Accounting and Auditing of Financial Derivatives: The Case of Maridive & Oil Services (MOS)

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Executive Summary

This case studies accounting and auditing implications resulting from the dispute among auditors and the management of Maridive Oil Services Company (MOS) in the preparation of the company's financial statements at December 31, 2008. The dispute occurred between the company's management and the auditors for the accounting treatment of losses of $ 18 million dollars expected to be realized on the Swap agreement made between MOS and a number of International Banks during the period 2009-2018. MOS is a publicly traded company at both Cairo and Alexandria Stock exchanges with total assets of more than $390 million dollars. The company entered into Swap Agreement with two International Banks to minimize the risk associated with credit facilities received by the company to expand its marine services through the construction of a number of marine vessels. The dispute among the three International audit firms resulted in the issuance of two different sets of audit reports.

The Egyptian Capital Market Authority (CMA) examined the company's financial statements for the year ended December 31, 2008 and the auditors' reports and forced the company's management, despite the objection of two of the company's auditors, to restate its financial statements at December 31, 2008 and modify its profit appropriation statement after their publication to shareholders and the public. The present research analyses the problems associated with the application of the International Financial Reporting Standards no 32 and 38 "Financial assets and Derivatives" and their Egyptian equivalents and the Egyptian Standards on Auditing no 700 and 702. Further, the research identifies differences associated with auditors issuing contradictory audit reports for a company's single set of financial statements. Finally, the research highlights the nature of errors of judgments embedded in the audit function and corporate management responsibility to mitigate the risk of expected future losses resulting from the interest rate swap agreements "derivatives".

Keywords: auditing standards, accounting standards, swap agreement, Maridive Oil Services (MOS), corporate financial reporting, Companies Act, re-statement of financial statements, financial derivatives.

Introduction

In general, this case is composed of three main sections. The first section provides a detailed background about Maridive & Oil Services Company showing the development of the company from a medium size marine services company into an international company providing a variety of marine and oil support activities including maintenance, installations, rescue aid, erections, towage whether above, outside, and/ or under water as well as land establishments. This section also highlights the management structure and competitive strengths used to achieve the growth seen by MOS since 1978 and the company's future strategy required to maintain its competitive edge in the market for marine and oil services. The second section summarizes the financial information of the company for the period 2006-2008 showing its financial position, results of operations and elements of corporate governance applied to enhance MOS's management performance. The third section presents the nature of financial derivatives mainly the characteristics of the Swap agreements made between MOS and the two international banks and the dispute occurring between the Egyptian Capital Market Authority, management of MOS and its auditors. MOS management charged the effects of ineffective Swap analysis into the company's special reserve for 18.6 million based on the companies Act 159 for 1981 and the company's articles of incorporations. Also, the company capitalized 1.6 million representing the cost of obtaining a loan without consideration of the requirements of the Egyptian Accounting Standards. Details about the accounting and auditing treatments of the Swap losses and capitalization of the costs of obtaining the loan are presented. The question of whether the requirements of laws have a priority over the application of both the accounting and auditing standards is discussed showing the need for future research to investigate such issue in other accounting and auditing cases.

An Overview of the Development of Maridive & Oil Services

Maridive History and Main Activities

Maridive Oil Services (MOS) was founded in 1978 as a free zone joint stock company, and now has its official headquarters in Port Said, Egypt, with offices in Cairo and Alexandria in Egypt and Abu Dhabi in the United Arab Emirates (" UAE"). With a history spreading over 31 years, the company is one of the leading and oldest companies in the Middle East North Africa (MENA) region to provide offshore marine and oil support activities including services, maintenance, installations, rescue aid, erections and towage whether above, outside and/ or under water. It also provides all activities related to the industrial services for maritime and land establishments such as cleaning, maintenance, erections, installations, transportation supply and providing all necessary equipment and relevant spare parts.

Being a highly integrated marine and offshore oil services company, the company provides services to oil and gas exploration and production ("E&P") clients throughout the value chain:

- Oil and gas related Offshore Construction Services ("OCS") such as pipe laying, platform installation as well as engineering, procurement and construction ("EPC") for underwater projects. The OCS operates through the company's subsidiaries MOP and valentine Maritime Ltd. ("Valentine")

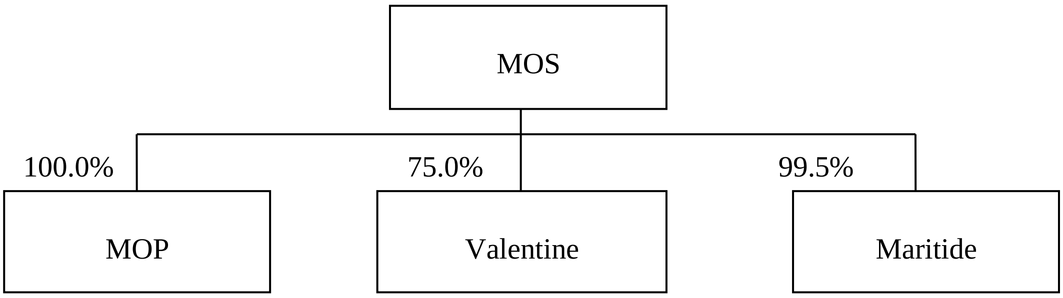
- Chartering Offshore Support Vessels ("OSV") needed to tow offshore rigs and supply both rigs and production platforms with all material required and ensure their safety through fire- fighting and anti- pollution systems that are installed on its vessels. The OSV business segment is operated through MOS and our subsidiary Maritide Offshore Oil Services S.A.E. (" Maritide").

