the quality and efficiency of the fleet may put owners in a strong position as we come out of a recession.

There are other options too – some are slow steaming or accepting lower rates; deploying more vessels but consuming less bunker oil; drifting or temporarily anchoring (idling), suggesting that things, particularly in some niche markets, may not all be bad or at least not bad enough to incur lay-up costs.

Each shipowner is confronted by a different set of circumstances, as ultimately any business decision comes down to what's important. A consideration of:

- How strong was your balance sheet and covenant as you entered into the recession?
- How will future capital commitments be financed?
- Are your investors concerned about earnings and dividends?
- How diverse are your operations?
- How vulnerable are you?
- And.... what's your view of the length and depth of the cycle?

Here market analysts cannot agree, but other than for niche sectors, it would be a brave person who predicted this part of the shipping cycle will be anything but long and painful.

The impact on cash and profit

In considering options, the decision not only has a significant impact on cash flows, but also accounting profit as we illustrate in the following table:

Option	Revenue impact	Cost savings	Incremental costs
Slow steaming	Reduce total earnings	Proportion of bunker	None
Rate reduction	Reduce total earnings, but more competitive	None	None
Idling	100% for duration	100% bunker Minimal other savings	Anchorage Some reactivation
Warm lay up	100% for > 30 days	100% bunker 50% crew/insurance Some maintenance	Preparation Some reactivation Some re-crewing
Cold lay up	100% for > 30 days	100% bunker 90% crew/insurance Some maintenance	Preparation Significant reactivation Significant re-crewing
Scrap	100%	100%	Profit/loss on disposal Finance break costs

The potential accounting impact of the above could include:

- Changes to depreciation charges – if you decide to lay-up, you will be changing the operating regime of the ship. You will still need to charge depreciation, but it might be lower. Useful economic lives might change and estimates of residual values may change as scrap values reduce.
- Increased risk of impairment – is the carrying value of a vessel on the balance sheet supported by the expected generation of future cash flows? You will need to consider whether that assessment is done on each individual ship, a class of ship, or a portfolio / cash generating unit approach. You may also accept disposal prices below book values leading to losses in the income statement.
- Onerous contracts – do you have unavoidable commitments which are now onerous? This would require you to record a loss today, regardless of when the cash flows are due.
- Derivative losses – do you hold derivatives? As the markets move, the derivative fair values will move and the instrument may no longer work as an effective hedge of the underlying cash flows.
- Going concern – can you still meet your financial obligations?



Impairment

The fundamental concept of impairment testing under IFRS is that it should be performed on assets when an indication of impairment exists, or at least annually for goodwill or intangible assets with an indefinite life. The relevant accounting standard, IAS 36, includes a number of example indicators of possible impairment such as:

- a significant adverse change in the market and economic environment in which an entity 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.

In light of this, impairment testing is a critical area of accounting judgement and will be high on the agenda in times of pricing pressure and laying-up.

Some commentators made note that as many as 30 percent of listed US owners incurred impairment losses last year, yet the liner companies appeared less concerned.

Accounting background

In terms of accounting, companies have a fairly simple conceptual issue. Where an impairment test is performed, the carrying (or book) amount of an asset or group of assets must be compared to its recoverable amount, which is the higher of;

- fair value less costs to sell (generally market value); or
- the value expected to be generated from the continuing use of those assets – its value-in-use.

If the carrying value is greater than the recoverable amount then a write-down of carrying value should be booked.

Individual assets or cash generating units

The complexities surround establishing the appropriate asset grouping (referred to as cash-generating units or CGU's) to perform the impairment calculation and the appropriate fair value and value-in-use figures to use.

IAS 36 indicates that impairment testing should be performed on individual assets if possible. In KPMG firms' experience the shipping sector, and in particular the liner companies, usually finds that inter-relationships between operating assets mean that specific allocation of all cash flows on a vessel-by-vessel basis is not always viable (and may certainly not be reflective of how those assets are managed). Where testing of individual assets is not practical, the testing of the smallest group of assets which generate cash inflows largely independent of other assets (a cash generating unit or CGU) is required. In identifying CGU's various factors are important, including how management organizes and monitors operations. However, the identification of independent cash inflows is the key consideration.

