FOO KON TAN

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FINANCIAL REPORTING UPDATES

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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 coments and view points on any significant developments.

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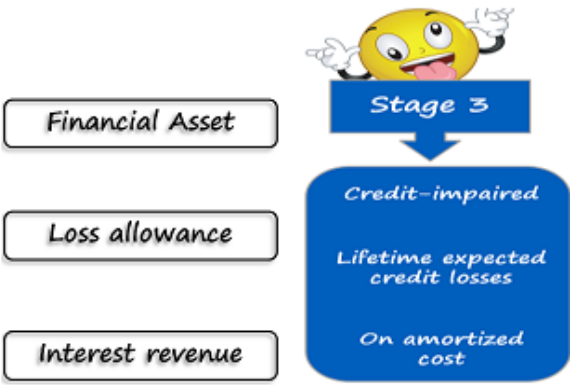
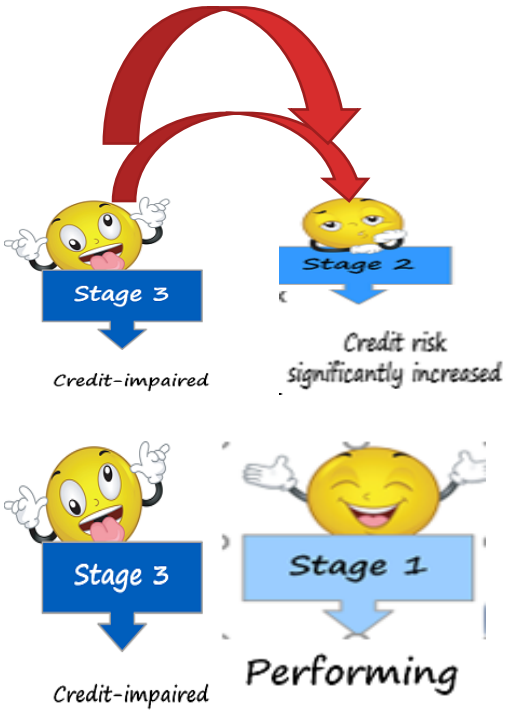
Curing of a credit impaired financial asset



The IFRS Interpretations Committee (the Interpretations Committee or the IFRS IC) received a request as to how an entity presents unrecognised interest when a credit-impaired financial asset (commonly referred to as a 'Stage 3' financial asset) is subsequently paid in full or is no longer credit-impaired. More specifically, the request asked whether an entity can present the reversal related to previously unrecognised interest within interest revenue.



If a financial asset 'cures', so that it is transferred back to stage 2 or stage 1, interest revenue would once again be recognised based on the gross carrying amount. The request to the IFRS IC asked whether, following the curing of the financial asset, an entity can present the difference as interest revenue or, instead, it is required to present this as a reversal of impairment losses.

The Committee observed that an entity recognises the adjustment required to bring the loss allowance to the amount required to be recognised in accordance with IFRS 9 as a reversal of expected credit losses ECLs in profit or loss. The allowance would be reversed to zero if the asset is recovered in full. The amount of this adjustment includes the effect of the unwinding of the discount on the loss allowance during the period that the financial asset was credit impaired. Ultimately, the reversal of impairment losses may exceed the impairment losses recognised in profit or loss over the life of the asset if amounts collected exceed the expected cash flows.

The Interpretations Committee tentatively concluded that an entity is required to present the difference described in the request as a reversal of impairment losses following the curing of a credit-impaired financial asset. It also tentatively concluded that the existing requirements in IFRS provide an adequate basis to conclude that an entity should recognise and present the reversal of ECLs following the curing of a credit-impaired financial asset in the fact pattern described in the request.

Illustrative example

- An existing loan with an effective interest rate of 10% has become credit impaired. Lifetime expected losses have been recognised on the loan as of 1 January Year.
- The expected shortfall in cash flows is shown in Table 1 and remain unchanged until 31 December N+3. Discounted at the EIR this gives an ECL as at 1 January of CU59,000, as shown in Table 1.
- For illustrative purposes, assume that the contractual cash flows (principal + accrued interest) are fully recovered, unexpectedly, on 31 December N+3.
- For simplification purposes, interest is not accrued on unpaid interest

Table 1: Contractual & expected cash flows in CU'000

Cash flows as at 31 Dec	N	N+1	N+2	N+3	Total
Contractual cash flows	10	10	10	110	140
Expected cash flows	0	0	0	60	60
Expected shortfall in cash flows	10	10	10	50	80
ECL as at 1 January N (shortfall discounted at EIR)	(9)	(8)	(8)	(34)	(59)

