FINANCIAL REPORTING PRACTICE GUIDANCE NO. 1 of 2022
(Issued on 4 NOVEMBER 2022)

AREAS OF REVIEW FOCUS FOR FY2022 FINANCIAL STATEMENTS

Under the Financial Reporting Surveillance Programme, ACRA reviews financial statements (FS) of Singapore-incorporated companies for compliance with the prescribed accounting standards in Singapore.

To guide directors, especially those in Audit Committees (ACs), in reviewing FS, we are publishing the proposed areas of review focus for FY2022 FS. ACs are advised to pay close attention to these emerging risks and trends.

We believe there are various areas where ACs should engage the external auditors and thus this year, we have included these areas. Such proactive and substantive engagements will help enhance the quality of audits.

THE ECONOMIC SITUATION

Two and a half years after COVID-19 was declared as a global pandemic, the economic impact is finally tapering down. The global gross domestic product (GDP) growth was strong again at 4.6% year-on-year in Q1 2022, the strongest since Q3 2008[1].

In Singapore, the easing of safe management measures and border restrictions from March 2022 also fuelled post-pandemic recovery. Our road to recovery was however dampened by the geopolitical uncertainty and supply chain disruption from the Russia-Ukraine war. On 11 August 2022, the Ministry of Trade and Industry forecasted Singapore's GDP growth at 3.0% to 4.0% in 2022, down from actual GDP growth of 7.6% in 2021[2].

ACCOUNTING IMPACT FROM GEOPOLITICAL UNCERTAINTIES

While companies with operations and investments in Ukraine and Russia were directly impacted, other companies have also experienced the indirect impact to varying extent.

For example, the invasion of Ukraine followed by government sanctions on Russia and Belarus had disrupted the global supply chain again. This time, key exports from these countries such as oil, natural gas, grains and edible oils have seen supply shortages, leading to surge in prices.

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[1] Source: *Macroeconomic Review Volume XXI Issue 1, Apr 2022*
https://www.mas.gov.sg/publications/macroeconomic-review/2022/volume-xxi-issue-1-apr-2022

[2] Source: *MTI Narrows Singapore's GDP Growth Forecast for 2022 to"3.0 to 4.0 Per Cent"*
https://www.singstat.gov.sg/gdp

The severity and duration from geopolitical uncertainties could have significant impact on a company's assets and liabilities. Directors are reminded to pay close attention to the following accounting considerations:

PROVISIONS

- *The increased prices due to supply shortages and/or government sanctions* may result in the unavoidable costs of fulfilling a customer contract to exceed the economic benefits expected to be received. If so, **the provision for onerous contract should be recognised**.

- When applicable, a **provision should be recognised** to record *any obligation to pay damages for delayed or cancelled deliveries to customers*.

INVENTORIES

- Following *trade sanctions imposed on Russia*, a company with inventories in Russia or inventories expected to be sold to customers in Russia may not be able to dispose these inventories in the normal order of business. If these inventories become obsolete or too slow-moving, their **carrying amount should be written down to their net realisable values**.

- Companies may experience *lower demand or forced closures from its production facilities located in regions affected by the war*. If so, **the unallocated overhead costs should be expensed entirely in the period they were incurred**. The amount of fixed overhead costs allocated to each unit of inventory should also not be increased.

IMPAIRMENT RISKS

- *Significant increases in the cost of raw materials and trade sanctions restricting sales to customers in Russia* could indicate that the carrying amount of an asset or cash-generating unit (CGU) may not be recoverable, thus **should be subject to impairment test**.

- Other **impairment indicators** include physical damage to assets or assets becoming idle in affected regions.

- Companies may *decide to sell assets or CGUs* in the affected war regions. If so, the **disposal group should be measured at the lower of carrying amount and fair value less cost to sell and presented as discontinued operations**.

EXPECTED CREDIT LOSS

- Companies with *significant customers* in jurisdictions with political uncertainties should consider whether the **risk of default** by such customers has increased, and whether the corresponding **receivables are credit impaired**.

INVESTMENTS

- Companies with *significant investments* in Russia should **re-look into previous assessments of control, joint control and significant influence**. These assessments may no longer remain appropriate, following retaliatory *measures taken by Russia such as nationalisation of assets*.

ACCOUNTING IMPACT FROM MACROECONOMIC UNCERTAINTIES

Supply-chain disruptions have pushed up energy, agricultural and commodity prices globally. In Singapore, inflationary pressures were intensified by overall manpower shortages and an increase in labour costs. In October 2022, the Monetary Authority of Singapore (MAS) revised MAS Core Inflation to 4% (up from 2.5% to 3.5) and CPI-All Items Inflation to 6% (up from 4.5% to 5.5%)[3]. To curb inflation, central banks around the world, including the United States Federal Reserve and MAS, have tightened their monetary policies. The Singapore Overnight Rate Average rose to 2.8% on 31 October 2022[4], up from 0.3% on 31 December 2021.