- In addition, the company provides Diving Support Vessels ("DSVs") and divers for sub-sea maintenance and repair operations.

Management expanded the business globally by winning contracts in the Persian Gulf area, Caspian Sea and Mexico as well as countries in Northern and Western African countries and Southeast Asia. The company's global business model is reflected in its revenue base where, more than 80% of 2008 revenues are being generated from outside Egypt. The company possesses a high reputation among numerous oil companies around the world. In 2008, the company owned and operated 43 vessels and 11 barges, making it the largest marine offshore oil and gas service provider based in Egypt and the Middle East and one of the largest in the world in this field in terms of fleet size. The company embarked on an aggressive expansion plan in 2004, contracting for 22 new vessels and two barges are expected to be delivered by 2011. For the fiscal year ended December 31, 2008, the operating revenue, gross profit and net profit were U.S. $257.1 million, U.S. $118.4 million, and U.S. $100.8 million, respectively.

Table (1) illustrates the current legal structure of MOS as follows:

Table 1: The Legal Structure of MOS



The names and registered offices of the subsidiary companies that form the MOS Group are listed below:

Equity	**Incorporated in**	**Ownership % at December 31, 2008**
Valentine Maritime LTD	Liberia	75.00%
Valentine Maritime (Gulf) LLC	UAE	49.00%
Valentine Maritime (Mauritius) Ltd	Mauritius	100.00%
Ocean Marine FZC	UAE	100.00%
Maritide Offshore Oil Services S.A.E	Egypt	99.46%
Maridive Offshore Projects S.A.E	Egypt	100.00%

The key milestone in the development of the MOS Group can be summarized as follows:

- In 1978, MOS was established and started its first year of operations with three vessels and four mooring boats and was awarded its first marine contract with the Western Desert Operating Petroleum Company.

- In 1980, Barclays Bank acquired a 10% stake in MOS and its management contacted G. Hitsler to build seven AHTS vessels. In 1987, Maridive entered into a Joint Venture agreement with Tidewater Marine Inc., the biggest U.S. oil& Gas Services Company, and established Maritide Marine.

- In 1990, Valentine was incorporated to provide full services of EPC and management and acquired its first pipe laying construction barge "REGINA" with a crane capacity of 300 tons. In 1991, MOS established its first office in the region (Abu Dhabi) and started expanding regionally by commencing operations in the Gulf of Arabia as part of the Kuwaiti reconstruction efforts.

- In 1993, Maridive Offshore Projects (MOP) was established and wholly owned by the three Founding Families of MOS to offer a comprehensive and integrated range of marine construction, support and diving services. In 1996, MOS was awarded the first contract in West Africa marking its first step in expanding operations beyond the region and ordered the first two advanced 6.000 brake horsepower ("BHP") vessels with Dynamic Positioning ("DP") systems. In 1998, Commercial International Bank S.A.E one of the largest banks in Egypt acquired a 10% stake in MOS.

- In 2004, Maridive Group initiated its first phase of the major expansion (22 vessels and two barges) and upgraded its strategy, ordering in that year six new vessels, one construction barge and upgrading five existing vessels with DP and fire fighting capabilities. In 2005, Valentine successfully signed its biggest EPC contract worth a total of U.S. $125 million in the Persian Gulf. In 2006, MOS received its first AHTS vessel from the new expansion project and was awarded its biggest series of OSV contracts from Aramco.

- In 2007, MOS received one AHTS vessels from the new expansion project. Barclays Bank divested its 10% stake in MOS and EFG-Hermes, through its asset management and private equity arms, acquired a 13.4% stake in Maridive. In January 2008, all shareholders of MOS approved the Share Swap between MOP and MOS under which MOS would acquire all the outstanding shares of MOP. On April 13, 2008 the Share Swap was completed and consequently the restructuring plan was completed as MOP was swapped into MOS in preparation for the the Initial Public Offering, and received three new AHTS vessels as part of the expansion strategy which begun in 2004.

Management and the Company Competitive Strengths

The management of the company describes Maridive business as being characterized by a number of competitive strengths. First, by leveraging on the company's strong brand name in the market and experienced management, management successfully implemented an ambitious organic growth plan over the past 31 years, continuously expanding and upgrading the company's fleet to cater to clients' needs and markets dynamics. The fleet's size grew from 33 marine units in 2000 to 51 at the end of 2008 and is expected to reach 73 units by the end of 2011. Currently the fleet size positions MOS as the largest player in Egypt and with the expected advanced new generation fleet the company will be positioned as the largest marine and offshore oil services company in the MENA region. Management sees that the significant investments required in owning a fleet represents a significant barrier entry for competitors.

Second, the company operates in an attractive industry which benefits from high demand for oil, consequently driving up oil E&P activities, the main driver for the offshore oil industry. Oil and gas E&P spending grew by a compound annual growth rate (" CAGR") of 19% over the past five years, driven by increased exploration to satisfy current levels of demand, as well as the depletion of onshore oil supplies, forcing E&P companies to search for oil in offshore areas, and expecting that this trend will continue in the future. Management emphasizes that the location in the MENA region positions the company to benefit from this potential, as the region contains 70% of the world's oil reserves and 46% of the world's natural gas reserves.

Third, the management team of MOS has a strong track record with respect to the achievement and effective management of growth. In the past three years, management team of MOS has achieved a compound annual growth rate of revenues of 37.7%. Management team has also succeeded in diversifying and expanding the range of products and services offered to clients to include salvage operations and ship and port management. The Group management had the vision to expand internationally in several markets such as Kuwait, UAE, India, Qatar, Southeast Asia, West Africa and the Gulf of Mexico allowing the Group to significantly diversify its clientele base and enhance profitability.

