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A sea of change in new IFRS Standards

Impact on the shipping industry

What could the changes mean to the shipping industry?

The shipping industry commonly operates through various structures and arrangements such as pool arrangements, joint ventures and technical and commercial management agreements. The rights and obligations arising from the structure or arrangement for each entity may vary. For example, two entities may enter into an arrangement whereby one investor contributes capital to a joint venture while the other investor contributes vessels and management in lieu of cash. Or, a ship owner may allocate only one of its vessels into a pool arrangement or may contribute an entire fleet. Additionally, entities may enter into profit sharing arrangements whereby a minimum rate per day is earned and additional profits are allocated between the charterer and the charteree based on a formula.

The International Accounting Standards Board (IASB) recently issued three new standards which affect the way that entities account for and disclose their ownership and involvement in other entities — IFRS 10 *Consolidated Financial Statements,* IFRS 11 *Joint Arrangements*, and IFRS 12 *Disclosure of Interests in Other Entities.*

The new standards will require a reassessment of an entity's existing structures and arrangements and could result in consolidation or deconsolidation or movement from the equity method of accounting to proportionate consolidation, or vice versa. For example, often an entity may contribute its assets to a pool arrangement and act as a manager of the pool at the same time. Under the new consolidation requirements, the entity will need to consider whether it is considered to control the pool and therefore, required to consolidate. This will depend on whether the pool manager is acting as a principal or agent, which requires the parties to assess, amongst other things, the decision-making ability of the pool manager, rights of others, and its exposure to variability in returns. The new standards are applicable for annual reporting periods beginning 1 January 2013. However, this does not provide entities with a two year lead time to prepare for the impact of these standards as all three standards require retrospective application. This would mean that for any joint venture, investments held from as early as 1 January 2011 would be required to be accounted for under the revised standards in the future. Therefore, an early assessment of its implications may allow you to revise existing contracts, partnership and management agreements as well as your investments to avoid undesirable consequences once the standards are effective.

What are the new standards and how are they different?

The three new standards are complementary:

- IFRS10 Consolidated Financial Statements introduces a new consolidation model based on an evaluation of control considering both power over critical activities and risk and rewards from financial involvements;
- IFRS 11 Joint Arrangements distinguishes between joint ventures and joint operations and eliminates the proportionate consolidation approach; and
- IFRS 12 Disclosures of Interests in Other Entities requires new disclosures for various involvements with subsidiaries, joint arrangements and involvements with unconsolidated structure entities.

IFRS 10 Consolidated Financial Statements

IFRS 10 replaces the guidance in IAS 27 *Consolidated and Separate Financial Statements* ("IAS 27") and SIC12 *Consolidation — Special Purpose Entities*. Under IAS 27, consolidation is required based on whether control exists, defined as the power to govern the financial and operating policies of an entity so as to obtain benefits. Although IFRS 10 also requires an entity to consolidate an entity where it controls that entity, control may be obtained in various manners including any other contractual rights, and not solely as a result of the power to direct the financial and operating policies. Under IFRS 10, control is deemed to exist where all of the following elements are met:

- power over the investee;
- exposure, or rights, to variable returns from involvement with the investee; and
- the ability to use power over the investee to affect the amount of the investor's returns.

The first element of control, power over the investee, represents a key area of interpretation that would be most judgemental for the shipping industry. Power over an investee is considered to exist when an investor has existing rights that give it the ability to direct activities that significantly affect the investor's return (the "relevant activities"). Although IFRS 10 does not specifically defined an investor, in performing your analysis on consolidation, an investor would be considered any entity that is involved with another entity (i.e. the investee) and is not solely restricted to parties with an equity investment. Within the shipping industry, the investor could include a pool manager and/or a vessel owner who has contributed a vessel into a pool.

We have included here some potential areas of consideration when determining whether the power over an investee exists.

