

IFRS industry series

Setting sail with new solutions

Examining International Financial Reporting Standards for the US shipping industry



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What companies can do now

The heart of the matter

US financial reporting will
see unprecedented change
over the next several years

International Financial Reporting Standards (IFRS) have been affecting US companies for some time, whether through the companies' business dealings with non-US customers and vendors that use IFRS or through their non-US subsidiaries' adoption of IFRS. Soon, US shipping companies will feel the increasing effects of IFRS at home as key aspects of accounting principles generally accepted in the United States (US GAAP) and IFRS continue to converge.

The next several years will bring near-constant change to US financial reporting. IFRS will be a main driver of the change, coming at shipping companies on a variety of fronts:

- Convergence of key areas of US GAAP and IFRS
- Ongoing adoption of IFRS by subsidiaries and competitors, as additional countries switch to IFRS (adoption may be further accelerated now that there's a version of IFRS tailored to small and medium-sized entities)
- Continued influence of IFRS on foreign counterparties' structuring of deals and transactions, as additional key US trading partners adopt IFRS for capital-market and statutory purposes
- Ultimate adoption of IFRS in the United States

Recent developments

In February 2010, the Securities and Exchange Commission (SEC) published a statement of continued support for a single set of high-quality global accounting rules. The commission acknowledged that IFRS is best positioned to be the global standard. The statement described the issues and the events that must occur this year and in 2011, when the SEC expects to make a final decision on whether, when, and how to incorporate IFRS in the US domestic reporting system.

The commission further stated that if it does move forward with IFRS in 2011, companies will need adequate time to transition and IFRS reporting would begin in approximately 2015 or 2016. Timing for the convergence projects has since been pushed back, but the SEC stated that will not impact its ability to make a decision on IFRS in 2011. Although a final decision has yet to be made, these developments indicate the SEC's continued commitment to the objective of a single set of high-quality standards.

In addition, IFRS adoption is ongoing elsewhere in the world. Multinational companies need to closely manage IFRS adoption by non-US subsidiaries. Adoption elections that non-US subsidiaries deem best for themselves won't necessarily be best for their US parent or the organization as a whole.

These elections can have a wider impact than just accounting; they could impact broader corporate initiatives such as tax planning. In addition, elections may also vary widely among subsidiaries, diminishing the potential benefit and cost savings from having one set of accounting principles within a company. A working understanding of IFRS, corporate oversight, and careful planning can help to maximize the benefits of a consistent adoption.

Looking forward

IFRS will impact the shipping industry as a whole, but the specific impact of a transition will vary from one shipping company to another. We believe that using the insights gained from this paper, shipping industry executives will have a better understanding of the potential impact of IFRS on their industry and individual companies.

An in-depth discussion

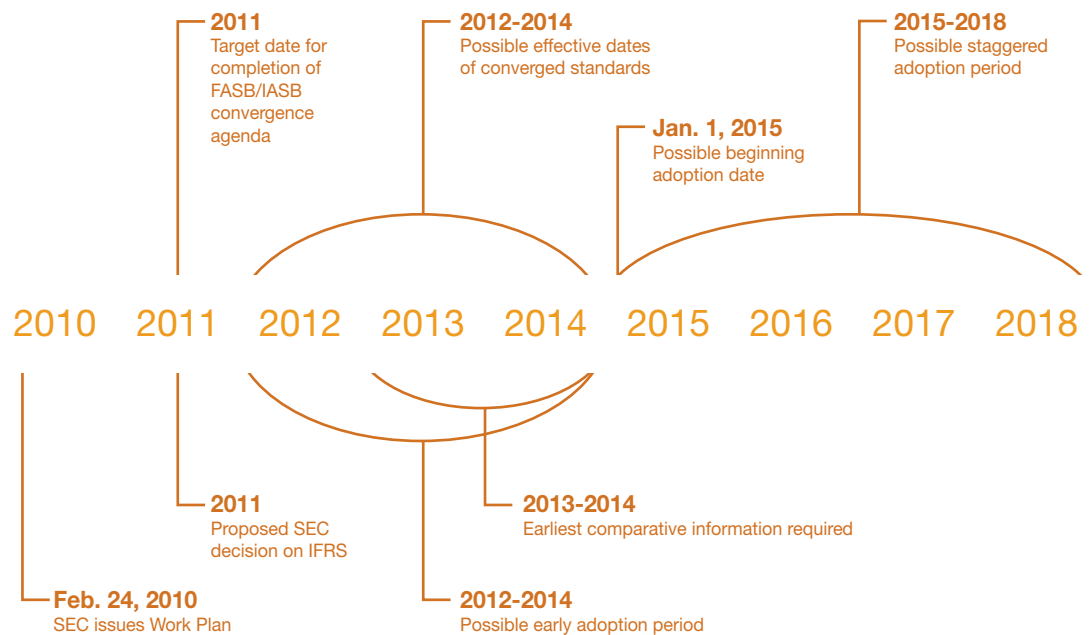
How IFRS may affect your company

A good working knowledge of International Financial Reporting Standards is no longer just optional for companies in the United States, but a business imperative. As more and more companies apply IFRS and US GAAP and IFRS continue to move closer as a result of convergence, US companies must consider how to prepare for the impact of convergence, global IFRS adoption, and potential US adoption of IFRS.

The shipping industry is no exception. It will be affected on all fronts, including:

- Property, plant, and equipment
- Lease accounting
- Revenue recognition
- Derivatives and hedge accounting
- Provisions
- Taxes
- Joint ventures
- First-time adoption exemptions and exceptions

While there is still time before the formal conversion date to IFRS, the window in the United States is relatively narrow, especially for such a complex industry as shipping. If we assume that the SEC determines in 2011 to incorporate IFRS into the US domestic reporting system, a possible timeline may be:



Property, plant, and equipment

Property, plant, and equipment (PP&E) is a major balance sheet caption for shipping companies. Vessels and terminals are complex items that are expensive to build and include land, buildings, and a vast array of equipment. Management makes detailed calculations of the expected return on investment before deciding to acquire a ship or a terminal. The acquisition costs are capitalized and depreciated over the assets' useful lives. International Accounting Standard (IAS) 23(R), *Borrowing Costs*, now requires capitalization of borrowing costs that are directly attributable to the construction period. The key applicable standards for PP&E are IAS 16, *Property, Plant and Equipment*; IAS 36, *Impairment of Assets*; and IFRS 1, *First-time Adoption of IFRS*.

