ACRA
ACCOUNTING AND CORPORATE REGULATORY AUTHORITY

WORKING TOGETHER TO RAISE THE BAR ON FINANCIAL REPORTING

Financial Reporting Surveillance Programme

Second Report 2016

ACRA is the national regulator of companies in Singapore and administers the Companies Act in Singapore. Through the FRSP, ACRA guides companies to comply with the prescribed accounting standards in Singapore. Only when accounting breaches are significant, ACRA enforces directors' duties under sections 201(2) and 201(5) of the Companies Act. This enforcement is necessary to ensure that the quality of financial reporting in Singapore is on par with global standards and instil greater confidence in investors.

Scope / Disclaimer

When perusing the findings set out in this report, the reader should bear in mind that the conclusions were reached by ACRA having regarded multiple factors in the actual circumstances, which could not be fully illustrated in the case studies. Accordingly, the findings should not be read in isolation or interpreted as additional mandatory rules to the prescribed accounting standards in Singapore.

Published September 2016

Acronyms

ACRA	Accounting and Corporate Regulatory Authority
FRSP	Financial Reporting Surveillance Programme
FY2014	Financial year ended between 1 January 2014 and 31 December 2014
FY2015	Financial year ended between 1 January 2015 and 31 December 2015
FRTAP	Financial Reporting Technical Advisory Panel of ACRA
ISCA	Institute of Singapore Chartered Accountants
ISCA-FSRC	Financial Statements Review Committee of ISCA
SFRS	Singapore Financial Reporting Standards
SGX	Singapore Exchange
SID	Singapore Institute of Directors

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- Apply rigour to complex and material judgements
- Cater time for discussions on accounting issues
- Ensure CFOs give sufficient time and priority to financial stewardship role
- Evaluate competency of finance team and fill the gap(s)
- Engage external experts upfront with the right scope

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EXECUTIVE SUMMARY

Earlier this year, the price of Brent crude oil fell to its lowest level in nearly 13 years. Global political developments such as the Brexit sent ripples across many currency and equity markets. The weakness in external demand has affected exports, dimming our economic outlook. Amidst these volatilities, it is not surprising that investors in Singapore are demanding for companies to provide greater transparency on financial reporting.

The primary objective of the ACRA's Financial Reporting Surveillance Programme (FRSP) is to **guide directors to comply with the prescribed accounting standards in Singapore.** A consistent application of the accounting rules will ensure that financial statements across different companies remain transparent and comparable, enabling investors to make informed investment decisions. This year, we reviewed 50 sets of the FY2014 Financial Statements of listed companies incorporated in Singapore, which were selected based on the FRSP's risk-based approach.

Key findings from the second review cycle

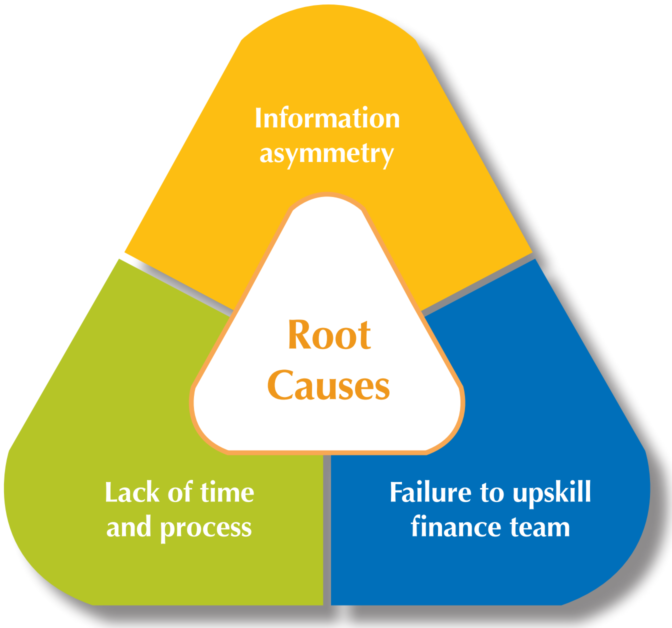
We continue to see a good level of quality in financial reporting by the listed companies in Singapore. Their boards took ownership over financial reporting. Many have also stepped up their game in documenting deliberations on complex accounting matters. However, there is still room for improvement as a number of non-compliances with the accounting standards were identified.

The **four areas with highest instances of findings** were: (1) New consolidation standards, (2) Business acquisitions, (3) Impairment of long-lived assets, and (4) Fair value of properties.

These areas were consistent with the areas of review focus in ACRA's Practice Guidance issued in January 2015[1] to guide directors in preparing the FY2014 Financial Statements. The general observations and some case studies are set out in Sections 2 and 3 of this report.

[1] ACRA's Practice Guidance is available at https://www.acra.gov.sg/training-and-resources/publications/bulletins-and-guidance/practice-guidance

Recognising the complexities in these areas of review, we held more than 30 meetings with directors this year to better understand the business rationales and judgements made. During these discussions, **three behavioural root causes** leading to the findings were observed:



Information asymmetry between business operations and finance function

Information asymmetry between a company's business operations and its finance function can lead to accounting lapses. While accounting should not drive business, it is **important to involve the finance team upfront so that they can understand the business rationale of unique arrangements and be alerted to important non-standard contract terms.** We noted instances where the operations team would proceed first to negotiate deals and then handover the signed contracts to the finance team with little explanations for accounting.

In Case Study A, the listed company entered into a unique arrangement for the first time, whereby it invested $200 million by subscribing to notes issued by an investee legally owned by a third party who invested $1 (dollar). Having neglected to consider contractual rights to unilaterally direct the relevant activities of the investee and extract returns equivalent to 99.99% interests at any time, the listed company failed to consolidate the loss-making investee.

Case Study A Page 13

In Case Study B, the listed company issued a non-convertible bond to the seller to partially settle the purchase price of a business acquisition. Even though the bond was worth $80 million at issuance **due to below-market coupon rate,** the listed company used the face value of the bond of $100 million to determine the purchase price. Accordingly, the listed company inflated goodwill and wrongly recognised a gain of $20 million due to re-measurement of bond liability in the income statement.

Case Study B Page 18

Lack of time and process to consider complex accounting matters

Directors, with their deep experience and good understanding of the board's business strategies, are best placed to provide critical scrutiny on the accounting of major complex transactions. At year-end board meetings, the focus of discussions is usually concentrated on the financial results of the company, with little time set aside for directors to consider whether the accounting is appropriate and consistent with their understanding of the business.

It is therefore **crucial that directors are given the opportunity and sufficient time to review and deliberate on complex accounting matters.** This process should also be conducted **upfront when the board is deciding on a deal** rather than to wait till the year-end board meeting. It is also important to **involve the entire board in such deliberations** and not leave them entirely to the audit committee.

Case Study C Page 20

In Case Study C, when conducting the goodwill impairment test, the listed company assumed that the mining license of a key operating mine, with two years' remaining life, could be extended by a further 10 years, and included the corresponding cash inflows for the renewal period. However, the cash flow projections omitted the renewal costs and capital expenditure to replace plant and machinery reaching the end of their useful lives. Given that goodwill represented 40% of total assets and the headroom was small, this impairment test could benefit from more scrutiny.

Failure to upskill finance team or engage experts

A qualified and experienced finance team is the directors' first line of defence in ensuring reliable financial reporting. Directors should **periodically assess the adequacy of the finance team's skills and fill the gaps.** External experts could also be brought in to supplement.

Companies, in the midst of expansion or restructuring, might sometimes find their management neglecting to gear up their finance teams to support the new business or transaction. As a result, the right accounting implications were not highlighted to the boards for consideration.

Case Study D Page 22

In Case Study D, the listed company entered into a new business venture of constructing a property for future rental. Due to the misconceived notion that the fair value of such property could not be reliably measured during construction, the listed company failed to recognise fair value loss on the property arising from a delay in construction.

