

Your gateway to industry information

An insight into the current environment

Although it has become patently clear over recent months that no industry is going to be spared from troubled times as a result of the current financial turmoil, the transportation and logistics industry and related sectors seems likely to be hit harder and earlier than most.

Owing to the inter-dependency within the logistics supply-chain, this will have consequences across this sector. The falling freight rates coupled with the US, Europe and Japanese recessionary economies has led to a reduction in the tonnage throughout the sector. Naturally, this will impact revenues and margins from integrated logistics providers to ports and airport cargo terminals as well as the shipping industry, both owners and agents alike.

The Baltic Exchange's dry sea freight index continued to fall in recent months, reaching almost ten-year lows in mid November, approaching rates not seen since 1998 and air cargo traffic in Asia has also seen shrinkage in recent months with a year-on-year fall in cargo tonnage of more than 9% in Hong Kong for October 2008.

In the past few weeks there has been evidence that expansion plans and related capital expenditure is being scrutinised; the new HK\$4.8 billion Hong Kong air cargo terminal to be operated by Cathay Pacific may be delayed. Construction had started in a few months ago and it was scheduled for completion in the latter half of 2011.

In light of the weaker demand from the major economies the sector will come up against a tougher environment than it has seen in recent years. This flyer raises the question of liquidity and other operational factors pertinent to the industry at this time as well as looking a few key accounting considerations for the coming months.

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there are challenging times ahead...

A question of liquidity

With loans from the credit-risk-averse banking sector being expensive, the forecasting of future spending, especially with respect to significant infrastructure and superstructure builds should remain a top priority.

To that extent, communications with lenders should occur well in advance of funding being required and evidence of clear plans for future cashflows to give the creditors the assurance of repayment capabilities.

With the current freight rate slump and the pressures of a slowed global economy, conservative and realistic forecasting should be undertaken, including hands on cash management such as:

- Re-examining your treasury, financing and funding exposures.
- Regularly monitor performance against financial and non-financial covenants
- Protecting your liquidity through securing sufficient funding and lines of credit

In such times the old adage of "cash is king" holds true but naturally this also extends to access to cash.

Operational efficiency

The onset of this global credit crisis will lead to a greater focus by all industries on operational efficiency:

- The small increments of operational efficiency made in each process can give value to customers and assist in retaining a market share.
- In non-customer-focussed processes efficiency can help manage underlying cost base.
- Targeted changes and reductions in complexities are generally preferable to across the board cuts. Furthermore, it is important to take tough decisions early in focussing on the key drivers of value and the key risks across the business.

Your people must remain on the agenda

The drivers of the business and those people who are key to it are important in maintaining the value to customers.

- Regular communication with employees is key to ensuring their engagement in any change agenda.
- Identifying key talent and ensuring appropriate incentives are in place to retain and motivate staff is key to continuing to deliver value and service.

Key accounting considerations

The counterparty default risk

The current liquidity squeeze may be loosening for inter bank lending but there remains a long way to go for corporate lending activity to normalise which may have greater impacts on shipbuilders and business with similar large infrastructure or build projects. As such, the challenge in mitigating the risk of credit default lies in maintaining business operations whilst reducing risks to an acceptable level.

However, whichever approach is taken the quality of information available to enable effective decision-making remains paramount.

Accounting for idle assets and impairment

Naturally with every business issue, there is likely to be an accounting implication. With an expected over-supply of vessels, consideration should be given to the recoverability of such assets. HKAS 36 "Impairment of assets" defines the recoverable amount as being the higher of the fair value of an asset less cost to sell and the value in use. However, this opens two accounting challenges:

- Finding a fair value for assets that reflects the market that has become more illiquid over recent months.
- Accurately forecasting of cashflows including assumptions such as utilisation, tonnage, appropriate discount rates and the initial identification of the cash generating unit.

The use of hedging instruments

In environments of high uncertainty and volatility:

- The ability to predict or manage costs through the use of derivative instruments (eg. freight forward agreements, bunker forwards) can enable businesses to have a better handle on cashflows and therefore financing requirements.
- The current volatility may result in hedge ineffectiveness and if the criteria for hedge accounting are no longer met, then hedge accounting should cease.
- The designation of the hedged risk from an accounting perspective needs to be carefully assessed on initial recognition.

Summary

All companies go through business cycles that feature both ups and downs. The key to managing business downturns is catching the problems affecting the business early. Whether or not the downturn or "special situation" can be arrested and reversed successfully depends upon many factors, including the calibre of the professional advisors retained by the stakeholders involved.

Our Business Recovery Services team members have amassed significant experience over recent years and are known for their industry knowledge and commercially driven solutions. We have experience across all aspects of distressed and special situations.

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