US GAAP and IFRS accounting and reporting issues for shipping companies – Reminders and Updates

13 January 2014
Training Agenda

1. Accounting for long term debt
2. Capitalization of interest cost
3. Restricted cash classification
4. Accounting changes
Accounting for Long-Term Debt

ASC 470 “Debt”
IAS 39 “Financial Instruments”
Classification of debt

Current Liability Definition:

• The term “current liabilities” is used principally to designate obligations whose liquidation is reasonably expected to require the use of existing resources properly classifiable as current assets, or the creation of other current liabilities.

• In the shipping industry, “current” is defined as a one-year period after the balance sheet date.

In the case of debt:

Classification is generally based on the repayment terms of the debt.

Obligations that, by their terms, are due on demand or will be due on demand within one year must be classified within current liabilities, even though liquidation may not be expected within that period.
Classification of long-term debt as a result of covenant violations

Current liabilities also include long-term obligations that are or will be callable by the creditor because:

The borrower has violated a covenant in the debt agreement, which makes the obligation callable by the lender.

Note:
The probability of whether the bank will call the debt is not considered – if legally the bank can call the debt and there is no waiver in place, then the company is in violation;

It is probable that the borrower will not be able to cure the default (comply with the covenant) at measurement dates that are within the next 12 months.

and
Classification of long-term debt as a result of covenant violations

Under US GAAP, callable obligations must be classified as current unless:

- The creditor has waived the right to demand repayment for more than a year from the balance sheet date.

- The creditor has subsequently lost the right to demand repayment for more than a year from the balance sheet date (one year and one day). For example, the debtor has cured the violation after the balance sheet date and the obligation is not callable at the time the financial statements are issued.

For obligations containing a grace period within which the debtor may cure the violation, it is probable that the violation will be cured within that period, thus preventing the obligation from becoming callable. However, probability needs to be considered separately on each type of violation.

- The debtor has the intent and ability to refinance the obligation on a long term basis. Ability means, that after the balance sheet date but before the issuance of the financial statements, the entity has issued long-term debt or equity.
Implication of waivers on debt classification

When the debtor is in breach of a covenant but **has a waiver** in place, the debt can be still classified as long-term provided that the waiver covers a one year plus one day period, i.e.

- For a company with a year end: December 31, 2013
- Waiver must be in place for the period to: January 1, 2015

**IFRS**
Under IFRS the waiver must be in place **before the balance sheet date** in order for the debt to be classified as a non-current liability (**non-adjusting subsequent event**).

**US GAAP**
Under US GAAP even if the waiver is obtained **after the balance sheet date**, the debt will still be classified as a non-current liability.
Going concern considerations following a covenant violation (SAS 59)

Careful consideration should be given to the financial statement classification of debt and related disclosure requirements when the debtor is in violation of a borrowing agreement provision at the balance sheet date and a waiver is not obtained or it is not probable that the violation will be cured within a specified grace period thus preventing the debt from becoming callable by the creditor.

Careful consideration should also be given to the financial statement classification of debt and related disclosure requirements when the debtor is in violation of a borrowing agreement provision after the balance sheet date and a waiver is not obtained or it is not probable that the violation will be cured within a specified grace period thus preventing the debt from becoming callable by the creditor.
Deferred Financing Fees
Accounting treatment of deferred financing fees

ASC 835-30-45-3 indicates that debt issue costs should be capitalized in the balance sheet as non-current deferred charges and amortized over the duration of the loan.

Amounts include:
- Loan origination fees
- Underwriters fees
- Legal fees
- Other costs directly attributable to acquiring the loan
- NOT general and administrative costs

Amortized to interest expense using the “effective interest method”

Straight-line may be used only if difference (per year, and cumulative) is NOT material
IFRS versus US GAAP

Under **U.S. GAAP**, transaction costs are *deferred as an asset* and amortized over the term of the debt using the effective interest method.

Under **IFRS**, transaction costs are *deducted from the carrying value of the financial liability* and are not recorded as separate assets. Rather, they are accounted for as a debt discount and amortized using the effective interest method.
Debt Restructuring

The 10% Rule:

\[
\frac{PV^* \text{ of new cash flows}^{**} - PV^* \text{ of old cash flows}}{PV^* \text{ of old cash flows}}
\]

* both PVs are calculated using the effective interest rate of the existing borrowing
** Cash flows should consider changes in principal amounts, interest rates, maturity, as well as, penalties and non-cash consideration, such as stock or warrants.