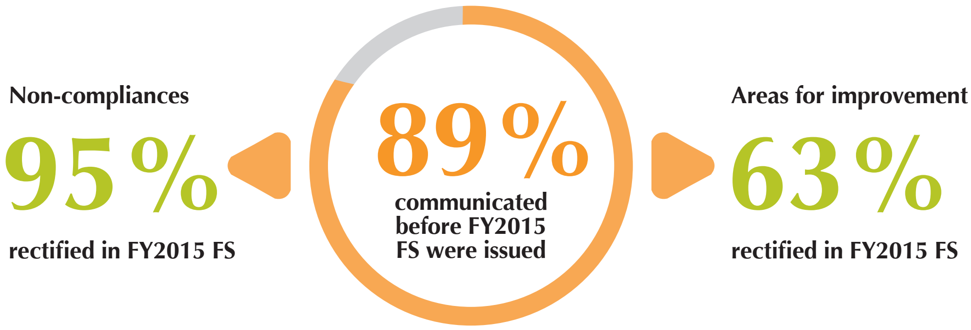
Case Study E Page 24

In Case Study E, the listed company failed to distinguish that net gains, rather than gross sale proceeds, from divesting available-for-sale investments should be presented as revenue. As a result, the reported revenue was overstated twofold and the cost of sales sixfold.

Restatements to address findings

To ensure investors obtain **reliable financial information** for their decision-making, companies are required to rectify the misstatements identified through the FRSP. This practice of restatements is in line with those of other leading regulators.

For **less serious non-compliances,** companies are required to **rectify in the subsequent year's financial statements.** Most (89%) of the findings in the second review cycle were communicated before the companies issued their FY2015 financial statements. Of this, 95% of non-compliances[2] and 63% of areas for improvement[2] were addressed in the FY2015 Financial Statements. The **high rectification rate,** including addressing areas for improvement which do not require mandatory correction, is **encouraging.** It shows that a number of boards are committed to delivering high quality financial information to investors.



For **serious non-compliances that led to warning letters,** companies are required to **restate, re-audit and re-file** their past financial statements. Arising from the first review cycle, two companies have restated, one company was exempted from doing so in view of a reverse take-over situation, and two companies are in progress.

Looking ahead

With the experience gained from the two review cycles, it is timely for us to review the FRSP's policies and processes. Bearing in mind the overarching objective of the FRSP in **raising financial reporting quality,** this programme review will take into account market feedback and also seek to recalibrate the fine balance between enforcement and collaboration with the stakeholders.

Directors should also refer to the FRSP's areas of review focus for the FY2016 Financial Statements (to be issued before end of 2016) and assess if those areas will give rise to potential misstatements in their FY2016 Financial Statements. Such assessment should be carried out in conjunction with the key audit matters that will be included in the new enhanced auditor's report.

Ensuring high quality financial reporting is a **collective responsibility.** For Singapore to maintain its reputation for trust and its pole position as a leading business and financial centre, it is imperative for all stakeholders in the financial reporting value chain – directors, management, finance teams, auditors, investors, and regulators to **work together to raise the bar on financial reporting.**

[2] All non-compliances and areas for improvement were instances where the financial statements were not compliant with the accounting standards, differentiated by the nature and extent of the mistatements. ACRA highlights areas for improvement for directors' attention but does not mandate them to be rectified.

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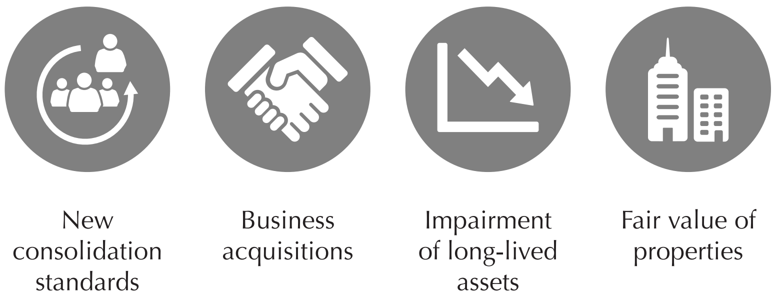
GENERAL OBSERVATIONS FROM THE FY2014 FINANCIAL STATEMENTS

As with last year, our enquiries centred on significant, and often unusual, transactions or balances that could **materially impact key measures used by investors** such as revenue, profits and operating cash flows. These measures have been rated by both institutional and retail investors as the most important quantitative financial measures, aside from dividends and earnings per share, in a recent NUS study[3] commissioned by ACRA and ISCA.

We continue to see a good level of quality in financial reporting by the listed companies in Singapore. Their boards took ownership over financial reporting. Many have also stepped up their game in documenting deliberations on complex accounting matters. However, there is still room for improvement as a number of non-compliances with the accounting standards were identified.

The **four areas with the highest instances of findings** were as follows:



These areas were consistent with the areas of review focus in ACRA's Practice Guidance issued in January 2015 to guide directors in preparing the FY2014 Financial Statements.

[3] Into the Minds of Investors - Investors' Views of Financial Reporting, Audit and Corporate Governance (2016) is available at https://www.acra.gov.sg/docs/default-source/default-document-library/training-and-resources/publications/reports/research-reports/into-the-minds-of-investors.pdf

This chapter focuses on the general observations relating to the areas above. Case studies, together with best practices observed, are included in the next two chapters.

New consolidation standards: Good application in the first year

The global financial crisis in 2007 heightened the criticism that some entities were not consolidating other entities they seemed to control, or were funding a distressed entity that had not been disclosed. The widespread use of special purpose vehicles, coupled with differing interpretations of accounting rules, were said to have enabled such accounting outcomes. The eventual collapse, or near collapse, of several large companies linked to this issue dented investors' confidence in financial reporting.

In response, a suite of five consolidation-related standards[4] were developed and introduced to clarify the accounting requirements, requiring the **substance of arrangements to be assessed more holistically.** This second review cycle involved the FY2014 Financial Statements, during which these standards became effective for the first time.

Sound judgements but boilerplate disclosures noted

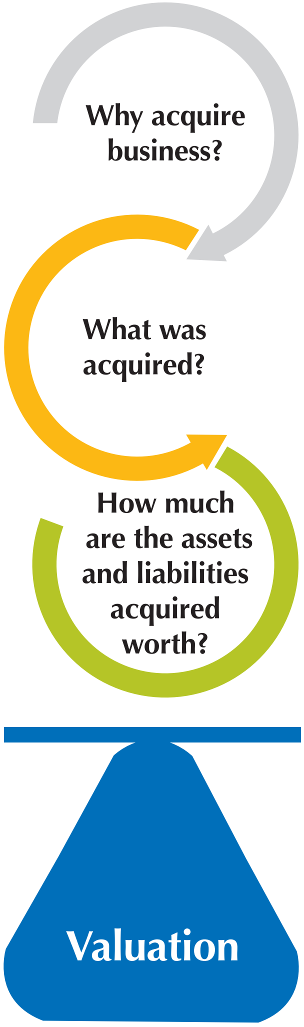
Many of the listed companies reviewed demonstrated good implementation of these new standards. They clearly articulated the rationale behind the accounting treatments adopted and the judgements undertaken. The deliberations by directors were often supported by analyses of clauses in the shareholders' agreements as well. However, the disclosures in their financial statements could be improved by avoiding boilerplate descriptions that did not adequately explain the accounting treatments adopted for unique circumstances.

In one case, the listed company invested $200 million by subscribing to notes issued by an investee. The investee was legally owned by a third party individual who invested $1 (dollar) in share capital. To protect its investment, the listed company procured contractual rights enabling it to unilaterally direct the relevant activities of the investee. The listed company was also granted warrants, enabling it to extract 99.99% of the variable returns from the underlying project since inception at any time without further cash outlay. Even though it did not hold a single equity share in the investee, the listed company should have consolidated the loss-making investee as if it owned 99.99% interests. *(Case Study A – Control could exist even when no equity share was owned)*

Case Study A Page 13

[4] The suite of five consolidation-related standards include: 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*.

