FINANCIAL REPORTING PRACTICE GUIDANCE NO. 2 OF 2015

AREAS OF REVIEW FOCUS FOR FY2015 FINANCIAL STATEMENTS UNDER ACRA'S FINANCIAL REPORTING SURVEILLANCE PROGRAMME

Under the Financial Reporting Surveillance Programme (FRSP), ACRA will review selected financial statements with financial year ended between 1 January 2015 and 31 December 2015 (FY2015 Financial Statements) for compliance with the Accounting Standards[1]. For details on the FRSP and directors' duties in relation to financial reporting, please refer to ACRA's website.

To guide directors and other financial statements preparers, ACRA is publishing the areas of review focus for the FY2015 Financial Statements. This will serve to remind directors of the risks of misstatements in the financial statements and questions they could ask before authorising the FY2015 Financial Statements for issue.

1. Control over investees – Bright line of 50% removed

SFRS 110 *Consolidated Financial Statements* has removed the bright line of 50% voting power and introduced new requirements for assessing whether an entity controls an investee from 1 January 2014. More attention and care should be placed to assess how Reserved Matters could apply and affect an entity's decision-making over its investee.

Reserved Matters that require unanimous consent

Business co-operation often involves different shareholders coming together to provide different expertise and/or funding. In business co-operation involving a few substantial shareholders, the Shareholders' Agreement could include Reserved Matters, which set out business decisions requiring unanimous consent from all shareholders. These Reserved Matters **could prevent a substantial shareholder holding more than 50% of the voting power from having control over an investee**.

To ensure proper accounting, directors should first understand the value that each substantial shareholder brings to the business co-operation and the rationale for including the Reserved Matters. Directors could then question whether these Reserved Matters give the other shareholders substantive rights to jointly make decisions that significantly affect the investee's returns. If so, the investee should be accounted for as a joint arrangement rather than be consolidated as a subsidiary. Any significant judgement made by the directors in the assessment should also be meaningfully disclosed.

[1] Accounting Standards refer to Singapore Financial Reporting Standards (SFRS), Singapore Financial Reporting Standards for Small Entities and Charities Accounting Standards, as issued by the Accounting Standards Council.

2. Call or put option over shares of investee

Companies are increasingly entering into exotic financial instruments, such as call options and put options over the shares of their investees. If a company holds a call option over the shares of an investee, the company is given the right to acquire more shares in the investee. On the reverse, if a company writes a put option over the shares of an investee, the company is obligated to sell the shares in the investee when the put option is exercised.

Directors should understand the business reasons and implications for entering into call and put options. With the knowledge, directors should question how these options would impact the assessment on whether the company controls or joint controls or has significant influence over an investee. Directors should also enquire whether these options should be accounted for as derivatives.

3. Business acquisitions – reflecting the real value of the acquired business

Business acquisitions remain a source of growth for many companies in Singapore. When the acquisition is accounted for as a business combination, directors should first **apply their knowledge on the reasons for acquiring the business and the factors they have considered in determining the purchase price paid for the business**.

With this knowledge, directors should determine if **part of the goodwill is attributable to the acquisition of specific intangible assets** such as know-how, licenses and customer lists. If so, those specific intangible assets should be separately valued and recognised during the purchase price allocation (PPA) exercise.

When there is no in-house specialist to perform the PPA, directors should engage an external professional valuer to **identify the specific intangible assets and value them separately**. The scope of the PPA exercise should not be limited to specific intangible assets pre-identified by management, which could lead to an omission.

It is important to **differentiate goodwill from specific intangible assets.** Goodwill is tested for impairment annually, whereas specific intangible assets are typically amortised. Had specific intangible assets been separately recognised, the expenses from their amortisation would **better match the revenue derived from these assets** subsequent to the business acquisition**.**

After specific intangible assets have been recognised, directors should understand the reasons (for example, assembled workforce) for the remaining amount recognised as goodwill and disclose meaningfully to shareholders the real value of the acquired business.

4. Long-life assets value and impairment testing

Against the backdrop of a new norm of low growth, impairment of assets is of increasing concern in sectors such as energy, commodity and shipping. Directors could use the following principles when reviewing impairment tests:

(a) Cash flow projections should be **reasonable and supportable**. Directors could request management to examine the **reasons for the differences between past year's cash flow projections and the actual cash flows**. Directors could also apply their knowledge of the business to enquire if **recent changes in circumstances**, such as a disposal of business segment, are reflected in the cash flow projections;

(b) Terminal value (net present value of forecasted cash flows beyond the explicit forecast periods) typically forms a **significant portion of the cash flow projection**. In most circumstances, terminal value is derived by extrapolating the final year's cash flow projections. Directors could challenge whether such extrapolation is **reflective of the current economic contraction/expansion** and **whether those cash flows could be maintained** until the end of the asset's economic life;

(c) **Discount rate** that reflects the risks specific to the asset should be used, rather than the company's borrowing rate without further adjustments. Directors should robustly challenge the basis of the discount rate used if it appears abnormally low or high compared to their understanding of the general business environment. For example, if the future cash flows from an asset are generated from a country where the risk-free interest rate of its government bonds is more than 10% per annum, then it would not be reasonable to use a discount rate of less than 10% per annum; and

(d) **Disclosures should be tailored to the facts and circumstances of the businesses**, such as the commercial reasons for recognising the impairment loss. In situations where there is small headroom in impairment testing and the carrying values of goodwill and/or other long-life assets are material, the disclosure of sensitivity analysis will allow readers to assess the safety margin based on the assumptions used.

