FINANCIAL REPORTING PRACTICE GUIDANCE NO. 1 OF 2019
(Issued on 1 February 2019)

AREAS OF REVIEW FOCUS FOR FY2018 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 the upcoming FS, ACRA is publishing the FRSP areas of review focus for FY2018 FS. This will serve to remind directors of some possible reporting misstatements and provide questions they may ask management.

New accounting standards

2018 and 2019 are years when significant changes in accounting standards have taken effect. In 2018, the accounting standards on revenue in effect since 1997 were replaced by SFRS(I) 15 / FRS 115 *Revenue from Contracts with Customers*, with markedly increased requirements. At the same time, SFRS(I) 9 / FRS 109 *Financial Instruments*, introduced notable changes for financial assets, including a new expected credit loss impairment model.

These changes have been followed by SFRS(I) 16 / FRS 116 *Leases*, which may increase the recorded liabilities of many companies. Aside from the need to implement new systems and processes, these changes may result in business impact on aspects such as compliance with loan covenants, ability to pay dividends, exposure to taxes and remuneration schemes.

In light of these developments and our recent observations from FRSP, we encourage directors to pay more attention to the following financial reporting areas:

1. New accounting standards – What are the areas with critical judgements and significant estimates?

<u>SFRS(I) 15 / FRS 115 *Revenue from Contracts with Customers*</u>
The new revenue standard is considerably more detailed. The standard may also require significant judgements and estimates in deciding when and how much to recognise as revenue. Directors should be alert to the following factors, which may trigger a further discussion with management:

a. *Customer contracts where the performance obligations straddle beyond one year*

The criteria to decide whether revenue is recognised 'at a point in time' (typically, at delivery) or progressively 'over time' (typically, using the percentage of completion method) have changed.

In particular, one criterion states that revenue is recognised 'over time' *only when* the company's performance does not create an asset with alternative use to the company and when the company has an enforceable right to payment for performance completed to date.

This may lead to a change in the timing when revenue is recognised, for example, in real estate, construction, shipbuilding and infrastructure projects.

Example 1: Determining whether an asset has alternative use to the company
Adapted from IFRS 15 Illustrative Example 15

A company constructs equipment for customers. Under the previous revenue standards, these contracts were accounted for using the percentage of completion method.

Under the new revenue standard, management must assess whether the equipment has alternative use to the company as follows:

- *Scenario A: Equipment is not specialised*

  The equipment requires minimal customisation. The equipment can be re-directed for sale to another customer with no significant rework.

  Conclusion: The equipment has alternative use to the company. Revenue is recognised when delivered 'at a point in time'. (*There is a change*)

- *Scenario B: Equipment is specialised*

  The equipment is specially designed and constructed to fit the customer's needs. Significant costs must be incurred to rework the design and function of the equipment for selling to another customer.

  Conclusion: The equipment has no alternative use to the company. If the other requirement is met (i.e. having an enforceable right to payment for performance completed to date, as illustrated in Example 2), revenue is recognised 'over time'. (*No change*)

Example 2: Enforceable right to payment for performance completed to date
Adapted from IFRS 15 Illustrative Examples 16 and 17, and IFRIC agenda decision (March 2018)

A company builds vessels for customers. Under the previous revenue standards, these contracts were accounted for using the percentage of completion method.

Under the new revenue standard, management must assess whether there is an enforceable right to payment for performance completed to date (for reasons other than company's failure to deliver as promised) in the event of termination as follows:

- *Scenario A: Right to receive progress payments that did not correspond to the performance completed to date*

  The company is entitled to retain progress payments received to date. Under the contract, progress payments are due as follows:
  - 10% at inception;
  - 50% over various milestones; and
  - 40% upon completion.

  Even though the progress payments received are non-refundable, the cumulative payments are not expected to, at all times throughout the contract, correspond to the amount necessary to compensate the company for the performance completed to date. For example, when the project is 80% completed, the company will receive only 60% (10% plus 50%) of the total selling price.

  Conclusion: There is no enforceable right to payment for performance completed to date. Revenue is recognised when the vessel is delivered 'at a point in time'. (*There is a change*)

- *Scenario B: Right to receive compensation for the loss of profit*

  The company is entitled to retain progress payments received to date. Under the contract, progress payments are due as follows:
  - 10% at inception;
  - 90% upon completion.

  In the event of termination, the customer is liable to compensate the company for any shortfall between the original contract price and the selling price to a replacement buyer.

  Conclusion: Compensation for the loss of profit is not equivalent to right to payment for the performance completed to date. The right to receive compensation for the loss of profit is derived from the new sales contract, and not the original contract. Revenue is recognised when the vessel is delivered 'at a point in time'. (*There is a change*)

- *Scenario C: Right to receive all consideration promised under the contract*

  The company receives a non-refundable deposit and progress payments over various milestones. If the customer defaults, the company has a right to receive the remaining consideration in the contract if it completes the construction of the vessel. The courts have previously upheld similar rights that entitle shipbuilders to require their customers to pay, subject to the shipbuilders meeting their obligations under the contracts.

