FINANCIAL REPORTING PRACTICE GUIDANCE NO. 2 OF 2019
(Issued on 21 November 2019)

AREAS OF REVIEW FOCUS FOR FY2019 FINANCIAL STATEMENTS UNDER ACRA'S FINANCIAL REPORTING SURVEILLANCE PROGRAMME

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

To guide directors in approving the upcoming FS, ACRA is publishing the areas of FRSP review focus for FY2019 FS. This will serve to remind directors of some possible accounting misstatements and provide questions they may ask management to improve the quality of financial reporting.

1. Accounting standards that took effect recently – What are the common challenges faced by companies and the areas for improvement?

<u>SFRS(I) 16 / FRS 116 *Leases*</u>

2019 is the first year when the new lease standard is effective. For a lessee, it must generally account for its leases as finance leases, i.e. recognise right-of-use assets on the balance sheet, with corresponding lease liabilities that may significantly impact the lessee's financial ratios and performance metrics.

We encourage directors to pay close attention to the following areas when implementing the new lease standard:

(a) when ascertaining ***if a contract is or contains a lease*****,** directors must determine if the company has the 'control' to 'direct' the use of the identified asset. While requirements remain the same as the previous standard, INT FRS 104, the new standard provides more guidance on how to identify the asset and how to establish if control exists when say, the supplier has the practical ability to substitute an alternative asset, or when the customer has right to direct how and for what purpose the identified asset is used. Directors are reminded to ensure the completeness of the lease population on hand as well;

(b) when determining ***the lease term*****,** which will affect the amount to be recorded, directors must consider if the renewal and/or termination option(s) is reasonably certain to be exercised. Whilst there is no change from the previous standard, FRS 17, determining the lease term may involve significant judgements and estimates, particularly when the lease contract does not contain specific clauses regarding the renewal, termination or cancellation of the lease;

(c) when deciding ***the amount of lease liability to be recorded*** on balance sheet, directors must discount the unpaid lease payments using the interest rate implicit in the lease. If this rate cannot be readily determined, which is often the case as most lease contracts would not indicate such interest rate, directors must use the company's incremental borrowing rate. This incremental borrowing rate should reflect the interest rate that the company would pay to borrow (i) over a similar term to the lease term, (ii) with a similar collateral, if any, (iii) to obtain an asset of a similar value to the right-of-use asset and (iv) in a similar economic environment, which could be rather judgemental to derive. Directors should bear in mind that it is generally inappropriate to use one discount rate for all leases, particularly when the identified assets are dissimilar; and

(d) when accounting for ***variable rents payable*** **to** JTC Corporation, which are typically revised to reflect changes in market rental rates, directors must take note of a change in accounting treatments. Previously, the practice was to treat the difference between the actual lease payments and minimum lease payments from the revision as contingent rents, which were recognised as and when they were incurred. With the new standard, directors must re-measure the lease liability as and when the adjustment to the lease payments takes effect. At inception of the lease, directors must also apply the index or rate available at that time, rather than the estimated *future* value of an index or rate. For details, refer to Institute of Singapore Chartered Accountants' (ISCA) Technical Bites[1];

(e) when reviewing the ***presentation***, directors must ensure that the right-of-use assets and lease liabilities are presented separately, either on the balance sheet or in the notes, and that the interest expense on lease liabilities is presented as a component of finance costs, separate from depreciation charge for right-of-use assets. In the statement of cash flows, cash payments for the principal portion of the lease liability must be classified within financing activities while payments for short-term leases, low value assets and variable amounts not included in the measurement of the lease liability must be included within operating activites; and

(f) when reviewing the ***disclosure*** to facilitate investors' understanding, directors must consider whether critical judgements in areas such as determining the lease term and discount rate, are meaningfully disclosed.

Directors should also be familiar with the transitional options, practical expedients and available exemptions to ease the implementation of this new standard. The right-of-use assets and lease liabilities recognised may differ depending on whether retrospective approach or modified retrospective approach is adopted.

The market practice continues to evolve for the lease standard. We urge preparers to keep a close tab on the agenda decisions[2] concluded or deliberated by the IFRS Interpretations Committee.

[1] ISCA Technical Bites (https://isca.org.sg/tkc/fr/techbites) – "*How are variable rent leases by JTC Corporation treated under FRS 116*" (23 Nov 2018)

[2] They include IFRS Interpretations Committee's tentative agenda decision in Jun 2019 on lease term and useful life of leasehold improvements, and discussion in Sept 2019 on determining incremental borrowing rates

SFRS(I) INT 23 *Uncertainty over Income Tax Treatments*

Effective on 1 January 2019, this new interpretation gives more guidance as to ***when*** and ***how*** to provide for uncertain tax provisions, which may not be available under the current standard. In particular, when determining the amount to be recorded for uncertain tax provisions, directors must assume that the tax authority has a right to examine, and has full knowledge of all relevant information when making those examinations.

We also encourage directors to critically assess management's estimates and assumptions used, particularly when making provision for tax treatments that are not probable of being accepted by tax authorities.