Business acquisitions: Application gaps remain for unique arrangements



While the accounting requirements for business acquisitions were not new, there continued to be application gaps among the listed companies reviewed.

One key challenge is the purchase price allocation ("PPA") exercise. The PPA exercise, to put simply, is a process of identifying the assets purchased and translating them into quantifiable numbers to be recorded in the financial statements. These acquired assets could range from tangibles such as properties, to intangibles such as licenses, brand names and customer lists.

When performed robustly, the PPA exercise tells the investors the "story" about the acquisition – the purpose of acquiring, what assets are purchased and whether the company has paid more or less as compared with the value of these assets.

Valuers were engaged but scope could be restrictive

Underpinning a robust PPA exercise is valuation, for which some listed companies reviewed have engaged external professional valuers to assist. However, we observed that some valuations were restrictive in scope, such as requiring the valuer to only assess specific intangibles pre-identified by management or to value specific intangibles using assumptions pre-determined by management. This was despite that the identification of specific intangibles and the determination of reasonable assumptions are considered by some to be the most complex elements in a PPA exercise. Given the higher likelihood that specific intangibles were acquired and included in hefty premiums paid, directors should ensure that the valuer's scope for large acquisitions resulting in significant goodwill is not unduly restrictive.

Other than the identification of specific intangibles, we observed an application gap in the measurement of purchase consideration when financial instruments were issued to partially fund an acquisition. In one case, the listed company paid a purchase consideration, comprising cash of $400 million and a bond with face value of $100 million. The bond's **fair value** was $80 million due to its below-market coupon rate. Instead of measuring the fair value of purchase consideration based on the bond's **fair value** of $80 million, the listed company measured it based on the bond's **face value** of $100 million. By doing so, the listed company inflated goodwill by $20 million and wrongly recognised a gain of $20 million due to re-measurement of bond liability in the income statement. *(Case Study B – Accounting gain should be aligned with the commercial reality)*

Case Study B Page 18

Impairment of long-lived assets: Assumptions could benefit from more scrutiny

It is common for companies to grow through acquisitions and thus goodwill could become a significant portion of the balance sheet over time. Under accounting standards, goodwill is subject to annual impairment assessment, and not amortised. If the impairment assessment is not robustly performed, goodwill may be retained on the balance sheet, even though the economic benefits it embodies no longer exist.

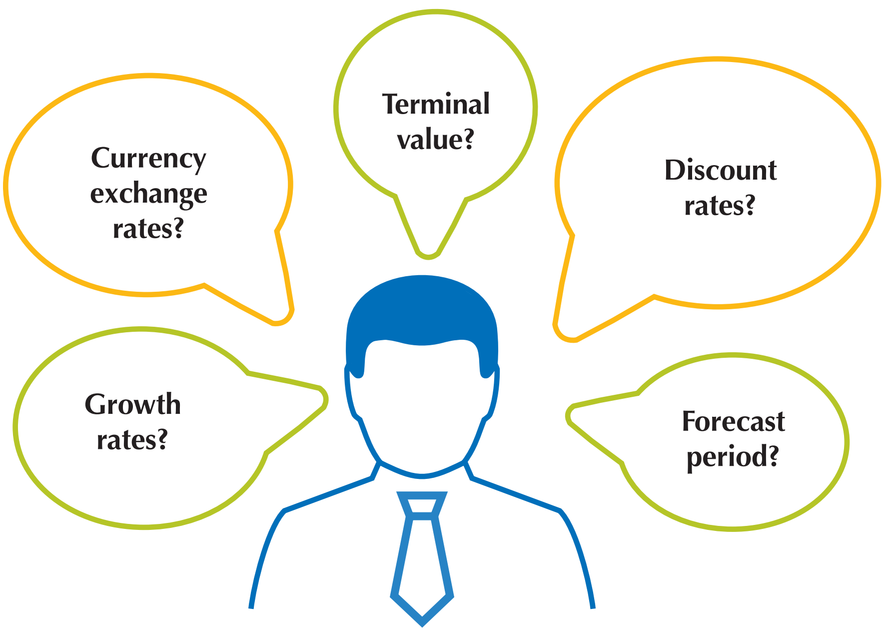
Some assumptions were not updated to reflect market conditions

When conducting the goodwill impairment assessment, many judgemental assumptions including growth rates, currency exchange rates, terminal value, discount rates and forecast period are made. As these assumptions are closely linked with market conditions and the economic environment, they could potentially change over time and thereby affect the headroom.

Directors should diligently **scrutinise the assumptions used by management** in such assessments, particularly when the **goodwill is large** and the **headroom is small.** Robust sensitivity analyses should also be performed by management to draw the directors' attention to those assumptions that may lead to impairment loss.

In one case, when conducting a goodwill impairment test, the listed company had assumed that its mining license would be renewed for a further 10 years upon its expiry in two years' time. Even though the renewal was uncertain, this assumption was not disclosed. In addition, the cash flow projections omitted the renewal costs and capital expenditure to replace plant and machinery reaching the end of their useful lives. Given the small headroom, any change in these assumptions could have resulted in goodwill impairment, which was also not disclosed. *(Case Study C – Key assumptions should be scrutinised when headroom is small)*

Case Study C Page 20



Fair value of properties: Smaller companies could do more to bridge the gap

Investment properties are properties held to earn rental or for capital appreciation, or both. The accounting standard provides a policy choice for companies to measure investment properties either at their cost or fair value. Most property companies in Singapore have elected for fair value accounting in order to reflect a better measure of their net worth.

Fair value accounting has the benefits of allowing investors to quickly identify and react to increases or declines in the market value of investment properties. At the same time, it may also contribute to fluctuations in the company's financial performance.

Good application by larger property companies

The larger property companies have done well in applying fair value accounting. Many had integrated robust valuation processes within the financial reporting processes, under which a consistent approach was applied. Their finance teams also demonstrated a good understanding over the valuation methodologies used by the professional valuers and implemented internal procedures to ensure assumptions used were within the market range.

Smaller companies could do more to bridge the application gap

Conversely, some smaller property companies could do more to follow through with their elected accounting policy, particularly in respect of properties under construction. In one case, instead of valuing the entire property under construction at fair value in accordance with its elected accounting policy, the listed company valued only the land component at fair value. The corresponding building component was recorded at cost, even though the **building was near 80% completed at year-end** and the unrecognised fair value gain was material.

Another listed company failed to recognise fair value loss on a property under construction arising from a delay in construction, due to the misconceived notion that the property's fair value could not be reliably measured while under construction. When asked to estimate the fair value of the property, the company also wrongly used a discount rate which was a **fraction of the discount rates used by other listed companies to value similar-purpose properties.** *(Case Study D – Fair value of properties under construction can be reliably measured)*

Case Study D Page 22

In respect of completed investment properties, another listed company company obtained professional valuation of its entire portfolio of shop houses and retail spaces once every three years, during which significant fair value changes were recognised. In the intervening years, it applied its own (and different) methodology to value the properties, for which manual adjustments were also made with their rationales not properly documented. While the fair value changes in those intervening years were modest, they might not reflect the prevailing market conditions.

Presentation: More care and diligence required

The presentation of financial information is as important as its recognition and measurement. For example, revenue is often examined when assessing the size and growth of a business. The operating cash flows provide insights on whether the company is generating enough cash to fund its operations. The current and non-current classification on the balance sheet provides information on whether the company has sufficient liquid assets to meet its short-term obligations.