  Conclusion: There is an enforceable right to payment for the performance completed to date. If the other requirement is met (i.e. the asset has no alternative use to the company, as illustrated in Example 1), revenue is recognised 'over time'. (*No change*)

Directors should also look out for the following hot topics in implementing the new revenue standard:

- Under the new standard, only costs that meet the definition of an asset are recognised as assets. A company that recognises revenue 'over time' is precluded from deferring or accruing costs to achieve a constant profit margin (in percentage) from one period to another. A contract may have fluctuating gross margin (in percentage) over different periods, particularly when its related costs incurred are uneven or lumpy. There will be no "contract work-in-progress" asset or liability on the balance sheet as well.

  Under the previous standard, a contract accounted for using the percentage of completion method would have a constant gross margin (in percentage) throughout the duration of the contract.

  For details, please refer to the Institute of Singapore Chartered Accountants' (ISCA) Technical Bites[1].

- For assets that take a long time to construct but are ready for sale (in their uncompleted state (for example, residential property units for which revenue is recognised 'over time'), the International Accounting Standards Board (IASB) issued a tentative view[2] that the related borrowing costs should not be capitalised for both the sold and unsold units.

  A final decision may be made by IASB after February 2019. If this matter applies to the company, its directors should engage their auditors before authorising the financial statements for issuance to assess if adjustments or additional disclosures are required. For details, please refer to ISCA's Technical Bites[3].

b. *Customer contracts with bundled products and/or services to be delivered at different times*

As companies aim to provide customers with a "one-stop solution", it becomes a common practice for them to sell bundled products and/or services. For example, an electronic equipment reseller may sell extended period of warranty or maintenance, in addition to selling the equipment to retail customers.

[1] ISCA Technical Bites (https://isca.org.sg/tkc/fr/techbites) - *"Costs to fulfil a contract – Can we defer/capitalise the costs incurred for construction of a building to work-in-progress when the contract with the customer is a single performance obligation satisfied over time in accordance with paragraph 35(c) of FRS 115?* "(23 Nov 2018)

[2] IFRS Interpretations Committee's tentative agenda decision (Nov 2018)

[3] ISCA Technical Bites (https://isca.org.sg/tkc/fr/techbites) - "*Capitalisation of borrowing costs*" (31 Dec 2018)

In such situations, the new revenue standard requires the company to identify separate distinct deliverables (referred to as performance obligations, or POs), and allocate the total contract sum to each PO.

The allocated revenue may also be recognised at different time periods. Following on the earlier example, the revenue attributable to the sale of equipment is recognised when the equipment is delivered, while that of warranty or maintenance service is recognised over the service period.

c. *Customer contracts with significant non-refundable upfront fees that are not related to a transfer of goods or service*

Companies may require customers to pay a one-off non-refundable activation or initiation fee at the inception of the contract.

The new revenue standard requires the company to assess whether these fees are payments for goods or service to be delivered at the inception of contract or in the future. If the latter, revenue is deferred and recognised when the goods or service are delivered in the future.

The fees may also be progressively recognised as revenue beyond the initial contractual period, as explained in the example below.

Example 3: Non-refundable upfront fee

A company charges new customers a non-refundable upfront fee of $200 for setting up the contract and $800 for providing a service in the first year. The customer has the option to renew the contract at $800 for the second and subsequent years.

Under the previous revenue standards, the company might recognise the upfront fee of $200 as revenue immediately when received. Under the new revenue standard, the company assesses if the option to renew at the lower rate of $800 is a “material right”, as compared to $1,000 (including the upfront fee) payable by new customers. If so, the upfront fee of $200 is recognised over the estimated period of the customer relationship.

If the past experience shows that the company’s customers would renew once on average, the upfront fee is recognised over 2 years, as shown below:

	New standard		**Previous standard**	
	Year 1	**Year 2**	**Year 1**	**Year 2**
Set-up revenue	100	100	200	-
Service revenue	800	800	800	800
Total	900	900	1,000	800

We also encourage directors to review the additional disclosures early and consider the following:

- Are the effects of first time application of the new revenue standard clearly explained and meaningful?

- Have the disclosures been tailored to the company's circumstances, enabling readers to understand the main drivers of a company's revenue?

    - Is there a meaningful breakdown of total revenue? For example, the breakdown of revenue may be disclosed based on the revenue recognition method ('at a point in time' versus 'over time'), geographical regions (by country), types of sales channels (direct sales and sales through intermediaries), types of contracts ("fixed price" and "cost-plus") and/or contract durations (short-term and long-term).

    - Are the disclosures consistent with other disclosures or announcements outside of the FS, including the management discussion and analysis, audit committee commentary and presentation to analysts?

- Are the quantitative and qualitative disclosures adequate to help readers understand the relationship between the revenue recognised and the changes in contract assets and contract liabilities (on the balance sheet)?