SFRS(I) 15 / FRS 115 *Revenue from Contracts with Customers*

This new revenue standard was implemented from 1 Jan 2018. Based on the practitioners' feedback, its implementation could be complex in the following areas. In particular, directors must understand the intricacies of the related concepts (such as control, performance obligations, timing of recognition, costs incurred to fulfil a contract) when complying with the new revenue recognition principles:

(a) variable consideration can take many forms such as incentives, penalty, discounts, rebates or refunds. Directors are encouraged to ensure that management has developed a robust system and processes to identify the variable consideration holistically and completely. The variable considerations must also be measured at contract inception and re-assessed based on changes in facts and circumstances;

(b) when a significant financing component exists due to payment in arrears or in advance, the financial effects of time value of money must be accounted for, if material. The resulting interest income or expense must also be presented separately from revenue;

(c) when borrowing costs are incurred for properties that take a long time to construct but are ready for sale in their uncompleted state, they must not be capitalised for both sold and unsold units. For details, refer to ISCA's Technical Bites[3];

(d) the accounting profession is building experience from applying this new standard. Directors are urged to monitor closely IFRIC's agenda decisions[4], assess their impacts and implement changes, if any, as soon as possible; and

(e) the disclosure on accounting policies should be made by each material revenue streams, and customised to the company's circumstances.

[3] ISCA Technical Bites (https://isca.org.sg/tkc/fr/techbites) – "*Capitalisation of borrowing costs – Agenda Decision March 2019*" (24 Apr 2019)

[4] IFRS Interpretations Committee (https://www.ifrs.org/supporting-implementation/supporting-materials-by-ifrs-standard/ifrs-15/#agenda)

Directors should also ensure that these disclosures, together with disaggregated revenue disclosures, are consistent with the information provided in the other parts of the annual report, and with the information provided separately to the analysts.

SFRS(I) 9 / FRS 109 *Financial Instruments*

This new standard was effective on 1 January 2018.

Some companies continued to face challenges in valuing their investments in unquoted equities at fair value. We encourage directors to critically assess the assumptions used by management in those valuations. We also encourage directors to obtain independent professional valuations, particularly where these investments are significant and there is no in-house expertise.

The new impairment loss model, which applies to trade receivables, contract assets and lease receivables, also applies to all companies, not only the financial institutions. A commonly used method to measure expected credit losses is a provision matrix which applies historical loss rates and involves judgements and estimates. The following factors can be used to guide directors' consideration:

(a) group debts that share similar credit risk characteristics, for examples based on geographical region, customer rating, product and customer type;

(b) determine how far back the historical data should be collected that is relevant to the future period over which debts will be collected; and

(c) consider forward looking information that could affect future credit losses.

2. Impairment assessment and valuation – What are the common mistakes in estimating future cash flows?

The forecast range for GDP growth in 2019 was lowered to 0.0%-1.0%[5] from 3.1% recorded in 2018, and may impact a company's assessment of its asset value. Directors of companies in industries with challenging outlook ought to pay close attention to the impairment tests conducted by management.

Here are some findings we noted during the third review cycle of FRSP:

(a) when conducting impairment test on property, plant and equipment (PPE), the future cash flows could be incorrectly projected to perpetuity, rather than to the remaining useful life of the PPE. In contrast, the future cash flows can be projected to perpetuity when conducting impairment test on goodwill and other intangible assets with *indefinite* useful life;

(b) when computing the recoverable amount of an asset, the projected future cash flows could be incorrectly discounted using the company's current

[5] Source: MAS (https://www.mas.gov.sg/publications/recent-economic-developments/recent-economic-developments-in-singapore-september-2019) Recent Economic Developments in Singapore – 6 Sep 2019

borrowing rate, the country's inflation rate or the government bonds' interest rate, without any adjustment to reflect the risks specific to the asset(s);

(c) when projecting the future cash flows, key assumptions such as revenue, gross margin and growth rate used could be overly optimistic. As a form of sanity test, we encourage directors to compare the projected cash flows to the current and past years' actual cash flows, and future growth plans. This comparison should also be done on a year on year basis; and

(d) where headroom is small and carrying value of the asset is material, sensitivity analysis ought to be disclosed for investors to assess the safety margin.

3. Business acquisitions – Have other intangible assets been separated from goodwill and what is the acquisition date for accounting purposes?

Merger and acquisitions in Singapore soared 70.6% year on year to S$121.8 billion[6].

Accounting and valuation of mergers and acquisitions can be complex. When a business is acquired, it is not uncommon to pay a premium price over the fair value of identifiable assets (including intangible assets). For accounting purposes, it is crucial to differentiate goodwill from other intangible assets during purchase price allocation (PPA) exercise. These assets are typically amortisable and may include customer lists, trademarks, patents, knowhow and licenses.

When there is no in-house specialist to perform the PPA, which is often the case, we encourage directors to engage an accredited professional valuer. Directors should pay attention to the scope of the valuation service, which should include identifying specific intangible assets, and assessing management's assumptions used to value them. The failure to separately identify, recognise (and amortise) specific intangible assets may lead to an overstatement of goodwill, and total assets, over time.

Directors should also understand the importance of determining the acquisition date. This is the date assets acquired and liabilities assumed are valued, and from when the results of the acquired business are consolidated.

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.

[6] Source: Straits Times (https://www.straitstimes.com/business/banking/singapore-ma-surges-706-to-1218b-to-date-this-year-refinitiv)– "*Singapore M&A surges 70.6% to $121.8b to date this year*" (20 Sep 2019)