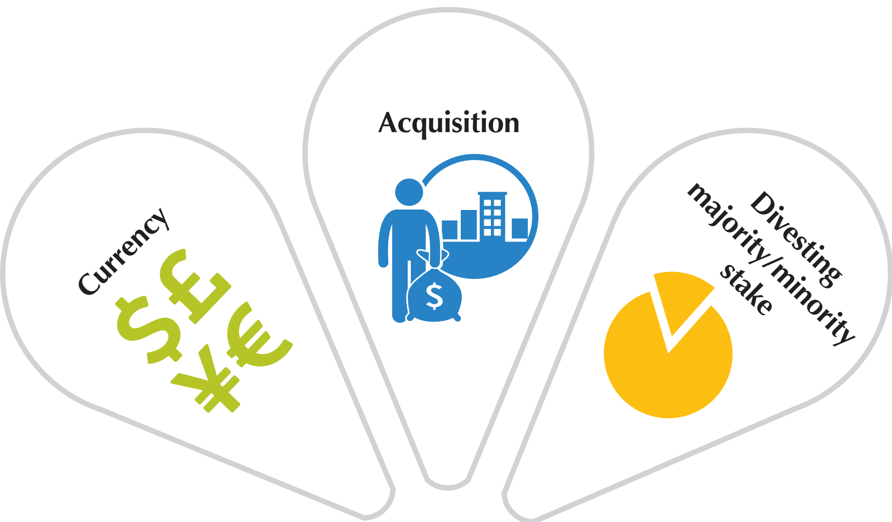
Revenue should reflect nature of business

In respect of the presentation of revenue, one listed company in the business of long-term equity investment invested its spare cash in quoted equity shares. The investments were classified as available-for-sale ("AFS") investments after determining that they were not held for trading. However, when those AFS investments were divested, instead of reporting (net) gain/loss, the listed company reported the (gross) sales proceeds within the 'revenue' line. Accordingly, the listed company overstated revenue twofold and cost of sales sixfold. The listed company subsequently restated its financial statements and presented the (net) gain as other income. *(Case Study E – Net gain from divesting AFS investments should be presented as revenue)*

Case Study E Page 24

Cash flow statements continue to contain errors

In respect of cash flow statement presentation, we continue to note straightforward errors. One listed company wrongly presented the cash paid for the acquisition of a business as an operating cash flow, instead of an investing cash flow, thereby understating its net operating cash inflows by 12%. Another listed company wrongly presented the proceeds received for divesting a minority stake in a subsidiary (while still retaining control) as an investing cash flow, instead of a financing cash flow, thereby understating its net investing cash outflows by 85%.



Cash Flow Statements Presentation

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CASE STUDIES FROM THE FY2014 FINANCIAL STATEMENTS

The following case studies are included to guide directors in **identifying red flags** and to prompt them to question further during their reviews of financial statements.

The learning points illustrated **should not be regarded as interpretations of the accounting standards nor applied as mandatory accounting rules,** in addition to the requirements in the accounting standards. This is because often, a conclusion was reached by us after having regarded multiple factors based on the actual circumstances, which were not fully illustrated in these case studies. To confer privacy to the companies reviewed, some information in the case studies may also be omitted or adjusted.

New consolidation standards	Business acquisitions	Impairment of long-lived assets	Fair value of properties	Presentation of revenue
Case Study A	**Case Study B**	**Case Study C**	**Case Study D**	**Case Study E**

New consolidation standards: Control could exist even when no equity share was owned

For ease of repatriation of funds or tax structuring purposes, an investor may choose to invest by holding other financial instruments, such as through 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 as when to cease the existing businesses, to enter into new businesses, to incur capital expenditure and/or to appoint or change key management personnel.

The new consolidation standards removed the bright-line test of 50% voting power and instead, require an investor to consolidate an investee based on whether it has control. Control is established when an investor has the power to run the business, is exposed to the investee's variable returns and has the ability to use its power to affect those returns.

Contractual rights could lead to control

The power to run the business can be established through rights granted to an investor through contractual agreements, rather than purely to a shareholder through share ownership. The ability, rather than past practice or future intention, is relevant in assessing such power. Hence, it would not have mattered if the investor is not currently exercising those rights or has no intention to do so.

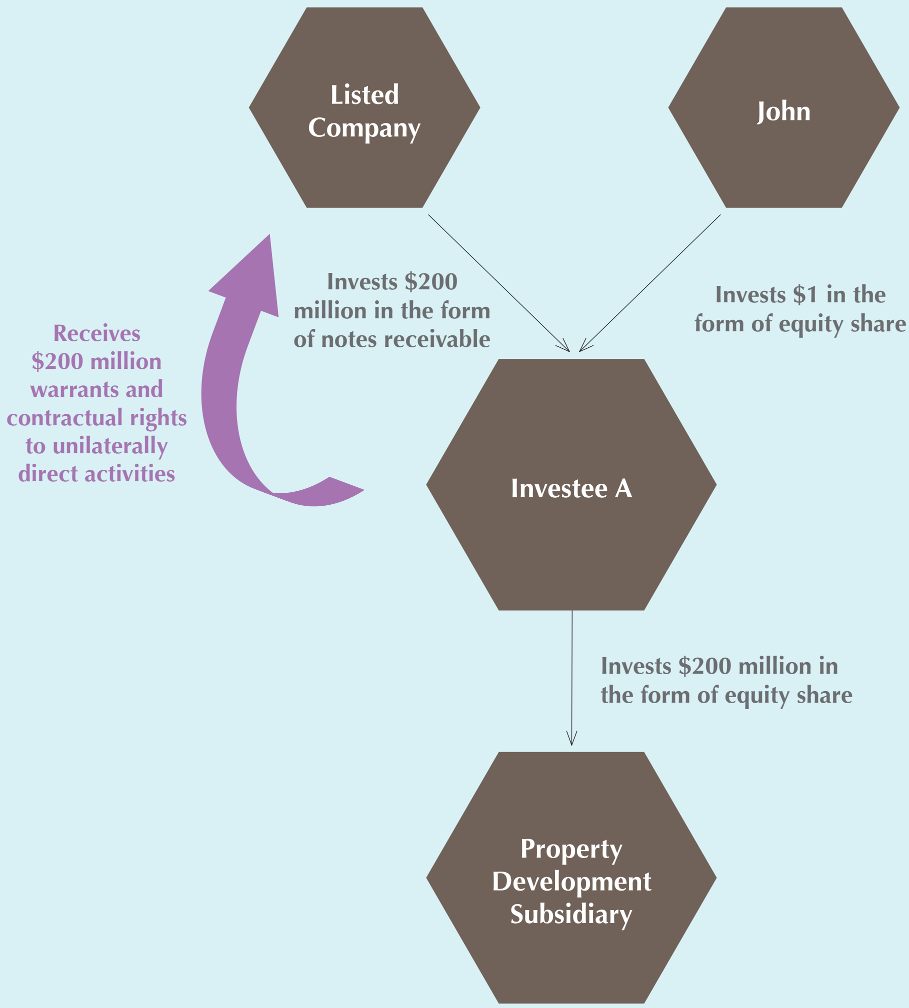
CASE STUDY A

Background

The listed company invested $200 million in the form of 5-year notes issued by a single-purpose investment company, Investee A. The notes bore interest at LIBOR + 7% per annum, payable on maturity. Investee A was wholly-owned by a third party, John, who injected $1 (dollar) as share capital.

In addition to the notes, the listed company was granted 200 million warrants convertible into 200 million new shares in Investee A at $1 (dollar) per share. The warrants were exercisable at any time during the 5-year notes period. The exercise price of the warrants could be offset against the notes to avoid further cash outlay.

Investee A invested all proceeds of the notes into a property development subsidiary, whose project would be completed in five years. **The maturity dates of the notes and warrants were set to coincide with the completion and sale of the property development.** Upon exercise of the warrants, the listed company would own 99.99% of Investee A (and be entitled to 99.99% of the returns from the development project) while John would own 0.01% (and be entitled to 0.01% of the returns).



