

DryShips, Inc.

Comment Letter Exercise for Intermediate Accounting I and II: Suggested Solution

As explained in the presentation, please obtain the following documents for DryShips, Inc. from the SEC's homepage. Read each document carefully and discuss in your group the answers to each one of the following questions. You will have 30 minutes to find the information and develop your answers. Please designate someone from your group/table to present the "consensus" answer and any disagreements.

Document 1: Comment Letter dated May 29, 2008 from the SEC

Read cover page of the SEC's Comment Letter dated May 29, 2008 written to Mr. George Economou, CEO and Interim CFO of DryShips, Inc. to answer the following questions:

1. What is the year end of the financial statements for which the SEC Staff has written this comment letter?

December 31, 2007

2. Which SEC Form was used by DryShips, Inc. to file its annual financial statements and why?

20-F because it is a foreign private issuer incorporated in Marshall Islands

Read the first comment on page 2 under "Deferred Drydock Costs" to answer the following questions.

3. What is the company's policy to account for the drydock costs that it incurs?

The company capitalizes some of its drydock costs that include (1) actual costs incurred at the drydock, and (2) cost of hiring a third party to oversee the drydock.

4. Does the SEC staff agree with the Company's accounting policy? If not, why not?

The SEC Staff questions the company's method of capitalizing part of the drydock costs as enumerated in #3 above. According to the SEC Staff, only those drydock costs that are eligible for capitalization are the ones which are incurred solely as a result of the regulatory requirement that a vessel be inspected. The Staff believes that costs that a company elects to incur at the time of drydocking out of convenience should not be capitalized.

Document 2: Obtain the Form 20-F for the year ending December 31, 2007 to answer the following questions

5. What is the business of DryShips, Inc?

The company owns and operates a fleet of 38 vessels that transport a variety of drybulk commodities such as coal, iron ore, and grains.

6. What are drydock costs? What are the two components of the drydock costs that the company is capitalizing? What is the ending balance in the deferred charges account at

Comment [CD1]: Delete underline since other section titles do not have an underline.

the end of 2006 and 2007? Ignoring amounts, what journal entry might the company have prepared to defer drydock charges for each of these years? Explain how the accounting equation remained balanced as a result of the entry.

The company's vessels are required to be drydocked approximately every 30 months for major repairs and maintenance that cannot be performed while the vessel is operating (see page 62 of 165 of 20F).

Costs capitalized as part of the drydock include actual costs incurred at the drydock yard and the cost of hiring a third party to oversee the drydock (see page 62 of 165 of 20F).

For the year ending 2006 and 2007, the ending balance in the deferred charges account was \$6.2 million and \$2.5 million respectively (see Deferred Charges, net on the Balance Sheet and footnote 8). Likely journal entry with how accounting equation remains in balance:

Accounts	Debit	Credit
Deferred Charges (+A)	XXX	
Cash (-A) or Payables (+L)		XXX

7. Over what period, does the company amortize the capitalized drydock costs? What authoritative accounting guidance does the company cite to support its decision to capitalize these costs?

The company amortizes these costs on a ST line basis over the period between drydock. The typical period between two drydocks is about 30-months.

The company states that its capitalization policy is consistent with industry practice and reflects the economics and market value of the vessels (see page 62 of 165 of 20F).

The only other authoritative accounting guidance the company refers to is FASB Staff Position (FSP) AUG AIR-1 "Accounting for Planned Major Maintenance Activities" which forbids accrue-in-advance. The company does not use accrue-in-advance method. Probable reason for not following this FSP may be because it will increase the expenses while eliminating an asset account from the books. Both the income statement and balance sheet would look a little worse under the accrue-in-advance method than the capitalization policy adopted by the company.

8. As a result of following its policy of capitalization, how much did the company capitalize and amortized each year for the three years ending 2005, 2006, and 2007? Show journal entries for 2006 for the capitalization, amortization and sale of vessels.

See footnote 8 (page 147 of 165 of 20F) for details:

	2005	2006	2007
Capitalization of Drydock Costs	\$3.2M	\$6.3M	\$1.9M
Amortization Charges	\$2.4	\$3.6M	\$2.8M
Write-off due to Vessel Sale	-0-	\$.3M	\$2.7M

Typical Journal Entries would be as follows:

1. Entry to capitalize drydock cost incurred during the year:

Accounts	Debit	Credit
Deferred Charges (+A)	XXX	
Cash (-A) or Payables (+L)		XXX

2. Entry to amortize the capitalized drydock costs during the year:

Accounts	Debit	Credit
Amortization Expenses (-SE)	XXX	
Deferred Charges (-A)		XXX

3. Sale of a vessel and write-off of unamortized drydock costs at the time of vessel sale

Accounts	Debit	Credit
Cash (+A)	Cash Received from Selling Vessel	
Accumulated Depreciation (+A)	Balance in the AD Account	
Drydock Costs Write-Off (-SE)	Portion of the Deferred Charges that relates to the sold vessel	
Vessel (-A)		Original Cost of the Vessel
Deferred Charges (-A)		Portion of the Deferred Charges that relates to the sold vessel
Gain (or loss) on Sale of Vessel		Plug or Cash minus BV of Vessel

9. Ignoring the opening balance in the Deferred Charges account and income taxes, calculate the impact on company's income statement due to its policy of capitalizing the drydocking costs for each of the three years ending 2005, 2006, and 2007.