The component approach

Vessels, terminals, and other fixed assets comprise a number of components that may have different useful lives. Under IFRS, each significant component must be depreciated separately; this is often referred to as the component approach. Under US GAAP, entities use another approach, composite depreciation, in which the complete asset is depreciated over one useful life and the cost of a new component is capitalized without derecognizing the replaced component.

Shipping companies applying IFRS need to analyze their assets and identify the components. For example, the cost of a complete vessel includes the hull, engines, gear boxes, communications and navigation equipment, hatch covers, and dry-docking, each of which may be determined to have a different useful life.

For first-time adopters, the identification of components of an asset is usually a difficult, cumbersome process because of a lack of detailed records maintained for this purpose. Often, input from operating personnel and technical ship managers

will be necessary to enable appropriate assumptions in “componentizing.” Consideration should be given to implementation of technology systems able to capture such data going forward.

Although the component approach is not complex, its implementation can often create an administrative burden associated with gathering data and changing systems, if necessary. Companies can often underestimate the time and effort associated with this issue when doing project planning. The degree of complexity and the level of change necessary in this area can range widely from company to company, depending on the underlying systems and the availability of historical data.

Dry-dock/major maintenance

US GAAP allows three alternatives for major maintenance and overhauls: expense as incurred, capitalize, and the built-in overhaul method. Under IFRS, the costs of major maintenance and dry docks are recognized in the carrying amount of the item of PP&E and are depreciated over the period of time until the next major overhaul or dry dock, provided such costs meet the definition of an asset (i.e., probable of future economic benefits and reliably measurable). Any remaining carrying amount relating to the previous major overhaul is derecognized.

Under both IFRS and US GAAP, routine maintenance costs are expensed as incurred. Companies that report under US GAAP typically capitalize dry-docking and major maintenance expenses, which is required by IFRS, in which case, the difference between IFRS and US GAAP typically is a presentation difference in the balance sheet and does not impact the income statement. However, if you currently expense as incurred, there would be an income statement impact.

Measurement

Under IFRS, companies have a choice on how to measure PP&E. They can choose to use either the historical cost method and carry the assets at cost less accumulated depreciation and impairment charges or the

of the asset after deducting the estimated costs of disposal, if the asset was already of the age and in the condition expected at the end of its useful life, also known as its scrap value. Residual value is an important factor in the shipping business.

For assets carried under the historical cost method or revaluation method, it is important for companies to review the assets' useful life, residual value, and depreciation method at least annually.

revaluation method and revalue the assets regularly to fair value. Companies can even elect different methods between asset classes, assuming that the asset classes will be treated consistently going forward.

For assets carried under the historical cost method or revaluation method, it is important for companies to review the assets' useful life, residual value, and depreciation method at least annually. Companies that report under IFRS typically carry their assets at historical cost and do not opt for the revaluation method. However, use of the revaluation method would result in volatility in balance sheets since this revaluation is recorded in equity.

US GAAP allows only the historical cost method.

Replacements

When the engines are replaced during the vessel's life, under IFRS, the cost of the replacement engines is added to the vessel's carrying amount. The remaining unamortized amount of the old engines, if any, is written off.

Residual value

Vessels and other assets owned by shipping companies usually have significant residual values. The residual value is defined as the estimated amount that an entity would currently obtain from disposal

The residual value and the useful life of an asset under IFRS should be reviewed at least annually with consideration of the "as of" date as the basis for the value. This approach differs from US GAAP, which considers the future intended use and residual value. The effect of a change in the estimate of the residual value is charged to the income statement over the asset's remaining useful life and could result in income statement volatility.

This demolition value is often quoted as a price per long ton light displacement. Demolition values are volatile and correlated to the steel price. Traditionally, the shipping industry tended to use relatively prudent demolition values because ships had long useful lives—for example, 25 years. Using a rule of thumb for estimated demolition value would not be appropriate under IFRS because it requires an "as of" date value.

The residual value in certain circumstances may increase to an amount that exceeds the asset's carrying amount. Depreciation ceases in those circumstances. The entity should start depreciating the asset again if the revised estimate of the residual value subsequently decreases below the asset's carrying amount.

Impairment

The shipping industry requires significant capital investment and is exposed to economic cycles and market volatility, which impact the fair values of vessels. Indicators for impairment are therefore likely to exist over time and under IFRS may result in earlier impairment charges than under US GAAP.

Calculation of impairment

Under IFRS, impairment testing is a one-step process that requires the asset's carrying value to be compared to the higher of fair value less costs to sell or value in use (which is typically a pre-tax discounted cash-flow model reflecting the entity's intended use). This same impairment model is used when assessing all types of assets, including long-lived tangible and intangible assets and goodwill; this differs from US GAAP, which has different impairment models based on the type of asset being evaluated.

ment. However, if undiscounted cash flows are less than the carrying value, then the impairment is measured as the amount by which the carrying amount exceeds the fair value of the assets.

Asset grouping — cash generating unit versus reporting unit

An important element of the standard emerges in how assets are grouped for impairment testing. The impairment is measured under IFRS on individual assets, unless an individual asset does not generate cash inflows that are largely independent from other assets or groups of assets. In these cases, impairment is measured at the cash generating unit (CGU) level. A CGU is the smallest identifiable group of assets that generates cash inflows largely independent of cash inflows from other assets or groups of assets.

Because the determination of the number of CGUs will depend on their ability to generate largely independent cash inflows,

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Additionally, under US GAAP, impairment is a two-step process for PP&E to be held and used. First, recoverability is assessed on an undiscounted cash-flow basis. If the undiscounted cash flows are greater than the carrying value, there is no impair-

CGU determination within the shipping industry should be considered carefully. Is each individual vessel its own CGU, or can you group similar types of vessels operating in the same region, trade, or route that are interchangeable as one CGU?

Discount rate

IFRS requires the discount rate for value-in-use calculations to be determined on a pre-tax basis. Thus, a CGU's pre-tax cash flows should be discounted at the pre-tax discount rate. In many cases the only observable market rate of return is a post-tax discount rate. This is the case, for example, where the discount rate is derived from an entity's weighted average cost of capital, which many companies look toward when estimating the appropriate discount rate for a CGU.