To protect its investments and returns, the listed company also procured the following **rights** relevant to directing the activities of Investee A and the underlying property development subsidiary **through the investment contract:**

- approve the cessation of existing businesses;
- approve any acquisition, disposal or dilution of any interests in businesses;
- approve any alteration in capital structure;
- approve borrowing, lending or guaranteeing above certain low thresholds;
- appoint or request for a change of directors and other senior management personnel; and
- restrict the dividends paid by Investee A to John, unless the same rate was paid to the listed company as interest on the notes.

The listed company had board representation in the property development subsidiary. The listed company's Executive Director and Chief Financial Officer took active roles in the management of the property development subsidiary including management of their treasury, sub-contract tenders, project suspervision and marketing of the project. The property development subsidiary's General Manager and Chief Financial Officer also reported to the listed company's Executive Director and Chief Financial Officer.

Accounting Issue Considered by ACRA

Did the listed company have **control** over Investee A and **current access** to Investee A's returns associated with 99.99% ownership interests? If yes to both, the listed company should consolidate Investee A as if it held 99.99% interests.

Directors' Explanation

Directors informed that the listed company intended to exercise the warrants only when the underlying development held by Investee A was completed and ready for sale. Since John was the sole legal owner and the listed company held notes and not equity shares, the listed company accounted for the $200 million invested as notes receivables and did not consolidate Investee A. Given no active market for similar warrants, directors also deemed the cost of warrants to be nil.

ACRA's Analysis and Conclusion

In the assessment of control, it is important to first consider the **purpose and design** of the investment. In this case, the purpose was for the listed company to invest in the underlying property development subsidiary of Investee A, while the design was to facilitate the ease of divestment.

Despite not owning any equity share, the listed company controlled Investee A for the following reasons:

- Investee A was a **structured entity** with **narrowly-defined activity and objective.** Investee A was set up solely to invest in the property development subsidiary and had insufficient equity to fund the underlying development project had it not been for the $200 million investment by the listed company;
- the **investment agreement accorded the listed company with the contractual rights** to direct Investee A's relevant activities that significantly affected the returns. The listed company had board representation in the property development subsidiary and took active roles in the management of the project; and
- the listed company was the **main party exposed to variable returns.** Should the project fail, it would incur losses of up to $200 million while John's loss was limited to $1(dollar). Should the project succeed, it would receive 99.99% of the profits, leaving John to enjoy only 0.01% of the profits.

LEARNING POINT

Directors, with their role in driving the strategic direction of the business, should perform reality checks that the **accounting treatment applied is consistent with the business rationale.** Contractual rights termed "protective" legally could be considered "substantive" for accounting purposes.

In addition, the listed company had **current access to returns** associated with 99.99% ownership interest of Investee A, **even though the warrants had not been exercised.** This is because the warrants were convertible to shares at any time without further notice or further cash outlay during the tenure of the notes. John was prohibited from declaring dividends in excess of the rate paid as interest on notes or alter any capital structure without approval from the listed company. All these terms, considered together, accorded the listed company with returns akin to a 99.99%-shareholder of Investee A.

The listed company should therefore consolidate Investee A as if it held 99.99% equity interests. As Investee A was loss-making, upon consolidation, the listed company's FY2014 pre-tax profit would have been reduced by 90%.

(Technical reference: Paragraphs 7 and B90 of SFRS 110 *Consolidated Financial Statements*)

LEARNING POINT

In a "watertight" structure, **returns from underlying investments are captured (without leakage to the legal owner)** for future distribution to the real investor.

When the investor has **current access to returns associated to ownership interests,** it should **consolidate the investee taking into account the eventual exercise of these potential voting rights.**

Business acquisitions: Accounting gain should be aligned with the commercial reality

Business acquisitions often require significant resources and capital investment. In lieu of cash payment, companies could enter into deferred payment schemes or issue bonds to the seller to help finance the acquisitions.

Where the financing arrangement is **negotiated together** with the business acquisition and bonds were issued to the seller, the terms of the **arrangements may be linked** and should be **considered together for accounting purposes.** In addition, any corresponding gain recognised in the income statement should be supported by business circumstances and commercial reality. In this case study, **had it not been for the business acquisition,** a third party would not have agreed to pay $100 million to subscribe for a bond worth $80 million.

CASE STUDY B

Background

The listed company acquired 70% of another listed company, for consideration payable in cash ($400 million) and a 10-year non-convertible bond (face value of $100 million) issued to the seller.

To comply with foreign regulations, which required cash settlement of the purchase consideration, there were two transactions performed. Firstly, the listed company paid $500 million cash to the seller. Secondly, the listed company issued the bond with $100 million face value and received $100 million cash from the seller on the acquisition date.

An external valuer determined the bond's fair value to be $80 million at issuance, as it carried an annual coupon rate of 1% when the market rate then was 6%. As a result, the listed company recognised a gain of $20 million in the income statement from the second transaction.

Accounting Issue Considered by ACRA

What was the **commercial substance** of the $20 million gain?

Directors' Explanation

Directors determined the **fair value** of the purchase consideration using the **face value** ($100 million), instead of the fair value ($80 million) of the bond. This was because:

- the purchase price for the acquisition was negotiated with reference to the investee's trading price and hence, reflected the fair value of the acquired business; and
- the issuance of the bond was a **separate financing arrangement**, for which money was received separately from the payment for the acquisition.

ACRA's Analysis and Conclusion

Accounting standards require the purchase consideration to be measured at fair value, which is calculated based on the acquisition-date fair value of assets transferred by the acquirer. Hence, it was not appropriate to determine the **fair value** of the consideration based on the **face value** of the bond.

Given that the bond was issued to the seller in connection with the business acquisition, it was also inappropriate to regard the issuance of the bond as a separate financing arrangement. **Given that the bond was worth $80 million at issuance, no third party would have subscribed for it at $100 million.** Furthermore, the cash settlement was done to comply with foreign regulations without considering the bond's fair value.

Accordingly, the listed company inflated goodwill by $20 million and wrongly recognised gain of $20 million in the income statement. The $20 million "gain" in substance represented a negotiated purchase price as a discount to the investee's trading price, rather than a windfall gain that was recognised immediately in the income statement.

(Technical reference: Paragraph 37 of SFRS 103 *Business Combinations* and paragraph 43 of SFRS 39 *Financial Instruments: Recognition and Measurement*)

LEARNING POINT

Given that the bond was issued to the seller in connection with the business acquisition, directors should question whether both transactions may be linked and considered together for accounting purposes.

Directors should be alert to **inconsistencies in the financial statements**. In this case, the listed company made a gain on settling the purchase price but also recognised significant goodwill on the business.

Impairment of long-lived assets: Key assumptions should be scrutinised when headroom is small

Other than assessing goodwill and indefinite-lived intangible assets for impairment annually, impairment assessments are required for other long-lived assets when there is an indicator of impairment. Typical indicators include reduction in trading volumes, negative financial performance, or when there are significant changes in the social economic factors such as falling demand and rising interest rates.

The focus of the impairment assessment should not be on the end result, i.e. the impairment amount. Rather, directors must be comfortable with the **reasons and circumstances on why there is impairment or not.** In reviewing the assessment by management, directors should spend time to **critically evaluate** the performance of different operating segments and take into account the accuracy of management's past estimates. The scrutiny of key assumptions used would also allow directors to identify business risks and take early mitigation actions.

CASE STUDY C

Background

Upon business acquisition of an operating mine in 2006, the listed company acquired a 10-year mining license due to expire in 2016. Significant goodwill arose from the acquisition. As at 31 December 2014, goodwill accounted for 40% of the listed company's total assets and the listed company had not commenced the negotiation to renew the mining license that would expire in two years' time.

In the goodwill impairment assessment as of 31 December 2014, the listed company assumed that the mining license would be renewed for another 10 years, and included the cash inflows up to 2026 based on the current operating capacity. However, the costs to renew the mining license were not included in the assessment.

