FINANCIAL REPORTING PRACTICE GUIDANCE NO. 1 OF 2018

AREAS OF REVIEW FOCUS FOR FY2017 FINANCIAL STATEMENTS UNDER ACRA'S FINANCIAL REPORTING SURVEILLANCE PROGRAMME

Under the Financial Reporting Surveillance Programme (FRSP), ACRA reviews selected financial statements (FS) for compliance with the accounting standards in Singapore.

To guide directors in reviewing their company's upcoming financial statements, ACRA is publishing the FRSP areas of review focus for FY2017 FS. This will remind directors of some potential risks of misstatement in the financial statements and provide the questions they may ask management to improve the quality of financial reporting.

Our economic environment and upcoming changes in accounting standards

For 2017, the economic outlook[1] is generally positive, with 3.0%-3.5% growth projected for the Singapore economy, with the global GDP growth projected to strengthen as well.

Various sectors posted improvements in results, notably in semiconductors, computer peripherals and retail. For these companies and those undergoing expansion, directors may find financial reporting areas such as business acquisitions and consolidation/equity accounting mentioned below to be relevant.

Some sectors continued to face challenges as of Q3 2017. For example, sluggish demand continued for oil and gas exploration capital equipment. For these sectors as well as companies significantly affected by digital disruption, impairment assessment may be of importance.

Separately, the effective dates of a few accounting standards are drawing close.

Against this backdrop as well as our recent observations from FRSP, we urge directors to pay more attention to the following financial reporting areas:

1. Upcoming changes in accounting standards – Is financial effect adequately disclosed?

By the time directors approve the FY2017 financial statements in 2018, some of the following changes to accounting standards will be effective:

Changes effective for financial years starting on or after	1 January 2018	1 January 2019
IFRS 15 (identical) / SFRS 15 *Revenue from Contracts with Customers*	✓	
IFRS 9 (identical) / SFRS 109 *Financial Instruments*	✓	
Convergence with IFRS	✓	
IFRS 16 (identical) / SFRS 116 *Leases*		✓

Based on our observations of FY2016 FS, we are encouraged to see some companies disclosing meaningful qualitative information on how their accounting policies would be affected when the new accounting standards are adopted. As some new standards will be effective by the time FY2017 FS is issued, we expect companies to report more progressive developments, including known or reasonably estimable quantitative

[1] Source: MAS Recent Economic Developments in Singapore - 6 Dec 2017

information, in the FY2017 FS. This will help shareholders assess the possible impact from the new accounting standards.

As for IFRS 16 (identical) / SFRS 116 *Leases* effective in 2019, many companies which are lessees of office/retail space and property, plant and equipment will be affected. Directors of these companies should ensure that the preparation for adoption is on track. As future lease payments will generally be recognised as a financial liability instead of just being disclosed as lease commitments, the entity's compliance with loan covenants may be affected. Directors may wish to keep a close tab on this, and have management engage their financiers, as necessary.

2. Going concern – Can the entity continue to operate in the near term (at least 12 months)?

Financial statements are normally prepared assuming the entity will continue its operations for the foreseeable future (i.e. as a going concern).

Where there are indications of financial difficulty such as substantial operating losses, net current liability position, unfavourable financial ratios, inability to pay creditors, breach of loan covenants or significant uncertainty on refinancing of maturing borrowings, directors should evaluate the key assumptions used to assess whether the company is able to continue as a going concern for a period that covers at least, but not limited to, twelve months from the financial year-end.

Directors are reminded that **significant judgements made** in concluding that the going concern assumption is appropriate must be disclosed fully and in a timely manner. This is to enable investors to make informed decisions when there are indications of financial difficulty.

In situations where a letter of financial support from a related party is used to substantiate the going concern assumption, directors are reminded to evaluate whether the related party has a realistic ability and intention to provide the financial support.

3. Value of long-lived assets – Any indication of impairment? If yes, has an impairment test been conducted? If a previous impairment loss is reversed, is this supported by real improvement in performance or economic conditions?

