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Business impact of forthcoming regulatory accounting changes for shipping

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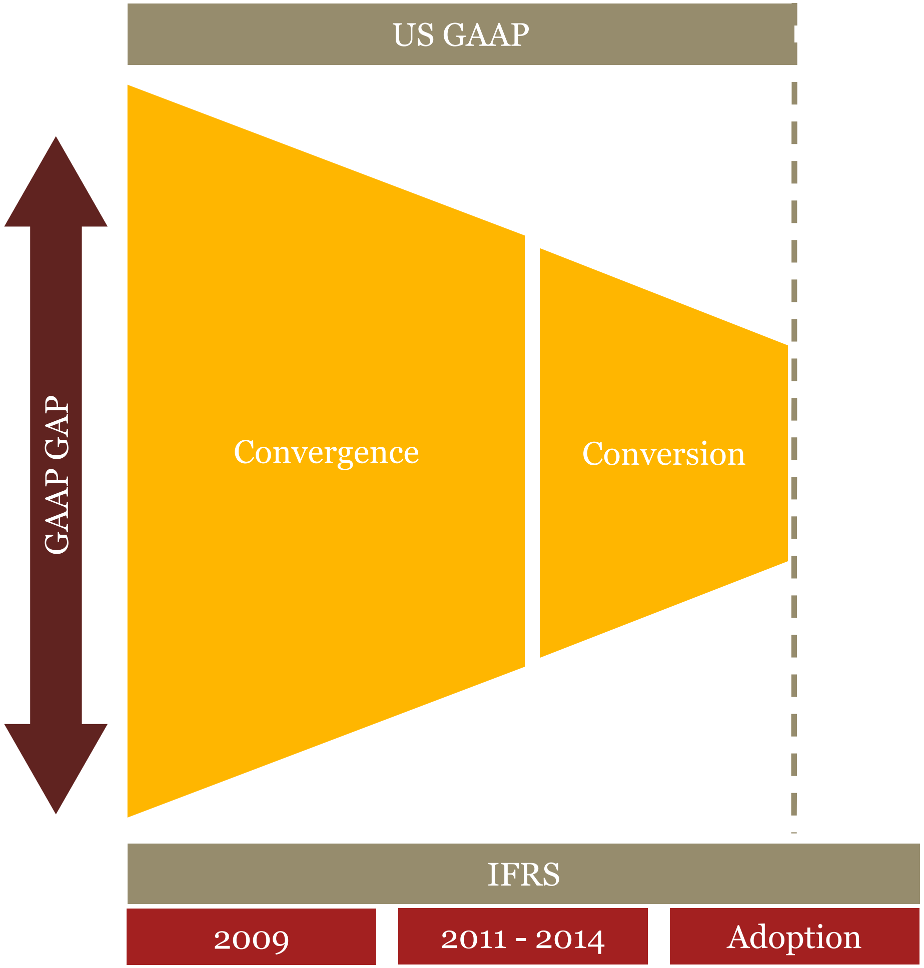
Global Accounting Developments