Deriving a pre-tax discount rate from a post-tax discount rate is a key practical issue and may be a complex exercise, since generally it is not simply a matter of grossing up the required post-tax rate of return at the standard or effective rate of tax and discounting the pre-tax cash flows at that grossed-up rate. To reflect the specific amount and timing of future cash flows, the post-tax rate will generally need to be adjusted much more carefully.

Reversal of impairments

Finally, under IFRS, an impairment of long-term assets (excluding goodwill) can be reversed, while US GAAP does not allow for a reversal of impairment. An entity must assess at the end of each reporting period whether there is any indication that an impairment loss recognized in prior periods for an asset, other than goodwill, may no longer exist or may have decreased. If any such indication exists, the entity shall estimate the recoverable amount of that asset and increase its carrying amount to the recoverable amount (not to exceed the carrying amount that would have been determined had no impairment loss been recognized for the asset in prior periods).

Lease accounting

Classification of leases

To finance vessels, leases are often used instead of bank or other borrowings. Leases are agreements in which the lessor conveys to the lessee the right to use an asset for an agreed period of time in return for payment. Although the lessor may be the legal owner of the asset, the lessee may enjoy substantially all the risks and rewards of owning the asset during the lease term.

A shipping company may also enter into an arrangement that does not take the legal form of a lease but conveys a right to use an asset in return for a payment or series of payments. Examples of such arrangements include outsourcing arrangements and take-or-pay contracts. IFRIC 4 (an interpretation from the Standing Interpretations Committee, now known as the IFRS Interpretations Committee), *Determining Whether an Arrangement Contains a Lease*, would be applicable to determine whether the arrangement is or contains a lease. Following are examples of contractual arrangements that are leases:

- Lease of terminal equipment, land, and buildings
- Bareboat contracts in or out
- Tax lease contracts
- Slot rentals (NVOCCs)
- Time charter contracts

Leases (including those concluded as such by applying IFRIC 4) are classified as either operating or finance leases based on the facts and circumstances at their inception. IAS 17, *Leases*, defines a finance lease as one that transfers substantially all the risks and rewards incidental to the ownership of an asset to the lessee. The title may or may not eventually be transferred. Operating

leases are the remainder category—they are defined as all leases that are not finance leases.

Under IFRS, classification depends on substance rather than legal form, while US GAAP applies quantitative breakpoints and bright lines. IAS 17 lists the following indicators that individually or in combination would lead to a finance lease:

- The lease transfers ownership of the asset to the lessee.
- The lessee has the option to purchase the asset at below-market value so that it is reasonably certain that the lessee will exercise the option.
- The lease term is for the major part of the asset's economic life.
- The present value of the minimum lease payments is close to the fair value of the leased asset when the lease contract is signed.
- The leased assets are of a specialized nature so that only the lessee can use them without major modifications.
- The lessor's losses associated with the cancellation of a lease are borne by the lessee.
- Gains or losses from the fluctuation in the fair value of the residual accrue to the lessee—for example, in the form of a rent rebate equaling most of the sales proceeds at the end of the lease.
- The lessee extends the lease term at substantially below-market rent.

The indicators are not always conclusive. Careful review and consultation with specialists are recommended when classifying complex leases.

Although a good portion of charters are considered operating leases and we would not expect this to change with the transition to IFRS, there are some transition items to consider. A common pitfall is not reevaluating the initial lease classification on the date of transition, whereby inappropriate classification could result. For example, a 15-year lease period for an asset with a 20-year useful life might be a finance

- b. A lessor would recognize an asset representing its right to receive lease payments and, depending on its exposure to risks or benefits associated with the underlying asset, would do one of the following:
 - i. Recognize a lease liability while continuing to recognize the underlying asset (a performance obligation approach)

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(capital) lease at inception. However, if the reassessment is done with two years left on the lease, it may well be an operating lease. Therefore, at the transition date, leases should be assessed assuming the IFRS lease guidance had been applicable at the inception of the lease. The lease classification at the transition date will then be based on this assessment.

In August 2010, the FASB and IASB jointly issued a leasing exposure draft addressing accounting by both the lessee and lessor for which the final standard is expected to be issued by mid-2011. Under the new approach, the operating lease accounting model would be eliminated. As such, all rights and obligations under lease arrangements, including those in effect when the new standard is issued, would be accounted for as assets and liabilities on the balance sheet—representing a major change from current practice.

The exposure draft proposes that lessees and lessors should apply a right-of-use model in accounting for all leases, which means that:

- a. A lessee would recognize an asset representing its right to use the leased asset for the lease term and a liability to make lease payments

- ii. Derecognize the rights in the underlying asset that it transfers to the lessee and continue to recognize a residual asset representing its rights to the underlying asset at the end of the lease term (a derecognition approach)

Assets and liabilities recognized by lessees and lessors would be measured on a basis that:

- a. Assumes the longest possible lease term that is more likely than not to occur, taking into account the effect of any options to extend or terminate the lease
- b. Uses an expected outcome technique to reflect the lease payments, including contingent rentals and expected payments under term option penalties and residual value guarantees, specified by the lease
- c. Is updated when changes in facts or circumstances indicate that there would be a significant change in these assets or liabilities since the previous reporting period

This area will be important to follow from a convergence perspective, especially since the current and past practice for shipping companies has been to enter into lease contracts with terms that qualify for operating lease treatment. At present, US GAAP and IFRS account for the lease payments arising from operating leases by recognizing them in the period in which they occur. The proposals would require lessees to recognize the assets and liabilities arising from these leases, thereby increasing the shipping companies' assets and liabilities and potentially impacting financial covenants related to long-term debt or other agreements.

If the leaseback is an operating lease, the accounting treatment is more complex because the sale price must be compared with the asset's fair value. The accounting treatment is as follows:

- If the sale price is at fair value, there has been a normal sale transaction, and any profit or loss arising from the sale is recognized immediately.
- If the sale price is below fair value, any profit or loss should be recognized immediately (unless the loss is compensated for by future lease payments at

Care must be exercised when evaluating certain transactions involving the legal form of a lease. IFRS and specifically SIC 27, which addresses issues that may arise when an arrangement between an enterprise and an investor involves the legal form of a lease, require the substance of an arrangement to override the legal form.