Fair value or value in use

Once a company's CGU's have been defined, attention turns to the determination of fair value less costs to sell or value-in-use.

Fair value is an estimate of current market value. Vessel values should be based on arm's-length, market observable transactions. In the absence of active markets for vessels, an entity should use the best information available to reflect the amount the entity could obtain from a disposal of the asset on the valuation date. The use of one or more independent brokers may be appropriate as our member firms have seen significant variations of values reported by different brokerages, suggesting that brokers are struggling to value vessels in a market with limited transactions. Where such differences exist, the use of multiple valuation techniques may increase the reliability of a fair value estimate. Where costs to sell are material (eg broker fees) these should be incorporated into the calculation of the fair value less costs to sell element of the recoverable amount.

Turning to value-in-use calculations, these are based on a prediction of future cash flows and as such can be highly judgmental. The value-in-use of an asset is defined in IAS 36 as the present value of the future cash flows expected to be derived from the asset or CGU. This leads to the need to establish two key parameters – the composition of the relevant cash flows and an appropriate discount rate to be used to estimate the present value of those cash flows.

Cash flow composition

The cash flow projections should be based on reasonable and supportable assumptions. These forecasts cannot simply be extrapolated from historical performance (especially in this market) but must reflect the best estimate of future cash flows. The support for future projections needs to be robust and IAS 36 specifically states that greater weight shall be given to external evidence. We will revert back to the difficulties of cash flow forecasting when considering going concern in the next section.

IAS 36 states that a maximum of a five year horizon is appropriate for the cash flows to be based on management's budgets/forecasts unless management is confident that a longer period is reliable and can demonstrate a history of forecasting cash flows reliably. Long-term contractual charter rates could be an example of such an example. Absent such arrangements, a steady terminal growth rate should be used unless a different rate can be justified. Once again, management should be able to support any terminal growth rate applied.

If a CGU consists of numerous vessels (such as we have seen for the liner companies), then the impairment test is determined based on the vessel or vessels with the longest useful life. The replacement of other vessels with shorter lives should be considered to be part of the day-to-day servicing of that CGU

Capital cash flows should not be included unless they will be required to maintain the asset's existing performance. In our view, known drydock obligations should be included in the projections. Terminal cash flows projected to result from the



scrapping or sale of a vessel should also be included as these represent further value to be derived from the asset.

We will come onto tonnage taxation disclosure developments later. However, where an entity is within a tonnage tax regime the payments made should be included as a cost of operating the asset or CGU. It will therefore be included in the cash flow to be discounted (if material).

Ultimately though, the assessment of the cash flows will come down to the quality of the individual ship owners' forecast data, their views of the length and depth of the cycle and the rate at which growth will return. Where an estimate of value in use materially exceeds the fair value less costs to sell of an asset, this may suggest that management is more optimistic or aggressive in its forecasting than the market.

Discount rate

The discount rate to be applied to the projected cash flows is a market rate that 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 this should not necessarily be regarded as the weighted average cost of capital (WACC) of the asset holder. This is because the debt/equity ratio of an entity may not represent the debt/equity ratio that a market participant would require if they were to choose to invest in the asset in question. Additionally required rates of return on debt and equity at current market conditions may not reflect an entity's historic cost of capital or long term expectations (so discount rates will need updating regularly).

A further complication is that IAS 36 requires disclosure of the pre-tax discount rate for a value-in-use calculation while a WACC is a post-tax measurement. Where the asset / CGU is within tonnage tax the difference between a pre- and post-tax discount rate may be immaterial due to the size of the tonnage tax charge relative to revenue and operating costs.

In the section below we have surveyed some of the publicly available discount rates being used in the industry. The survey is based on information available on the companies' websites or those of a market regulator.

As this section shows, the impairment calculation process contains a number of well defined steps. However, these steps contain significant subtleties and areas of judgement.