DISCOUNT RATES / INFLATION

- *Rising interest rates would likely lead to higher discount rates* being used to compute value in use (VIU) or fair value less costs of disposal (FVLCD). Similarly, inflation may affect the assumptions used in these computations. **Lower VIU or FVLCD could lead to impairment loss, lowering a company's bottom line**.

- **Income-based valuations** of financial and non-financial assets would be similarly impacted.

DEBT COVENANTS

- A company may be *highly leveraged and dependent on debt financing*. If so, with the rising interest rates, ACs should consider if the company is still able to **service its debt obligations and interest payments**.

- *Rising interest rates leading to higher discount rates* would **reduce asset value**, which **could lead to a breach of debt-to-equity or asset-to-liability ratios**.

GOING CONCERN

- ACs of *highly leveraged* companies should not conduct going concern assessment on a 'business as usual' mode. An in-depth assessment should be performed, including **detailed scenario analysis** of the impact of higher interest payments together with other factors.

- If *interest rates are rapidly rising*, **cash flow projections should be updated up to the date of authorising the FS**, which is several months after the financial year-end.

- Other **factors relevant for going concern assessment** include higher interest payments, supply-chain disruptions, increasing operation costs, loss of customers and overall economic uncertainty. They should be considered concurrently with impact of interest rates.

- Often, a **combination of several factors occurring concurrently** could tilt the going concern assessment. These combinations should be incorporated in the detailed scenario analysis.

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[3] Source: *Macroeconomic Review Volume XXI Issue 2, Oct 2022*
https://www.mas.gov.sg/publications/macroeconomic-review/2022/volume-xxi-issue-2-oct-2022

[4] Source: Domestic Interest Rates
https://eservices.mas.gov.sg/statistics/dir/DomesticInterestRates.aspx

ACRA's Tips for ACs

- Review projections of financial performance and positions ahead of financial year-end. In the event of a potential breach of loan covenants, engage lenders early for waivers and/or arrange for alternative financing.
- Rely less on historical trend information and consider if reassessment of facts and circumstances are needed, when making cash flow projections.

ACCOUNTING IMPACT FROM CLIMATE CHANGE MOVEMENTS

Globally, there is a growing coalition of countries and businesses that have pledged to achieve net-zero emissions. Locally, the Singapore Green Plan 2030 was launched in February 2021, aiming to strengthen Singapore's commitments to sustainable development and achieve a net-zero emission by 2050.

As companies are ramping up their sustainability efforts, ACs should consider the relevant accounting implications. For example, with the government's plan to increase carbon tax, ACs should seek understanding from management on:

- the impact on bottom line due to increased costs of operation or production;
- the impact from changing consumer preference towards sustainable products; and
- in extreme cases, whether carbon intensive operation or business may become economically unfeasible, hence should be restructured or discontinued.

The above decisions may impact forecasted cash flows used for valuations and/or impairment testing, leading to energy-inefficient equipment being written down/off and their useful lives and residual values being reduced.

ACs should also be mindful of climate commitments, which may create a constructive obligation to be recognised as a provision or to be disclosed as a contingent liability.

ACRA's Tips for ACs

The Institute of Singapore Chartered Accountants (ISCA) has issued a Technical Bulletin[5] on climate-related risk considerations in financial reporting and audits of financial statements. Directors are strongly encouraged to read it.

[5] This bulletin is issued by the ISCA AASC-FRC ESG working group, which includes ACRA representatives and is accessible from https://www.isca.org.sg/standards-guidance/isca-technical-bulletins

RISK ASSESSMENT OF COMPANY, INCLUDING FRAUD RISK

Post-pandemic, a company's processes or controls may change due to new ways of working. Coupled with the geopolitical and macroeconomic uncertainties, there may be *heightened incentive or pressure* to commit fraud.

The primary responsibility for the prevention and detection of fraud rests with both those charged with governance (TCWG) of the entity and management. Hence, in addition to performing their own risk assessment, ACs should **understand the auditor's assessment of fraud risk** and **their audit procedures** performed with respect to Singapore Standard on Auditing (SSA) 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, including how they had (i) assigned audit staff, taking into account the knowledge, skill and ability of those individuals and the identified risks; (ii) evaluated the company's selection and application of accounting policies, particularly those related to **subjective measurements**; and (iii) incorporated an **element of unpredictability** in their audit procedures.

SSA 315 (Revised 2021) *Identifying and Assessing the Risks of Material Misstatement* is effective for audits of financial statements for periods beginning on or after 15 December 2021 and introduces certain new concepts and other changes, key ones being summarised in Section 5 of ACRA's 2022 Practice Monitoring Programme (PMP) Public Report [6]. ACs should engage the auditor to understand the auditor's understanding/assessment of the entity's IT environment, including relevant use of IT and control activities, especially given that there may be new ways of working as mentioned.