Critical elements	Key considerations for your business
Determination of existing rights, including consideration of other contractual arrangements	In accordance with IFRS 10, the determination of which party has "power" is required, not only through consideration of your voting rights over the entity, but also other contractual arrangements that you may have including consideration of the terms and conditions of the commercial and technical arrangements. For example, pooling arrangements are usually established through separate legal entities that are set up solely for the purpose of operating the pool. These legal entities usually do not have specified management and staff and operations and management of the pool is often conducted through separate contractual arrangements such as through a pool manager and separate commercial and technical arrangements. If you either own the legal entities or own or otherwise act as pool manager (or vessel owner), you will have to consider your decision-making power over the vessels in the pool under these arrangements (see also Principal vs. agency).
Existence of "special relationships"	IFRS 10 outlines certain indicators of special relationships" with an investee that may result in other parties' rights being attributed to yourself which may be sufficient to give you power over an investee. Some of these special relationships that are common within the shipping industry are: • The investee's key management personnel are current or previous employees of the investor or individuals on secondments from the investors. • The investee's operations are dependent on the investor — you may have specific arrangements that are highly dependent on you or your related parties for operational technical commercial and management expertise. • A significant portion of the activities of the investee either involve or are conducted on behalf of the investor. For example, you may have a significant number of vessels contributed to a single arrangement.
Principal vs. agency	IFRS 10 introduces guidance on assessing whether an entity with decision making rights is a principal or agent. This is most likely to apply to entities who own or otherwise act as pool managers as they will usually have significant decision-making abilities in relation to the pool. The pool manager will need to consider: • the scope of its decision-making authority over the pool — the more restricted the manager's discretion, the more likely the manager will be considered an "agent." • rights held by other entities, including removal or "kick-out" rights — if a single entity has the right to remove the manager, then the manager is an "agent." • the magnitude of and variability in the manager's remuneration relative to the expected returns of the pool — fixed fees would potentially indicate the manager is acting as an "agent" while variable returns may indicate the manager is acting as a "principal." • exposure to variability of returns from other interests — if the manager or its related parties have a significant investment in the pool, then it is possible the manager will be considered a "principal" and hence consolidation is required by the pool manager. This may be the case where the pool manager or its owner is also a major contributor of vessels to the pool and therefore is exposed to the return of the pool, and not just the fees earned as pool manager.
Requirement to consider de facto agents (incl. related parties) in assessment	IFRS 10 provides guidance on when an investor may have a relationship with another party such that the investor may direct the other party in acting on the investor's behalf ("de facto agent") and hence should consolidate the result of that party. De facto agents include related parties as defined in IAS 24 Related Party Disclosures and a party that shares a majority of their board or key management personnel with an investor. As a result of the family-owned structures common within the shipping industry, services are often provided through separate arrangements by related parties who may be part of the same ownership group. In applying IFRS 10, you will need to carefully consider the impact of any related parties or de facto agents and ultimately which parties would need to consolidate the entity.

In addition to determining whether the power over an investee exists, you will need to assess the entity's exposure, or rights, to variable returns from involvement with the investee, and its ability to affect the amount of the investor's returns. Example returns include changes in the value of the investment, residual interests in cash flows dividends, and guarantees.

As described above, the determination of whether "control" exists could result in some key changes to the industry. It is possible that certain entities not previously consolidated will now need to be consolidated and vice versa, resulting in some expected financial reporting and operational changes. Therefore, an early assessment of the potential impact of the standard can ensure that any unexpected outcomes can be avoided.

IFRS 11 Joint Arrangements

IFRS 11 replaces the guidance in IAS 31 *Interests in Joint Ventures* ("IAS 31") and SIC-13 *Jointly Controlled Entities — Non-Monetary Contributions by Venturers*. Under the previous requirements, the treatment of a joint venture is partly dependent on its legal structure that will drive whether it is classified as a jointly controlled operation, jointly controlled entity or jointly controlled asset. IFRS 11 defines joint arrangements and further requires their classification as either joint operations or joint ventures. It establishes a principles-based approach for determining whether a joint arrangement is a joint operation or joint venture based on the rights and obligations of the investors. In a joint operation, the investors ("joint operators") have rights to the assets and obligations for the liabilities of the arrangement. By contrast, in a joint venture, the investors ("joint venturers") have rights to the net assets of the arrangement.

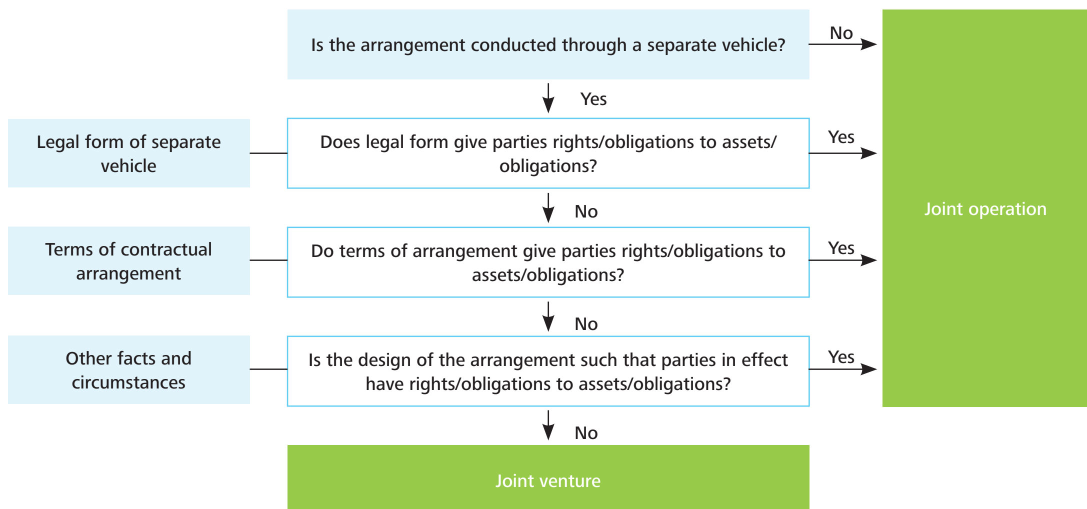
IFRS 11 requires that a joint operator recognise its share of the assets, liabilities, revenues and expenses in accordance with applicable IFRSs while a joint venturer must account for its interest using the equity method of accounting. Proportionate consolidation is no longer allowed, although application of the rules for a joint operation may result in broadly the same effect.