US GAAP

IFRS

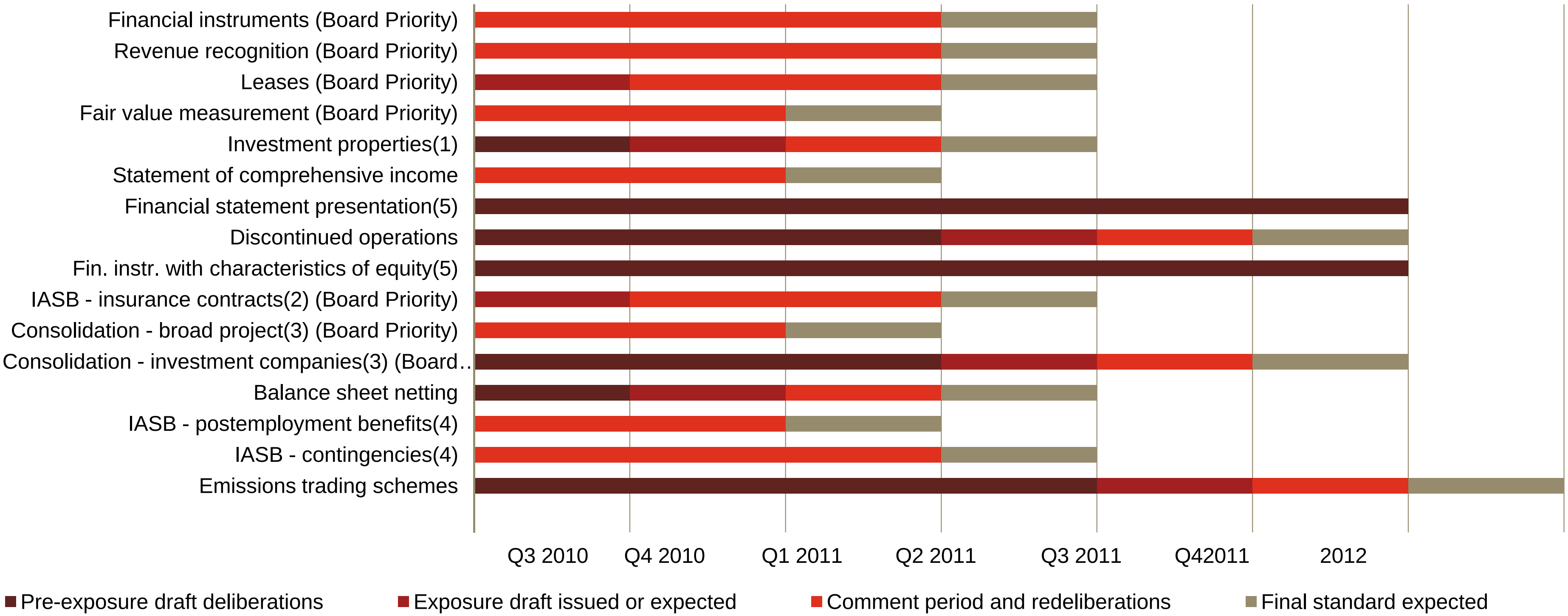
US GAAP / IFRS
Convergence then conversion



Convergence of US GAAP and IFRS will result in a significant number of new US GAAP standards between now and approximately 2014, significantly influenced by IFRS

After convergence project, many differences will remain requiring conversion phase

The current status of convergence



(1) This is a FASB-only project but is related to the Leases project and is based on IAS 40, Investment Property, an IFRS.

(2) IASB timeline. The FASB issued a Discussion Paper in September 2010 that seeks input on whether it should adopt some version of the IASB proposal, or whether targeted changes to U.S. GAAP should be made.

(3) The consolidation project has been divided into two projects: one focused on investment companies and one that is comprehensive. The broad project timeline is that of the IASB. The FASB will consider in late 2010 or early 2011 whether to propose amendments that would achieve convergence of US GAAP consolidation requirements for voting interest entities with IFRSs.

(4) These are IASB projects that have the potential to impact the views of the FASB as it evaluates existing U.S. GAAP in these areas.

(5) Recently delayed. Deliberations which, in the light of the decision to prioritize certain other major MoU projects, are now expected to commence after June 2011.

Potential business impacts will be wide ranging and potentially very significant

- EBITDA/Revenue
- Debt Covenants
- Rating agencies
- Data/System needs
- Other - various

Potential business impacts –EBITDA/Revenue

- Leasing standard (charter ins) impacts calculation of EBITDA (rental expense is now interest and depreciation/amortization)

- Revenue standard impacts timing <u>and</u> measurement of revenue (e.g. credit risk)

- How quickly will the market adapt to new multiples on transactions?

- How will acquisitive companies must adjust for the "artificial" increase in EBITDA created by new standard?

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Potential business impacts - Debt covenants

- Debt covenants typically "freeze" GAAP at date of agreement? Common but not necessarily universal.

- How to avoid multiple sets of books? Frozen GAAP solves compliance issues but is there a way to avoid maintaining two sets of books?

Potential business impacts - Ratings agencies

- How close will a company's lease liability under the new standard be to the "pro forma" number built into ratings agency models?