Separately, most of the listed company's mining plant and equipment would be fully depreciated in the next two years. However, no cash outflows were forecasted for their replacement during the renewal period.

There was a small headroom and hence, any change in these assumptions would have resulted in goodwill impairment.

Accounting Issue Considered by ACRA

Why was the goodwill as of 31 December 2014 so significant when the mining operations could potentially halt within two years?

Directors' Explanation

Directors were confident that the renewal would be granted, given some instances of successful renewal in the same country. Directors informed that the renewal costs were not included in the cash flow forecasts because the listed company did not have any track record of renewing a mining license and renewal costs could be wide-ranging based on its research. Directors also shared that the listed company was undergoing a cost-cutting exercise and would freeze all capital expenditure for the time being.

ACRA's Analysis and Conclusion

By including the income stream for the renewal period while excluding the associated costs, the goodwill impairment assessment was not consistently performed. Given that goodwill is such a significant portion of the balance sheet, it is imperative that **goodwill impairment assessment be given more scrutiny.**

To address the uncertainty in estimating renewal costs, management could consider a **sensitivity analysis** based on the extreme ends of the range of renewal costs. This would enable directors to evaluate the full impact and decide whether some impairment loss should be recognised.

Mining, being a capital intensive business, would need its plant and machinery replaced in order to maintain the current operating capacity of the mine. The listed company should assess whether its assumption of incurring no capital expenditure throughout the next 12 years while maintaining the current operating capacity was reasonable and disclose the judgement accordingly.

Taking a step back, the listed company should consider its policy of not recognising the mining license separately from goodwill as an intangible asset. If mining license was separately recognised, the amount would be recognised in income statement over the license period through the amortisation of the intangible asset. Conversely, goodwill may be retained as asset even though the economic benefit it embodies no longer exists if the impairment test is not performed robustly.

(Technical reference: Paragraphs 39(b) and 49 of SFRS 36 *Impairment of Assets*)

LEARNING POINT

Directors should **scrutinise key assumptions** in the goodwill impairment assessment when the **goodwill is material** and the **headroom is small.**

Given the **judgemental nature** of the impairment assessment, **transparent disclosures on critical judgements and sensitivity analyses** would facilitate investors' understanding of the risks.

Fair value of properties: Properties under construction can be reliably measured

Properties under construction are usually harder to value as compared to completed properties. Aside from a lack of comparable properties under construction around the vicinity, there is an additional need to robustly estimate the construction costs to complete. However, these difficulties do not render it impossible to reliably measure the fair value of properties under construction.

Accounting standards prescribe that the fair value of investment properties cannot be reliably measured only in exceptional cases, such as when the market for comparable transactions is inactive and alternative reliable measurements of fair value are not available. Given the widely-available market data and the well-established valuation profession, this is a high hurdle to cross for Singapore properties.

To provide investors with accurate information about the financial performance of properties held, companies should recognise the fair value changes of investment properties on a timely basis. In respect of a property under construction, a fair value gain could indicate a surge in the property value and/or a realisation of the developers' profit as the construction progresses. Conversely, a fair value loss could arise when there are construction cost overruns and/or weak demand for rental, overlaid with oversupply exerting downward pressure in property prices.

CASE STUDY D

Background

In 2013, the listed company entered into a 3-year land lease to build a commercial property, with construction expected to complete in March 2015. The 3-year land lease was renewable for two consecutive 3-year periods, subject to the approval of the relevant authorities and the revision of the lease payments.

As at 31 December 2014 (year-end), due to a delay in commencing the construction, the property was 30% completed at year-end, instead of 70% as projected.

In October 2015, due to a further delay, the property was 95% completed. Due to the intention to sell, the property was professionally valued, indicating a fair value loss.

As at 31 December 2015 (year-end), the listed company recognised fair value loss of $20 million. One month later, the property was sold at a price close to the valuation.

Accounting Issue Considered by ACRA

Why were there no fair value loss recognised earlier in 2014 when there were **indications that construction was significantly delayed?**

Directors' Explanation

Directors informed that due to a lack of comparable properties under construction, the fair value of the property was considered not reliably measurable. Directors did not obtain a professional valuation as of 31 December 2014 as it would be more cost-efficient to do so when the property was fully constructed.

When asked to value the property as of 31 December 2014, directors estimated the fair value to be $20 million higher than the carrying amount (at cost). In that valuation, directors used an annual discount rate based on the average inflation rate in Singapore.

ACRA's Analysis and Conclusion

As at 31 December 2014, given the delay in commencing construction and the 30% completion (as compared to 70% projected), there were indications that the property under construction might be impaired due to cost overruns and a decrease in projected cash inflow from renting the property when completed. Even if the property was measured at cost, the property should be subjected to impairment assessment.

The direct comparable method is not the only technique available to value an investment property. The value could also be derived based on discounted cash flows, for which reasonable assumptions should be used.

The discount rate used in a valuation should reflect the **risks specific to the property,** with a **higher discount rate used to reflect higher risks.** Hence, it was not appropriate for the listed company to use an annual discount rate based on the general inflation rate. Furthermore, the rate used by the listed company was a fraction of those used by other listed companies to value similar-purpose properties. Given that those other similar-purpose properties were located either on freehold land or leasehold land exceeding 40 years, a higher discount rate should also be applied to this property with the remaining lease term of 7 years (assuming renewal).

(Technical reference: Paragraph 53 of SFRS 40 *Investment Property* and B14 of SFRS 113 *Fair Value Measurement*)

LEARNING POINT

The delay in commencing construction should prompt the directors to consider impairment assessment, particularly when the margin was small and period to recover investment was short.

Assumptions used in valuation should reflect the **specific risks of the asset** and be independent of the way the asset is financed. A **quick comparison to peers in the same industry** could help to **identify outliers** in the assumptions used.

Presentation: Net gain from divesting AFS investments should be presented as revenue

Revenue is a key line item used by investors to assess the size and growth of a business. Inconsistent presentation of revenue would reduce the comparability of a company's performance against its peers. For example, a company which presents its non-ordinary activities under revenue may portray a misleading picture of growing business operations. Similarly, an agent that presents its revenue and cost of sales on a gross basis would not accurately reflect the nature of its business transactions.

Available-for-sale ("AFS") is a residual category of financial assets, which commonly comprises equity securities held by companies for investment purposes. AFS investments are recorded at fair value with the corresponding fair value changes recognised directly in equity. The net fair value changes would be recognised as gain/loss on disposal in the income statement upon the sale of the AFS investment.

CASE STUDY E

Background

The listed company, in the business of long-term equity investment, invested in quoted equity securities. The investments were classified as AFS investments after determining that they were not held for trading.

However, the listed company presented the proceeds and cost of sales of these quoted equity securities under 'revenue' and 'cost of sales' respectively in its income statement.

Accounting Issue Considered by ACRA

Would the inclusion of the sales proceeds in revenue mislead investors about the revenue sources and growth of the listed company?

Directors' Explanation

Directors explained that the sale proceeds of the AFS investments were recorded as revenue because:

- such investment activity was one of the listed company's core businesses; and
- the listed company acted as a principal in the purchase and sales of these investment securities as it had ownership of these investment securities.

ACRA's Analysis and Conclusion

The listed company's assessment that it was acting as a principal in the purchases and sales of these investments was not relevant because these relate to financial investments where the accounting standard required net gains and net losses to be disclosed.

A comparison to financial institutions and other companies with similar active trading of AFS investments saw them recording a (net) gain/loss on disposal, instead of the entire (gross) sales proceeds, within revenue. By adopting the wrong presentation, the listed company overstated "Revenue" twofold and "Cost of sales" sixfold.