Table 2: Stage 3 accounting in CU'000

	31 December				Cumulative P/L effect	
	N	N+1	N+2	N+3		
Gross carrying amount: Opening balance	100	110	120	130		
Interest calculated based on gross carrying amount	10	10	10	10		
Settlement	0	0	0	(140)		
Gross carrying amount: Closing balance	**110**	**120**	**130**	**0**		
ECL allowance: Opening balance	(59)	(65)	(70)	(75)	(59)	*Initial allowance*
Unwinding of discount	(6)	(5)	(5)	(5)		
Reversal of ECL allowance	0	0	0	80	80	*Reversal of unused allowance*
ECL allowance: Closing balance	**(65)**	**(70)**	**(75)**	**0**	**21**	**Impairment expense**
Amortised cost: Opening balance	41	45	50	55		
Interest revenue based on the amortised cost	4	5	5	5	19	Interest on the amortised cost
Settlement	0	0	0	(60)		
Amortised cost: Closing balance	**45**	**50**	**55**	**0**	**19**	**Interest revenue**

As the loan is credit impaired, interest revenue is restricted to the amount derived from applying the EIR to the amortised cost of the loan. The Interpretations Committee's decision clarifies that the reversal of the ECL allowance is recognised in full in the impairment expense line. The impact of this on a cumulative basis is that some of the effective interest on the gross carrying amount of the loan (CU40,000) would not be presented as interest revenue, but rather, as a reversal of impairment. This is the portion (CU21,000) which represents the unwinding of discount on the ECL provision while the loan was credit impaired.

The Interpretations Committee's guidance could present a significant operational change for entities that previously recognised such reversals in interest revenue. The Interpretations Committee decided not to add the matter to its agenda. Therefore, for implementation purposes, entities should refer to the IASB's publication: Agenda decisions – time is of the essence on the implementation of accounting policy changes resulting from published IFRS IC agenda decisions.

Impact of SFRS(I)16 and FRS 116: *Leases* within 2018 and 2019 annual reports

SFRS(I) 16 and FRS 116, the new accounting standard for leases, becomes effective for annual reporting periods commencing on or after 1 January 2019. As with other new accounting standards, SFRS(I) and FRS reporters are required to disclose information relevant to assessing the impact of SFRS(I) 16 and FRS 116 in periods prior to adoption.

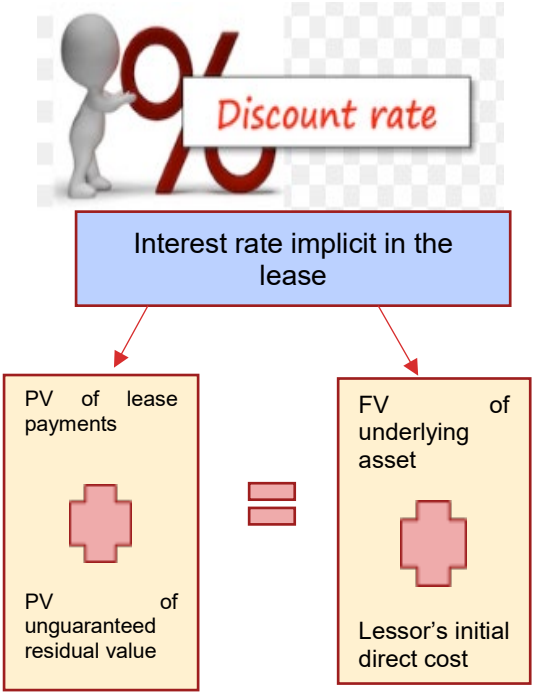
There has been recent regulator focus on providing robust disclosure of the impact of SFRS(I) 16 and FRS 116 within 2018 annual reports. The IASB has issued the recently published an 'Essentials' article on lessees and non-GAAP performance measures. 'Essentials' is the IASB investor publication that covers either key elements of a completed Standard or aspects of a Standard that relate to financial statements and analysis.

Discount rates under SFRS(I) 16 and FRS 116
SFRS(I) and FRS 116 says that the lessee should discount the lease payments using:

(a) The interest rate implicit in the lease, or
(b) The lessee's incremental borrowing rate if the interest rate implicit in the lease cannot be determined.

The incremental borrowing rate is determined on the commencement date of the lease. As a result, it will incorporate the impact of significant economic events and other changes in circumstances arising between lease inception and commencement.

(a) Interest rate implicit in the lease



Therefore, if you are a lessee, you should find out **the unguaranteed residual value and the lessor's initial direct cost**.

The trouble is that not many lessors would tell you this information as they might consider it confidential and sensitive.

