A large container ship is docked at a pier. The ship's hull is black with a red stripe along the waterline. The deck is stacked with numerous colorful shipping containers in shades of blue, red, and white. Several people are walking along the pier in the foreground, looking towards the ship. The sky is clear and blue. The overall scene is brightly lit, suggesting a sunny day.

# A new wave of change - Implications of FRS 110, FRS 111 and FRS 112 to Shipping Entities

April 2013



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## Introduction

The introduction of the new consolidation model affects the shipping industry largely because it is common in the shipping industry to operate through pool arrangements, special purpose entities and joint ventures.

The question of control is one of the most difficult questions to answer in accounting, leading to the diversity in practice related to consolidation.

Either member-controlled or administration-controlled pools are pool arrangements. For example, a member-controlled pool may be formed by one or two main partners to jointly undertake large contracts of affreightment. The strategy of an administration-controlled pool may be one of building up a fleet comprising many different shipowners to enjoy economies of scale, to become visible to charterers and through its diversification and risk-spreading, enable it to give its members an adequate return on their investment.

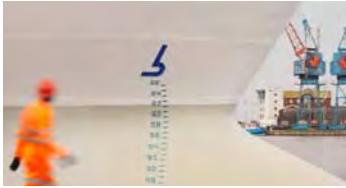
Sometimes, Special Purpose Entities (SPEs) have been used by shipping entities as a means of securitisation, financing, risk-sharing, asset transfers, financial engineering or raising capital for vessel owners. The underlying assets (e.g. vessels) are purchased by SPEs to meet credit risk preferences of a wide range of investors. SPEs may take the form of a corporation, trust, partnership or unincorporated entity. Many SPEs are set up as "orphan companies" with their shares settled in a charitable trust and with professional directors provided by an administration company.

The following new standards, which are recently issued, may affect the way entities account for their ownership interests and their involvement in other entities:

- a) FRS 110 *Consolidated Financial Statements*
- b) FRS 111 *Joint Arrangements*
- c) FRS 112 *Disclosure of Interests in Other Entities*

The new standards require an investor to reassess its existing structure and arrangements, which could result in consolidation or deconsolidation of its investee. It could also result in changes in accounting for joint arrangements from "proportionate consolidation" to the "equity method" of accounting, or vice versa.

For example, if an investor contributes its vessels to a pool arrangement and acts as a pool manager at the same time, it needs to assess whether it controls the pool and therefore, is required to consolidate. This depends on whether the pool manager is acting as a principal or agent. This requires the investor to determine the decision-making ability of the pool manager, rights of others, and its exposure to variability of returns.



## A. FRS 110 Consolidated Financial Statements (FRS 110)

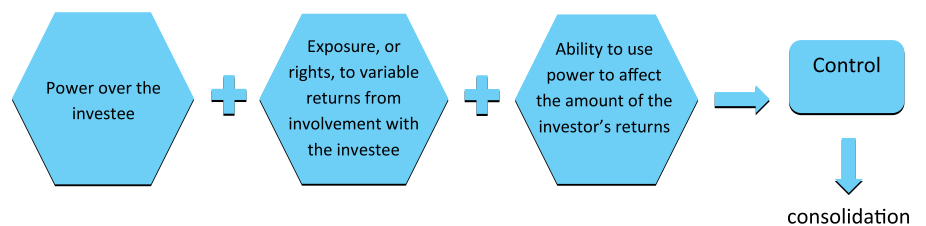
FRS 110 *Consolidated Financial Statements* replaces FRS 27 *Consolidated and Separate Financial Statements (FRS 27)* and INT FRS 12 *Consolidated – Special Purpose Entities (INT FRS 12)*.

Under FRS 27, control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

The principle of control under FRS 110 is not the same as the definition of control under FRS 27 and INT FRS 12.

Although FRS 110 also establishes control as the basis of consolidation, control may be obtained in various manners as discussed in the paragraphs below.

Under FRS 110, an investor has control over an entity, if **all** of the following three elements are met:



The single control model under FRS 110 can be summarised as follows:

- (1) Identify the investee
- (2) Identify the relevant activities of the investee
- (3) Identify how decisions about the relevant activities are made
- (4) Assess whether the investor has power over the relevant activities
- (5) Assess whether the investor is exposed to variables in returns
- (6) Assess whether there is a link between power and returns

We believe that the determining power over an investee is the most judgemental for the shipping industry.