Current trends

To assess the extent of impairment risk on the sector as a whole, we have undertaken a brief survey of major listed shipping companies applying IFRS to review the clarity of the impairment disclosures made. The below table summarizes our findings:

	Number	Percentage
Total sample (based on last annual financial statements)	19	100
Impairment risk and policy clearly disclosed	16	84
Asset based assessment of impairment	6	32
CGU based assessment of impairment	13	68
Impairment charge made in latest annual accounts	9	47
Disclosure of discount rate provided	7	37
Average discount rate (where disclosed)		8%
High end of observable range		13%
Low end of observable range		6%
Disclosure of impairment sensitivities provided	6	32

Source: KPMG firms research using OneSource and financial reports, July 2009

High level impairment tests

When the recoverable amount of a CGU is determined on the basis of fair value less cost to sell, and a substantial part of the entity is tested for impairment, a high level comparison between market capitalization and recoverable amount should generally be performed. On this basis it may be appropriate to add a control premium to the market capitalization when reconciling between the two.

The test is slightly different where the CGU is assessed on a value-in-use basis. Where substantial parts of a business are tested for impairment the sum of these should be compared to market capitalization. The market capitalization amount should not however be adjusted for a control premium but should consider the fair value of other assets and debt. The discount rate used in the value-in-use calculation has, in theory, considered all entity wide synergies.

Of the entities we have sampled above only half had a current market capitalization in excess of their latest reported net assets¹. For these same companies the effective write-down already made by the market accounts for an average of 17 percent of their latest reported net assets. This is a potentially difficult message for CFO's to deliver to analysts and stakeholders.

What is clear from this small sample is that disclosure of this important issue in Annual Reports is behind industry best practice.

¹ We have used market capitalisation data from OneSource (July 2009) and compared against the most recent financial information available. Does not include any consideration of control premium.



Going concern and forecasting

During a period of profitable operations and ready access to financial resources it may be easier to conclude that a going concern basis is appropriate. Consequently a detailed analysis to demonstrate this was not always necessary (as acknowledged by IAS 1).

Indeed the robustness of business planning may also not have been subject to the degree of rigour that is now essential by management.

Cash forecasting

In order to survive, a company's focus will often be on cash generation and preservation. We summarize below KPMG's recession wheel which identifies areas where shipping companies can seek to manage their risk, optimize performance and survive long enough to see the next upswing. By stepping around the wheel, companies can gain more comfort in their forecasts, their decision making ability and their conclusion over whether it remains a going concern.

- Cash is king – how good is your rolling forecast and is it detailed enough? Can you and do you sensitize it? How much undrawn facility headroom do you have?
- Manage your working capital – Shipping companies shouldn't be financing the operations of others, be on top of it and offer incentives if needed. Your own working capital is likely to be your cheapest source of finance.
- Focus on covenants and liquidity – what would it take to breach your covenants? As well as sensitizing cash flows, make sure you are sensitizing the covenants. Talk to your finance providers, get them on board now, rather than wait until you have bad news to tell them. In short, have you adequately stress tested compliance?
- Expect the unexpected – what extent of downside risk have you applied to your sensitivities – is this enough? Headroom under one sensitized case could well lead to a different decision to another (perhaps the difference between scrap and lay-up). As well as ensuring strong dialogue with the bank, ensure you keep close to your supply chain. Revisit your risk maps, your estimates and assumptions.
- Counterparty risk – do you have large concentrations of risk? Are you over-reliant on one customer or one supplier? Do you have security? Should you revisit previous credit risk assessments? In this climate, imagine the implications of any of them failing.

- Can you legitimately avoid future commitments – we highlighted earlier opening up previous agreements, your counter party may be willing to negotiate.
- Reduce costs – consider every avoidable cost, from front to back office. Is your aim to simply survive or could you take the opportunity to introduce sustainable high performance/optimal solutions? Take a hard look at procurement to ensure you are getting the best prices. What about indirect tax?
- And finally, sensitize – reforecast, reforecast, reforecast!

It's only when you have gone through this exercise and keep the exercise refreshed can you take the right decision over fleet strategy and whether the company is a going concern.

Whilst most companies rightly focus on cash, surprisingly it may be accounting (profit and balance sheet net assets) that turn out to be your key area for concern. Profit does not always equal cash and covenants are often measured on profit, loan to values, EBITDA measures, fixed charge ratios etc. If there is insufficient regard for the income statement when making business decisions, lines of credit can be withdrawn.

