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FINANCIAL REPORTING UPDATES

1Q 2020

This is your quarterly update on all things relating to international financial reporting standards or Singapore Financial Reporting Standards. We will bring you up to speed on topical issues, provide our comments and view points on any significant developments.

JANUARY 2020

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IFRS 16/ SFRS (I) 16/ FRS 116 *Leases* and its Deferred Tax Implications

Under the new Leases standard which is already effective on 1 January 2019, the lessee records a right-of-use (ROU) asset and a corresponding lease liability on balance sheet at lease commencement date (full retrospective approach) or at transition date (modified retrospective approach). Lease expense is recorded in the income statement as depreciation of ROU asset and interest expense on the lease liability. However, for the purpose of income tax computation, tax deduction continues to be on a cash basis as lease payments are made. This creates a timing difference between the accounting and tax profits.

Entities will need to consider the deferred tax implications whereby entities can currently either:

1. Apply the initial recognition exemption under IAS 12/ SFRS(I) 1-12/ FRS 12 *Income Taxes* and thus, no deferred tax is recognised; or

2. Account for deferred taxes on the temporary differences arising from the ROU asset and lease liability.

The potential implications now that IFRS 16/ SFRS (I) 16/ FRS 116 *Leases* is effective – have prompted the International Accounting Standards Board (IASB) to propose a narrow-scope amendment to the application of the initial recognition exemption in IAS 12 / SFRS(I) 1-12/ FRS 12 *Income Taxes*. IASB has proposed the narrow scope amendments to IAS 12 *Income Taxes* which is expected to be effective no earlier than annual reporting periods beginning on or after 1 January 2021. SFRS (I) 1-12 would similarly be amended and make option 1 (above) unacceptable. The proposed amendments (Exposure Draft) would result in companies recognising deferred tax on such transactions. This amendment is expected to be applied retrospectively.

The expected due date for issue of the Amendments to IAS 12 is March 2020. When issued, the necessary changes are retrospectively applied (i.e. affects initial application on 1 Jan 2019, effective date of IFRS 16/ SFRS (I) 16/ FRS 116 *Leases*). There are 2 possible options:

1. Do not provide for deferred tax and disclose the deferred tax implications with reference to the Exposure Draft (thus, when the Amendments are issued and effective, entities will be required to put through prior year adjustment on the deferred tax impact)

2. Provide for deferred tax by not applying the initial recognition exemption; no need to disclose anything about the Exposure Draft (thus, no prior year adjustment is required in this case when the Amendments are issued and effective)

The decision on which option to adopt will also partly be affected by the date of authorisation of the financial statements for the financial year ended 31 December 2019 – whether the date of financial statements is before or after the date when Amendments to IAS 12 is issued and adopted by ASC.

Amendments to SFRS(I) 9, SFRS(I) 1-39, SFRS (I) 7/ FRS 109, FRS 39 and FRS 107 *Interest Rate Benchmark Reform*

On 4 December 2019, the Accounting Standards Council Singapore (ASC) has issued Amendments to SFRS(I) 9, SFRS(I) 1-39 and SFRS(I) 7: *Interest Rate Benchmark Reform* and Amendments to FRS 109, FRS 39 and FRS 107: *Interest Rate Benchmark Reform*.

The amendments modify specific hedge accounting requirements so that entities would apply those hedge accounting requirements assuming that the interest rate benchmark on which the hedged cash flows and cash flows of the hedging instrument are based is not altered as a result of interest rate benchmark reform.

The amendments are effective for annual reporting periods beginning on or after 1 January 2020. The amendments must be applied prospectively and earlier application is permitted.

Amendments to IAS 1 *Classification of Liabilities as Current or Non-Current*

On 23 January 2020, the International Accounting Standards Board (IASB) has issued narrow-scope amendments to IAS 1 *Presentation of Financial Statements* to clarify how to classify debt and other liabilities as current or non-current.

The amendments aim to promote consistency in applying the requirements by helping companies determine whether, in the statement of financial position, debt and other liabilities with an uncertain settlement date should be classified as current (due or potentially due to be settled within one year) or non-current. The amendments include clarifying the classification requirements for debt a company might settle by converting it into equity.