If the 10% Rule results in a:

- Change greater than 10%:
  - Extinguishment

- Change less than 10%:
  - Modification
Fees incurred during debt restructurings

Fees between debtor and creditor

**Modification:** Are added to the existing deferred financing fees and amortize over the remaining term of the modified debt instrument using the effective interest method

**Extinguishment:** Are included in the calculation of the gain / loss arising on the debt extinguishment (since new debt is recorded at fair value)

Third party fees

**Modification:** Are expensed as incurred

**Extinguishment:** Are “new” deferred financing fees, when such fees clearly relate to the new debt
Any questions?
Capitalization of interest costs

ASC 835 “Interest”
IAS 23 “Borrowing costs”
General principle

Mandatory under both IFRS and US GAAP
Assets qualifying for capitalization

In accordance with ASC 835:

“Interest shall be capitalized for the following types of assets (qualifying assets):

• Assets that are constructed or otherwise produced for an entity’s own use, including assets constructed or produced for the entity by others for which deposits or progress payments have been made.

• Assets intended for sale or lease that are constructed or otherwise produced as discrete projects (e.g. ships or real estate developments)”

In essence: A long-lived asset that necessarily takes a period of time to get ready for its intended use or sale.
The amount of interest cost to be capitalized

In accordance with ASC 835:
“The amount of interest cost to be capitalized for qualifying assets is that portion of the interest cost incurred during the assets’ acquisition periods that theoretically could have been avoided if expenditures for the assets had not been made. Thus, the basis of capitalization is the expenditures made for the asset.”

Interest Cost includes:
- Stated interest
- Imputed interest
- Amortization of discount or premium related to borrowings
- Amortization of debt issuance costs, and
- Finance charges associated with capital leases.

In essence: capitalized interest is driven by the value of the asset, not the debt incurred
The amount of interest cost to be capitalized

In accordance with ASC 835:

“The amount capitalized in an accounting period shall be determined by applying the capitalization rate to the average amount of accumulated expenditures for the asset during the period. The total amount of interest cost capitalized in an accounting period shall not exceed the total amount of interest cost incurred by the entity in that period.”

Capitalization rate = weighted average cost of borrowings. In practice usually capitalize direct interest expense plus WA interest rate of all other borrowings

Expenditure = Progress payments, services rendered, finance cost and interest on borrowings associated with the construction during the construction period

Capitalized amount = Expenditure*capitalization rate (capped to the actual total borrowing costs incurred by the Company)
**IFRS versus US GAAP**

**US GAAP**

Gains and losses on derivative instruments an be capitalized, if the agreement for the derivatives was entered in conjunction with the agreement of the debt and hedge accounting is applied.

The capitalization rate should take into account the **effective** portion of hedging relationships for **fair value hedges**.

In a **cash flow hedge**, the effective portion of the hedging relationship will be classified in other comprehensive income and will be reclassified to earnings in the period during which the hedged forecasted transaction affects earnings (ie over the depreciable life of the constructed asset).

**IFRS**

Gains and losses on derivative instruments that have not been designated in a hedging relationship are not eligible for capitalization.

Although not explicitly addressed in IAS 23, the capitalization rate should take into account the **effective** portion of hedging relationships (both for cash flow hedges and fair value hedges).
The capitalization period

In accordance with ASC 835:

“The capitalization period covers the duration of the activities required to get the asset ready for its intended use, provided that expenditures for the asset have been made and interest cost is being incurred.”

In essence:
Capitalization should match timing of acquisition, construction or production of asset.

**Commencement** when:
- Borrowing costs are incurred
- Expenditure is incurred
- Development activities are undertaken

**Suspension** when:
Active development is suspended for extended periods

**Cessation** when:
Activities necessary to prepare the asset for its intended use are substantially completed.
## IFRS versus US GAAP

<table>
<thead>
<tr>
<th>Impact</th>
<th>US GAAP</th>
<th>IFRS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Borrowing costs under IFRS are broader and can include more components than interest costs under US GAAP.</td>
<td>US GAAP does not allow the capitalization of exchange rate differences arising from foreign currency borrowings.</td>
<td>Borrowing costs under IFRS are broader and can include more components than interest costs under US GAAP.</td>
</tr>
<tr>
<td>US GAAP allows for more judgment in the determination of the capitalization rate, which could lead to differences in the amount of costs capitalized.</td>
<td>The guidance does not require that all borrowings be included in the determination of a weighted-average capitalization rate. Instead, the requirement is to capitalize a reasonable measure of cost for financing the asset’s acquisition in terms of the interest cost incurred that otherwise could have been avoided.</td>
<td>Determining the amount of borrowing costs directly attributable to an otherwise qualifying asset might require professional judgment. The guidance first requires the consideration of any specific borrowings and then requires consideration of all general borrowings outstanding during the period.</td>
</tr>
</tbody>
</table>
Any questions?
Restricted Cash
Balance Sheet
Definition & Examples

Cash that is not immediately available to the Entity due to legal requirements.

