

Corporate Watch

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Acronyms

CA 2005	Companies (Amendment) Act 2005
CCDG	Council on Corporate Disclosure and Governance
FRS	Financial Reporting Standards
ISA	International Standards of Auditing
IFRS	International Financial Reporting Standards
INT FRS	Interpretations of Financial Reporting Standards
SGX	Singapore Exchange
SSA	Singapore Standards of Auditing

Quarterly reporting: To stay or to go?

In January 2006, the CCDG issued a Consultation Paper to seek public feedback on whether listed companies should continue with quarterly financial reporting. This article highlights the issues relating to:

- (a) costs and benefits of quarterly reporting;
- (b) alternatives and options to quarterly reporting; and
- (c) quarterly reporting for companies below \$75 million market capitalisation (exempt companies).

(a) Costs and benefits of quarterly reporting

The Consultation Paper highlighted both costs and benefits of quarterly reporting. On one hand, quarterly reporting:

- provides a regular release of information which assists investors with investment

decisions, manages investors' expectations and reassures investors;

- levels the playing field between minority investors and controlling shareholders;
- imposes financial discipline on companies by compelling management to regularly review financial performance; and
- aligns Singapore with those other jurisdictions which already require quarterly reporting.

On the other hand, it has been argued that quarterly reporting:

- provides only marginal benefit as information is already being disclosed through half-yearly and annual reports, as well as SGX announcements;
- raises preparation and analysis costs;

- distracts companies from the proper management of their businesses;
- makes controlling shareholders bear the cost for making information available to minority shareholders;
- encourages short-term focus on immediate results by both investors and management; and
- creates greater volatility in share prices.

Besides the costs and benefits outlined in the Consultation Paper, we also highlight the factors that affect the quality and reliability of quarterly financial reports:

(i) Non-uniform form and content of financial information in quarterly reports

The current mandatory quarterly/half yearly reporting requirement under the SGX Listing



Manual Rule 705 allows listed companies to present financial information in any format provided that the same format is used for each quarter. With no requirements to refer to any generally acceptable accounting principles and practices framework for the preparation and presentation of quarterly financial information, this may lead to a haphazard approach in the preparation and presentation of such financial information. This could reduce the reliability and comparability of the information reported among companies.

An accounting standard is available, FRS 34 *Interim Financial Statements*, and it sets out relevant accounting principles and practices for interim reports. FRS 34 prescribes the minimum content of an interim financial report and the principles for recognition and measurement in complete or condensed financial statements for an interim period. However, unlike other FRS, application of FRS 34 is not mandatory.

If the use of an established framework for interim reporting is mandated, listed companies would produce information which is more uniform, consistent and streamlined, thus improving the comparability, reliability and usability of the reported information. In the absence of such a requirement, listed companies are at liberty to adopt different practices, such that users of these quarterly reports have to undertake their own research to identify, compile, and/or extract the relevant information for their investment decisions.

(ii) Greater use of estimates

Following from the discussion in (i) above, on the non-uniform form and content of quarterly reports, even if the application of FRS 34 was mandated, new issues could arise in choosing to apply FRS 34. The preparation of interim financial reports in accordance with FRS 34 generally requires a greater use of estimation methods than would have been applied in annual financial reports. A higher level of estimation in quarterly reporting affects the reliability of these quarterly reports.

Examples of the greater use of estimates in interim periods include:

- **Inventories:** Full stock-taking which is usually done at financial year end may not be done at the interim dates. Valuation of inventories at interim dates may be based on sales margins.
- **Provisions:** Determination of the appropriate amount of a provision (e.g. provisions for warranties, contingencies, pension obligations or decommissioning costs) may be complex and often costly and time-consuming. Companies

sometimes engage outside experts for assistance but this is done only on an annual basis. Making similar estimates at interim dates often entails updating of the prior annual provision rather than engaging outside experts to do a new calculation.

- **Revaluations and fair value accounting:** Certain accounting standards permit a company to revalue its property, plant, and equipment and/or investment property. Some financial assets, even though unquoted in an active market are required to be stated at fair value. For these measurements, a company may rely on professionally qualified expert valuers at annual reporting dates, but experts may not be involved at interim reporting dates.

(iii) Level of assurance and degree of confidence about financial information included in the quarterly reports

The SGX Listing Manual requires each quarterly report to include a statement as to whether 'the figures have been audited or reviewed, and in accordance with which auditing standard or practice'. Listed companies are at liberty to determine the level of assurance they wish to provide to users of these quarterly reports.

The level of assurance and degree of confidence a user of the quarterly reports would have on the quality and reliability of the quarterly reports could differ when there is no external independent involvement on the quarterly reports, versus when an external auditor is engaged to issue a review report, or even when an external auditor is engaged to issue an audit report.