This is the reason why most lessees will simply use the incremental borrowing rate. The internal rate of return of the lease as the interest rate implicit in the lease may be refused because it was the rate of the lessee, not the lessor. The Board explained in the Basis for Conclusions to SFRS(I) 16: and FRS 116 … the ASC noted that it is likely to be difficult for lessees to determine the interest rate implicit in the lease for many leases, particularly those for which the underlying asset has a significant residual value at the end of the lease, for example, property leases.

(b) Incremental borrowing rate

SFRS(I) 16 and FRS 116 says that the incremental borrowing rate is the rate of interest that a lessee would have to pay to ***borrow the funds*** to obtain:

- An asset of a ***similar value*** to the underlying asset,
- Over a ***similar term***,
- With a ***similar security***,
- In a ***similar economic environment***.

This definition implies that the incremental borrowing rate is not only a specific for the lessee, but also for the underlying asset and that's the reason why you cannot use the same incremental borrowing rate for all of your leases. It would not be appropriate for a lessee to use its weighted average cost of capital (WACC), which includes equity as well as borrowings. An entity's weighted average cost of capital is not specific to the term, security and amount of the lease.

Such an observable rate can be, for example, an actual borrowing rate of an entity, or a property yield for the property leases. Entities may also use their cost of debt. Such an observable rate must be then adjusted to reflect maturity profile of a lease and type of asset being leased.

When a subsidiary uses financing centralised by a parent, an actual borrowing rate should be adjusted to reflect differences in credit rating of these entities. For lease payments denominated in a foreign currency, the discount rate for that foreign currency should be used. It would also not be appropriate for a lessee to use its parent's incremental borrowing rate instead of calculating and determining its own rate.

Alternatively, the lessee should use the rate at which it would finance 100% of the cost of the right – of – use asset. i.e. (80% * rate for secured borrowing) + (20% * rate for unsecured borrowing). This is sometimes known as the blended rate.

The *security is not the same* and you would need to apply different incremental borrowing rate when leasing a car and when leasing a land.

Illustrations:
If you want to lease the valuable land in a high-level area – that's really a great value collateral and it affects your incremental borrowing rate.

But, if you would like to lease a car, that's not so valuable collateral as the land.

- Imagine you want to lease a land for S$ 2 million and a car for $40 000 – not the same level of risk for the bank as ***not the same amount of funds*** necessary to borrow.
- Imagine your car leases are for ***5 years, but the office lease is for 10 years***. I am quite sure that the interest rate offered by the bank for 5-year loans would be different from the rate offered for 10-year loans.
- Imagine you want to lease an office space in the capital city center and a warehouse in a cheap area of your country. Again, ***not the same value, strength and environment***.
- Imagine you entered one lease on 1 January 2017 and the second one is planned on 1 January 2019 – ***not the same economic environment***, since it is 2 years apart, and you must take all the changes into account. Alternatively, in some cases, the lease is denominated in a currency that is different from the company's functional currency (i.e. the currency of the primary economic environment in which the company operates) – e.g. land is denominated in S$ but the Company's functional currency is US$. In this case, the incremental borrowing rate is determined by using the currency in which the lessee should borrow the funds necessary to obtain an asset of a similar value to the right – of – use asset, i.e. S$.

The same incremental borrowing rate for all the leases that you have may be refused.

How to determine the incremental borrowing rate?
There are 3 basic steps:

1. **Take some observable rate**
   Observable rates can be for example the rate on your past similar borrowings, or the actual offers from your bank for the loans with similar amount, security and term.

   Or, if you are renting the property, then the property yields could be a great start.

2. **Make adjustments**
   Adjustment might be needed exactly because your observable rates might not precisely reflect the lease.

   For example, when you take the rates for unsecured loans, then you need to adjust the rates for the collateral – which is your underlying asset.

   Or, maybe you took the rates offered to companies with low credit risk, but your credit profile is worse – then you need to adjust.

   Finally, let me point out the ***materiality***.

   It can happen that you have just a few leases and thus the impact of these adjustments to observable rates would not be material.

   In this case, just take the observable rates and don't bother with adjustments – they would be costly, judgmental and immaterial. But you need to make absolutely sure that you are below your materiality level.

3. **Use the market yield on high quality bonds, if (a) and (b) cannot be readily determined**
   If (a) and (b) cannot be readily determined, the lessee shall determine the rate used to discount lease payments by reference to market yields at the end of the reporting period on high quality corporate bonds because such a rate reflects the time value of money and includes a risk allowance for the risk associated with the liability and hence such a discount rate is appropriate to discount the lease liability.