Fourth, MOS has a strong brand name and extensive client base. MOS benefits from good long-term relationships with its key clients, including shell, PETRONAS, BP, British Gas, Adnoc, Bunduq, Fujikura, Kuwait Oil Company, Aramco, Pemex, Qatargas, ADGas, Total, Egyptian Natural Gas Co., Suptec, Cairn, Maersk Oil, Bechtel, Smit Gas Systems, and Petrobel. MOS presence in the sector for 31 years has placed it in a strong position to bid for, and secure, international tenders for marine offshore services. Management has been involved in projects in West Africa, Tunisia, Italy. India, Mexico and the Caspian Sea and are in the process of submitting bids in other regions including Venezuela, Congo and Southeast Asia. The international operations of MOS generated an average of more than 80% of the combined revenues for the years 2006, 2007 and 2008 respectively.

Fifth, the management of MOS realizes that MOS is one of the lowest costs marine offshore oil services providers worldwide due to several factors, including economies of scale which give an advantage when negotiating with supplier and shipyards. As a result of MOS strong ties with local partners in countries in which MOS operates, management has access to and can attract qualified personnel with competitive compensation packages compared to the international markets average. In addition, management works to reduce the average age of MOS fleet through the current expansion program, thus reducing MOS average maintenance costs as well as the average time when the fleet is out of services for maintenance and dry-docking.

Finally, MOS revenue, gross profit and net profit after tax grew from U.S.$139.3 million, U.S.$32.5 million and U.S.19.2 million, respectively, in 2005, to U.S.$257.1 million, U.S.$ 118.4 million and U.S.$ 100.8 million, respectively, in 2008 with a compound annual growth of 84.6%, 264.31% and 425%, respectively, from 2005 to 2008.

The Structure of MOS management and their remuneration

The board of directors of MOS is formed of five to fourteen members appointed for three years term which may be renewed by a resolution adopted at the general shareholder's meeting. The current board of directors is formed of fourteen directors, the majority of which are non-executive members. The board of directors meets as needed (but in any case at least four times per financial year) at the request of the chairman or of one-third of the board of directors. Meetings of the board of directors may be held at Company’s headquarters or at any location within Egypt. The chairman of the board of directors will have a casting vote in the case of a tie.

Pursuant to Maridive & Oil 's bylaws, the board of directors is entitled to 10% of the Company's profits after:(i) first deducting 5% of the profits as a legal reserve (deduction to cease once legal reserve is equivalent to 50% of capital); (ii) deducting 10% of profits as the employees' share in the profits, with a cap equal to the employees' aggregate annual salary; and (iii) distribution of a first dividend of 5% of the company’s paid-in capital. In addition, members of the board of directors are appointed and their remuneration and any attendance allowances are determined in the annual general shareholders' meeting.

The Company Future Strategy

MOS strategic plans are to continue to expand, replace and upgrade the fleet and equipment. MOS already contracted for 22 new vessels (five of which have been delivered) and two new barges which are all new generation units that are highly sophisticated and technologically advanced. While the new vessels will allow MOS to operate in deeper waters, the new barges will allow MOS to undertake more EPC projects that generate higher revenue and profit margins. In addition, management will continue to focus on profitability. The new investments made by MOS shareholders are aimed at improving operating and cost analysis and control. These initiatives include:

- Focusing on securing long term contracts for vessels to ensure high utilization rates.
- Expanding and upgrading the fleet with technologically advanced and sophisticated marine units that will command higher daily rates.
- Reducing the average fleet age to control maintenance and dry-docking expenses.
- Continuing to capitalize on strong relationships with local partners and thus depending mainly on local labor rather than expatriates.

Furthermore, management of MOS stresses that a foundation of the rapid growth of MOS was due to its ability to attract, develop and retain high caliber personnel and ensure the continued loyalty of its employees by providing competitive salaries, bonus and benefits package compared to situations occurring in public sector companies. As a mean of retaining key management employees, as well as continuing to attract highly qualified candidates, the management intends to establish an employee stock option plan to reward, remunerate and retain senior management in line with industry best practices.

Finally, as demand and prices for oil and gas have continued to increase E&P has moved further offshore in search of exploitable reserves. This has led to an increase in demand for deep water environment. Currently, the total worldwide production of offshore oil accounts for approximately one-third of the world oil supply and offshore gas production accounts for approximately one quarter of world natural gas production. Due to high oil prices and rising demand, E&P companies have been able to maintain high margins working in offshore concessions. Offshore oil production is a relatively new global industry, and offshore areas contain more untapped reservoirs than onshore areas. In addition, the depletion of onshore oil supplies is causing an increase in offshore exploration. The offshore services industry is driven by the demand for E&P activity. Contracted rigs require maintenance and supply vessels, thus creating increased demand for offshore services. The market for offshore maintenance is also supported by a large aging offshore infrastructure in need of maintenance for continuous production. Although the number of offshore rigs is expected to grow in the next two years, global utilization rates are expected to remain stable.

MOS Combined Financial Information

This section summarizes the financial information for MOS Company and briefly presents the main corporate governance aspects complied with by the company. The combined financial statements are presented for the three years ended December 31, 2006, 2007 and 2008 and consist of the historical consolidated financial statements of MOS and its consolidated subsidiaries for the above years. The combined financial statements have been prepared in accordance with the Egyptian Accounting Standards (EAS). EAS differs in certain significant respects from the International Financial Reporting Standards (IFRS).