Cash may be restricted for various reasons, such as the following:

- it may be used to satisfy the terms of long-term debt obligations:
  Examples:
  - retention accounts which can only be used to fund loan installments or interest payments coming due
  - potential loan collateral requirements, as defined in loan agreements

- Restrictions are considered effective even if the funds are not set aside in special bank accounts!

- it may be held as security in the form of letters of guarantee or letters of credit

- it may be specifically designated for acquisition or construction of long term assets held in escrow accounts
Restricted cash is to be classified as current or non-current, in accordance with the guidance included in ASC 210-10-45-4:

“The concept of the nature of current assets contemplates the exclusion from that classification of such resources as the following:

Cash and claims to cash that are restricted as to withdrawal or use for other than current operations, are designated for expenditure in the acquisition or construction of noncurrent assets, or are segregated for the liquidation of long-term debts.

Even though not actually set aside in special accounts, funds that are clearly to be used in the near future for the liquidation of long-term debts, payments to sinking funds, or for similar purposes shall also, under this concept, be excluded from current assets. However, if such funds are considered to offset maturing debt that has properly been set up as a current liability, they may be included within the current asset classification.”
**Balance Sheet Classification**

Based on this definition:

- Restricted cash for acquisition / construction of a non-current asset, e.g. a vessel → will be classified under **non-current assets**

- Restricted cash for liquidation of long-term debt → generally will be classified under **non-current assets**

  However, if such restricted cash offsets amounts presented under “Current portion of long-term debt”, then this will be classified under **current assets**, e.g. cash restricted to fund a loan installment coming due six months after year end, where the debt is also classified under “Current Portion of long term debt”.

- Restricted cash pledged as collateral for the funding of current liabilities, such as interest payments will be classified under **current assets**
Cash flow statement
In accordance with Rule 5-02, caption 1 of Regulation S-X, restricted cash should **not be included** within cash and cash equivalents in the statement of cash flows.

**General rule:** Changes in restricted are classified under *investing activities*, because in most cases, the requirement is for a Company to “invest” its cash in a cash account and use it only for a specific purpose.

**However:**
Changes in restricted cash arising from the borrowing and repayment of borrowings are classified under *financing activities*

Changes in restricted cash used in the normal operating cycle, such as advance payments received for services to be provided to a customer are classified under *operating activities*

**Conclusion:** Classification depends on the reason of the restriction
**IFRS versus US GAAP**

<table>
<thead>
<tr>
<th>Impact</th>
<th>US GAAP</th>
<th>IFRS</th>
</tr>
</thead>
</table>
| Balance Sheet classification | Restricted cash classification depends on the use of such cash.  
**Example:**  
Cash restricted for the acquisition of a vessel will always be presented under non-current assets | Restricted cash classification depends on the timing of use of such cash.  
**Example:**  
Cash restricted for the acquisition of a vessel will be presented:  
a) Under current assets, if the vessel is to be acquired within one year  
b) Under non-current assets if the vessel is to be acquired after more than one year |
Any questions?
Accounting for changes in accounting estimates

ASC 250 “Accounting changes and errors”
IAS 8 “Accounting policies, changes in accounting estimates and errors”
Definition

A change that has the effect of **adjusting the carrying amount** of an existing asset or liability or **altering the subsequent accounting** for existing or future assets or liabilities.

Common areas where estimates are made:

- Salvage values of depreciable assets
- Useful lives of depreciable assets
- Impairment assessment for tangible and intangible assets
- Deferred dry docking costs
- Inventory obsolescence
- Uncollectible receivables
- Claims receivable
- Contingencies
When does it take place and manner of application

- A change in accounting estimate is a necessary consequence of the assessment, in conjunction with the periodic presentation of financial statements, of the present status and expected future benefits and obligations associated with assets and liabilities.
- Changes in accounting estimates result from new information.

A change in an accounting estimate is accounted for prospectively.