The amendments clarify, not change, existing requirements, and so are not expected to affect companies' financial statements significantly. However, they could result in companies reclassifying some liabilities from current to non-current, and vice versa; this could affect a company's loan covenants. Thus, to give companies time to prepare for the amendments, IASB has set the effective date at January 2022. Early application of the amendments is permitted.

ACRA has issued the FRSP – Review Procedures Guide and ACRA's Practical Guidance No. 2 of 2019

On 21 November 2019 ACRA has issued the following:

ACRA's Practical Guidance No. 2 of 2019

To guide directors in approving their company's upcoming financial statements, ACRA is publishing the FRSP areas of review focus for FY2019 FS. This will serve to remind directors of some potential risks of misstatement in the financial statements and provide the questions they may ask management to improve the quality of financial reporting. Directors are urged to pay more attention to the following financial reporting areas:

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

   SFRS(I) 16/ FRS 116 *Leases*

   2019 is the first year when the new lease standard is effective. The new lessee accounting requires recognition of right-of-use (ROU) assets and corresponding lease liabilities on the statement of financial position that may significantly impact the lessee's financial ratios and performance metrics.

   Directors are encouraged to pay close attention to the following areas when implementing the new lease standard:
   (a) ascertaining if a contract is or contains a lease
   (b) determining the lease term
   (c) deriving the discount rate
   (d) accounting for variable lease payments
   (e) presentation and disclosure in the FS

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

   This new revenue standard was implemented from 1 January 2018. Based on the practitioners' feedback, its implementation could be complex in the following areas:
   (a) variable consideration
   (b) significant financing component
   (c) borrowing costs
   (d) disclosure in the FS

   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. Directors are encouraged to:
   - critically assess the assumptions used by management in those valuations; and
   - obtain independent professional valuations, particularly where these investments are significant and there is no in-house expertise.

   The new impairment loss model 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?

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

Common Pitfalls on Adoption of SFRS(I) 9/ FRS 109 *Financial Instruments*

We have covered some common pitfalls on revenue recognition (i.e. SFRS(I) 15/ FRS 115) in our previous quarter's publication. In this current issue, we discuss below some of the common errors noted in the application of SFRS(I) 9/ FRS 109 *Financial Instruments*, which was effective for more than one year since adoption.

Differences between SFRS(I) 9/FRS 109 and the superseded FRS 39 for impairment

The new expected credit loss (ECL) model is a forward-looking impairment model designed to depict expected credit losses. Accordingly, a loss event no longer needs to occur before an impairment loss is recognised, and this should result in more realistic recognition of impairments. This is a major shift from the incurred loss model under FRS 39 whereby impairment losses are recognised only if there is objective evidence of impairment as a result of the occurrence of a loss event(s) after the initial recognition of the asset. FRS 39 prohibits the recognition of losses expected as a result of future events, no matter how likely they are to happen. This often results in impairment being too little too late.

However, in practice, it is often noted that entities continued to use subsequent receipts and ageing of the receivables as the key considerations in determining provision for doubtful debts. Little or no consideration was given to forward-looking factors and credit risk rating of the debtors to compute the expected default rate in the debtors. It appears that entities still did not fully comprehend the drastic change from the incurred loss model (under FRS 39) to the new forward-looking ECL model (under SFRS(I) 9/ FRS 109).

Two approaches for the ECL model – Simplified and General

The simplified approach (recognition of lifetime expected credit losses at all times) is only available for trade receivables, contract assets and lease receivables. All other receivables (including non-trade receivables with related parties) are required to adopt the general (3-stage) approach for ECL assessment, in which entities shall measure the loss allowance at an amount equal to 12-month expected credit losses, and subsequently re-assess (at least at every reporting date) whether the credit risk on that financial instrument has increased significantly since initial recognition.