Power arises from rights. To have power over an investee, an investor must have existing rights that give it the current ability to direct activities that significantly affect an investor's returns (i.e. the relevant activities). Examples of returns include dividends, changes in the value of the investor's investment in the investee, remuneration, fees, returns that are not available to other interest holders such as economies of scale and cost savings. (See Examples 1, 2 and 3 in C Application Examples of this article)

## A. FRS 110 Consolidated Financial Statements (FRS 110) (cont'd)

The following are some key considerations in determining whether power over an investee exists:

### I. Power with a majority of the voting rights (which must be substantive)

For a right to be substantive, the holder must have the practical ability to exercise that right. Factors to consider in determining whether rights are substantive:

- a) Are there any barriers (economic or otherwise) that prevent the holder from exercising the rights?
- b) Do several parties need to agree for the rights to become exercisable?
- c) Would the holder benefit from the exercise of the rights?

### II. Power without a majority of voting rights

An investor can have power with less than a majority of the voting rights in an investee through:

- a) Contractual arrangements with other vote holders;
- b) Other contractual arrangements;
- c) Investor's voting rights relative to size and dispersion of holdings of other vote holders;
- d) Potential voting rights; or
- e) A combination of a) – d)

Potential voting rights are rights to obtain voting rights of an investee such as those arising from convertible instruments or options, including forward contracts. The potential voting rights must be substantive, when assessing control over an investee. (See Examples 5 and 6 in C Application Examples of this article)

## A. FRS 110 Consolidated Financial Statements (FRS 110) (cont'd)

### III. Principal or Agent

An investor with decision-making rights (a decision-maker) shall determine whether it is a principal or an agent. An investor that is an agent does not control an investee when it exercises decision-making rights delegated to it; therefore, no consolidation is required. (See Examples 2 and 3 in C Application Examples of this article)

FRS 110 provides guidance in assessing whether the decision-maker is an agent, considering all of the following factors:

a)	Scope of decision-making authority	The more restricted the decision-maker's discretion, the more likely the decision-maker is considered an agent.
b)	Substantive rights held by other parties	If a single party holds substantive rights to remove the decision-maker and can remove the decision-maker without cause, then the decision-maker is an agent.
c)	Remuneration	Variable returns may indicate that the decision-maker is a principal. Fixed remuneration may indicate that the decision-maker is an agent.
d)	Exposure to variability of returns from other interests that it holds in the investee	Holding other interests (e.g. investments in an investee or providing a guarantee with respect to the performance of the investee) in the investee may indicate that the decision-maker is a principal.

### IV. De Facto Agents

FRS 110 requires an investor to consider whether there are other parties who are acting on its behalf (i.e. de facto agents) by virtue of its relationship with the other parties and hence consolidation is required. An entity should consider its de facto agent's decision-making rights and its indirect exposure, or rights, to variable returns through the de facto agent together with its own when assessing control of an investee.

Decision-making rights delegated to the de facto agents are considered as held by the investor directly.

## A. FRS 110 Consolidated Financial Statements (FRS 110) (cont'd)

Examples of entities that might act as de facto agents for the investor:

- a) Investor's related parties.
- b) Party that received its interest in the investee as a contribution or loan from the investor.
- c) Party that has agreed not to sell, transfer or encumber its interest in the investee without the investor's prior approval.
- d) Party that cannot finance its operations without subordinated support from the investor.
- e) Party whose governing body or key management personnel are the same as those of the investor.
- f) Party that has close business relationship with the investor.

### V. Special Relationships

FRS 110 includes certain indications of a special relationship with an investee, which suggests that the investor has more than a passive interest in the investee which may be sufficient to indicate having power over an investee. These indications are:

- a) Investee's key management personnel are current or previous employees of the investor.
- b) Investee's operations depend on the investor.
- c) A significant portion of the investee's activities either involve or are conducted on behalf of the investor.
- d) Investor's exposure to returns from its involvement with the investee is disproportionately greater than its voting rights or other similar rights.



## B. FRS 111 Joint Arrangements (FRS 111)

FRS 111 supersedes FRS 31 *Interests in Joint Ventures (FRS 31)* and INT FRS 13 *Jointly Controlled Entities – Non-Monetary Contributions by Venturers (INT FRS 13)*.