	2005	2006	2007
Capitalization of Drydock Costs	+\$3.2M	+\$6.3M	+\$1.9M
Amortization Charges	(\$2.4)	(\$3.6M)	(\$2.8M)
Write-off due to Vessel Sale	-0-	\$.3M	\$2.7M
Net Increase/(Decrease) in Income	+\$800,000	+\$3,000,000	+\$1,800,000

Document 3: Obtain Company's response to the SEC dated June 18, 2008 to answer the following questions:

10. How many vessels did the company dry-dock in 2005, 2006 and 2007? What were the components of the total cost that the company incurred as part of its dry-docking costs that it capitalized? From reading a description of these from the registrant's response is there any question whether these costs were repairs and maintenance or not?

6 vessels in 2005; 7 vessels in 2006; and 4 vessels in 2007

There are three specific components of the costs that the company capitalized: Dry dock yard costs, Paints, and Class Certificates. The dry-dock yard costs included steelworks, coatings, piping, valves, machinery and electrical works, and other expenses.

From reading a description of these expenses in the registrant's response, it appears that these outlays were planned as opposed to required by any regulation.

Deleted: comments

11. Going forward, how is the Company proposing to account for the costs in question?

Deleted: what

Deleted: do to

Deleted: .

Effective January 1, 2008, the company commits to implementing a voluntary change in accounting policy and expense all dry-docking costs as incurred. It will revise its previous year's financial statements in accordance with FASB Statement 154 "Changes and errors Corrections" (ASC 250). (Retroactive application to be reported in 6-K for 3/31/2008 and also the Form 20-F for year ending December 31, 2008)

Deleted: .

Document 4: Obtain the company's 20-F for the year ending December 31, 2008 to answer the following questions:

12. Which, if any, external auditor reports discuss the change in accounting principle implemented retroactively by the company?

April 27, 2007 EY Report issued from Athens, Greece and March 27, 2009 Deloitte Report issued from Athens Greece mention in the 2nd to the last paragraph that the company has changed its method of accounting for the dry-dock costs and it has retroactively adjusted the 2007 year-end financial statements.

13. Review Deloitte's March 27, 2009 Report on the Company's internal controls issued under S-OX 404(b). In light of the accounting changes implemented by the company, what is the external auditor's conclusion on the effectiveness of DryShip's ICFR? Explain why you agree or disagree with their conclusion.

Deleted: .

Deloitte concluded that company's ICFR was effective as of December 31, 2008. Various arguments can be presented for and against the auditor's conclusion on ICFR. Other points that can be discussed here are: what exactly constitutes an effective ICFR? To what extent does the COSO 1992 Framework help a company in evaluating the effectiveness of its ICFR? To what extent the COSO does the 1992 Framework help an external auditor in opining on the effectiveness of a company's ICFR?

Deleted: s

Deleted: s

Deleted: .

14. Why is the retained earnings statement as of December 31, 2005 the only one adjusted retroactively for \$3,781 as a result of the change in accounting principle for accounting for dry-dock costs?

Per FASB 154 (ASC 250), retained earnings statement is adjusted only for the beginning balance (in this case \$3,781 was the balance in the Deferred Charges Account as of 12/31/2007) because for the ensuing years, the income or loss number reflects the effect of change due to this accounting principle.

15. Which accounts are adjusted as a result of implementing this change in accounting principle for the 2007 year end?

Since as of 12/31/2007, the balance in the deferred change account was \$2,492, the adjustment was made for the same amount for the following accounts (see page F-15 or 177 of 222 of 20-F for footnote 5).

Accounts	12/31/2007	12/31/2007	Difference
----------	------------	------------	------------

	Deferral Method	Direct Method	
Deferred Charges	\$2,492	-0-	(\$2,492)
Total NCA	431,370	428,878	(\$2,492)
Total Assets	2,346,924	2,344,432	(\$2,492)
Retained Earnings	569,316	566,824	(\$2,492)
Total SE	1,024,221	1,021,729	(\$2,492)
Total Liabilities and SE	2,346,924	2,344,432	(\$2,492)

16. If the company would have continued with its capitalization policy, by how much would its assets have increased for the year end December 31, 2008?

\$5,142 (See page F-15, footnote 5)

Accounts	12/31/2008 Deferral Method	12/31/2008 Direct Method	Difference
Deferred Charges	\$5,142	-0-	(\$5,142)
Total NCA	63,971	58,829	(\$5,142)
Total Assets	4,847,822	4,842,680	(\$5,142)
Retained Earnings	192,490	187,348	(\$5,142)
Total SE	1,296,714	1,291,572	(\$5,142)
Total Liabilities and SE	4,847,822	4,842,680	(\$5,142)

17. Would the retroactive application of FAS 154 (ASC 250) lead the company to report higher or lower vessel operating expenses during each one of the three preceding years: 2006, 2007, and 2008? If so, by how much?

Retroactive application of FAS 154 (ASC 250) would lead the company to report higher vessel operating expenses in each of the three years as follows (F-26, footnote 5):

12/31/2006			12/31/2007			12/31/2008		
Deferral Method	Direct Expense	Difference	Deferral Method	Direct Expense	Difference	Deferral Method	Direct Expense	Difference
(\$47,889)	(54,146)	(6,275)	(61,409)	(63,225)	(1,816)	(75,019)	(79,662)	(4,643)

18. By how much has the EPS of the company declined for 2006, 2007, and 2008 due to this change in accounting principle?

12/31/2006			12/31/2007			12/31/2008		
Deferral Method	Direct Expense	Difference	Deferral Method	Direct Expense	Difference	Deferral Method	Direct Expense	Difference
\$1.75	\$1.68	(\$0.07)	\$13.29	\$13.40	(\$0.11)	(\$8.04)*	(\$8.10)*	(\$0.06)

* Footnote on F-25 shows loss of (\$8.04) and (\$8.11).

Deleted: which is erroneous calculated