REVENUE

COST OF SALES

(Technical reference: Paragraph 20 of SFRS 107 *Financial Instruments: Disclosures*)

LEARNING POINT

Inconsistent presentation makes it difficult for investors to better understand the company's operations and evaluate its performance.

In addition, directors should **periodically benchmark its accounting treatment and presentation to other companies** to assess if they are out of the norm.

4

BEST PRACTICES TO RAISE THE QUALITY OF FINANCIAL REPORTING

Directors are both strategic advisors to management and guardians of shareholders' interests. Each director brings different skill-sets, perspectives and experience to the boardroom. Collectively, they are best placed to ensure that the company's financial statements reflect the underlying business and are compliant with the accounting standards.

Through our interactions with directors in the second review cycle, the following best practices were observed for some leading companies. Directors would do well to consider these practices to strengthen their company's financial reporting process, while recognising that some adjustments may be necessary to suit the company's size and circumstances.

Apply rigour to complex and material judgements

Being **principle-based,** our accounting standards have the advantage of being able to respond to emerging business trends and the latest business practices. However, principle-based standards also require judgement to be exercised before deciding on a single position amongst a possible range of outcomes. Depending on the position taken, the judgement could significantly impact the financial outcome and even result in "close call" situations.

Accordingly, judgements should be based on a **rigorous process** that (a) incorporates different stakeholders' views; (b) aligns with acceptable practices in the market; and (c) ensures that the final accounting treatment faithfully reflects the economic reality of the transactions. To add depth, this process should include consideration of **alternative accounting treatments,** if any, and why they do not apply. The deliberations should then be **diligently documented** so that the directors' decision could **withstand future or external scrutiny.**

One listed company demonstrated exemplary rigour when implementing the new consolidation standards. A cross-functional task force led by the Finance Director was set up two years before the standards became effective to re-visit key contractual arrangements and to re-assess the classification of investees. The task force engaged the auditors upfront and provided regular updates to the directors on proposed accounting treatments, including explanation on why certain judgements were undertaken. The robust discussions between management and directors were documented, before the final accounting policies were endorsed by the audit committee, followed by the board.

This best practice is highly recommended for the implementation of the new revenue standard, SFRS 115 *Revenue from contracts with customers* that will become effective in 2018. With its pervasive impact, companies can avoid the potential risk of misapplying the new standard by making early preparations and re-examining the accounting treatment of its significant revenue streams.

Cater time for discussions on accounting issues

Directors, as stewards of companies, are responsible to drive business strategies to enhance long-term shareholder value. Sound corporate governance and financial reporting are essential to support the directors in the discharge of these duties.

To ensure sound financial reporting, directors must **invest time** to understand and ensure that the information reflected in the most important public document of the company, i.e. its annual report, is consistent with how they have steered the business during the year. Hence, it is **important to cater sufficient time for the whole Board, and not just the Audit Committee, to walk through critical judgements and assumptions made by management for significant transactions during the year.** This should be performed on a timely basis throughout the year such as when deciding whether to proceed with a transaction, instead of waiting till the year-end when approving the financial statements for issue.

The findings from the past two FRSP review cycles revealed that most instances of non-compliance could have been avoided had the directors been consulted. Having this process performed on a timely basis would also allow directors to better prepare for its communication with the investors, who are applying a higher level of scrutiny on the financial statements and with the introduction of the enhanced auditor's report.

Ensure CFOs give sufficient time and priority to financial stewardship role

With the multiple demands placed on today's CFOs, they are left with little time to focus on their **core responsibility of financial stewardship and reporting.** Amidst the global economy slowdown, CFOs are facing the added pressures of helping with business operations including meeting financial targets and even leading restructuring exercises. These are by no means easy tasks to juggle, and yet, CFOs have to deal with increasing investors' expectations and public scrutiny.

CFOs, as strategic financial leaders, must be able to support the directors in discharging their duties, which include communication with different stakeholders, such as the shareholders at Annual General Meetings, the media and analysts at private briefings, and even the regulator during the FRSP enquiries. To that end, CFOs should set aside sufficient time to discuss and agree the accounting treatments of significant transactions with the directors, and ensure that their **judgements are supportable and properly documented.**

The recent media spotlight on accounting gaps and corporate governance lapses serve as timely reminders for CFOs to put sufficient focus on their financial stewardship role. Given the myriad of demands placed on the CFO, it may also be worthwhile for CFOs to consider identifying a finance team member to help look into accounting issues.

Evaluate competency of finance team and fill the gap(s)

The finance team is the company's **first line of defence** in ensuring quality financial reporting. A finance team that can be entrusted to prepare reliable financial reports and evaluate the application of accounting requirements will free the CFO to focus on other important matters.

A joint study[5] by the Singapore Management University and ACRA in 2014 showed that more than half (51%) of the 257 listed companies surveyed made five or more audit adjustments in their FY2013 financial statements. 87% of the 3,222 proposed audit adjustments were factual or misclassification errors, which could be corrected by the finance teams before the audits.

To up the game for the finance team, directors can ask for a **root cause analysis on adjusted and unadjusted adjustments proposed by auditors.** As a start, the finance team should be expected to **reduce the number of factual or misclassification errors.** This expectation should however be carefully communicated so as to avoid a situation whereby management becomes reluctant to rectify errors or become un-cooperative with the auditors.

On a functional level, **the finance team should be adequately resourced from the ground up, and continue to be upskilled.** As the business grows or where there are new requirements in the accounting standards, directors should also consider the need to expand the finance team or bring in new skills. The finance team should also be **expected to robustly evaluate appropriate accounting treatment while staying guided by experts** such as the auditors, lawyers and bankers. The finance team **should not be accepting experts' advice unreservedly,** without considering the company's circumstances and aligning the accounting treatment with the business rationale.

Engage external experts upfront with the right scope

When companies enter into complex transactions, it is sometimes difficult for them to execute good financial reporting without the help from experts. Often, accounting technical specialists are called upon to advise on the accounting treatment, valuers are engaged to value complex derivatives that are not quoted in active market and lawyers are relied upon for the legal interpretation of contractual clauses.

When external experts are engaged, the **scope of work** laid out for them should not be **overly restrictive.** Last minute surprises could also be avoided if the auditors were engaged upfront to provide their independent views before the year-end audit.

[5] Audit Adjustments Matter: Upholding Financial Reporting Quality (2014) is available at https://www.acra.gov.sg/docs/default-source/default-document-library/training-and-resources/publications/reports/research-reports/audit-adjustments-matter_report.pdf

Appendix – About the FRSP

Enforcing directors' duties over financial reporting

ACRA administers the Companies Act that applies to companies incorporated in Singapore. Companies incorporated outside Singapore as well as other investment vehicles such as real estate investment trusts and business trusts do not come under ACRA's purview.

The FRSP enforces directors' duties in relation to financial reporting under the Companies Act. Specifically, **sections 201(2) and 201(5) of the Companies Act** require the directors of a company to present and lay before the company, at its annual general meeting, financial statements that:

(a) comply with the prescribed accounting standards in Singapore; and

(b) give a true and fair view of the financial position and financial performance of the company.

The **directors must fulfil both conditions** in the discharge of their responsibilities under the Companies Act.

Focusing on what matters to investors

The ultimate goal of the FRSP is to ensure that investors are provided with reliable and meaningful financial statements for their decision-making. As such, ACRA has focused its review and enquiries on areas that might significantly impact the key measures used by investors such as revenue, profit and operating cash flows.

Due to the focus on significant key measures used by investors, many enquiries are made in the areas of **accounting recognition and measurement**, particularly in relation to complex or unusual transactions.

In determining the impact to key measures used by investors, besides **quantitative amount**, subjective **qualitative factors are also considered**.

For example, emphasis is placed on assessing the classification of properties for a property-developer company, as with the measurement bases of inventories for a manufacturing company. More questions are raised on areas that might impact the income statement if a company appears to face significant pressures to show a trend of increasing earnings, amidst a difficult business environment.