Here there has been some unpredictable behaviour from banks. What is clear is that, to date, few have been interested in seizing assets, many are prepared to negotiate. If the cash generation is strong and the debt is being serviced, they might be less likely to call in the loan – in the short term, at least.

This is likely to change as:

- they step up their turnaround capability;
- the market for distressed debt portfolios develops; and
- the instances of default are triggered by failed debt service / cover ratio breach rather than valuation issues.

KPMG firms have been working with a number of companies helping to improve budget processes and looking at cost enhancement projects. Even the very best companies have opportunities to improve.

The going concern basis for the preparation of accounts

The assessment of going concern by company Directors in forming a view over the appropriateness of the basis of preparation differs by jurisdiction. Here, local law and regulation plays an important role in the obligations of Directors and the approach taken by the company auditors.

IFRSs require management to take into account all available information about the future, which is at least, but not limited to, 12 months from the end of the reporting period. Some jurisdictions have longer assessment periods – the UK being one of them – where the assessment must consider at least 12 months from the date of authorization of the financial statements.

In some circumstances, it may be appropriate to consider a longer period, for example if debt facilities are due for renewal thereafter. A similar approach is applied for interim periods.

Sector accounting issues

This section outlines some of the key sector accounting issues you asked us to address.





Property, plant and equipment

Following feedback from our first Shipping Insights we have looked again at the issues surrounding vessel cost capitalization, specifically what costs can be considered capital and therefore to be included within the initial carrying amount of a vessel. A number of sector specific issues are relevant and are highlighted below.

Initial positioning costs

IAS 16 details that the cost of property, plant and equipment ("PPE") includes "any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management." Examples of directly attributable costs provided in IAS 16 include "initial delivery and handling costs." This would suggest that, along with initial inspection and certification costs, the capitalization of initial positioning costs may be appropriate. Consideration as to whether or not the vessel is located where it is capable of operating is likely to be important. This is different to managements' intention of where the asset will be first used.

Hedge gains/loss associated with hedges of foreign currency stage payments

Many vessel construction contracts have long-term stage payment schedules in place. These are often in foreign currencies and companies frequently undertake hedging to mitigate exposure to exchange movements. Where designated as such these hedge transactions may qualify for hedge accounting under IAS 39. For cash flows hedges, the effective portion of exchange gains/losses on the hedges is initially posted to other comprehensive income rather than to profit or loss. IAS 39 allows an accounting policy choice to remove these gains and losses recognized in other comprehensive income and include them in initial cost of the vessel when it is recognized. Alternatively, a company may choose to leave the gains and losses in accumulated other comprehensive income and reclassify them to profit or loss as the unadjusted cost of the vessel affects profit or loss. Under either policy, the hedging gains and losses will impact profit or loss as the vessel is depreciated or is impaired or sold.

Companies have a choice over whether or not to hedge account. This choice is made on a transaction by transaction basis.

Complications are likely to arise if the schedule of stage payments changes substantially. Careful consideration as to which, if any, hedges remain eligible for hedge accounting is likely to be necessary.

For example, where your cash and fleet management policy changes and leads you to look to defer or alter the delivery dates or terms of a new build contract, how are the existing hedges treated? This will depend on the terms of the existing and any new hedge agreement. IAS 39 sets specific criteria for when hedge accounting must be discontinued and when gains and losses recognised in other comprehensive income must be reclassified to profit or loss.

Borrowing costs

A revision to IAS 23 now requires companies to capitalise interest costs directly attributable to the acquisition, construction or production of a qualifying asset. Previously companies had an option to expense such costs. A qualifying asset is one that takes a substantial period of time to get ready for use or sale.

If a company previously expensed borrowing costs, it needs to capitalize borrowing costs only on qualifying assets for which the commencement date for capitalization falls after the beginning of its first financial year starting on or after 1 January 2009. Therefore for a vessel (for example) where construction started prior to 1 January 2009 and the company, which has a calendar year end, has expensed borrowing costs, it may continue to do so for that asset. Alternatively, the transitional rules allow retrospective application from an earlier date. For a vessel where construction starts after 1 January 2009, the company must capitalise borrowing costs.