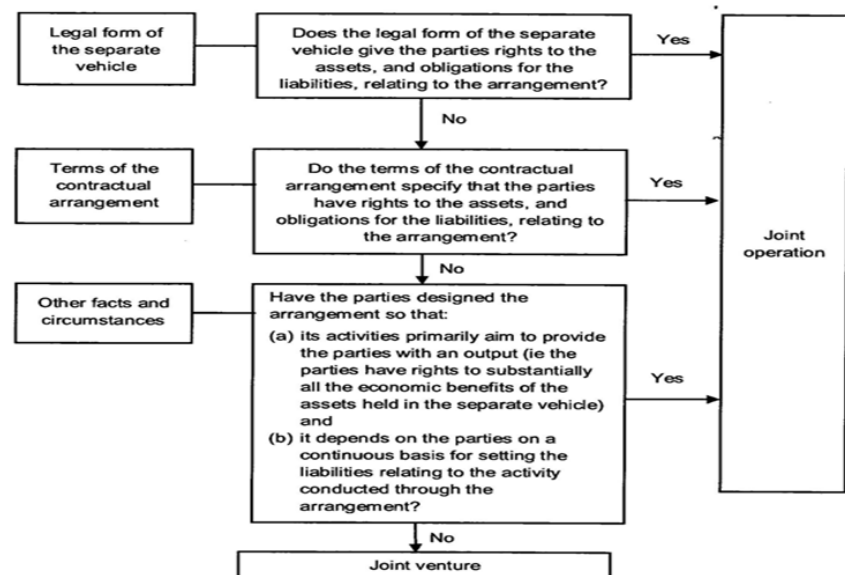
Under FRS 111, the structure of joint arrangements is not the only determinant of classification. It also eliminates the use of proportionate consolidation as a policy choice of accounting treatment.

Under FRS 111, a joint arrangement is an arrangement over which two or more parties have joint control. Joint control is contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control. In a joint arrangement, no single party controls its arrangement on its own and two or more parties must agree to share control.

FRS 111 requires that the classification of a joint venture should be based on the type of arrangement, i.e. the rights and obligations of the parties arising from the arrangement in the normal course of business (see Figure 1).

A joint arrangement that is not structured through a separate vehicle is a joint operation. A joint arrangement in which the right to the assets and obligations for the liabilities of the arrangement or rights to the net assets in the arrangement are held in a separate vehicle is a joint operation or a joint venture respectively. (See Example 4 in C Application Examples of this article)

Figure 1: Classification of a joint arrangement structured through a separate vehicle



### Accounting Treatment

When a joint arrangement is classified as a joint operation, the investor recognises its assets, liabilities, revenue and expenses and/or its relative shares thereof in its own financial statements.

When a joint arrangement is classified as a joint venture, the investor accounts for its investment using the equity method of accounting. The free choice between using the equity method or proportionate consolidation (under the previous accounting standard – FRS 31) has been eliminated.





## C. Application Examples

### Example 1

"A" and "B" formed a bulk shipping Pool to undertake marketing, contracting, operations, scheduling, bunkering, cargo handling, accounting, cash management, insurance and agencies (the relevant activities). "A", a dominant member of the Pool, contributed the largest tonnage and is the one who initiates the Pool.

"A" currently has the ability to direct, unilaterally, the relevant activities that significantly affect the Pool's returns. Under FRS 110, "A" is required to consolidate the Pool in its own financial statements.

### Example 2

Using the facts in example 1, if the Pool appoints a Pool management company to undertake the relevant activities to significantly affect the Pool's returns and "A" holds substantive rights to remove the Pool manager, without cause, then its Pool manager is considered an agent of "A".

Therefore, "A" is required to consolidate the Pool.

### Example 3

"A" (a sponsoring shipowner) sets up and manages a Special Purpose Entity (SPE). "A" transferred certain vessels to the SPE for the purpose of securitisation of loans obtained from its bankers. The risk of ownership over the vessel and future cash flows arising from the operations of the vessel has also been transferred to the SPE.

Assume that:

- "A" has a 30% equity interest in the SPE.
- SPE issued shares to other investors (including 25% to a professional trustee), representing a 70% equity interest in SPE.
- A board of directors of the SPE has been appointed by the investors (other than "A"). The board of directors has the power to appoint / remove a professional trustee of the SPE.
- The professional trustee of the SPE was appointed for the benefit of all investors. The professional trustee has been granted wide decision-making discretion in directing the relevant activities to affect the SPE's returns.
- The remuneration of the professional trustee is based on market-based fees (1% of assets under management and 20% of SPE's profit) which commensurate with the professional fees provided to the SPE.

"A's" 30% equity interest in the SPE will not give "A" the power to affect the returns of the SPE as the board of directors of the SPE has been appointed by other investors and not "A".

Therefore, "A" does not control SPE, hence, "A" does not consolidate the SPE.