Sale and leaseback transactions

Sale and leaseback is frequently used to raise capital in the shipping industry. The transaction involves the sale of a vessel or other assets and the leaseback of the same assets, usually under a finance lease. The future lease payments and the sale price are often interdependent because they are negotiated as a package.

The accounting treatment of such a transaction, under IFRS, depends on classification of the leaseback as either a finance or operating lease. If the leaseback is a finance lease, any excess of sales proceeds over the carrying amount is deferred and amortized to income over the lease term. If the sales proceeds are less than the carrying amount, the loss is also deferred unless there has been an impairment of the asset's value (which is more typical).

below-market price; then the loss should be deferred in proportion to the lease payments over the period for which the asset is expected to be used).

- If the sale price is above fair value, the excess over fair value should be deferred and amortized to adjust the future rent over the period for which the asset is expected to be used.

Care must be exercised when evaluating certain transactions involving the legal form of a lease. IFRS and specifically SIC 27, which addresses issues that may arise when an arrangement between an enterprise and an investor involves the legal form of a lease, require the substance of an arrangement to override the legal form. For example, an entity may sell a ship to a bank and enter into a leaseback agreement. The terms are such that the bank must sell the asset back

to the entity at the end of the lease at an amount that has the overall effect, when also considering the lease payments, of providing the bank with a yield of LIBOR + 2 percent margin. The assessment of such an arrangement is based on its substance as a bank borrowing rather than a sale and leaseback.

For sale and leaseback transactions, the accounting treatment under US GAAP also depends on the classification of the lease—either operating or capital. However, US GAAP focuses on whether the lessee retains “substantially all” or a “minor” use of the asset, and this use of the asset drives the recognition or deferral of the gain or loss.

Debt covenants and violations

Virtually all lending agreements entered into by shipping companies include various covenants. Violation of loan covenants usually constitutes an event of default that gives the lender the legal right to call the loan and demand repayment at any time (i.e., the loan becomes demand debt that is immediately due and payable).

Under IFRS, where the borrower has violated the debt covenant as of the balance sheet date or is projecting to violate the debt covenant within the 12 months from the balance sheet date, the debt would be classified as current obligation if a waiver is not obtained by the balance sheet date. Obtaining a waiver after the balance sheet date and prior to the authorization of the financial statements is considered a nonadjusting, post-balance sheet event.

Under US GAAP, long-term debt that is callable by the lender as a result of a covenant violation as of the balance sheet date requires current classification, unless a waiver of the violation that occurred is obtained for a period that extends beyond one year from the balance sheet date (or operating cycle) or the short-term debt is refinanced on a long-term basis (i.e., either by replacing it with newly issued long-term debt or equity or by entering into a financing agreement that allows for long-term borrowings). This waiver can be obtained subsequent to the balance sheet but before the authorization of the financial statements.

Revenue recognition

In June 2010, the FASB and IASB released an exposure draft outlining a new revenue recognition model that is a contract-based approach that focuses on the assets and liabilities that are created when an entity enters into and performs under a contract. The objective of the converged standard is to increase the consistency of revenue recognition for similar contracts, regardless of industry.

Under the proposed model, an entity would identify the contract with the customer, identify the separate performance obligations in the contract, determine the transaction price, allocate the transaction price to the separate performance obligations, and recognize revenue when the entity satisfies each performance obligation.

A good or service is distinct if either the entity or another entity sells an identical or similar good or service separately or the entity could sell the good or service separately because the good or service has a distinct function and a distinct profit margin.

Transfer of control

Under the proposed model, an entity would recognize revenue when it satisfies a performance obligation and control of a promised good or service transfers to the customer, which is when the customer is able to direct the use of and receive the benefits from the good or service.

When the promised goods or services underlying a separate performance obli-

Companies should carefully consider the indicators of control transfer and assess whether under the new model there is a continuous transfer of control for the services performed.

The proposal defines a performance obligation as an enforceable promise in the contract that includes both explicit and implicit promises to transfer goods and/or services to a customer. If an entity promises to provide more than one good or service, it would account for each promised good or service as a separate performance obligation if the good or service is distinct.

gation are transferred to a customer continuously, an entity would apply to that performance obligation one revenue recognition method that best depicts the transfer of goods or services to the customer. Acceptable methods include those based on an entity's outputs or inputs and on passage of time.

Identifying the performance obligations in a contract will be critical in applying the proposed model and will require significant judgment. This may be particularly challenging for service arrangements and long-term contracts. Also challenging will be determination of when performance obligations should be combined and when they should be separated, which will be a key driver in determining the amount and timing of revenue recognition.

Companies should carefully consider the indicators of control transfer and assess whether under the new model there is a continuous transfer of control for the services performed. Careful consideration of the model's principle for revenue recognition and the indicators that demonstrate that the customer has obtained control is needed to determine when the revenue should be recognized. The indicators of control transfer are difficult to apply to certain service transactions such as transportation services, and more guidance may be helpful in making the assessment as to when control transfers. For

some companies, this may result in a significant change in the timing of revenue recognition. In addition, if the recovery of shipping costs is expected under the contract and generates or enhances resources of the entity that will be used in satisfying performance obligations in the future, the costs would be deferred as an asset until the related revenue is recognized. Costs of obtaining a contract (costs of selling, etc.) will be expensed as incurred.

This will be an important area to follow from a convergence perspective, especially since industry-specific GAAP that allows for a policy choice for revenue recognition will be replaced by a new model.

Derivatives and hedge accounting

Derivatives and hedging represent one of the more complex topical areas within both US GAAP and IFRS. While IFRS is generally viewed as less rules based than US GAAP, both standards embody a significant volume of detailed implementation guidance in relation to derivatives and hedging.

Shipping companies operate in an international environment and are exposed to a variety of financial risks, the most common being foreign currency, interest rate, and price risks. Management authorizes the use of derivatives to mitigate these risks or seeks to achieve natural hedges by borrowing in the currency of the entity's cash inflows.

The exposure to currency exchange rate movements is often hedged using currency swaps and forward contracts. The exposure to the interest rate risks can be managed by fixing interest rates through interest rate swaps. Shipping companies can use "forward freight swap agreements" to manage price risks. This derivative fixes the price per day of contract routes.

The accounting for derivative instruments and hedging activities represents one of the more complex areas within IFRS. Some differences could be more restrictive than US GAAP, whereas others could provide more flexibility under IFRS. As companies work to understand and embrace the new opportunities and challenges associated with adopting IFRS in this area, it is important that they fully consider the data requirements and underlying systems support.

