In the Spotlight

A Shipping Industry Focus on COVID-19 Accounting Considerations under IFRS

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COVID-19: Top Accounting Issues for Shipping Entities

At a glance

The coronavirus (COVID-19) pandemic has developed rapidly in 2020, with a significant global impact. Measures taken to contain the virus have affected economic activity, which in turn has implications for financial reporting.

Measures to prevent transmission of the virus include limiting the movement of people, restricting flights and other travel, temporarily closing businesses and schools, and cancelling events. This will have an immediate impact on industries such as tourism, transport, retail and entertainment. It will also begin to affect supply chains and the production of goods throughout the world, and lower economic activity is likely to result in reduced demand for many goods and services.

COVID-19 will impact many areas of accounting and reporting for all industries, as outlined in our publication: Accounting implications of the effects of coronavirus – In Depth.

As the situation continues to evolve, it has become clear that COVID-19 has introduced uncertainty in several areas of the shipping business and has disrupted operations. Demand for commodities and raw materials has declined significantly, as well as trade of consumer goods, with both the manufacturing sector and retailers being closed for business in many countries. This has had a direct impact on the dry bulk and containership segments of shipping. In addition, at the time of publication, oil prices are nearing historic lows. For shipping businesses across all sectors, this has driven down the cost of fuel, In addition, this has positively affected tanker owners due to the increased demand since a significant part of the fleet is being employed as floating storage.

In this Spotlight we provide our insights into the top accounting and reporting issues that shipping entities might face. While this Spotlight focuses on issues that are likely to be the most frequently encountered, many others are certain to arise. As the situation continues to evolve, so too will the consequential accounting issues. For these reasons, the following is not an exhaustive list of all relevant accounting considerations.

The top issues that we expect to see impacting shipping entities are:

1. Going concern considerations

Management should consider the potential implications of COVID-19 and the measures taken to mitigate such risks when assessing the entity's ability to continue as a going concern. If the effect of COVID-19 is ongoing, shipping entities might be unable to re-charter their ships at reasonable rates or for a reasonable duration. Additional considerations might include:

- the ability of existing charterers to settle current obligations or to utilise the vessels over the remaining charter period;
- fair value of the vessels;
- fuel price trends;
- the impact of lower Heavy Fuel Oil ("HFO") and Low Sulphur Fuel Oil ("LSFO") margin on projected inflows for scrubber-fitted vessels;
- debt covenants (as discussed below);
- potential delays for scheduled dry docking and special surveys, or for the installation of scrubbers and/or ballast water treatment systems and/or availability of personnel for repairs;
- potential delays in delivery of vessels under construction; and
- the impact to operating costs, such as crew costs and spare parts.

Liquidity and concentration risk

The current market conditions might increase liquidity and concentration risk. Shipping entities should evaluate their ability to obtain additional financing (either debt or capital) or to refinance existing loans on acceptable terms, and the impact on the going concern assumption. Shipping entities should also consider the impact of the concentration in specific segments of the market (for example, by type and size of vessel) or concentration with the deployment of a vessel with a specific charterer.

Post balance sheet events

For the purposes of the going concern assessment, all post balance sheet events are taken into consideration; management is required to assess, at the time of preparing the financial statements, the entity's ability to continue as a going concern, and this assessment should cover the entity's prospects for at least 12 months from the end of the reporting period.

The 12-month period for considering the entity's future is a minimum requirement; an entity cannot, for example, prepare its financial statements on a going concern basis if it intends to cease operations 18 months from the end of the reporting period.

Disclosures

Material uncertainties that might cast significant doubt on an entity's ability to continue as a going concern, and significant judgements related to the going concern assessment, should be disclosed in accordance with IAS 1.

Liquidity and credit risk disclosures might also need to be expanded on issues such as the availability of undrawn credit facilities, working capital requirements, minimum cash balances required by credit facilities, and insurance policies for business interruption.