## C. Application Examples (Cont'd)

### Example 3 (Cont'd)

Although the professional trustee is a decision-maker that gives it the current ability to direct the relevant activities of the SPE, and is exposed to variability in SPE's returns, it is likely that the professional trustee is an agent as the board of directors has the substantive right to appoint / remove the professional trustee.

Therefore, the professional trustee is an agent and does not consolidate the SPE.

### Example 4

Using the facts in example 1, if "A" and "B" jointly make decisions about the relevant activities that significantly affect the Pool's returns, this Pool arrangement is considered a joint arrangement.

If both "A" and "B" have the respective rights to the assets and obligations for the liabilities of the Pool, it is considered a joint operation, therefore, "A" and "B" would recognise their own assets, liabilities, revenue and expenses in their respective financial statements.

If, however, "A" and "B" do not have interests (i.e. no rights, title and ownership) in the assets and no obligations for liabilities of the Pool, but only have rights to the net assets of the Pool, the Pool is considered a joint venture. In this instance, "A" and "B" would account for their respective interests in the Pool using the equity method of accounting.

### Example 5

"A" owns 40% of the voting rights of an investee. The remaining voting rights are held by 2,000 shareholders, none individually holding more than 1% of the voting rights. Based on the absolute size of its holding and the relative size of the other shareholdings, "A" concludes that it has a sufficiently dominant voting interest to meet the power criterion without the need to consider any other evidence of power.

Therefore, "A" is required to consolidate the investee.

### Example 6

"A" and 2 investors ("B" and "C") each holds a third of the voting rights of an investee. In addition to its equity instruments, "A" also holds debt instruments that are convertible into ordinary shares of the investee at any time for a fixed price that is out of the money (but not deeply out of the money). If the debt were converted, "A" would hold 60 percent of the voting rights of the investee. "A" has power over the investee because it holds voting rights of the investee together with substantive potential voting rights that gives it the current ability to direct the relevant activities.

Hence, "A" is required to consolidate the investee.



## D. FRS 112 *Disclosure of Interests in Other Entities (FRS 112)*

As a result of adoption of FRS 110 and FRS 112, an entity must comply with FRS 112 on the disclosure requirements for subsidiaries and all forms of interests in other entities, including joint arrangements, associates, special purpose entities, and other off balance sheet vehicles.

FRS 112 has increased the disclosure for subsidiaries, associates, joint ventures and unconsolidated entities, especially the expanded disclosure rules governing unconsolidated special purpose entities to demonstrate that an investor cannot get away easily despite successfully avoiding the consolidation of the special purpose entities.

Some key disclosures that an entity is required to disclose:

- 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.
- To provide summarised financial information about the assets, liabilities, profit or loss and cash flows of each subsidiary that has non-controlling interests that are material to the reporting entity.
- To disclose the nature and extent of its interests in a joint venture and the nature of the risks it is exposed to as a result.
- To disclose the nature and extent of its interests in unconsolidated structured entities (e.g. SPEs) and the nature of the risks it is exposed to as a result. Some specific disclosures are a summary of carrying amounts of the assets and liabilities recognised in its financial statements, and the amount that best represents the entity's maximum exposure to loss from its interests in unconsolidated structured entities.



## E. Getting Ready for the Changes

Entities are reminded that the effective dates of FRS 110, FRS 111 and FRS 112 are from annual accounting periods beginning 1 January 2014 (the effective dates of IFRS 10, IFRS 11 and IFRS 12 are 1 January 2013). These Standards are complementary and must be applied at the same time, together with revised FRS 27 *Separate Financial Statements* and revised FRS 28 *Investments in Associates and Joint Ventures* where relevant to an entity.

Retrospective application is required to the opening balance sheet which means that entities may be impacted from 1 January 2012 (1 January 2011 for IFRS).

An entity should perform the following to prepare for the changes:

1. Reassess terms and conditions of the contractual arrangement especially for those entities not previously consolidated or previously consolidated.
2. Review the clauses in the joint venture agreements to determine the correct classification, i.e. as to whether it is joint operations or joint venture.
3. Review whether there is any joint venture previously accounted for under the proportionate consolidation method which would be accounted for under the equity method in accordance with FRS 111 and its impact to the financial statements.
4. Review the current financial reporting system, such as modifying and enhancing the accounting system where necessary to address the changes in FRSs and to provide the necessary information for the new enhanced disclosure requirements of FRS 112.

Upon adoption of these new standards, a continuous assessment is still needed to revisit the accounting treatment of investment in subsidiaries, joint ventures and SPEs with regard to the key considerations highlighted above.



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