Transition method
As the effective date is on 1 January 2019, entities should decide on either a full retrospective approach or a modified retrospective approach to transition to the new standard. The selected approach has to be applied to the entire lease portfolio.

Effective date	Years to be presented in accordance with SFRS(I) 16 and FRS 116 in financial statements
1 January 2019	• Full retrospective ended FY 2018, FY 2019 • Modified retrospective ended 2019

The full retrospective approach
The transition accounting under the full retrospective approach requires entities to retrospectively apply the new standard to each prior reporting period presented as required by SFRS(I) 8 and FRS 8: *Accounting Policies, Changes in Accounting Estimates and Errors*. Under this transition approach, entities need to adjust equity at the beginning of the earliest comparative period presented.

The modified retrospective approach
Under this approach, a lessee does not restate comparative information. Consequently, the date of initial application is the first day of the annual reporting period in which a lessee first applies the requirements of the new leases standard. At the date of initial application of the new leases standard, lessees recognise the cumulative effect of initial application as an adjustment to the opening balance of equity as of 1 January 2019.

To illustrate the impact of selection of the respective approach:

Opening adjustment as at 1 January 2019:

	Full Retrospective Approach		**Modified retrospective Approach Transition (Option 1) [1]**		**Modified retrospective Approach Transition (Option 2)[1]**	
	$ mil	**$ mil**	**$ mil**	**$ mil**	**$ mil**	**$ mil**
DR Leased assets	32.71		36.00		31.95	
DR Operating lease accrual	4.80		4.80		4.80	
CR Lease liability		41.33		40.88		40.80
DR Opening reserves	3.82		0.00		4.06	

[1] *If choosing to apply a Transition Option, entity may apply Option 1 or 2 on a lease-by-lease basis.*
If applying either of the Transition Options, opening reserves is adjusted only in the transition year - no adjustments applied to comparatives.

Cumulative Post Transition P&L Charges:

	Full Retrospective Approach	**Modified retrospective Approach Transition (Option 1) [1]**	**Modified retrospective Approach Transition (Option 2)[1]**
	$ mil	**$ mil**	**$ mil**
Depreciation of Leased Asset	32.71	36.00	31.95
Finance lease interest	6.67	7.20	7.20
	39.38	43.20	39.14
Opening reserve adjustment on transition	3.82	0.00	4.06
	43.20	43.20	43.20

Before the effective date, companies will need to gather significant additional data about their leases and make new estimates and calculations. For some companies, a key challenge will be gathering the required data. For others, more judgemental issues will dominate – e.g., identifying which transactions contain leases.

Preparation of financial assets on a going concern basis

The Hyflux saga and collapse of Noble Group have led to increased scrutiny of the audit process. Singapore Exchange plans to increase the accounting oversight of listed companies, adding pressure on audit committees (ACs) and auditors to increase the thoroughness of the year-end audit.

Accounting regulator is keeping close watch as investors ask why auditors failed to flag risks such as going concern.

Companies should assess if going concern uncertainty in accordance to the accounting standards, which states "When preparing financial statements, management shall make an assessment of an entity's ability to continue as a going concern. An entity shall prepare financial statements on a going concern basis unless management either intends to liquidate the entity or to cease trading or has no realistic alternative but to do so. When an entity does not prepare financial statements on a going concern basis, it shall disclose that fact, together with the basis on which it prepared the financial statements and the reason why the entity is not regarded as a going concern."

According to Singapore's auditing standards, auditors are duty-bound to question this assumption, assessing any risks to the company's ability to stay afloat and avoid bankruptcy. They are also required to remain alert to any events or conditions that show otherwise.

SFRS(I)s for subsidiaries of listed parent companies

ASC prescribes full IFRS convergence for Singapore - listed companies. Singapore-incorporated companies that have issued, or are in the process of issuing, equity or debt instruments for trading in a public market in Singapore shall apply a new framework that will be identical to IFRSs for annual periods beginning on or after 1 January 2018.

SFRS(I)s is the applicable framework for Singapore-incorporated companies specified in first paragraph. It is also available to other Singapore-incorporated companies as an alternative framework to the Singapore Financial Reporting Standards (SFRSs) as well as the Singapore Financial Reporting Standard for Small Entities (SFRS for Small Entities).

For Singapore-incorporated unlisted subsidiaries of listed parent companies, the group entities would also need to decide if they are to apply SG-IFRS for their separate accounts as the application is optional for non-listed companies.

Subsidiaries of listed parent companies can use SFRS(I)s instead of SFRS. As part of their Annual return filing, companies will lodge their accounts and indicate in the XBRL that the Company is using SFRS or SFRS(I)s.

Contact us

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

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