

## **FINANCIAL REPORTING PRACTICE GUIDANCE NO. 1 OF 2015**

### **AREAS OF REVIEW FOCUS FOR FY2014 FINANCIAL STATEMENTS UNDER THE FINANCIAL REPORTING SURVEILLANCE PROGRAMME ADMINISTERED BY THE ACCOUNTING AND CORPORATE REGULATORY AUTHORITY (ACRA)**

Under the Financial Reporting Surveillance Programme (FRSP), ACRA will review selected financial statements with financial year ended between 1 January 2014 and 31 December 2014 (FY2014 Financial Statements) for compliance with the Accounting Standards<sup>1</sup>. For details on FRSP, as well as directors' duties in relation to financial reporting, please refer to ACRA website.

To guide directors and other financial statements preparers, ACRA is publishing the areas of the FRSP's review focus for the FY2014 Financial Statements. This will serve to remind directors of the risks of misstatements and/or non-disclosures in the financial statements as well as users' information needs.

#### **1. New consolidation suite of standards**

The suite of five consolidation standards<sup>2</sup> comes into effect on 1 January 2014.

SFRS 110 removes the bright line of 50% voting power and introduces new requirements for assessing whether an entity controls another entity. With these changes, a shareholder holding less than 50% voting shares may need to consolidate a company that it effectively runs when there is a wide group of other shareholders that do not commonly exercise their votes.

In the case of joint arrangements, SFRS 111 requires the investee to first assess whether it is a joint venture or a joint operation. For joint ventures, SFRS 111 eliminates the accounting policy choice of using proportionate consolidation, thus requiring all joint ventures to be equity accounted for. For joint operations, which are common in the oil and gas, energy and construction industries, the joint operators will account for their rights in the underlying assets, liabilities, revenue and expenses in accordance with their agreements.

As SFRS 110 and SFRS 111 are substantially different from the previous standards, directors should consider the changes carefully when applying the standards for the first time. Meaningful disclosures on the reasons and effects of changes in accounting should be made, together with the new disclosures under SFRS 112 such as summarised financial information of each material associate, joint venture and subsidiary with significant non-controlling interests.

---

<sup>1</sup> 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.

<sup>2</sup> SFRS 110: 'Consolidated Financial Statements', SFRS 111: 'Joint Arrangements', SFRS 112: 'Disclosures of Interests in Other Entities', SFRS 27: 'Separate Financial Statements' and SFRS 28: 'Investments in Associates and Joint Ventures'.

## **2. Business acquisitions**

### *Separate recognition of intangible assets*

When an acquisition resulted in material goodwill, directors should challenge whether the company had overpaid for the acquisition or part of the goodwill should have been attributed to the acquisition of intangible assets such as know-how, licenses and customer lists.

Paragraphs IE16 to IE44 of SFRS 103 provide a list of 28 classes of intangible assets that must be recognised separately from goodwill, such as brands, customer lists, production backlog and licensing rights. Expert assistance may be required to identify and fair value these intangible assets, as they are typically not recognised in the acquiree's financial statements.

It is important to differentiate goodwill from intangible assets as they are accounted for differently. Goodwill is annually tested for impairment whereas intangible assets are typically amortised.

### *Contingent share consideration*

In some business acquisitions, the acquirer agrees to pay an additional amount when specified future conditions such as profit targets are met, and such amounts are paid using acquirer's shares (contingent share consideration).

Directors are reminded that contingent share consideration should not be classified as equity merely because it will be settled in shares. Instead, such consideration is classified as liability when a variable number of shares may be issued. This classification is important because liability is re-measured with the changes taken to the profit and loss, while equity is not re-measured.

## **3. Statement of Cash Flows**

Cash flow is the lifeblood of all businesses. A Statement of Cash Flows provides useful information on an entity's ability to generate cash and its needs for cash.

It is common to have groups investing in overseas subsidiaries with functional currencies which are different from the presentation currency of the group. The resulting translation difference can be significant and must be taken directly to the foreign currency translation reserve. Directors are reminded not to include them as a non-cash adjustment to profit before tax under operating activities.

SFRS 7 also requires cash flows to be classified according to the nature of their underlying activities, namely operating activities, investing activities and financing activities. The net cash flows arising from operating activities give an indication on whether sufficient cash flows are generated to support the group's operations without recourse to external sources of funds. Accordingly, it is generally not appropriate to include inter-company borrowings and deposits placed to acquire investments as part of cash flows from operating activities.

#### **4. Long-life asset value and impairment testing**

Long-life assets should not be recorded at an amount exceeding the amount that can be recovered from either selling or using the assets. Impairment testing is conducted at least annually for goodwill and when there are indications of impairment for other long-life assets.

Directors could use the following principles when raising questions to management on impairment tests:

- (a) It may not be appropriate to consider the entire group of companies as a whole when assessing impairment, particularly when the group operates different businesses. The impairment loss in one business unit may be offset by the surplus in another business unit. Hence, if not assessed separately, due attention needed on a loss making unit may be diverted;
- (b) Cash flow projections should be reasonable and supportable. Directors could request management to compare past cash flow projections with the actual cash flows. Directors could also use his knowledge of the business to enquire whether the changes in circumstances were reflected in the cash flow projections, for example, a recent loss of a key customer;
- (c) Discount rate that reflects the risk specific to the asset should be used, rather than borrowing rate without further adjustments. Different discount rates should generally be applied to businesses operating in different industries or different jurisdictions;
- (d) Listed companies should consider performing impairment testing in situations where its market capitalisation has fallen significantly below its net asset value; and
- (e) Disclosures tailored to businesses should be made, such as the events and circumstances leading to the recognition or reversal of material impairment loss. In situations where there is only a small headroom in impairment testing and the carrying values of goodwill and/or other long-life assets are material, the disclosure of sensitivity analyses will allow users to assess the safety margin based on the key assumptions used.

#### **5. 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. EPS also facilitates comparison of performance over different periods and with peers.

Directors are reminded to avoid these common pitfalls:

- (a) the comparative basic and diluted EPS are not adjusted to reflect the bonus shares or rights issued during the year;

- (b) the diluted EPS is not adjusted for the effects of all dilutive potential ordinary shares such as share options; and
- (c) ordinary shares issued to pay for business acquisition are not included in the weighted average number of shares from the acquisition date.

## **6. Operating segment**

SFRS 108 requires disclosure of segment information 'through the eyes of management' using the same information used by management in managing its operations and evaluating performance.

Directors should question segments identified in the financial statements when they are not consistent with those included in the Management Discussion and Analysis section of the annual report.

Directors are also encouraged to obtain clear explanations in support of management's decision to aggregate segments, particularly when the segments have dissimilar economic characteristics. An operating segment should then be reported separately if it meets the quantitative thresholds provided (10% of revenue or assets).

## **7. Fair value measurement**

SFRS 113 establishes the framework for measuring and disclosing fair value from 1 January 2013, 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.

Directors should question the basis for categorising the fair value of investment properties and biological assets as Level 2, as the valuation for these assets typically involves many significant unobservable inputs.

Directors should also expect more disclosures on assets and liabilities for which fair value is classified within Level 3. Such disclosures should 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.