Depending on the change, this will be accounted for in:

a) The period of change if the change affects that period only or
b) The period of change and future periods if the change affects both.
Application in the shipping industry

Reassessing vessels’ salvage values and vessels’ useful lives

Under IFRS, “The residual value and the useful life of an asset shall be reviewed at least at each financial year-end and, if expectations differ from previous estimates, the change(s) shall be accounted for as a change in an accounting estimate in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors.”

There is no similar explicit requirement under US GAAP. Under US GAAP review of residual values and useful lives is required only when events or changes in circumstances indicate that the estimates or method are no longer appropriate.
Adjusting the salvage value of vessels
**Salvage Value: IFRS versus US GAAP**

| IAS 16 requires that residual value be estimated at the acquisition date based on the **realizable value of similar assets** that have reached the end of their useful lives and that have operated under similar conditions. |
| US GAAP does not specifically state how to estimate the residual value. However, practice is generally consistent with IFRS. |
Example 1

The Company has a panamax vessel with a $20 million carrying value with an expected salvage value of $2 million and a remaining economic life of 4 years. Since the acquisition of the vessel in 2003, there has been an increase in the demolition prices prevailing in the market, as evidenced in the diagram below.

Demolition prices

Source: Clarksons
Example 1

Vessel’s salvage value: Lightweight tonnage (LWT) * estimated scrap rate
In 2003, this was computed as: 10,000LWT * 200 per ton = $ 2 million

Due to the significant increase in scrap rates, management reassessed the scrap rate to 400 per ton. Accordingly, the revised salvage value is $ 4 million.

Annual depreciation expense before the change:

$$ \frac{($20 \text{ million} - $2 \text{ million})}{4} = $4.5 \text{ million} $$

Annual depreciation expense after the change:

$$ \frac{($20 \text{ million} - $4 \text{ million})}{4} = $4 \text{ million} $$
**Example 1 - disclosure**

Up to December 31, 2012, management estimated the salvage value of its vessel at $200 per LWT. Effective January 1, 2013, following management's reassessment of the residual values of the company's vessels, the estimated salvage value per LWT was increased to $400. This change reduced depreciation expense by $0.5 million (approximately $0.10 per share) for the year ended December 31, 2013.
Adjusting the useful life of vessels
**Example 2**

A Company has a panamax vessel with an estimated useful life of 20 years. One year before the end of the useful life of the vessel, the Company enters into a time charter agreement for a period of 4 years.

The vessel has a carrying value of $8 million at the time of entering in the charter party agreement. The vessel has a salvage value of $2 million.

**How should the Company account for the vessel going forward?**

**Analysis**

The Company considered that the entering into the new charter party for the vessel was an event triggering the re-evaluation of the useful life of the vessel.

Management considered the physical condition of the vessel along with the fact that the Company will be in the position to successfully dry-dock the vessel after its 20th anniversary. Further, the Company considered that it will be able to charter-out the vessel after its 23rd anniversary.
**Example 2 – US GAAP & IFRS**

Further, management noted that it is not uncommon in the shipping industry for vessels to be operable to their 25th anniversary. Accordingly, the client extended the useful life of the vessel to 25 years.

**Conclusion:**
Since the Company anticipates that the useful life of the vessel now is 25 years, the depreciation expense will be adjusted prospectively.

And therefore annual depreciation expense will be:

Annual depreciation expense of $1 million (($8 million - $2 million) / 6).
Disclosure requirements
**IFRS versus US GAAP**

<table>
<thead>
<tr>
<th>IFRS</th>
<th>US GAAP</th>
</tr>
</thead>
<tbody>
<tr>
<td>a) An entity shall disclose the <strong>nature and amount</strong> of a change in an accounting estimate that has an effect in the <strong>current period</strong> or is expected to have an effect in <strong>future periods</strong>, except for the disclosure of the effect on future periods when it is impracticable to estimate that effect.</td>
<td>a) The <strong>effect on income</strong> from continuing operations, net income, and any related <strong>per-share amounts</strong> of the <strong>current period</strong> shall be disclosed for a change in estimate that affects several future periods, such as a change in service lives of depreciable assets.</td>
</tr>
<tr>
<td>b) If the amount of the effect in future periods is not disclosed because estimating it is impracticable, an entity shall disclose that fact.</td>
<td>b) If a change in estimate does not have a material effect in the period of change but is reasonably certain to have a material effect in later periods, a description of that change in estimate shall be disclosed whenever the financial statements of the period of change are presented.</td>
</tr>
</tbody>
</table>
Any questions?
Thank you