Income Statement

	Years ended December 31,		
	2006	**2007**	**2008**
	(U.S.$'000s)		
Operating revenues	250,040	264,065	257,710
Cost of operations	(162,196)	(151,437)	(138,797)
Gross profit	**87,844**	**112,628**	**118,913**
General and administration expenses	(15,738)	(16,119)	(23,532)
Capital gain	432	248	9,456
Impairment of fixed assets	(4,157)	——	--
Operating profit	**68,381**	**96,758**	**104,837**
Other Income	574	509	1,078
Financing charges	(4,719)	(3,266)	(4,586)
Foreign exchange (loss) gain	(695)	(131)	(624)
Compensations	--	--	689
Interest income	110	206	794
Net profit for the year before tax	**63,652**	**94,067**	**102,188**
Change in fair value of cash flow Hedge	--	--	(18,602)
Income tax	(2,751)	(1,658)	(1,387)

Net profit for the year after tax	**60.901**	**92.418**	**82199**
Minority Interest:			
Valentine	7,439	12,332	13,183
Maritide	21	15	18
Net profit attributable to minority shareholders	**7,459**	**12,347**	**13,201**
Net profit attributable to equity shareholders	**53,441**	**80,071**	**68,998**

Balance Sheet

	Years ended at December 31,		
	2006	2007	2008
	(U.S.$000s)	(U.S.$000s)	(U.S.$000s)
Non- current assets			
Property, plant and equipment	112,221	192,283	186,081
Goodwill	9,841	9,841	9,841
Loans to related parties	278	278	278
Other long term assets	—	137	6,128
Assets under construction			118,252
Total non- current assets	**122,340**	**202,539**	**320,580**
Current assets			
Inventories	3,958	5,815	5,584
Trade and notes receivables	88,305	90,935	72,417
Due from related parties	58	318	2,062
Prepaid expenses	891	1,595	2236
Due from customers	4.554	7,924	9,394
Cash in hand and at banks	15,193	9,451	78,100
Other receivables	42,537	39,145	6,339
Total current assets	**155,496**	**155,182**	**176,132**
Current liabilities			
Provisions	1,688	1,885	2,546
Bank credit facilities	7,290	24,516	11,791
Trade and note payables	20,275	40,818	17,837
Due to related parties	3.260	432	1
Short term loans installments	10,148	24,080	38,503
Dividends payable	56	330	8
Accrued expenses	18,052	6,652	16,404
Customer advanced payment	32,810	2,146	5,317
Other current liabilities	3,248	3,816	7,441
Total current liabilities	**96,826**	**104,674**	**99,848**
Working capital	**58,670**	**50,508**	**76,284**
Total investment	**181,010**	**253,047**	**396,864**
Financed as follows:			
Shareholder's equity			
Issued and paid up capital	65,000	85,000	102,400
Legal reserve	9,009	11,709	20,480
Special reserve			76,877
General reserve	24	24	
Consolidation reserve			(2,557)

Retained earnings (accumulated loss)	(3,885)	(10,514)	3,329
Minority interest	18,680	22,540	26,131
Net profit for the year	53,441	80,071	68,998
Total shareholder's equity	**142,268**	**188,830**	**295,658**
Non- current liabilities			
Long-term loans installments	38,742	64,217	82,605
Change in fair value of cash flow Hedge			18,601
Total non-current liabilities	**38,742**	**64,217**	**101,206**
Total finance of working capital and non-current assets	**181,010**	**253,047**	**396,864**

MOS and Corporate Governance

The company complies with applicable corporate governance rules in effect in Egypt. An audit committee was established in 2008 comprised from three non-executive directors in compliance with article 7 of the Capital Authority Stock Exchange (CASE) listing rules. The audit committee is authorized to investigate any activity it deems appropriate, to seek any information from any officer or employee of the Company, all of whom will be directed to cooperate with any request made by the audit committee, and to have recourse to seek independent counsel and advice and to assist in any review or investigation on such matters as the audit committee deems appropriate.

In addition to the general duties and obligations under Article 7 of the CASE listing rules, MOS audit committee is also responsible for:

- ensuring that there is an open avenue of communication between internal auditors, external auditors and the board of directors;
- considering, in consultation with the external auditors and the Internal Audit Director, the audit plans and scope of the external and internal auditors, ensuring that the coordination of audit effort is maximized;
- reviewing the financial statements with the Deputy General Manager and General Manager for Finance at the completion of the annual examination
- assessing with Internal Audit Directors significant risks or exposures and evaluating the steps to be taken to minimize such risks or exposures to the company as well as reviewing related party transactions;
- considering and reviewing with senior management and the Internal Audit Director significant violations of internal control systems, if any, during the year and the senior management's responses thereto;
- considering and reviewing internal control systems, findings and the contents of the external auditors management letter, if any, together with the senior management's responses thereto, with the external auditors and the Internal Audit Director;

The audit committee operates in accordance with charters approved by the board of directors and holds at least four ordinary meetings a year and may also hold additional meetings when deemed necessary.

Egyptian law requires that all relationships between the Company and the board must be at arm's length. All contracts entered into with a board member or shareholder are considered related party transactions and must be authorized or approved by the general shareholders meeting; otherwise any such contract will be voidable at the request of any shareholder if proven to be favoring or causing harm to a group of shareholders, or against the best interests of the Company. Under Egyptian law, members of the board of directors who have a conflict of interest with the Company are required to inform the board of directors of such conflict and may not vote on the subject matter of conflict. These matters are reported by the board of directors to the first general shareholder's meeting to be convened thereafter.

The law prohibits the Company from providing cash loans to any members of the board of directors and guarantees any loan such member takes from a third party. Board members may not vote on any transaction related to the shareholder they represent.