Two key considerations of IFRS 11 adoption for shipping companies are:

(I) Is the arrangement a joint venture or a joint operation?

Joint ventures are no longer classified based on structure alone. Legal form is still a first step in the process — but is not the only — you will have to perform an analysis of the contractual terms and consideration of other facts and circumstances, including an assessment of whether the design of the arrangement is such that the parties in substance have rights and obligations to assets and obligations of the investee.

The steps in determining whether an arrangement is a joint venture or joint operation are outlined below:



Although joint ventures within the shipping industry are often set up through separate legal entities with some rights that appear to provide investors with rights to "net assets", it is no longer appropriate to simply assume that they will be classified as joint ventures and hence, application of the equity method is appropriate. You will have to assess whether there are other clauses within the joint venture agreement or other contracts that provide the investor with rights to individual assets or obligations. For example, in a pool arrangement there may be side agreements that will provide an individual underlying vessel owner with additional rights to direct the usage of a vessel within the pool or for certain vessel owners to have specific additional exposures (e.g. guarantees) to the loan relating to a vessel. In addition, in a pool arrangement where the return to an individual vessel owner varies depending on the performance of their vessel relative to the overall performance of the pool, the pool may be considered a joint operation instead of a joint venture as the vessel owner, through contractual arrangements, has rights to the underlying assets/obligations.

(II) Do you have joint ventures previously accounted for under the proportionate consolidation method?

Joint ventures must now be accounted for under the equity method as the option of proportionate consolidation for jointly controlled entities in IAS 31 *Interests in Joint Ventures* has been eliminated.

In recent years, most shipping entities have gradually moved from applying proportionate consolidation to the equity method of accounting for their joint ventures. Nevertheless, some entities continue to apply proportionate accounting — for these entities, the new requirements can potentially change the "headline" numbers reported by companies such as revenue and gross profit. Further, as most vessel financing arrangements are governed by strict debt covenant ratios including debt to equity ratios, any changes can potentially result in unintentional breaches to such debt covenant ratios.

IFRS 12 *Disclosures of Interests in Other Entities*

In addition to the requirements of IFRS 10 and 11, IFRS 12 enhances the disclosure requirements with the intention to clarify the nature of, and risks associated with, consolidated and non-consolidated entities and their impact on the financial statements. These include subsidiaries, joint arrangements, associates and unconsolidated structured entities. IFRS 12 replaces the disclosure requirements set forth in IAS 27, IAS 28 Investments in Associates and IAS 31. IFRS 12 was issued to provide consistent disclosure requirements for subsidiaries, joint arrangements, associates and unconsolidated structured entities.

In general, entities will need to disclose information about significant judgements and assumptions it has made in determining whether it has control, joint control, or significant influence over another entity and the type of joint arrangement when the arrangement has been structured through a separate vehicle.

For interests in joint arrangements and unconsolidated structured entities, IFRS 12 requires disclosure of the nature and extent of the entity's interests and the nature of, and changes in, the risks associated with those entities. Disclosure is also required of an estimate of the entity's maximum exposure to loss from its interests in unconsolidated structured entities in comparison to its recorded interest. If an entity is obligated, has provided or intends to provide any financial or other support (whether contractually required or not) it should disclose information around those arrangements.

What can you do now to prepare for the changes to come?

Although the new accounting standards are applicable from 1 January 2013, entities are required to retrospectively apply these requirements to its opening balance sheet. This means that these requirements may impact you from 1 January 2011. In assessing the level of preparation required to implement these requirements, some key considerations are:

Readiness checklist
Do you have access to information relating to investments that the company did not consolidate previously?
Can you obtain information required for a complete picture of all rights and obligations relating to an investee
(including other contractual arrangements) through a simple and efficient process?
Does the entity have a sufficient understanding of other terms within their key joint venture agreements or have
they relied in the past in assessing joint venture accounting based on the legal structure of the entity?
Does the entity understand the potential impact of these standards on any future acquisitions and investment decisions?
With the removal of proportionate consolidation, do you know how changes to measures such as revenue, gross profit and operating profit will impact other parts of the entities (e.g. loan covenant ratios, KPIs and employee remuneration measures)?
Are the right processes in place to ensure that assessments around consolidation vs. deconsolidation are done consistently throughout the business?
Is there sufficient understanding within the company of the new requirements or is additional training required?

Why Deloitte?

Deloitte can assist you in your assessment of the impact of these standards and its implementation. The services we can provide will be tailored based on your specific needs, including:

- advising on the treatment of a material and/or complex investment;
- provision of training (webcasts, face to face training);
- longer term project implementation including project management, technical advice; and
- any related process and system changes.

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Designed and produced by The Creative Studio at Deloitte, London. 14071A

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