2. Borrowings and covenants

A global downturn in the shipping industry might impact financial covenants, and the classification of loans and other financing liabilities between non-current and current. Management should review financial covenants and ‘cross default clauses’, such as:

- loan to value or net worth – due to the volatility in the fair value of vessels and the potential for COVID-19 to have a negative impact, this type of covenant might be significantly impacted;
- EBITDA – due to a possible significant decrease in revenues; and
- vessel lay-up clauses – management should consider if there is a covenant related to the prohibition on laying up a vessel.

Management should also seek to understand any material adverse change clauses and whether the current COVID-19 events could trigger such clauses.

Entities should seek waivers for covenant violations before the end of the reporting period, because waivers obtained after the reporting date are treated as non-adjusting events. Management should also consider potential challenges in obtaining valuations for vessels to support the ‘loan to value’ or ‘loan to net worth’ ratios.

Where the contractual terms of the borrowings are amended, management should determine whether this change results in derecognition or modification of the loan.

3. Vessels, goodwill and other intangibles

Impairment considerations

IAS 36 requires goodwill and indefinite-lived intangible assets to be tested for impairment at a minimum every year, and other non-financial assets whenever there is an indicator that those assets might be impaired.

Shipping entities should determine whether impairment indicators exist for vessels, goodwill and other non-financial assets. Management should consider whether the general economic downturn, a decline in certain charter rates and vessel market values, and the volatility in oil and other commodities prices trigger the need to perform an impairment review.

When measuring value in use, management should update cash flow projections in accordance with the most recent budgets that reflect the conditions that existed at the balance sheet date. Revised assumptions should be consistent with market evidence in relation to future charter rates and fuel prices (including changes in charter rate premiums for scrubber-fitted vessels), the possible increase in off-hire days and any impact in other operating expenses.

Our In depth publication describes a number of considerations for assessing impairment in the current environment. In particular, an expected cash flow approach (multiple probability-weighted scenarios) might be a better way to capture the increased risk and uncertainty when estimating a recoverable amount, as opposed to a single predicted outcome. It is expected that, depending on the circumstances, either the cash flows or the discount rate should reflect the increased risk caused by the COVID-19 uncertainty. Further information is available in Accounting implications of the effects of coronavirus – In Depth.

Vessel lay-up and suspension of vessel construction

With governments and ports imposing various travel restrictions, and due to falling demand, owners might be required (or decide) to lay up vessels. IAS 16, 'Property, plant and equipment', requires depreciation to continue to be charged in the income statement while an asset is temporarily idle if the entity uses a straight-line depreciation method.

In addition, the current situation might result in the construction of vessels being suspended. If vessels are under construction, paragraph 20 of IAS 23, 'Borrowing costs', requires the capitalisation of interest to be suspended during extended periods when active development is suspended.

Directly attributable costs incurred cannot be capitalised while the vessel is standing idle (for example, a vessel that can operate but is not brought into use immediately). IAS 16 only permits directly attributable costs to be capitalised until the point at which the asset is 'capable of operating in the manner intended by management'.

4. Expected credit losses

Expected credit losses (ECL) are likely to be higher in the current environment. Shipping entities should consider the impact on all of their financial assets subject to the IFRS 9 impairment requirements.

Many shipping entities use the simplified model for trade receivables (including receivables from lessees) and they measure ECL for lifetime expected losses. Macroeconomic factors could impact the measurement and result in higher ECL due to the credit deterioration of charterers.

For financial assets not subject to the simplified model (such as intercompany loans), shipping entities should again consider macroeconomic factors in assessing increases in credit risk and the estimate of ECL by adjusting probability of default, exposure at default and the losses given default (since the values of vessels given as collateral might have fallen or might take longer to realise).

For further guidance, see our publications Accounting implications of the effects of coronavirus – In Depth and In the Spotlight – How corporate entities can apply the requirements of IFRS 9 expected credit losses (ECL) during the COVID-19 pandemic.