Impairment testing is important to ensure that assets are carried at a value no more than their recoverable amount. Directors, particularly those of companies in sectors that are facing challenges, may consider the following:

(a) If an operating segment is loss making and no impairment test is conducted, enquire why none of the eight prescribed indications of impairment in the accounting standard is relevant. Examples of these indications include loss of major customers, cancellation of orders and plan to discontinue or restructure operations;

(b) If there are material goodwill and other intangible assets with indefinite useful lives, and no impairment test is conducted, enquire why no impairment test is conducted. For such assets, impairment test must be conducted annually, even where there is no indication of impairment;

(c) If an impairment test is conducted, assess whether the key assumptions used by management reasonably reflect the current business plan, the economic outlook and other industry-specific conditions. Ask if there is any change in the methodology used and if yes, evaluate the reason for change;

(d) Where the recoverable amount is determined using "value in use" method:

 (i) Ask management how they have ensured all cash outflows (e.g. costs for renewing mining licence) required to generate projected cash inflows (e.g. revenue from renewed mining licence) are included;

 (ii) Check that the discount rate reflects the **risks specific to the asset(s)**, rather than based on the entity's borrowing rate, the country's inflation rate or government bonds' interest rate without any adjustments;

 (iii) Assess the reliability of key assumptions such as revenue, gross margin and net profits by comparing last year's projections to current year's actual results. Where practicable and available, compare current year's projections against those used by industry peers as a form of sanity check; and

(e) If the headroom is small or the quantum of impairment charge is not aligned with the directors' understanding of the business, ask which are the key assumptions where a reasonable possible change would significantly affect the impairment charge. Review these key assumptions carefully to ensure that they are not overly aggressive or conservative. Request for **sensitivity analysis** to assess the impact of reasonably possible changes to these assumptions.

On the other hand, if there is a reversal of impairment loss, directors should confirm the following:

(a) The reversal is a result of a real improvement in underlying factors and not from discounting effect such as when projected cash flows are getting closer to the reporting date;

(b) The reversal of depreciable/amortisable asset is limited to its carrying amount, net of depreciation/amortisation had no impairment loss been recognised; and

(c) The reversal is not attributable to goodwill, which is prohibited by the standard.

Directors should ensure that impairment disclosures are **meaningful and complete**, including the commercial reasons for recognising or reversing an impairment charge. Where the headroom is small and the asset's carrying value is material, directors should check that the sensitivity analysis is disclosed for investors to assess the safety margin.

Aside from discount rate and long-term/terminal growth rate, assumptions such as revenue growth, margins and specific costs could significantly affect the recoverable amount but they are frequently not disclosed. In addition, the standard requires disclosure of whether the assumptions reflect past experience or are consistent with external sources of information, and if not, how and why they differ from past experience or external sources of information. Such disclosure is also frequently missed out.

4. Significant one-off gains or losses – Does it make business sense?

Significant one-off gains or losses can arise from transactions arranged in a certain legal form for various reasons (for example, tax efficiency). As a guiding principle, these transactions should be accounted for based on the **economic substance** of the arrangements, rather than their legal forms.

Some transactions we have observed include:

(a) Partial disposal of a subsidiary to a financial institution with **an obligation to reacquire** the sold interests in 12 months' time. The re-purchase price was set at the original sale price plus a margin that was akin to the borrowing rate. By accounting based on the legal form (i.e. as a disposal, rather than a financing arrangement), the "seller" recognised a gain in the year of "disposal", followed by another gain (from re-measuring the retained interests to fair value) in the year when it "reacquired" the "disposed" interests; and

(b) Sale of a vessel to a financial institution, with non-cancellable leaseback arrangement during which the **"seller" retained substantially all risks and rewards** associated with ownership. The "seller" also provided residual value guarantee via an option to reacquire the same vessel. By accounting based on the legal form (i.e. as a sale and leaseback arrangement, instead of a financing arrangement), the "seller" recognised a gain on "disposal" of the vessel and significantly improved its gearing ratio by recognising the lease as an off-balance sheet item.

Directors are in a position to approve major transactions and hence, are expected to evaluate the appropriateness of one-off material gains or losses. To ensure that the **accounting of such transaction reflects the economic reality of the arrangement**, directors are reminded to:

(a) Consider all relevant facts and circumstances, including the commercial intent of entering into the transactions, the contractual terms and financial instruments used;

(b) Evaluate alternative accounting treatment(s) and conclude that the adopted accounting treatment is the most appropriate; and

(c) Make critical judgements in good faith, without biases or pressure, with supportable evidence and where necessary, advice from experts.

Fair value changes of assets or liabilities may lead to significant gains or losses. Examples of assets or liabilities that may be carried at fair value include investment property, derivatives, biological assets and investments. Directors should seek the assistance of independent professional valuers if such items are significant and specialised in nature. When engaging a valuer, directors should review the valuer's credential, scope of work (full or desktop valuation) and valuation interval considering factors such as the significance of the asset and volatility of prices. Directors should also assess whether the fair value change is in line with their understanding of the market conditions and asset attributes.

5. Consolidation or Equity Accounting – Looking beyond legal forms, has the rights to participate in decision-making held by various parties been considered?