5. Breaches of borrowing covenants

It is a common practice for financial institutions to include borrowing covenants measured on the borrower's financial condition or performance in the loans extended to companies. With the slowing down of the global economy, some borrowers may face a risk of breaching these borrowing covenants or defaulting on loan repayments, which could lead to their long-term borrowings becoming immediately payable.

Directors of companies with high gearing should query on whether all borrowing covenants have been met and whether loan repayments have been paid timely. If not, directors should consider their implications, including whether the borrowing should be reclassified from a non-current liability to a current liability.

6. Sale-and-leaseback transactions

An increasing number of companies are turning to sale-and-leaseback as an alternative to traditional forms of financing. A sale-and-leaseback occurs when a seller sells an asset, but retains the use of that asset by leasing from the buyer.

Directors are reminded that the accounting for sale-and-leaseback transactions should be based on the '**substance over form**' consideration, i.e. whether the seller had **transferred substantial risks and rewards relating to ownership of the asset** to the buyer.

In most cases, sale proceeds and lease payments of sale-and-leaseback transactions are negotiated as a package. Where these transactions are **structured with terms** such as purchase option, deferred consideration or seller's obligation to provide residual value guarantee and/or future capital expenditure, directors should challenge if these terms will result in the seller continuing to bear substantial risks and rewards of the asset. If so, the "profit" from the sale transaction should be deferred and recognised as financing income over the lease term, rather than in full immediately.

7. Statement of Cash Flows

Operating cash flow is an important indicator to investors when assessing the ability of a business to generate cash to fund its operations and investments, and to repay its debts.

When presenting the statements of cash flows, many listed companies in Singapore use the indirect method, whereby the profits are adjusting for non-cash items and changes in working capital to arrive at the operating cash flows. Sometimes, significant balances relating to business combinations were inappropriately included as part of working capital, thereby misstating the operating cash flows. Examples include progress payments received for the disposal of a subsidiary, refunded deposit from an aborted business acquisition and prepayments made to acquire a controlling stake in an investee.

In addition, companies continued to wrongly include foreign currency translation differences taken directly to equity as adjustments to operating cash flow. Such translation differences commonly arise from overseas subsidiaries with functional currencies that are different from the presentation currency of the Group. Directors are reminded that these translation differences should be tracked and allocated to the assets and liabilities that gave rise to the differences instead.

8. Impact from currency environment

There have been significant currency movements recently in countries in which Singapore companies have significant investments, such as Malaysia, China, Indonesia and Australia.

When determining the recoverable amounts of foreign currency assets such as investments in shares, investments in associates, and underlying assets of subsidiaries, directors should ensure that the assessments are conducted in the functional currency of the entities holding these investments, which could lead to impairment charge. For example, with the recent deterioration of the Malaysian Ringgit (RM) against the Singapore Dollar (SGD), a company with SGD functional currency may need to recognise an impairment charge on its available-for-sale equity investment in Malaysia, even though the investee's share prices in RM have stayed constant.

9. Earnings per share (EPS)

EPS is a ratio widely used by financial analysts and investors to assess a company's profitability and value its shares using the price-earnings ratio. EPS facilitates comparison of performance of a company over different periods and with its peers.

When companies undertake **capital structure changes** such as share consolidation, share split, bonus shares or rights issue during the year, directors are reminded to ensure that the basic and diluted EPS are **adjusted during the period and for past periods** to reflect the change in the number of shares without a corresponding change in resources.

10. Fair value measurement

SFRS 113 *Fair Value Measurement* establishes the framework for measuring and disclosing fair value, including the disclosure of fair value hierarchy. The fair value hierarchy provides an indication of the extent to which market observable inputs are used to determine the fair value, with Level 3 being the category with many significant unobservable inputs used.

Given that the valuations of assets such as investment properties and biological assets involve many significant unobservable inputs, directors should expect these fair values to be classified as Level 3. Directors should also **expect more disclosures** on **assets and liabilities** for which fair values are **classified as Level 3.** Such disclosures should also be made at a **meaningful level of aggregation**.

The above factors are provided as a general guideline. They do not exhaustively define the requirements of the Accounting Standards. When in doubt, professional help ought to be sought by directors. ACRA also reserves the right to conduct review of the other areas in the financial statements as deemed necessary.