Areas where IFRS is more restrictive than US GAAP include the nature, frequency, and methods of measuring and assessing hedge effectiveness. IFRS requires that in all instances, hedge effectiveness be measured and any ineffectiveness be recorded in profit or loss. For example, US GAAP provides for a shortcut method that allows an entity to assume no ineffectiveness and, hence, bypass an effectiveness test as well as the need to measure quantitatively the amount of hedge ineffectiveness.

The US GAAP shortcut method is available only for certain fair value or cash flow hedges of interest rate risk using interest rate swaps when certain stringent criteria are met. IFRS has no shortcut method equivalent. IFRS does acknowledge that in certain situations, little or no ineffectiveness could arise, but IFRS does not provide an avenue whereby an entity may assume no ineffectiveness. Because the shortcut method is not accepted under IFRS, companies using the shortcut method under US GAAP will need to prepare the appropriate level of IFRS-compliant documentation if they want to maintain hedge accounting.

The documentation will need to be in place no later than at the transition date to IFRS if hedge accounting is to be maintained on an uninterrupted basis. For a shipping company whose first IFRS-based financial statements will be issued for the three years ended December 31, 2016, hedging documentation needs to be in place as of January 1, 2014, if the entity wants to continue to apply hedge accounting on an uninterrupted basis.

IFRS is also more restrictive than US GAAP in relation to the use of internal derivatives. Restrictions under the IFRS guidance may necessitate that entities desiring hedge accounting enter into separate, third-party hedging instruments for the gross amount of foreign currency exposures in a single currency, rather than on a net basis, as many treasury centers do currently under US GAAP.

The FASB and IASB have currently undertaken a project to significantly improve the decision usefulness of financial instrument reporting for users of financial statements. The project will replace the FASB's and IASB's respective financial instruments standards with a common standard. The boards believe that simplification of the accounting requirements for financial instruments should be an outcome of this improvement. The boards believe that this project will recon-

Areas where IFRS is more restrictive than US GAAP include the nature, frequency, and methods of measuring and assessing hedge effectiveness. IFRS requires that in all instances, hedge effectiveness be measured and any ineffectiveness be recorded in profit or loss.

At the same time, in a number of areas, IFRS provides opportunities not available under US GAAP. Such opportunities arise in a series of areas where hedge accounting can be accomplished under IFRS, whereas it would have been precluded under US GAAP. For example, under IFRS, an entity can achieve hedge accounting in relation to the foreign currency risk associated with a firm commitment to acquire a business in a business combination (whereas US GAAP would not permit hedge accounting).

IFRS allows an entity to use a single hedging instrument to hedge more than one risk in two or more hedged items. That difference may allow entities under IFRS to adopt new and sometimes more complex risk management strategies while still achieving hedge accounting. IFRS is more flexible than US GAAP with respect to achieving fair value hedge accounting in relation to interest rate risk within a portfolio of dissimilar financial assets and in relation to hedging a portion of a specified risk and a portion of a time period to maturity (i.e., partial-term hedging) of a given instrument to be hedged.

consider the recognition and measurement of financial instruments, address issues related to impairment of financial instruments and hedge accounting, and increase convergence in accounting for financial instruments.

As part of this project, in May 2010, the FASB issued a proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*. In addition, in November 2009, the IASB issued IFRS 9, *Financial Instruments*, which covers classification and measurement of financial assets. The IASB made a decision to retain most of the existing classification and measurement guidance in IAS 39 for financial liabilities. However, the IASB also tentatively decided to propose changes to the fair value option for financial liabilities and issued an exposure draft, *Fair Value Option for Financial Liabilities*, in May 2010.

The IASB has also made tentative decisions about impairment and issued an exposure document on amortized cost and impairment in November 2009. This project is ongoing as the FASB and IASB continue to work toward achieving convergence.

Provisions

Shipping companies are exposed to the potential for various claims and litigations related to vessel damages, personal injury, property damage, environmental liability, and other matters.

The recording of provisions is required for both IFRS and US GAAP if the outflow of resources is probable. However, the definition of *probable* differs under IFRS and US GAAP. IFRS defines it as “more likely than not,” or greater than a 50 percent likelihood. US GAAP defines it as “likely to occur,” or generally 75 percent or greater in practice. This difference could lead to additional liabilities under IFRS that are not recognized under US GAAP.

In addition, there may be differences in the expense classification because IFRS requires that provisions for pollution caused by transportation services should be charged to costs of sales if the income statement is presented by function and expense.

A range of possible outcomes is established when measuring provisions. When no amount within that range represents a better estimate of the provision than any other amount, there is a difference in the amount recorded under IFRS and US GAAP. For IFRS, a company would measure the provision based on the midpoint of the range, while for US GAAP, the low point of the range would be used to measure the liability.

The amount recognized as a provision for IFRS is the best estimate of expenditure required to settle the present obligation as of the balance sheet date. The anticipated cash flows are discounted to their present value if the effect of discounting is material. Under US GAAP, a provision is discounted only when the timing of the cash flows is fixed or reliably determinable.

At the time of this publication, the IASB is working on a stand-alone project on provisions. It has issued an exposure draft that proposes to require that potential liabilities be measured at the present value of the amount that an entity would rationally pay to be relieved of the obligation at the balance sheet date. If this amount is uncertain, then the provision is measured on a probability-weighted average of all possible outcomes. The final standard is expected to be issued in 2011.

Onerous contracts

The industry commonly uses long-term contractual arrangements—for example, contracts of affreightment with a shipper. These contracts can become onerous over time if they cannot be canceled without payment of a significant penalty or other compensation to the counterparty. Management should analyze specific facts and circumstances and, if appropriate, recognize a provision for the expected loss in accordance with IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*. IAS 37 requires a provision for the minimum unavoidable costs of meeting the obligations under a contract where the costs exceed the economic benefits expected to be received under the contract.

The standard also prohibits making a provision for future operating losses. Distinguishing onerous contracts from expected future operating losses may be difficult. Economics dictates that a contract that two unrelated parties have entered into on an arm’s-length basis should not be considered onerous at inception. Facts and circumstances causing the contract to become onerous should be carefully considered, and management should seek to determine whether future inflows of economic benefits from the contract would exceed the unavoidable costs of meeting the obligations under the contract.