During the course of its ordinary business in 2008, MOS made business transactions with MOP amounting to U.S. $4492893 in addition to consultancies and diving services for U.S. $4743129. Moreover, MOS rented marine units from Maritide Offshore Company for the amount of U.S. $5274890 in addition to providing technical consultancies of U.S. 60000. As to Valentine Company, there was a current balance owed to MOS for U.S. 102523. All the above transactions were made at arm’s length.

Accounting and Auditing of MOS Derivative Swap losses

The management of MOS decided to minimize the risk of borrowings associated with the acquisitions of the new vessels and barges needed to achieve the objectives of the company future strategy and maintain its competitive edge in the marine and oil industry. Management considered minimizing on a long-term basis the risk associated with interest expected to be paid by the company on existing credit facilities. Management entered into swap agreements with both credit Agricole and City Bank to minimize the likelihood of increase in interest rates for loans contracts amounting to $30 million (the first contract for the period from 1/6/2008 until 1/9/2017 with interest rate to be paid by MOS for 8.4%) and $30 million (the second contract for the period from 1/6/2008 until 1/3/2018 with interest rate to be paid for 3.825%) and $44 million (the third contract for the period from 30/5/2008 until 1/1/2013 with interest rates from 2.9% to 5.8%) & 26.4 million (the fourth contract for the period from 30/5/2008 until 1/10/2013 with interest rate of 2.9% to 5.8%) Swap agreements are considered an example of Cash flow hedging.

Paragraph 9 of International Accounting Standard No 39 defines a hedging instrument as " a designated derivative or (for a hedge of the risk of changes in foreign currency exchange rates only) a designated non-derivative financial asset or non-derivative financial liability whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item". Under paragraph 9 of IAS 39 a hedged item is "an asset, a liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation that (a) exposes the entity to risk of changes in fair value or future cash flows and (b) is designated as being hedged" (IASB, 2009, p 2001). Under paragraph 81 of IAS 39 if the hedged item is a financial asset or financial liability, it may be hedged with respect to the risks associated with only a portion of its cash flows or fair value provided that effectiveness can be measured (IASB, 2009, p 2020).

IAS 39 defined cash flow hedge as " a hedge of the exposure to variability in cash flows that (i) is attributable to a particular risk associated with a recognized asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction and (ii) could affect profit or loss (IASB, 2009, p 2021). An example of a cash flow hedge is the use of a swap to change floating rate debt to fixed rate debt (i.e. a hedge of a future transaction where the future cash flows being hedged are the future interest payments). Trombley (1999, p 72) indicated that the hedging company enters the pay-fixed, receive-floating side of the Swap, and the Swap has the effect of converting floating-rate debt into fixed-rate debt. He added that this type of hedging is typically attractive to a company that has issued floating rate debt but does not have floating-rate interest-bearing assets and is therefore concerned about cash flow variability from adverse changes in interest rates.

Management is required under IAS 39 to assess hedge effectiveness (i.e. Swap effectiveness). Hedge effectiveness is the degree to which changes in the fair value or cash flows of the hedged item that are attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument. Effectiveness is assessed whenever an entity prepares its annual or interim financial statements. A cash flow hedge is considered highly effective if both of the following conditions are met (a) at the inception of the hedge and in subsequent periods, the hedge is expected to be highly effective in achieving offsetting changes in cash flows attributable to the hedged risk during the period for which the hedge is designated, and (b) the actual results of the hedge are within a range of 80-125 per cent (IASB, 2009, p 2071). For example, if management decides that the total loss on hedging instrument is $ 100 and the gain on the cash instrument is 120, offset can measured by 100/120, which is 83.33 per cent or by 120/100 which is 120 per cent. In such a situation, assuming that the hedge meets the condition stated in (a) above, the company would conclude that the hedge is highly effective.

IAS 39 differentiated between the accounting treatments of the results of the assessment of effective versus ineffective Cash flow hedges. IAS 39, in paragraph 95, indicated that the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge shall be recognized in other comprehensive income; otherwise the ineffective portion of the gain or loss on any hedging instrument shall be recognized in profit or loss.

MOS entered into four swap agreements totaling U.S. Dollar 130.4 million. In assessing the effectiveness of the swap agreement, the management of MOS considered the past changes in the fair value or cash flows of the hedged item that are attributable to the hedged risk with past changes in the fair value or cash flows of the hedging instruments which showed that libor (interest rate on $ loans) exceeded 8% resulting in positive offsetting for calculation of fair value of the hedging instruments. The management of Maridive, based upon the information included in the previous years' financial statements up to 2008 and the forecasted information for the period until 2012, are confident that the company's financial capabilities are adequate for payment of yearly differences between fixed interest rate & interest actually paid on loan credit facilities. The intention of the management of Maridive is to either make additional Swap agreements or adjust the existing agreements with the continuous use of the credit granted under existing loan agreements. The management's aim from such risk strategy is to mitigate any negative effects which may result from the current & future forecast of the various Swap agreements.