Ship finance often tends to be asset specific (e.g. a loan or finance lease to purchase a particular asset). In these cases, identifying the borrowing costs for capitalization may be straight forward. The amount eligible for capitalization is reduced by any interest income from the temporary investment of funds drawn down in advance of need.

However, should general borrowings be used IAS 23 states that the amount of borrowing costs to be capitalized will be based on the expenditures to date on the asset multiplied by a weighted average interest rate across all general borrowings. The amount of borrowing costs capitalized in a period cannot exceed the total amount borrowing costs on general borrowings incurred in the same period.

Tonnage tax

In March 2009 the International Financial Reporting Interpretations Committee (IFRIC), a body that issues interpretive guidance on matters not specifically addressed by IFRSs debated whether tonnage taxes should be considered as a separate subject requiring their attention and guidance. The IFRIC decided however that there was significant guidance already within IAS 12 "Income Taxes."

In essence, the IFRIC concluded that tonnage taxes that are calculated on a gross basis – by reference to tonnage transported or capacity - rather than on a net profit basis do not meet the definition of an income tax. Accordingly they should not be presented as such in the financial statements.

The IFRIC did however, note that, in accordance with IAS 1, an entity may present information about such tonnage taxes separately in the statement of comprehensive income, in order to give greater relevance and understanding of performance.

Two examples for the presentation of taxes in the primary statements are shown below which, in our view, meet the IFRIC requirements whilst providing meaningful information in cases in which tonnage tax is paid as a substitute for income tax but does not meet the definition of income tax:

	200X US\$	200Y US\$
Results from operating activities	X	X
Net finance expense	(X)	(X)
Profit before tonnage tax	X	X
Tonnage tax	(X)	(X)
Profit before income tax	X	X
Income tax expense	-	-
Profit from continuing activities	X	X

Or:

	200X US\$	200Y US\$
Results from operating activities	X	X
Net finance expense	(X)	(X)
Profit before tonnage tax and income tax	X	X
Tonnage tax	(X)	(X)
Income tax expense	-	-
Profit from continuing activities	X	X

This issue remains a topic for debate. It will be interesting to see how the industry deals with this in the upcoming reporting season.



Currency and bunker adjustment in revenue contracts

A common issue is whether currency and bunker adjustments in revenue contracts represent embedded derivatives. Before exploring this question in more detail, a little bit of the basics.

IAS 39 defines a derivative as a financial instrument or other contract within its scope that displays all three of the following characteristics:

- its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying');
- it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and
- it is settled at a future date.

An embedded derivative is a part of a non-derivative contract that causes some or all of the cash flows that otherwise would be required by that contract to be modified according to a market variable or index. IAS 39 requires an embedded derivative to be separated from the host contract and accounted for separately as a derivative when:

- the economic characteristics and risks of the embedded derivative 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 combined instrument is not measured at fair value with changes in fair value recognized in profit or loss.

So, let us consider an example revenue contract. There is a carriage contract between a carrier and a customer whereby the customer pays an agreed amount. This amount varies if the market price of fuel moves outside a specified range. A feature of this type would meet the definition of a derivative if it were a separate instrument.

However, this feature would be separately accounted for as a derivative only if its economic characteristics and risks are not closely related to the host carriage contract. Evaluating whether there is such a close relationship would require consideration of the economic risks and characteristics of the host carriage contract and the nature of the underlying of the embedded feature. If the nature of both the underlying and the host contract are similar, then they generally are closely related.

If the embedded feature is not separated from the carriage contract, the carrier reflects its effect as an adjustment to the revenue earned from the contract in accordance with its revenue recognition policies.

However, if the embedded feature contains significant leverage, for example the contract price is adjusted exponentially with changes in the market price of fuel, then it will not usually be considered closely related. In this case, the feature would be separately accounted for as a financial asset or liability at fair value through profit or loss.

A carriage contract may be denominated in a foreign currency. IAS 39 states that an embedded foreign currency derivative in a non-financial contract is considered closely related and is not separated if it is not leveraged, does not contain an option feature, and requires payments in: the functional currency of a substantial party to the contract; the currency in which the price of the related good or service is routinely denominated in commercial transactions around the world; or a currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place.