IAS 37 requires that any impairment loss on assets dedicated to a contract with contractual requirement and caused by insufficient future cash inflows is recognized before a separate onerous contract provision is established as a liability. The amount of the onerous contract provision has to be discounted if the effect of the time value of money is significant.

Examples of contracts that may become onerous are:

- Operating lease contracts for vessels or terminal equipment when there is overcapacity
- Contracts to buy or sell nonfinancial items at a fixed price
- Bareboat contracts in/out
- Time charter contracts

An unfavorable contract, such as a purchase agreement for fuel at a fixed above-market price, is not necessarily onerous. The purchased fuel may be used profitably in shipping operations.

Taxes

Transitioning to IFRS accounting policies will impact a company's tax function. From a financial reporting perspective, key differences exist between US GAAP and IFRS with respect to accounting for income taxes. Examples of these differences include accounting for uncertain tax positions, tax consequences of share-based compensation, unrealized intragroup profits, measurement of nonmonetary assets and liabilities

As companies progress in their IFRS efforts, it is critical that their tax function understands IFRS and the potential tax implications both in the United States and in each foreign jurisdiction in which the organization operates, develops a tax-specific implementation plan, and is thoroughly involved in the company's overall conversion process from beginning to end.

In addition to tax accounting, several components of a company's tax planning structure could also be affected by the transition to IFRS, including cash taxes, tax accounting methods, domestic and international tax planning, and transfer pricing.

where the local currency is not the functional currency, intraperiod allocation related to subsequent changes in deferred tax balances, outside basis differences, recognition of deferred tax assets, and determination of the tax basis. As a result of these and other differences, the accounting and disclosure requirements associated with income taxes, including the effective tax rate, may be impacted.

In addition to tax accounting, several components of a company's tax planning structure could also be affected by the transition to IFRS, including cash taxes, tax accounting methods, domestic and international tax planning, and transfer pricing. Further, a company's tax processes, systems, and internal controls may require modifications to properly reflect the transition to IFRS.

For more information on the tax considerations associated with the transition to IFRS, please visit our IFRS-Tax webpage at www.pwc.com/usifrs/tax.

Tonnage tax

A large number of shipping companies are permitted to apply for tonnage tax. This tax is based on the tonnage transported during a fiscal year or the tonnage capacity of the vessels. IAS 12, *Income Taxes*, defines *income taxes* as all domestic and foreign taxes based on taxable profits. Tonnage tax generally is therefore not an income tax. It should be presented as an operating cost rather than in the income tax line.

Joint ventures

Joint ventures are common in the shipping industry because they allow entities to share the risks and capital costs of new vessels and other entities. Under US GAAP, the term *joint venture* refers only to jointly controlled entities where the arrangement is conducted through a separate entity. The scope of joint activity is much broader under IFRS than under US GAAP. IAS 31, *Interests in Joint Ventures*, defines a joint venture as “a contractual agreement whereby two or more parties undertake an economic activity that is subject to joint control.”

The concept of joint control is the contractually agreed sharing of control of an economic activity, which exists only when the strategic financial and operating decisions relating to the activity require the unanimous consent of the parties sharing control. This includes jointly controlled entities as well as jointly controlled operations (each venturer uses its own assets for a specific project) and jointly controlled assets (project carried on with assets that are jointly owned). A transition to IFRS would necessitate close consideration of business relationships and alliances to determine which arrangements may be accounted for as joint ventures.

Accounting for joint ventures under IFRS depends on the type of arrangement identified. For example, if the arrangement results in a jointly controlled entity, IFRS permits the use of either proportionate consolidation or the equity method. If an arrangement does not result in a jointly controlled entity (i.e., one entity has clear control through, for example, voting rights or qualitative factors), the controlling entity typically will follow consolidation accounting while the other entity will follow the equity method, provided significant influence exists.

Under US GAAP, proportional consolidation typically is not permitted. US GAAP requires an assessment of whether the joint venture is a variable interest entity before the accounting model can be determined. Under IFRS, such considerations fall under SIC

Interpretation 12, *Consolidation—Special Purpose Entities*. This guidance may result in more entities being consolidated under IFRS because the consolidation requirements are less restrictive than under US GAAP.

In September 2007, the IASB issued Exposure Draft 9, *Joint Arrangements*, which would amend existing provisions of IAS 31. The exposure draft’s core principle is that parties to a joint arrangement recognize their contractual rights and obligations arising from the arrangement. The exposure draft therefore focuses on the recognition of assets and liabilities by the parties to the joint arrangement.

Exposure Draft 9 proposes two key changes. The first is the elimination of proportionate consolidation for a jointly controlled entity. Entities that currently use proportionate consolidation to account for jointly controlled entities may need to account for such arrangements by using the equity method. The second change is the introduction of a dual approach to the accounting for joint arrangements, whereas IAS 31 allowed for three types of joint arrangements.

The board determined that joint arrangements and joint operations would be merged into a single type of joint arrangement called joint operations. The key change is that a single joint arrangement may contain more than one type — for example, joint assets and a joint venture. Parties to such a joint arrangement account first for the assets and liabilities of the joint assets arrangements and then use a residual approach to equity accounting for the joint venture part of the joint arrangement.

The board is continuing its discussions. The final standard is expected to be issued at the end of 2010. As drafted, the exposure draft broadly achieves convergence in principle with US GAAP, which generally requires the use of the equity method to account for jointly controlled entities.

Consolidation/special purpose entities

Shipping companies frequently transfer vessels or other assets to special purpose entities (SPEs) and lease them back. Banks or other investors provide the funding for the SPEs to acquire the assets. SPEs are created to accomplish narrow and well-defined objectives. SPEs may take the form of a corporation, partnership, or unincorporated entity. SPEs' decision-making powers are often subject to strict limits. They operate on a so-called "autopilot." A shipping company may in substance control its SPEs. Even though it may not own the SPEs' equity, the company can be considered a beneficiary of the SPEs' activities.

Any of the following circumstances indicates control of an SPE:

- a. In substance, the SPE's activities are being conducted on behalf of the entity according to its specific business needs so that the enterprise obtains benefits from the SPE's operation.
- b. In substance, the entity has the decision-making powers to obtain the majority of the benefits of the SPE's activities, or, by setting up an autopilot mechanism, the entity has delegated these decision-making powers.
- c. In substance, the entity has rights to obtain the majority of the benefits of the SPE and therefore may be exposed to risks incident to the SPE's activities.
- d. In substance, the entity retains most of the residual or ownership risks related to the SPE or its assets to obtain benefits from its activities.