The management of the MOS performed the analysis of the effectiveness of the Swap agreement made with the two banks (Credit AGricole and City Bank) as at 31 December 2008. The results of such analysis were that this hedge instruments are ineffective with total losses of $ 18.6 million. The management prepared the company's financial statements for the year ending December 31, 2008 where they charged the effects of ineffective swap analysis into the company's special reserve for $18.6 million based upon the requirement of the Egyptian companies Act 159 for 1981. Article 57 of the Egyptian Law 159 for 1981 and its amendments allowed the management of companies established under such law to use the company's special reserve for purposes which may benefit the company's shareholders. Management decided that this is the time at which the special reserve should be used to offset losses resulting from the financial crisis. The accounting treatment proposed by the company was presented to the auditors Crowe Dr A.M.Hegazy & Co, RSM Magdi Hashish & Co and Delloitte & Touch Kamel, Saleh and Barsom. Auditors were in disagreement concerning the above accounting treatment. Hegazy & Hashish offices agreed to the accounting treatment made by MOS management, whereas Deloitte objected and requested that the swap losses of $ 18.6 million should be charged to the company's income statement based upon the requirement of IAS no 32 & 39. The auditors in favor of management treatment of the Swap losses issued an unqualified audit report with explanatory paragraph "emphasis of matter" and the third auditor Delloitte & Touch issued a qualified report.

The audited financial statements were sent to the Egyptian Capital Market Authority (CMA) - equivalent of SEC in the U.S.A) as required by the Capital Market Law no 95 for 1992. The Capital Market Authority issued an opinion in favor of the proposed treatment by Delloitte & Touch. The CMA justified its position based on the following justification.

1- The charging of the expected losses resulting from the application of the fair value of the swap agreement which were considered ineffective on the owner' equity section, is considered in violation with the requirement of the Egyptian Accounting Standards No. 26 (equivalent to IAS 39) which charges such losses to the income statement for not having the effectiveness of the contract. In accordance with this treatment, one of the auditor's reports was qualified while other auditors did issue unqualified report with explanatory paragraph for the same accounting treatment stating that "such losses were charged to the Special Reserve instead of charging it to the income statement in accordance to the requirement of EAS No. 26. The board of directors of MOS decided to charge such losses to the special reserve due to the global financial crises". CMA felt that there is an agreement among all auditors for the non-compliance of such treatment with the requirements of the Egyptian Accounting Standards no. 21.

2- The company in its decision to charge more losses to the special reserve account is in violation with article No. 39 of the Joint-Stock companies Act No. 159 for 1981 and article 6 of the capital Market Law No. 95 for 1992 and article 58 of its executive regulations. The above articles require the company to prepare their financial statements in accordance with the Egyptian Accounting Standards, a matter which makes the company liable for penalties in accordance with article No. 60 of Capital Market Authority Law. Since the company has listed its shares by initial public offering the management insistence to apply such treatment would fall under non-compliance with the Egyptian Accounting Standards during the period of covering of such contracts until 2018.

The Capital Market Authority mandated that MOS should restate the financial statements for the year ending 31 December 2008 to comply with the Egyptian Accounting Standards and charge the losses to the income statement even if this results in net income reduction by 23% of the financial year's profits ended 31\12\2008 and the company is required to publish the adjusted financial statements in two widely distributed daily newspapers, at least one of them in Arabic. Also, the Capital Market Authority noted that the company had capitalized $1.6 million as the net cost of obtaining loan No. 5 of the long-term loans on the loan's duration of 10 years without consideration of the Egyptian accounting standards. The company has to re-state the appropriate adjustment to charge such amount to the income statement for the year ending 31\12\2008.

At the same time, the CMA communicated its opinion to the two auditors who issued an unqualified report with explanatory paragraph objecting to such opinion and asking for a correction of the auditors' reports:
"We noticed that your report on the financial statements of Maridive and Oil Services Co. included an explanatory paragraph violating the Egyptian Accounting Standards in light of the significant effects resulting from the accounting treatment applied in treating the losses of MOS financial swap contracts which represent 23% of the year's profits ended 31\12\2008, a matter which necessitated a qualification based on what was included in article No.16 of the Egyptian Accounting Standard No.1, the justification of the management treatment cannot be considered a correction to inaccurate and inappropriate accounting treatment".

Officials at the Capital Market Authority asked for a meeting to discuss the disagreement occurring between the three auditors before the annual general meeting to approve MOS financial reports for 2008. The meeting was attended by the partners and managers from the three CPA firms, CFO and officials from MOS and from the Capital Market Authority. The following discussions occurred during the meeting:

Official CMA: What are the justification that made the MOS management and auditors agreed to charge the 18.6 million dollars to the company's income statement at the end of December 2008?

The Auditors (Hegazy & Hashish): The decision of the board of directors to use the special reserve amount of $76.8 million on 31/12/2008 to cover losses resulting from future expectation of the swap agreement amounting to $18.6 million instead of charging such losses to the income statement for the year 2008 was in accordance with the companies Act 159 for 1981 and its executive regulations and the company article of incorporations as follows:

a. Article no 57 of the company's articles of incorporation refer to the Special Reserve as a last resort to help the company treat unusual circumstances. The board decision to use such account was for the benefit of the company. Therefore, the board exercised its authority mandated by the above article for the accounting treatment referred to and will present such treatment to the annual general meeting which will have the final decision concerning such issue.

b. The decision to apply the wording of the company's articles of association quoted from the companies Act No. 159 for 1981 in reference to the special reserve account is in accordance with article 57 of the Companies Act and article 94 of its executive regulations superseded the requirements of the accounting standards. The board of MOS decision for the Swap losses was in compliance with the wording of the above mentioned articles.

Officials of CMA: The CMA officials referred to Deloitte's qualification which explicitly stated that the accounting treatment of the Swap losses is in violation with the requirements of the Egyptian Accounting standards no 25 & 26 (the equivalent to IAS 32 & 39) and CMA advisor advocated this qualification and requested CFO of MOS to comment about such qualification?