Deep-dive into accounting issues

Financial statements are selected for review using a risk-based approach. Emphasis will be placed on the financial statements of listed companies with:

(a) significant public interest risks based on criteria such as market capitalisation, revenue and asset size, as well as multiple employees, creditors, customers and other stakeholders;

(b) operations that require subjective judgement in accounting for their transactions, hence increasing the risk of significant misstatement;

(c) change in listing or trading status (e.g. newly listed, suspended or delisted) or in key stakeholders, including controlling shareholders, directors, management and auditors; and

(d) modified audit reports indicating potential non-compliance with the accounting standards and other requirements of the Companies Act.

Focusing on compliance with the accounting standards

Enquiries are made to directors when a desktop review of the financial statements indicates a potential significant non-compliance with the accounting standards.

Appendix – About the FRSP (continued)

Section 31(1) of the ACRA Act (read with section 6(1)(a) of the ACRA Act and the Second Schedule to the ACRA Act) empowers ACRA to require any person to furnish information or produce any book or document in connection with the review. ACRA may also call upon an auditor of the company or other experts to assist ACRA in its queries or investigation.

Enquiry letters are issued to the Board of Directors to request for explanations and supporting documents where necessary. Directors are given up to 21 calendar days to respond with a written reply for the first enquiry.

All explanations are received in writing, but directors' requests for physical meetings to address clarifications are acceded. Measures are taken to ensure strict confidentiality for all information provided to ACRA.

First expert opinion from the ISCA-FSRC

To benchmark enquiries and findings of the FRSP to expert views and market practices, ACRA collaborated with ISCA-FSRC to review all the financial statements.

Established more than 30 years ago, ISCA-FSRC comprises more than 20 experienced audit partners from the various audit firms in Singapore, with a majority from the Big-Four[6] audit firms. They bring a wealth of accounting knowledge and experience to the FRSP.

Measures were put in place to safeguard the confidentiality and independence of the review and deliberation process, such as setting up small groups for discussion. More than 50 small group discussions were held in 2016 to deliberate on the enquiries and findings. ACRA retains the sole discretion in deciding the regulation outcome, after considering the expert opinion from the ISCA-FSRC.

Second expert opinion from the FRTAP

When serious non-compliances leading to regulatory sanctions are considered complex and/or judgemental, they are referred to the FRTAP for a second independent expert opinion. The FRTAP was set up by ACRA to ensure that any serious enforcement decision is undertaken judiciously. The FRTAP comprises senior audit partners, directors, Chief Financial Officers, financial controllers and academia of the broader financial reporting community.

A review group of five members is drawn from the 20-member FRTAP to deliberate on each case. To ensure neutrality, each review group must comprise three senior audit partners from different audit firms with at least one non-auditor representative. Each member must declare their independence in respect of the case before the proceedings.

Decide regulatory outcome

The prescribed accounting standards in Singapore are principle-based, which require judgement during their application. It is important that preparers, auditors, users and regulators make the judgement faithfully. If two or more methods are appropriate to achieve the outcome, both methods would be accepted. The judgements made should be documented in support of honest and fair attempt to meet the principles. It should be noted that disclosure does not compensate for wrong accounting.

The findings are grouped initially into three categories, namely:

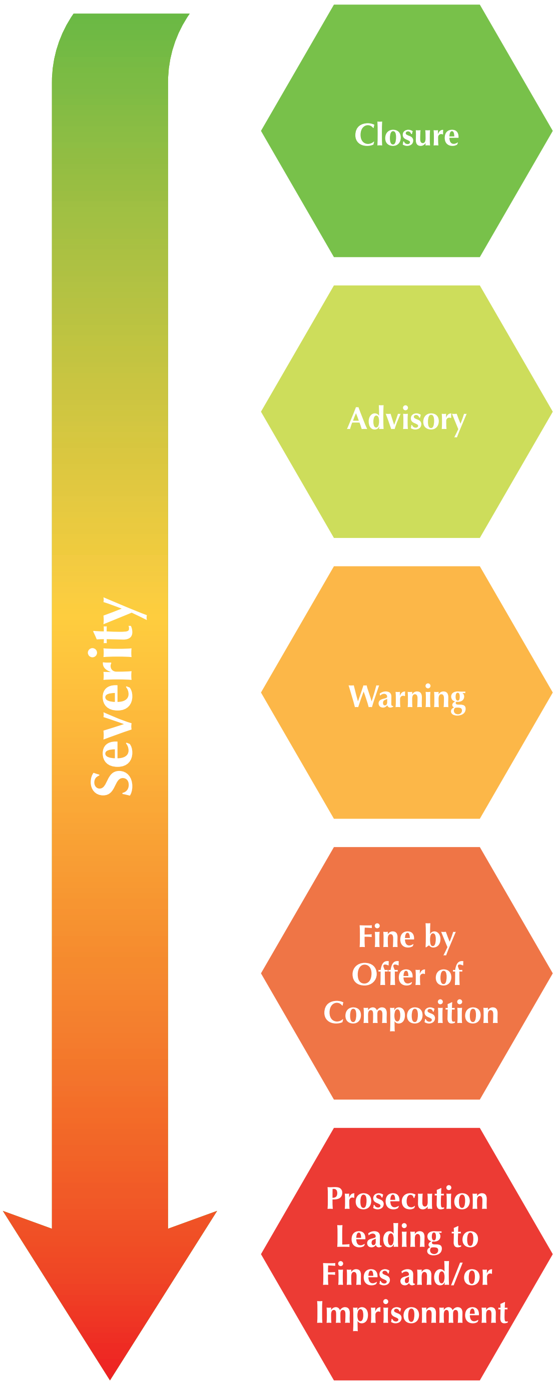
(a) Instance of serious non-compliance
(b) Instance of less serious non-compliance
(c) Area for improvement

All instances of non-compliance and areas for improvement are incidences where the financial statements were not compliant with the accounting standards, differentiated by the nature and extent of the misstatements, which are assessed using both quantitative and qualitative factors.

[6] Big-Four audit firms comprise Deloitte & Touche, Ernst & Young, KPMG and PricewaterhouseCoopers.

Appendix – About the FRSP (continued)

ACRA applies the following range of regulatory outcomes, depending on the severity and volume of non-compliances:



A **closure** letter is issued when ACRA is satisfied with the explanations provided by the directors. There may be suggested areas for improvement for the directors' consideration in the preparation of the future year's financial statements.

An **advisory** letter is issued when there is one or more instances of less serious non-compliance. It does not represent a regulatory sanction. Directors are required to rectify the non-compliance(s) in the future year's financial statements.

A **warning** letter is issued when there is one or more instances of serious non-compliance. Directors may be requested to rectify the deficient financial statements, including having the previous year's financial statements restated, re-audited and re-filed. Directors may also be requested to disclose that the restatement(s) arose as a result of the FRSP findings.

Composition and **prosecution** will be levied on cases with instances of non-compliance with an adverse impact on the financial statements and/or non-rectification of the previous instances of non-compliance.

The maximum penalty for directors under the Companies Act is imprisonment of three years and/or fine of S$100,000.

For regulatory sanctions such as warning letters, composition and prosecution, ACRA calls upon the directors for statement-taking before imposing the sanctions.

Directors of listed companies who received the regulatory sanctions should also consider the implications from the SGX Listing Rules. In particular, under Rule 704(7) and Appendix 7.4.1(k), a director who receives a warning letter from a regulatory authority must announce that fact at his future appointment(s) or re-appointment(s) as a director of any company listed on the SGX. Under the SGX Listing Manual Rule 703, the directors of a listed company must also consider whether the regulatory sanction constitutes 'material information' in relation to the company and, if so, an announcement should be made.

It should be noted that ACRA has the right to take regulatory action against the auditors in respect of an inappropriate audit opinion, under section 207 of the Companies Act.

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