SIC 12, *Consolidation—Special Purpose Entities*, provides guidance on when an SPE should be consolidated. SIC 12 requires that an SPE be consolidated if the entity in substance controls it. The challenge is to determine which party has the ability to direct or dominate the SPE's decision making, regardless of whether this power is actually exercised. Control may in substance exist even in cases where an entity does not participate in the SPE's equity. Determining control based on substance requires judgment to be exercised in the context of all relevant facts and circumstances.

In practice, the SPEs are tailored to the needs of each individual company. Determining appropriate accounting therefore requires specific, detailed analysis of often relatively complex arrangement terms.

The FASB and IASB are jointly developing a comprehensive consolidation model for all entities. The basis for consolidation is expected to focus on control of an entity, likely to be defined in terms of who has the power to direct the most significant activities together with the right to benefits or losses in the entity. The boards have tentatively decided that a reporting entity with less than half of the voting rights in an entity can have control and that options and convertible instruments should be considered when assessing who may control the entity. The boards are debating the factors to consider when determining whether a reporting entity is acting as an agent, including whether to view kick-out rights held by multiple parties in this assessment. If a reporting entity is acting as an agent, then it would not consolidate the entity. The final standard is expected to be issued at the end of 2010.

First-time adoption exemptions and exceptions

The IASB grants limited exemptions from adoption requirements in specified areas where the cost of complying with them would be likely to exceed the benefits to users of financial statements. The IASB also prohibits retrospective application of IFRS in some areas, particularly where retrospective application would require judgments by management about past conditions after the outcome of a particular transaction is already known.

The selection and application of the optional exemptions can be complicated. Careful consideration and analysis should be applied to ensure the most appropriate actions are taken. The following chart summarizes the elections available to companies under IFRS 1.

Exemption	Choice	Exemption applies to all items? ¹
Business combinations (IFRS 3R)	For all transactions qualifying as business combinations under IFRS 3R, a company can choose to: <ul style="list-style-type: none"> • Not restate business combinations before the date of transition • Restate all business combinations before the date of transition • Restate a particular business combination, in which case all subsequent business combinations must also be restated and the IAS 36 impairment guidance must be applied 	No
Deemed cost	For property, plant, and equipment, a company can choose to measure the value using: <ul style="list-style-type: none"> • Fair value at the date of transition as deemed cost • A revaluation in accordance with previous GAAP as deemed cost • Fair value at the date of an event such as a privatization or an initial public offering as deemed cost • An allocation of an amount determined under previous GAAP as deemed cost The first two elections can also be applied to intangible assets that meet the criteria for revaluation in IAS 38 and to investment properties where the cost method in IAS 40 is applied. The first two elections may not be used for any other assets or for liabilities.	No

¹ This column designates whether the exemption should be applied to all transactions ("Yes") or only selected transactions based on the guidance in IFRS 1 ("No"). This designation does not apply to assets and liabilities of a subsidiary that has already adopted IFRS. In that case (where a parent becomes a first-time adopter later than its subsidiary), IFRS 1 requires the parent to use the "same carrying amounts as in the financial statements of the subsidiary (or associate or joint venture), after adjusting for consolidation and equity accounting adjustments and for the effects of the business combination in which the parent acquired the subsidiary." Once a subsidiary has adopted IFRS, the carrying amounts of assets and liabilities of that subsidiary cannot be adjusted later when the parent adopts IFRS (except as necessary to conform to the parent's policies).

Exemption	Choice	Exemption applies to all items? ¹
Employee benefits	Recognition of all cumulative actuarial gains and losses as an adjustment to opening retained earnings is allowed. Deferral of the recognition of future actuarial gains and losses using the corridor approach in IAS 19 may still be applied prospectively.	Yes
Cumulative translation differences	The cumulative translation reserve may be reset to zero.	Yes
Compound financial instruments	A compound financial instrument does not need to be bifurcated if the liability component is not outstanding at the transition date.	No
Assets and liabilities of subsidiaries, associates, and joint ventures	A subsidiary that adopts IFRS later than its parent can elect to apply IFRS 1 or to use the carrying amounts of its assets and liabilities included in the consolidated financial statements, subject to eliminating any consolidation adjustments. If a parent adopts IFRS later than its subsidiary, the parent, in its consolidated financial statements, must measure the assets and liabilities of the subsidiary at the same carrying amounts as in the IFRS financial statements of the subsidiary, adjusting for normal consolidation entries.	No
Designation of previously recognized financial instruments	A company may choose to designate a financial instrument as a financial asset or financial liability “at fair value through profit or loss” or may designate a financial asset as available for sale at its transition date. If it is impracticable (as defined in IAS 8) for an entity to apply retrospectively the effective interest method or the impairment requirements of IAS 39, the fair value of the financial asset at the date of transition to IFRS shall be the new amortized cost of that financial asset at the date of transition to IFRS.	No

¹ This column designates whether the exemption should be applied to all transactions (“Yes”) or only selected transactions based on the guidance in IFRS 1 (“No”). This designation does not apply to assets and liabilities of a subsidiary that has already adopted IFRS. In that case (where a parent becomes a first-time adopter later than its subsidiary), IFRS 1 requires the parent to use the “same carrying amounts as in the financial statements of the subsidiary (or associate or joint venture), after adjusting for consolidation and equity accounting adjustments and for the effects of the business combination in which the parent acquired the subsidiary.” Once a subsidiary has adopted IFRS, the carrying amounts of assets and liabilities of that subsidiary cannot be adjusted later when the parent adopts IFRS (except as necessary to conform to the parent’s policies).