CFO of MOS: Article No. 39 of the Companies Act 159 for 1981 stated "the company will have a financial year specified by its articles of incorporation and financial statements will be prepared according to the accounting standards". Then Article 40 of the same law stated" it is possible to use the special reserve to cover the company's losses and to increase its capital… and if the special reserve is not identified for specific purposes included in the company's articles, the annual general meeting based upon recommendations of the board may use it for the benefit of the company and its shareholders". From the wording of the above article, MOS management as well as Hegazy and Hashish auditors interpreted that the Companies Act authorized the General Meeting to use the special reserve in any form other than the distribution of profits, otherwise the rights of shareholders will be restricted if MOS did not violate the requirements of the Egyptian Accounting Standards. On the contrary, the law did exceptionally allow the use of reserves and give such decision to shareholders in relation to losses realized by the company. Thus, the accounting treatment of the general reserve to offset future expectation of unrealized losses for the swap agreement for the year 2009 – 2017 is **the proper accounting treatment.** As a matter of principle, the management can use the reserve to offset such future losses of the Swap transaction rather than charging such losses to MOS income statement as of December 31, 2008. In addition, if the balance of the special reserve account is not used to offset future unrealized losses, what can those accounts be used for otherwise?

Hegazy & Hashish: Our opinion to treat the unrealized future losses of the swap agreement was made in order not to charge the income statement for the period 2009 – 2017 with the results of unstable and significant changes related to the forecast of interest rates and the offsetting of its related losses to the special reserve reflects the actual performance of the company's operations for the year 2008 and future periods.

Hegazy & Hashish They also added that there is noticed subjectivity associated with the calculation of the expected losses resulting from such contracts due to the exceptional financial circumstances as the valuation of such contracts during the period 30 Sept. 2008 until 25 Feb. 2009 using the present value approach were as follows:

Amount at 30 Sept. 2008	Amount at 31 Dec. 2008	Amount at 25 Feb. 2009
\$6,7 Million	\$18,6 Million	\$14,2 Million

From the above analysis, one cannot rely on the accuracy of such forecast in the light of the current financial circumstances and the right treatment of such losses or profit should be charged to the special reserve account.

Hegazy & Hashish: They justified also to the CMA officials that the report took into consideration the uncertainty related to results of future expectation of the swap agreement. Moreover, they agreed with the company's management of the accounting treatment of the results of the Swap agreement because this complies fully with paragraph 5 of the Egyptian Standards on Auditing No. 701 which includes:

"In special circumstances, the auditor may modify his report by adding an explanatory paragraph for a special matter which may affect the financial statements and should be explained in details in the notes of these statements and such explanatory paragraph does show the auditor opinion not to be considered as a qualified one".

Hegazy & Hashish They explained further that their report complied fully with paragraphs 5 & 7 of the Egyptian Standards on Auditing No. 701 as the auditor may modify his report with the addition of an explanatory paragraph if there is fundamental uncertainty circumstances (other than the going concern) which are based on future events affecting the financial statements. The uncertainty is an issue where its results are based on future events, the company cannot control but which may affect the financial statements. The company's management decided to minimize the effects of such future expectation during the period 2009 until 2017 by charging these uncertain forecasts to the special reserve for the benefit of the company and its shareholders in accordance with article 57 of the articles and the companies Act No. 159 for 1981 and its executive regulations.

Officials of CMA: They inquired about the basis under which MOS capitalized the cost of the loan obtained by Maridive and Oil Services (S.A.E)?

MOS CFO: He explained that on April 2008 Maridive has signed a medium-term joint financing contract with three banks for an amount of USD 133.6 million, to finance 80% of the total cost of construction of 9 marine vessels. The cost of obtaining such loan amounted to USD 1691400. According to the guidelines of applying the international accounting standard No.39 of the financial instruments, the financial assets which must be evaluated on the fair-value basis shall appear in the revenues and loss, and the costs of obtaining such loan shall appear (in the net value after deducting the accumulated amortization) deducted from the balance of the obligation (loan) as issue fees. Moreover, according to the Egyptian accounting standard No.14 " the cost of borrowing " section 11, the company applied the alternative method in accordance with the Egyptian accounting standards which state that the costs of borrowing related to establishing and producing a specific asset should be capitalized on that asset, until such asset is used or sold.

MOS CFO: He added that the capitalization of the cost of acquiring the loan on the loan period was made in accordance with article 14 of the Egyptian Accounting Standards No. 14 which states:

"The amortization of other costs incurred by the company for borrowing …." The two auditors need to also emphasize that what is stated in the notes of the financial statements comply fully with what is contained in the standard as follows:

The amortization of the cost of acquiring the loan on the period of loan agreement, such amortization of the cost of borrowing will be charged to the income statement unless such borrowing is related to an asset susceptible for capitalization, at that time such costs should be capitalized on that asset. MOS CFO emphasized the fact that the decision made by the board in its meeting dated 23 February 2009 is a recommendation to the annual general meeting and shareholders have the final decision.

Hegazy & Hashish: They added that according to article 4.C in the Egyptian Accounting standard No 14, the cost of obtaining a loan includes other deductions occurring during the period of obtaining such loan which means that the company has the right to deduct the cost of obtaining the loan occurred during the time when the assets on marine vessels are being constructed instead of charging it as expenses. According to such method the cost of obtaining the loan has been capitalized over the period of the loan and was deducted annually as follows:

1. The deducted amount for the period of constructing the assets has been capitalized on such assets as a part of the debts of obtaining the loan of marine vessels which amounted to USD 70476 and it has been postponed the deduction of the remaining part amounted to USD 1620924 as a deferred asset presented in the financial statements with the net value to be deducted from loans balance.