- How can companies prepare the ratings agencies and other end users for possibly bigger or smaller debt amounts than have historically been built into models?

Potential business impacts - Data/system needs

- Possibly less of an issue for shipping companies…but
- How to collect data to adopt new standards, in some cases retroactively?
- Possible need for new systems to handle the standards (e.g. leasing)?
- When will major ERP and other software providers have solutions ready? SAP/Oracle haven't begun work in meaningful way on a leasing module

Potential business impacts – Other various

- Cash flow statements – direct method verses indirect method now – significant new data requirements (value not so clear)

- Financial instruments

PwC survey of 1400 separate respondents – indicates strong support to not converge/convert to IFRS

- 70% believe either no improvement or benefits outweighed by costs of implementation
- 30% believe benefits will justify cost

Final Thoughts

«Ετεόν δε ουδέν ίδμεν, εν βυθώ γαρ η αλήθεια»

“We know nothing with certainty : truth is hidden at the bottom of the well”

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Convergence, conversion and "condorsement"...

- ***Convergence***
  - IASB/FASB joint projects
  - Big three: leasing, revenue and financial instruments
  - Eliminates existing GAAP differences <u>but</u>...
  - Will require pervasive changes to both sets of standards
- ***Conversion***
  - Change from one GAAP (US) to another (IFRS)
  - Voluntary or compulsory?
  - Compulsory adoption politically challenging for SEC
  - Will impact domestic and FPI shipping companies alike
- ***"Condorsement"***
  - Long-term conversion to IFRS without converting
  - Completion of convergence standards (above)
  - FASB becomes an endorsement mechanism for IFRS standards but does not create new standards

The path to IFRS in the U.S. remains unclear in terms of when and how we will ultimately move to IFRS.

SEC has indicated that mandatory adoption, if approved, would not be required prior to 2015/2016. Convergence standards likely to have effective dates between now and then.

No matter the path, registrants should prepare for an extended period of nearly continuous change from an accounting perspective.

Convergence - background

- ***More than a dozen possible standards***
  - Big three, big impacts…
    - Historically, new standards may not have had major impacts on shipping companies
    - Unlikely to be the case for many of the joint/convergence standards
    - Not much support for the changes in the preparer community
  - Others than the big 3 are also unpopular in the preparer community
    - e.g. Direct method for statement of cash flows (analyst community)
- ***Why converge?***
  - Current differences generates pain for U.S. companies and int'l companies alike
  - "Onboarding" the U.S. with respect to IFRS
  - Unlikely to continue beyond current agenda (what is current agenda)

Leasing

- ***Escape of the lessors***
  - Lessor accounting likely to be scoped out of the standard
  - Meaning no change to charter out accounting…for now
- ***Back to the future?***
  - Initially, all leases would be treated the same
  - However, Boards now contemplating a continuing distinction between operating and finance leases…
- ***All leases will generate a liability (debt)***
  - Profit share arrangements and term extension options on charters in may also be incorporated into the measurement of the liability
  - Boards re-evaluating inclusion of these provisions in final standard
- ***Expense recognition patterns will result in higher expense in earlier years (possibly, only for finance leases)***
- ***P&L geography will change (rental expense replaced with interest and depreciation)***

$1.2 trillion in gross lease obligations expected to be affected

More than 60% of respondents to a PwC survey indicated that they account for leases using spreadsheets

Revenue recognition

- ***Amount and timing of revenue recognized may change***
- ***Recognize revenue when control has transferred***
  - Easier said than done
  - When does control transfer on a service contract? Ratably Pro Rata or at completion of the voyage?
- ***Credit risk (day 1) incorporated into revenue measurement***
  - Currently, bad debt expense generally recognized as operating expense
  - New standard will require Day 1 credit risk to be considered as reduction of revenue
  - Subsequent revisions – favorable or unfavorable – go to operating income/expense
  - Revenue will not equal cash received
- ***Onerous contracts***
  - More opportunities/obligations to recognize earlier under the new standard
- ***Retroactivity***
  - Currently contemplated that new standard would be applied retrospectively