Directors should pay closer attention to the classification of investees where external parties have special rights to participate in decision-making of the investees. The existence of potential voting rights (for example, call options and warrants) may also affect the determination of control.

Directors should ask if the agreements with co-investors provide for “reserved matters” (i.e. decisions that require unanimous consent from the various groups of shareholders). If reserved matters relate to relevant activities (i.e. activities that significantly affect investee’s returns), an investor would not have unilateral control even if it owns more than 50% of the voting power. In such a case, the investor should equity-account, rather than consolidate, the investee.

For ease of fund repatriation, an investor may choose to invest through financial instruments such as notes receivable and warrants, instead of directly owning shares in investees. To protect the investor’s interests, these instruments may provide contractual rights enabling the investor to participate in deciding how the investee’s business is run. While such rights may be termed “protective” in the agreement, they can be “substantive” (grants control) from an accounting perspective and hence, resulting in the need to consolidate the investee.

Directors should **perform reality checks** that the accounting treatment is consistent with the economic reality. To do so, directors must first **understand the value** each business partner (i.e. shareholders, lenders and option holders) brings to a business co-operation and **the rationale for including** reserved matters, granting other contractual rights and using various financial instruments. Directors should then assess whether they agree with the management’s conclusion on whether the company controls, jointly controls or has significant influence over an investee. Any significant judgement made should be meaningfully disclosed in the financial statements.

6. Business acquisitions – Have other intangible assets been carved out from goodwill and separately recognised? What is the date of acquisition for accounting purposes? Are there terms that may affect purchase consideration?

Business acquisitions remain a source of growth for many companies in Singapore. Accounting and valuation of acquired businesses could be complex.

Accounting may be complex due to arrangements such as:

- Earn-outs or contingent consideration;
- Step-acquisition;
- Pre-existing relationship with vendor; and
- Call or put options entered into as part of the business acquisition.

When a business is acquired, it is not uncommon to pay a premium over the fair value of net tangible assets. For accounting purpose, the acquirer should analyse if the acquired business has **specific intangible assets** that should be carved out from the premium paid. Typical examples include knowhow, licences, patents, trademarks, contracts, order backlog and customer lists. After carving out these intangible assets, they should be recognised separately (and generally amortised) with the residual premium being recognised as goodwill. The failure to separately recognise (and amortise) specific intangible assets may lead to a net overstatement of assets over time.

The larger the goodwill relative to the consideration paid, the higher the likelihood that specific intangible assets exist. Coupled with the fact that some valuations could be complex, directors are encouraged to engage a professional valuer for acquisitions with material goodwill. Directors should check if the scope of the valuer's involvement includes identification of specific intangible assets (versus restricted to valuing only intangible assets pre-identified by management). To obtain more comfort, directors may wish to ask the valuer to assess the reasonableness of management assumptions used in the overall valuation exercise.

Directors should also pay attention to the determination of the acquisition date. This date is important as:

(a) Assets acquired (including intangible assets) and liabilities assumed are valued as of this date; and

(b) Results of the acquired business are consolidated from this date.

Some common errors we have observed include:

(a) Using the date when the sale and purchase (S&P) agreement was signed as the acquisition date when there were substantive precedent conditions in the agreement that had not been fulfilled; and

(b) Consolidating profits from a date before the parent obtained control of a subsidiary and before the S&P agreement was signed, on the basis that the parent would be entitled to some pre-acquisition profits.

7. Statement of cash flows – Are cash flows appropriately classified within operating, investing or financing cash flows?

Net operating cash flow is an important indicator of the entity's ability to generate cash to fund its operations. Investors often look at operating cash flow as a key metric of short-term health and performance as it shows realised economic benefits.

We continue to observe errors where foreign currency translation differences are presented as an adjusting item in the statement of cash flows prepared using the indirect method. Such translation differences typically arise from the consolidation of foreign subsidiaries / operations and do not involve cash flows. Hence, they should not be presented as an adjusting item.

Companies with significant foreign operations are encouraged to prepare the consolidated statement of cash flows by using the individual foreign operations' statements of cash flows presented in their respective functional currencies. This will facilitate the identification of non-cash foreign currency translation differences.

8. Significant judgements and estimates – Are disclosures tailored to the circumstances?

Preparers of financial statements often exercise their judgement to:

(a) Apply accounting treatment in a manner that is consistent with the economic reality of the company's transactions, for example, change in the use of a property under construction; and

(b) Estimate the effects of uncertain future events to determine the amounts of some assets and liabilities, for example, impairment of long-lived assets or liquidated damages.

To facilitate investors' understanding, directors should ensure that those judgements with the most significant impact and that are most subjective or complex, are meaningfully disclosed.

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