5. Modification of contracts accounted for as leases

Due to current market conditions, charterers might seek to renegotiate their time charter and bareboat agreements that are typically within the scope of IFRS 16. Such renegotiations might result in one or a combination of the following: reduction in charter rate; change in lease term; and/or deferral of payments. The accounting treatment of any changes in rates or the possible deferral of payments could be complex and requires judgement.

Shipping entities should determine the accounting treatment of any such changes in the contracts, as either a modification, or negative variable lease payments, or a combination of the two.

For example, changes in payments required under the contract's initial terms (or required by laws or regulation) might result in negative variable lease payment treatment. In making this assessment, careful evaluation of the terms of the relevant agreements and of the applicable laws is required. Adequate disclosure of any significant judgements should be made.

Lease amendments might impact lease income recognition for concessions granted to customers. However, shipping entities might also enter into 'charter-in, charter-out' agreements, and so they might also be impacted as lessees.

On 24 April 2020, the IASB issued proposed amendments to IFRS 16 that would provide lessees (but not lessors) with a practical expedient to elect not to treat certain rent concessions that are a direct consequence of the COVID-19 pandemic as a lease modification. Entities should monitor progress on this project, which is expected to be completed in the near term.

For further guidance on the treatment of rent concessions, see our publication [Accounting implications of the effects of coronavirus – In Depth].

6. Demurrage revenue

Recognition of revenue in relation to demurrage is an area that usually involves significant estimates. IFRS 15 requires variable consideration to be included in the transaction price only when it is highly probable that it will be due and that it will not subsequently result in a significant reversal.

Many countries have imposed lockdown and restriction of movement, causing disruption in the supply chain. Even where ports remain open, they usually operate with reduced workforce. The situation creates significant delays and congestion of cargo, and shipping entities will likely be required to use estimates to a greater extent in order to determine demurrage revenue. In making these estimates, management should consider all facts and circumstances and carefully evaluate the relevant terms in the agreements, including force majeure clauses.

Shipping entities are expected to provide adequate disclosures in their financial statements in relation to such significant estimates.

7. Force majeure clauses

Entities in the shipping industry often have contracts which contain force majeure clauses, which can relieve parties of all or certain obligations in a contract in the case of serious unforeseen circumstances beyond the control of the parties to the contract.

Entities should seek to understand the scope of such clauses in their contracts, and how these might apply in the relevant legal jurisdiction. Such clauses could, for example, impact charter hire agreements or agreements for the construction of vessels.

In some cases, significant judgement and legal advice might be required to interpret such clauses. Where such clauses are triggered, the impact on revenue/lease income recognition, expenses and provisions due to possible legal disputes with charterers, yards or ports will need to be considered. Entities will need to carefully consider what disclosures about estimates and judgements are required in such circumstances.

8. Interim reporting

Many entities might first report the impact of COVID-19 in interim financial statements. The recognition and measurement guidance described above applies equally to interim financial statements.

Shipping entities that issue interim reports in 2020 will need to explain events and transactions since the end of the last annual reporting period that are significant to understanding changes in financial position and performance. Additional disclosures on significant judgements and updated estimates might be required, and such disclosures should be entity-specific and should reflect each entity's circumstances.

Entities should also consider how the situation has evolved after the end of an interim period. If material post balance sheet events provide additional information in relation to the COVID-19 situation, further examination will be required to understand the extent to which the measurement of assets and liabilities will be impacted. In making this assessment, entities should consider IAS 10 requirements and the applicable measurement standards for each item affected.

For more information on post balance sheet events, see our publication [Accounting implications of the effects of coronavirus – In Depth].

Conclusion

COVID-19 has given rise to challenges that have affected virtually every aspect of modern life. The economic implications of the virus will have a consequent impact on many aspects of accounting and financial reporting. We hope that this Spotlight will help you and your advisors as you navigate the key issues.

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