FINANCIAL REPORTING PRACTICE GUIDANCE NO. 1 OF 2016

AREAS OF REVIEW FOCUS FOR FY2016 FINANCIAL STATEMENTS UNDER ACRA'S FINANCIAL REPORTING SURVEILLANCE PROGRAMME

Under the third review cycle of the Financial Reporting Surveillance Programme (FRSP), ACRA will review selected financial statements with financial year ended between 1 January 2016 and 31 December 2016 (FY2016 FS) for their compliance with the Accounting Standards[1].

To guide directors and other financial statements preparers, ACRA is publishing the areas of review focus for the FY2016 FS. This will serve to remind directors of some risks of misstatements in the financial statements and provide the questions they may ask management to improve the quality of financial reporting.

Background

In 2016, many Singapore companies were affected by weak market sentiments, slow-growth in the global environment and volatilities in the currency, equity and commodity markets. The following financial reporting areas may therefore require more attention:

1. Going concern – Is this assumption appropriate? If yes, are the disclosures adequate?

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

In difficult situations where a company has substantial operating losses, net liability position, adverse financial ratios, inability to pay its creditors when due or breached its loan covenants, the directors must assess whether the company is able to continue as a going concern.

- If the directors have concluded so but the uncertainties are considered significant, these uncertainties must be disclosed fully and meaningfully in the financial statements.
- If the directors have concluded otherwise (i.e. the company is unable to continue as a going concern), the financial statements will need to be prepared on a liquidation basis.

In making this assessment, directors must consider all available information about the future, which must take into consideration at least, but not limited to, twelve months from the financial year-end. The extent of assessment will depend on the circumstances. Where a company has a history of profitable operations and ready access to funding, it may be possible to come to a conclusion without detailed analysis. In other cases, directors must critically evaluate relevant factors including future profitability, debt repayment schedules and sources of replacement financing.

Where there are material litigation case or cases with outcomes that may cast doubt on the going concern assumption, directors should engage competent legal experts, understand their bases of and assess the reasonableness of the advice(s) given. When the going concern assumption is supported by a letter of financial support from the parent company, directors

[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.

should evaluate if the parent company has the realistic ability and intention to provide the stated support.

Directors are reminded that **significant judgements made** in concluding that the going concern assumption is appropriate must be disclosed fully and timely to enable investors to make informed decisions.

2. Value of long-lived assets – any indication of impairment? If yes, has impairment test been conducted? If no impairment charge, why so and are assumptions realistic?

Against the backdrop of low demand and idle capacity in certain sectors, asset value should be an area of concern. Directors of companies in capital intensive industries should pay closer attention to this area, particularly when the economic outlook is not rosy.

Directors may find the following approaches useful when reviewing this area:

(a) If certain operating segments are loss making and no impairment test is conducted, **enquire** why none of the eight prescribed indications of impairment was relevant**.** These indicators include lower trading volumes, loss of customers, order cancellations and rising interest rates. Note that annual impairment test must be done for goodwill and other intangible assets with indefinite useful lives, even where there is no indication of impairment.

(b) If impairment test is conducted, **review the key assumptions used by management** to ascertain that they reasonably reflect the current business plan, the economic outlook and other industry-specific conditions. Be mindful of any change in the methodology and evaluate the reasons for change.

(c) Periodically, **request management to back-test** key assumptions such as revenue and net profits and explain the differences between the past year's projection and their actual results. Where practicable and available, compare key assumptions against those used by industry peers as a form of sanity check.

(d) If the headroom is small or the quantum of impairment charge is not consistent with the directors' understanding of the business, request management to explain and **identify those key assumptions** whose likely changes would significantly affect the impairment charge recognised. **Scrutinise these assumptions** to ensure that they are not overly aggressive or prudent.

(e) Be vigilant to ensure that cash inflows from assumptions (for example, renewal of mining license) are **matched** by the related cash outflows (for example, costs of license renewal).

(f) Ensure that the discount rate reflects the **risks specific to the asset**, rather than using the company's borrowing rate, the country's inflation rate or interest rate for government bonds without any adjustments.

(g) Ensure that disclosures are **tailored to the facts and circumstances**, particularly for the commercial reasons for recognising or not recognising the impairment loss. Where the

headroom is small and the carrying value of the asset is material, ensure that the sensitivity analysis is adequately disclosed for investors to assess the safety margin.

3. Significant one-off gains or losses – does it reflect the economic reality of arrangements?

Significant one-off gains or losses can arise from business arrangements involving transactions structured to overcome certain business hurdles. Generally, they should be accounted for based on the **economic reality** of the arrangements, rather than their legal forms.

Some arrangements we have observed include:

- partial disposal of a subsidiary to a financial institution with **an obligation to reacquire** it in 12 months' time at the original sale price with a fixed margin akin to its borrowing rate. By accounting based on the legal form, the "seller" recognised a gain in the year of "disposal", followed by another gain in the year when it "reacquired" the subsidiary.