MULTI-LOCATION AUDITS OF GROUP COMPANIES

With more audit work done remotely and travel restrictions still in place in certain countries, ACs should **understand how the auditor** (of the group financial statements) **discharges their responsibilities as group auditor**. In particular, ACs should step in when there are any component auditors that have refused the group auditor's access to documents (or audit documentation), impeding the group auditor's ability to perform their role effectively.

In extreme cases when the group auditor cites *extraordinary events* as part of the challenges in gaining access to component auditors' work papers, such as those discussed in Audit Guidance Statements (AGS) 12[7], ACs **should enquire about the procedures performed by the group auditor to discharge their responsibilities in such circumstances**.

[6] Accessible from https://www.acra.gov.sg/training-and-resources/publications/reports/practice-monitoring-programme-public-reports

[7] Accessible from https://isca.org.sg/standards-guidance/audit-assurance/standards-and-guidance/audit-guidance-statements-(agss)

USE OF TECHNOLOGY IN AUDIT

Auditors are increasingly leveraging on technology and data analytics in conducting audits. Benefits from the use of technology include (i) reducing sampling risk and increasing audit coverage; and (ii) conducting better analysis of data and exceptions. ACs should **engage the auditor to understand**:

(a) how it is **leveraging on technology (and data)** to improve audit quality; and

(b) conversely, the **complexities/challenges** preventing the use of technology.

Auditing standards require auditors to obtain **reasonable assurance** about whether the financial statements are free from material misstatement. Even if auditors may widen the scope of testing by using technology and data analytics (as opposed to traditional audit procedures), ACs should not expect auditors to provide beyond a 'reasonable assurance' opinion.

ENSURE AUDITOR'S INDEPENDENCE

Auditor's independence is the foundation for high quality audits. ACs should understand (i) how the audit firm monitors compliance with independence rules, including **financial independence** and **personal relationships** between the auditor and the entity's personnel, particularly those in accounting or finance functions; and (ii) what processes are in place to identify independence violations (including regulatory violations) and to ensure that they are properly communicated to the ACs, on a timely basis.

The ACRA Code of Professional Conduct and Ethics for Public Accountants and Accounting Entities will be revised to adopt the Final Pronouncements on Revisions to Non-Assurance Services (NAS) and Fee-related Provisions of the Code issued by the International Ethics Standards Board for Accountants. The objectives are to (i) strengthen independence requirements, particularly for audit clients which are public interest entities that audit firms provide NAS to; and (ii) enhance engagement with TCWG and transparency of fee-related information to TCWG and stakeholders. The Revised ACRA Code is expected to be effective from 15 December 2022. Key changes are set out in Section 6 of ACRA's 2022 PMP Public Report[6].

INCREASE TRANSPARENCY OF AUDIT INSPECTION FINDINGS

The audit work of public accountants is subject to inspection by ACRA under PMP. With the passing of the Accountants (Amendment) Bill in October 2022, ACRA will require public accountants who have obtained "Not Satisfactory" inspection outcome to disclose their audit inspection findings to the audit client of the inspected engagement. This change is expected to take effect in 2023.

With such information, ACs are encouraged to **understand the root causes of the inspection findings and the remediations taken** by the public accountants to avoid recurrence. ACs should also assess **implications to the company's financial reporting and future audits approaches and procedures**, where applicable. This will enable the AC to assess the audit firm's commitment towards the delivery of quality audits.

ACRA's Tips for ACs

ACs should **request AQI data from the auditor and conduct in-depth discussions with the team to assess the audit firm's commitment to audit quality**. This includes, but is not limited to, AQIs highlighted in the Audit Quality Indicators Disclosure Framework[8].

ACRA publishes information on industry average and ranges for audit firms in the listed companies' segment on a semi-annual basis[8], such as (i) leverage ratios; (ii) average year of experience; and (iii) overall staff attrition rates.

The audit profession is currently facing a talent crunch and heightened attrition. Coupled with the increasing offshoring/outsourcing of certain audit tasks, ACs should pay **special attention** to (i) the tasks that the audit team offshores and how it ensures that these tasks are appropriately performed and reviewed; and (ii) whether sufficient time is spent by the partners and managers during each audit phase, to ensure there is adequate oversight.

The above factors are provided as a general guideline. They do not exhaustively define the requirements of the prescribed accounting and auditing standards in Singapore. When in doubt, directors should seek professional help. ACRA reserves the right to conduct review of other areas as deemed necessary.

[8] Accessible from https://www.acra.gov.sg/public-accountants/audit-quality-indicators-disclosure-framework