Exemption	Choice	Exemption applies to all items? ¹
Share-based payment transactions (IFRS 2)	A company is encouraged (but is not required) to apply IFRS 2 to any equity instruments that were granted on or before November 7, 2002, or that were granted after that date and vested before the date of transition, but only if the company has previously disclosed publicly the fair value of the instruments, determined at the measurement date. In addition, a company may choose (but is not required) to apply IFRS 2 to a liability relating to share-based payment transactions that were settled prior to the date of transition to IFRS.	Yes
Insurance contracts (IFRS 4)	A company that issues insurance contracts and has a date of adoption before January 1, 2006, may choose not to restate comparatives for IFRS 4. The company applies its previous GAAP to insurance contracts for its comparatives.	No
Decommissioning, liabilities included in the cost of property, plant, and equipment	When accounting for asset retirement obligations, first-time adopters may apply a shortcut method by: <ul style="list-style-type: none"> • Measuring the liability at transition date in accordance with IAS 37 • Estimating the amount of the liability that would have been included in the cost of the related asset when the liability first arose • Calculating the accumulated depreciation on that discounted amount, as of the date of transition to IFRS 	No
Leases	A company may elect to assess whether an arrangement contains a lease at the date of transition, rather than at the inception of the arrangement.	No
Fair value measurement of financial assets and financial liabilities at initial recognition	First-time adopters can choose to measure their Day One profits on initial recognition of financial instruments either: <ul style="list-style-type: none"> • Retrospectively to all transactions • Prospectively for all transactions entered into <i>after</i> October 25, 2002 • Prospectively for all transactions entered into <i>after</i> January 1, 2004 	No
Service concession arrangements	Companies may elect to apply the transitional provisions of IFRIC 12, rather than full retrospective application.	No

¹ This column designates whether the exemption should be applied to all transactions ("Yes") or only selected transactions based on the guidance in IFRS 1 ("No"). This designation does not apply to assets and liabilities of a subsidiary that has already adopted IFRS. In that case (where a parent becomes a first-time adopter later than its subsidiary), IFRS 1 requires the parent to use the "same carrying amounts as in the financial statements of the subsidiary (or associate or joint venture), after adjusting for consolidation and equity accounting adjustments and for the effects of the business combination in which the parent acquired the subsidiary." Once a subsidiary has adopted IFRS, the carrying amounts of assets and liabilities of that subsidiary cannot be adjusted later when the parent adopts IFRS (except as necessary to conform to the parent's policies).

Exemption	Choice	Exemption applies to all items? ¹
Borrowing costs	If the accounting treatment for capitalized interest required by IAS 23 is different than a company's previous accounting policy, the company may apply IAS 23 to borrowing costs related to qualifying assets capitalized on or after January 1, 2009, or the date of transition to IFRS, if later.	No
Investments in subsidiaries, jointly controlled entities, and associates	In their separate financial statements, first-time adopters can measure their investment in subsidiaries, jointly controlled entities, and associates at either: <ul style="list-style-type: none"> • Cost, determined in accordance with IAS 27R • Deemed cost, defined as fair value (determined in accordance with IAS 39) at the company's IFRS transition date • Deemed cost, defined as previous GAAP carrying amount at the IFRS transition date 	No
Transfer of assets from customers	If the accounting treatment for transfers of assets from customers required by paragraph 22 of IFRIC 18 is different than a company's previous accounting policy, the company may apply IFRIC 18 to transfers of assets from customers on or after July 1, 2009, or the date of transition to IFRS, whichever is later. In addition, the first-time adopter may designate any date before the date of transition to IFRS and apply IFRIC 18 to all transfers of assets from customers received on or after that date.	No
Extinguishing financial liabilities with equity instruments	A first-time adopter may apply the transitional provisions in IFRIC 19, <i>Extinguishing Financial Liabilities with Equity Instruments</i> .	No

¹ This column designates whether the exemption should be applied to all transactions ("Yes") or only selected transactions based on the guidance in IFRS 1 ("No"). This designation does not apply to assets and liabilities of a subsidiary that has already adopted IFRS. In that case (where a parent becomes a first-time adopter later than its subsidiary), IFRS 1 requires the parent to use the "same carrying amounts as in the financial statements of the subsidiary (or associate or joint venture), after adjusting for consolidation and equity accounting adjustments and for the effects of the business combination in which the parent acquired the subsidiary." Once a subsidiary has adopted IFRS, the carrying amounts of assets and liabilities of that subsidiary cannot be adjusted later when the parent adopts IFRS (except as necessary to conform to the parent's policies).

Mandatory exceptions from retrospective application

There are also several mandatory exceptions to full retrospective application of IFRS. As described below, some of these exceptions may or may not have an impact on US companies:

Expected to impact US companies	Not expected to impact many US companies
Hedge accounting	Derecognition of financial assets and financial liabilities
Estimates	Classification and measurement of financial assets
Noncontrolling interests	

What this means for your business

What companies can do now

Independent of when the United States ultimately adopts IFRS, these standards are already having a significant impact on US businesses. The impact will only increase in the next several years as convergence takes place and eventual adoption of IFRS gains momentum.

Awareness and preparedness are essential. Given the timeline, companies should be thoughtful and measured in their approach as they consider this complex challenge. Following are our suggestions for what companies should be doing now:

- **Focus on the challenge.** The next several years will bring major changes to US financial reporting. Whether changes arrive through convergence, an SEC-mandated move to IFRS, or continued IFRS adoption by subsidiaries and counterparties, the effect on US businesses will be considerable.
- **Perform an assessment.**
 - Keep it high level and strategic.
 - Consider the implications for accounting, business strategy and policy, tax, financing, long-term contracts, stakeholders, compensation programs, systems, processes, and controls.
 - Anticipate the impacted behaviors of non-US customers and vendors using IFRS already.
- **Be poised to adapt to ongoing change.** Use scenario planning to incorporate likely convergence and IFRS adoption expectations into your strategic thinking and business planning. Closely follow SEC actions, new FASB and IASB standards, and the increasing international acceptance of IFRS and IFRS for small and medium-sized entities for statutory purposes.
- **Maintain corporate oversight.** Influence transition timing, strategies, and policy decisions of non-US subsidiaries that are increasingly likely to be using IFRS or IFRS for small and medium-sized entities in the foreseeable future. IFRS adoption for statutory reporting continues in many territories. The United Kingdom is one example, with its proposal to adopt IFRS for statutory purposes in 2012.
- **Identify what can be done now.** Being mindful of the specific aspects of convergence and conversion that will take the longest, and consider smaller, controlled, one-off projects and “easy wins” where desirable.

By staying focused on aspects of convergence and adoption that have a long lead time, shipping companies can stay ahead of the game. A new era of financial reporting language is approaching, and it will have a significant impact as a driver of change throughout the industry.

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