- 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 with an option to reacquire the same vessel. By accounting based on the legal form, 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 expected to scrutinise all significant one-off gains or losses. To ensure that the **accounting 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 terms in the agreements 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 possible, advice from experts.

4. Consolidation or Equity Accounting – have reserved matters or other contractual rights been considered?

With the removal of 50% voting power bright line and the introduction of new requirements, more attention and care should be placed to assess how reserved matters and other contractual rights may affect a company's control over its investees. This assessment will determine whether an investee should be consolidated or equity-accounted.

(a) 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 two or more substantial shareholders, the shareholders' agreement may include reserved matters, which set out business decisions requiring unanimous consent from all shareholders.

If **reserved matters include business decisions on relevant activities of an investee**,

- A shareholder may not unilaterally control an investee even when it holds more than 50% of the voting power. The shareholder must therefore not consolidate such an investee.
- A shareholder may jointly control an investee even when it holds less than 50% of the voting power. The shareholder must therefore equity-account for such an investee.

(b) Contractual rights that accord power to direct relevant activities of the investee

For ease of fund repatriation or tax structuring, an investor may choose to invest by holding other financial instruments, such as notes receivables and warrants, instead of holding shares in investees directly. To protect its investments, the investor may also procure contractual rights, which accord it with a say on how the investee's business is run. Such rights, often termed "protective" legally, may be considered "substantive" for accounting purposes.

In a unique arrangement where contractual rights accord power to a note holder to direct relevant activities and a "watertight" structure to ensure profits were distributed proportionately to the note holder and shareholder based on funds injected, the note holder may control an investee even though it did not hold any shares of the investee. If so, the note holder must consolidate the investee.

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

5. Business acquisitions – have significant specific intangible assets, for which a premium was paid, been carved out from goodwill and separately recognised?

Business acquisitions remain a source of growth for many companies in Singapore. As goodwill is not amortised, it may become a major asset over time.

When a business acquisition resulted in a large goodwill, directors should enquire if **part of the goodwill is attributable to the acquisition of specific intangible assets** such as knowhow, licenses and customer lists. If so, those specific intangible assets should be separately recognised during the purchase price allocation exercise and amortised going forward.

Given the higher likelihood that specific intangible assets were acquired and included in hefty premiums paid, directors should engage a professional valuer to **identify specific intangible assets and value them** for large acquisitions. The scope should not be restricted to identifying only specific intangible assets pre-identified by management as this may lead to omissions.

The scope should be extended to include assessing reasonableness of management assumptions used to value specific intangible assets, if they are material.

6. 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 ability of a company to generate cash to fund its operations. Common presentation errors include:

(a) cash flows relating to business acquisitions/disposals should be included within investing cash flows, not operating cash flows. These 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.

(b) foreign currency translation differences arising from the consolidation of foreign subsidiaries do not involve cash flows and should not be presented as an adjusting item when determining operating cash flows using the indirect method.

7. Significant judgement and critical 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, directors should ensure that those judgements with the most significant impact and that are most subjective or complex, are completely and meaningfully disclosed in the financial statements.

From 15 December 2016, auditors of listed companies will disclose key audit matters (KAMs) in their audit reports. KAMs are matters that are of the most significance to the auditors when performing the audit. They are often areas where directors have also made significant judgements or critical estimates.

The introduction of KAMs represents an opportunity for directors to work with management and auditors to develop a rigorous process for making judgements and estimates and in turn to ensure disclosures are **tailored to the company's specific circumstances**.

The above factors are provided as a general guideline. They do not exhaustively describe 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.

Other Matters – Preparing for new financial reporting framework and accounting standards

Directors are reminded to ensure that the preparation work is on track for the following:

(a) New financial reporting framework

In 2014, the Accounting Standards Council announced that Singapore listed companies must apply a new Singapore financial reporting framework that is identical to the International Financial Reporting Standards (IFRS).

For December year-end preparers, the new framework is effective 1 January 2018, with retrospective application to the earliest comparative year i.e. 1 January 2017.

Accordingly, before the FY2016 FS is authorised for issue, management should complete the impact assessment of IFRS 1 *First-time adoption of IFRS*, a standard that specifies how a company should transit from a previous financial reporting framework to IFRS. Restatement of comparatives may result, even though the Singapore Financial Reporting Standards (SFRS) are substantially word-for-word IFRS. This is mainly because the transition provisions in IFRS 1 are generally different from those in the individual SFRS standards.

(b) New accounting standards

Several major accounting standards have also been issued, which will be effective soon:

- SFRS 115 *Revenue from Contracts with Customers* (effective 1 January 2018).
- SFRS 109 *Financial Instruments* (effective 1 January 2018).
- SFRS 116 *Leases* (effective 1 January 2019).

The annual general meeting for the FY2016 FS represents a good opportunity for directors to engage shareholders on the possible impact to the company's financial statements from adopting these new requirements.

Directors should also ensure that the reasonably estimable financial effects from adopting the new accounting standards are meaningfully disclosed in the FY2016 FS, rather than merely stating that "the company is in the process of assessing the impact".