<u>SFRS(I) 9 / FRS 109 *Financial Instruments*</u>

In general, more financial instruments are recognised at fair value, as compared to before. Under the previous financial instruments standard, companies might carry their investments in unquoted equities at cost, on the basis that their fair values cannot be reliably measured. Under SFRS(I) 9 / FRS 109, such investments are carried at their fair values, unless their costs approximate the fair values. The new standard also lists seven indicators that cost may not be representative of fair value.

While financial institutions are expected to be significantly impacted, the new standard is applicable to all companies. A company that is not a financial institution should pay attention to the new expected loss impairment model, which also applies to trade receivables, contract assets and lease receivables, for which a simplified approach is provided. The new standard also prescribes new disclosures relating to judgements and estimates.

<u>SFRS(I) 16 / FRS 116 *Leases*</u>
For preparers with December year-end, by the time the FY2018 FS are authorised in 2019, the new lease standard will be effective.

The new lease standard is expected to impact companies that are lessees of office, retail, warehouse space and property, plant and equipment.

As more amounts are expected to be recognised on the balance sheet as financial liability, directors should pay attention to the implications such as compliance with loan covenants. We also expect directors to ensure that there are adequate disclosures of known or reasonably estimable information relevant to assessing the possible impact (quantitatively and qualitatively) from adopting the new standard.

2. Impairment assessment and valuation – Are they performed using a suitable model with objective and realistic assumptions?

Impairment continues to be an area prone to misstatements. This area is applicable to many companies, and it also requires estimates of future cash flows.

As more items are now required to be recognised at fair value (including investment property, derivatives, biological assets, financial assets such as unquoted equity instruments and convertible debts), directors should critically assess the assumptions used by management in those valuations.

Where these items are material to the FS, we urge directors to apply their professional scepticism and challenge assumptions used by management, particularly if the underlying estimates of future cash flows do not appear to conform with the company's circumstances.

We also encourage directors to obtain independent professional valuations for assets that are significant or when there is no in-house expertise. Directors should also assess the final valuation results correspond with their understanding of the market conditions, business model and asset attributes.

Areas	Questions that directors may ask management
Competency of valuer	• Who has conducted the valuation? • (If an internal valuer is used) Does the person have sufficient competency and experience to value the particular asset? • (If an external valuer is engaged) What are the valuer's professional qualifications and experience? What are the areas excluded from the scope of the valuer's work and who are reviewing those areas?
Inputs used	• Are the assumptions realistic? How do these assumptions compare to actual results? • Do the assumptions reasonably reflect the current business plan, the economic outlook and other industry-specific conditions, including technological advances? • Are external inputs (e.g. market information) used to the extent that they are available and relevant?
Model used	• Is the valuation model suitable to value the particular instrument? For example, the Black-Scholes model may not be appropriate for the valuation of an option with complex terms.

Areas	Questions that directors may ask management
Frequency	• How frequently should full valuations be performed on investment properties? (*Consider the financial effect of the asset and the volatility of the value*)

3. Major transactions – Does the accounting treatment reflect the economic substance of the arrangement?

As major transactions are typically approved by directors, they are in a good position to evaluate if **the accounting treatment reflects the economic reality of the arrangement**. The following factors can be used to guide directors' consideration:

a. consider the underlying intent of entering into those transactions, the relevant contractual terms and the financial instruments used;

b. evaluate the alternative accounting treatment(s) and conclude that the adopted accounting treatment most reflects the underlying intent and complies with the accounting standards;

c. make judgements and estimates in good faith and objectively, bearing in mind the possible incentives to various parties; and

d. when in doubt, seek accounting advice from independent experts.

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

Investors often look at operating cash flow as a key metric of short-term health and performance. Directors should do the same, and pay significant attention when a company's profit is not substantially realised in cash.

We also continue to observe the following errors in preparing consolidated statements of cash flows:

a. unpaid liability was incorrectly included in "Cash outflow from acquisitions of property, plant and equipment or business". This overstated the cash outflow from investing activities and the cash inflow from operating activities; and

b. cash flow from transactions with non-controlling interests was incorrectly presented under operating activities or investing activities, instead of financing activities.

Directors should also ensure that there are adequate disclosures of significant non-cash investing and financing transactions to facilitate readers' understanding. Common examples include acquisition of assets using leases or issuance of shares, and a conversion of debt into equity.

5. Significant judgements and estimates – Are disclosures tailored to the company's circumstances?

Preparers often exercise their judgements when:

a. adopting an accounting treatment that reflects the underlying intent of entering into major transactions or holding an asset, for example, change in the use of a property under construction; and

b. estimating the effects of uncertain future events when determining 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 critical judgements and significant estimates that are subjective or complex, are meaningfully disclosed. Directors should also refrain from approving boilerplate disclosures that do not differentiate across different industries, transactions or a company's circumstances.

When there are indications of financial difficulty such as substantial operating losses, negative operating cash flows and breaches of loan covenants, directors must assess whether the company is able to continue as a going concern. In doing so, directors should evaluate the key assumptions for a period covering at least 12 months from the financial year-end. Adequate disclosures should also be made in respect of the significant judgements and key estimates applied.

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