2. The remaining amount of the post-construction period will be realized on an annual- basis as an expense in the income statement, it will be considered as a settlement to loan interests. According to what is stated in the Egyptian accounting standard No. 14 that the cost of obtaining the loan depends on the loan period so it cannot be totally charged to the income statement for one year and it also cannot be fully capitalized on the assets.

The meeting between MOS CFO, auditors and CMA officials was concluded and CMA officials promised to inform the company with their final decision concerning whether CMA would insist on the re-statement of MOS financial statements as at December 31, 2008. A few days later, the management of MOS received CMA decision quoted as follows:

"Referring to the discussions at the meeting held at CMA Head office attended by the auditors and the management of the company concerning the financial statements of MOS as at December 31, 2008, the Capital Market Authority confirms the need to restate the financial statements of MOS as at December 31, 2008 due to the followings:

1. The accounting treatment that the company applied in charging the losses resulting from the recognition of the fair value of the obligations arising from the swap contracts which were considered ineffective to the owners' equity (special reserve), is considered a violation of the Egyptian accounting standards.
2. The authority did not assess the legality of using the special reserve and the responsible authority for that and the basis of its use!!!
3. There is general legal commitment to prepare the financial statements of the listed companies according to the Egyptian Accounting Standards in accordance with the companies Act no. 159 of 1981, and there is a legal commitment on the joint-stock companies whose shares are listed by initial public offering to comply with these standards in preparing their financial statements according to law No.95 of 1992.
4. According to the significant effects resulting from violating the standards which represent 23% of the year's profits, the violation of the Egyptian accounting standard No.26 is considered a misleading presentation of the financial statements. According to the board's suggestion to distribute 25 cent on each share the company will distribute part of the special reserve used to cover the financial losses related to swap contracts – indirectly - because if the company charged such losses to the income statement the realized revenues will decrease to USD 62.5 million and the suggested distribution amounted to USD 64 million will not be met. It is illegal to use the special reserve formed from additional paid up capital balances in cash distribution.
5. In relation to the amortization of the cost of obtaining the loan on the duration of the loan, the company's accounting treatment did violate the requirements of the Egyptian Accounting Standard no 14 which allowed the capitalization of finance costs directly attributable to obtaining or producing an asset on the cost of such asset. Therefore, such cost is considered part of the cost of the asset being depreciated based upon the agreed upon depreciation rates, and not to be amortized over the duration of the loan.

In sum, the authority is still of the opinion for the restatement of the company's financial statements of 31 December 2008 after applying the appropriate changes to comply with the Egyptian Accounting Standards and to publish the adjusted financial statements in two widely distributed daily newspapers at least one in Arabic.

As to the type of the auditors' report issued by both Hegazy and Hashish CPA firms, the authority confirms that the Egyptian Accounting Standard No.26 included only one accounting treatment and did not include any alternative treatment to agree upon it with the company's management. Accordingly, a qualified opinion should have been issued in light of the significant violations to the Egyptian Accounting Standards discovered.

Based upon the final decision of the Capital Market Authority, the management of MOS decided to restate the company's financial statements for the year ending December 31, 2008 and charged the losses of the Swap agreements to the income statement and complied with CMA request for finance cost on borrowings related to acquiring assets. Auditors restated their audit opinion and the three auditors issued a single unqualified audit opinion.

Conclusion

The case study discussed points of strengths for a successful International Company "Maridive & Oil Services" in terms of its management structure, company strategies and competitive strengths, governance issues and other financial and non financial measures. The case also explained the nature of derivatives mainly Swap agreements and the financial implications related to the assessment of such agreements as being ineffective. The case outlined the accounting and auditing treatments for losses computed for the Swap Agreements with both Credit Agricole and City Bank showing points of dispute between management and auditors on one side and government authority (CMA) on the other side. The case demonstrated the problems related to the auditors' independence, auditors' possible errors of judgments versus audit failures, accounting standards versus requirements of various laws and the company's articles of incorporation. The case emphasized the authority of the government supervisory board represented in the Egyptian Capital Market Authority, in forcing the management of MOS to restate its financial statements at December 31, 2008 despite the objection of two of its auditors and the non-qualification of their report. There is still an unanswered question of whether the decision of CMA to restate the financial statements of MOS is the right decision giving the facts surrounding the Swap agreements, the requirements of the accounting and auditing standards and the solid financial position of MOS.

The case also pointed out the need to undertake future research to solve points of conflicts between the requirements of local laws and International accounting and auditing standards. Such conflict needs to be assessed not in the light of the possible interpretation of the requirements of both the laws and the standards but in the light of what is considered beneficial to shareholders, investors and other users of MOS financial statements.

Lessons learned

1- What is the nature of the professional differences faced by the auditors of MOS?

2- How do you assess the nature of restatements made by MOS in its financial statements at December, 31 2008, do you consider such restatement a correction of the existence of misstatement based upon fraudulent financial reporting or is it simply error of judgment made by MOS management and Hegazy & Hashish CPA firms?.

3- Which of the two has a priority for application in the preparation of the company's financial statements; the Egyptian or International Accounting Standards or the requirements of various laws governing the companies' operations?

4- Do you consider the decision made by Hegazy & Hashish CPA firms a violation of their independence as they subordinated their judgment to the management of MOS or did they have a good justification for issuing unqualified audit report with explanatory paragraph?

5- Explain the role of the government supervisory boards and whether they have the rights to force listed companies to re-state their financial statements & the implications of such authority on investors' welfare?

6- What is your opinion concerning the accounting and auditing dispute of the losses resulting from the swap agreements, do you concur the auditor's decision to issue unqualified opinion or they should have issued qualified report?

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