On the horizon

Accounting standards are changing! A number of new proposals are likely to have a material impact on the profitability and balance sheet of shipping companies.

Overview

A number of new proposed accounting standards are being debated by the International Accounting Standards Board (the IASB) and the FASB (the US accounting standard setting body), with the intention of converging US GAAP with IFRS.

Proposals for full adoption of IFRS by US companies is still at the “roadmap” stage, but both standard setting bodies are continuing to release proposals with this goal in mind. This is consistent with the aims of the G20 countries who are supporting one set of global accounting standards.

A number of the proposals, if adopted as accounting standards, would have a material impact on the shipping industry and we would encourage sector participants to respond to the IASB’s and FASB’s comment periods.

We set out below two of the potentially biggest changes to the shipping sector, recognizing that there are a number of other proposals which could also effect companies.

Lease accounting

Many investors have complained that financial statements do not provide a clear picture of the effects of operating leases – they believe that operating leases, like finance leases, also give rise to assets and liabilities and these should be recognized. Potential investors and analysts may be making adjustments to the primary statements to bring operating leases “on balance sheet”.

The split between finance and operating leases can mean that economically similar transactions can be accounted for very differently, reducing both the transparency of accounts and comparability for investors. It certainly has been an area of historic arbitrage as companies have sought to structure leases in certain ways to obtain a desired outcome.

Whilst still at the discussion phase underlying the new principle for lease accounting will be that all lease contracts create assets and liabilities that should be recognized in the lessee balance sheet with the aim being to increase transparency and comparability of lease accounting.

This will result in:

- an asset for the lessees right to use the leased item; and
- a liability for their obligation to pay rentals.



The right of use asset will be measured initially at cost, which would equal the liability, being the present value of the lease payments discounted using the lessee's incremental borrowing rate.

The liability will be payments for the most likely lease term, and include amounts payable under contingent rental arrangements and residual value guarantees.

Clearly companies, such as shipping groups, with significant operating leases will have substantial changes to the size of their balance sheets – covenant ratios could be under threat and the ability of the entity to borrow may be restricted.

The exposure draft on leases is scheduled for the first half of 2010, with the standard expected in 2011. The application date for the standard has not yet been discussed.

Revenue recognition

The IASB and FASB aim to develop a common revenue recognition standard which removes inconsistencies and weaknesses in existing standards and practices in order to improve the comparability of revenue across companies, industries and countries.

The underlying principal will be that revenue recognition will be based on accounting for a contract with a customer, as and when an entity enters into a contract with a customer they obtain rights to receive payments and obligations to provide goods/services. A net contract position is created which could be an asset, liability or net nil. Revenue arises from increases in that net contract position over the contract life.

Revenue will be recognised only as it satisfies the performance obligation in the contracts. In other words when the goods and services promised have been delivered/transferred:

- for a good this will typically mean the customer taking physical possession;
- for a service, as the entity performs and the customer receives the service; and
- if more than one good or service is promised then revenue will be recognized on a basis of what has been transferred.

This could result in a change for shipping groups as the proposed principle may result in an entity recognizing revenue based on changes in rights and obligations which may not provide the same result as the percentage of completion method for uncompleted voyages. However, the IASB and FASB are continuing their development of the proposed standard and further changes may occur.

Under the proposal, after a contract has been entered into, a company should re-measure a performance obligation when it is deemed 'onerous', i.e. when the costs expected to satisfy the obligation exceed the carrying value of that obligation. In which case the obligation is re-measured to the expected costs of satisfying the contract and the corresponding loss is recognised immediately.

The IASB and FASB are also considering whether re-measurement can take place in instances other than when a contract is deemed onerous, although the initial position is that it would not.

The proposals have generated debate amongst companies that are involved in long term contracting, with some concerned that the proposals are focussing on the legal form rather than the economic substance.

The exposure draft is timetabled for the first half of 2010, with the full standard scheduled to be published for 2011.

Other areas to consider

The current pace of accounting change is as fast as its ever been with many significant areas currently being reviewed and debated, including consolidation, financial instruments, income taxes, and financial statement presentation.

The sector needs to keep on top of these issues, and by commenting on the proposals it can influence the outcome.

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