Financial assets measured at FVOCI are subject to the same impairment model under SFRS(I) 9/FRS 109

FRS 39's incurred credit loss model requires there to be a significant or prolonged decline in the fair value (objective evidence of impairment) before an available-for-sale financial asset can be impaired. If such evidence exists, impairment is measured as the difference between the acquisition cost and the current fair value. This approach has been criticised because once an impairment trigger occurs, an impairment loss has to be recognised based on changes in fair value even though the fair value changes would be impacted by variables other than credit risk (eg. changes in interest rates). Accordingly, under SFRS(I) 9/FRS 109, financial assets classified under FVOCI and financial assets classified as at amortised cost are subject to the same single impairment model. Therefore, the fair value changes arising from credit risk (i.e. impairment) of financial assets measured at FVOCI will be recognised in the income statement, whilst all other fair value changes (eg. arising from changes in interest rates) are recorded in other comprehensive income (OCI).

FRG 1 *Real Property Valuation for Financial Reporting – Best practices when engaging valuers: Considerations for Scope Of Work (“SOW”) and Valuation Report (“VR”)*

Financial Reporting Guidances (FRGs) are issued to share technical views and insights on issues, and/or best practices in an area/industry. Unlike the accounting standards, FRGs are not mandatory but are consistent with the purpose of accounting standards. They reduce diversity and ensure better and more consistent financial reporting. Therefore, they are expected to be followed.

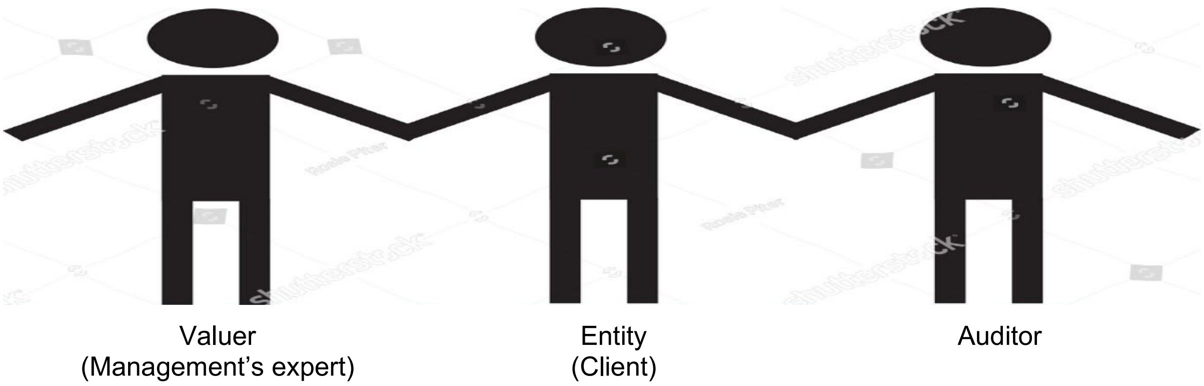
On 26 November 2019, ISCA issued FRG 1 *Real Property Valuation for Financial Reporting – Best practices when engaging valuers: Considerations for Scope Of Work (“SOW”) and Valuation Report (“VR”)*.

FRG 1 helps to close the expectation gaps amongst the valuers, auditors and reporting entities by stipulating salient terms and considerations to be included in the SOW, which should be agreed by all parties prior to the commencement of the valuation work. Timely agreement of the SOW by all parties allows for contentious issues and limitations to be discussed and resolved upfront.

The key considerations when determining the SOW are as follows:

- Credential of the Valuer
- Asset(s) being valued
- Purpose of the Valuation (financing vis-à-vis financial reporting)
- Basis of value for financial reporting (fair value vis-à-vis market value)
- Valuation date
- Any limitations of valuer’s scope and information
- Confirmation that the valuation will be undertaken in accordance with recognised professional valuation standards, e.g. International Valuation Standards
- Recommended workflow of the engagement process of valuation amongst the Client, the Valuer and the Auditor

By providing guidance on the responsibilities of each party, FRG 1 aims to reduce diversity in practices when engaging valuers in the valuations for financial reporting purposes and thereby facilitates compliance with FRS (including the relevant requirements in SFRS(I) 13 about valuation information to be disclosed in the financial statements).



Contact us

If you need assistance or advice on the above, we are here to assist you.

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