Although not required by the regulators, companies could enhance their corporate governance and quality of financial reporting by requiring an external review/audit of the quarterly financial reports.

(iv) Level of assurance or statement about the company's internal controls over financial reporting

In SGX's Consultation Paper of May 2005, reference was made to the likelihood of requiring some form of assurance or statement from the directors about the adequacy of company's internal controls over financial reporting, as strong internal controls directly impact on the reliability and quality of the financial information provided in quarterly reports.

While the outcome of this Consultation Paper is still pending, there is merit in this proposition and listed companies should consider the benefits of doing so, balanced against the higher compliance costs.





(b) Alternatives and options to quarterly reporting

The Consultation Paper suggested changes and alternatives to mandatory quarterly reporting, which include:

- clarifying that voluntary periodic reports may be announced by companies without briefings or publicity statements;
- allowing shareholders to waive quarterly reporting if they decide that the costs outweigh the benefits;
- shortening time-frames for half-yearly and annual reports in place of quarterly reports;
- allowing companies to hold quarterly meetings in place of quarterly reports;
- allowing companies to use simplified formats for quarterly reports.

The SGX did not specifically seek feedback on the criteria for requiring companies to announce quarterly results. Currently, companies with a market capitalisation (as of 1 March 2003) of \$75 million are required to announce quarterly results. The issue is whether a mechanism could be included to enable the determination of the market capitalisation to be periodically updated, rather than pre-fixed based on conditions at 31 March 2003, so that the threshold is progressively updated and representative of market conditions through the years.

In addition, companies reporting on a quarterly basis would have optimal benefit if they were of a certain size and maturity. As such, the threshold for quarterly reporting could be raised, say from \$75m to \$125m.

Alternatively, different levels of reporting could be required for the different market capitalisation thresholds. For example, listed companies with market capitalisation:

- less than \$75m be exempted from quarterly reporting (although half-year reporting still required);
- \$75m to \$125m be required to provide quarterly reporting in free form (with certain key information to be disclosed) but on a timely basis; and
- more than \$125m be required to provide quarterly reporting in compliance with FRS 34.

As mentioned in the Consultation Paper, it may be helpful to modify the current requirements to permit a company's shareholders to vote and decide if the costs of quarterly reports outweigh the benefits and needs, and hence allows the company to be exempted from quarterly reporting. However, given the voting

system renders greater say to the majority shareholders, the outcome may be such that the needs of the minority shareholders are not catered for. As such, it would be necessary to devise mechanisms to protect the minority shareholders.

(c) Quarterly reporting for exempt companies

Arguments for and against requiring all companies to report quarterly are also presented in the Consultation Paper. Currently, only companies with market capitalisation of above \$75 million are required to report quarterly. It is argued that those companies that are currently exempt from quarterly reporting usually have small floats, and it may not be worth the time and cost to provide quarterly reports to the small number of minority investors. Such companies are also less likely to be able to afford the system, processes and people to ensure the process quality and objectivity of the quarterly reporting system. Further, larger companies are usually more able to afford the consequential speculative fluctuations in share price that may follow the release of their quarterly reports.

Also in the Consultation Paper, proponents of mandatory quarterly reporting for exempt companies argue that quarterly reporting is even more important for small companies as such companies tend to have less developed business models, internal control systems, management experience, track records, disclosure and communications procedures, as well as a lower level of public scrutiny. It has also been suggested that those companies that do not have sufficient economies of scale to prepare quarterly reports should consider if listing is in their best interests.

Besides the potential coverage by research analysts and the resulting investor interest, quarterly reporting could also provide internal benefits by indirectly instilling in these exempt companies the discipline and practice of consolidating and reviewing their performance on a quarterly basis. This actively aids the company in meeting its longer term strategy through prompt re-calibrations and adjustments to their operating plans, as well as enabling the company to identify and address issues and problems on a timely basis. All of this makes for better management and strengthens the financial reporting process. Timely and regular reporting also serve to remind the company's management and directors of their stewardship responsibility and accountability to stakeholders.

In terms of the requirements in other jurisdictions, countries such as China, Malaysia and Canada require all listed companies to release quarterly reports. In Singapore and the US, quarterly reporting is required of those companies with market capitalisation or public float above a particular threshold. Other countries such as Australia and the UK do not require quarterly reporting.

The differing practices bear out the fact that the overall need for and associated benefits of quarterly reporting is mixed, and more so, for those quarterly reports released by companies below a certain size.

On one hand, quarterly reports from smaller companies often fill the information gap for its investors, for there is usually less public information available due to limited or no analyst coverage. However, it can be argued that there may not be many users of this financial information.

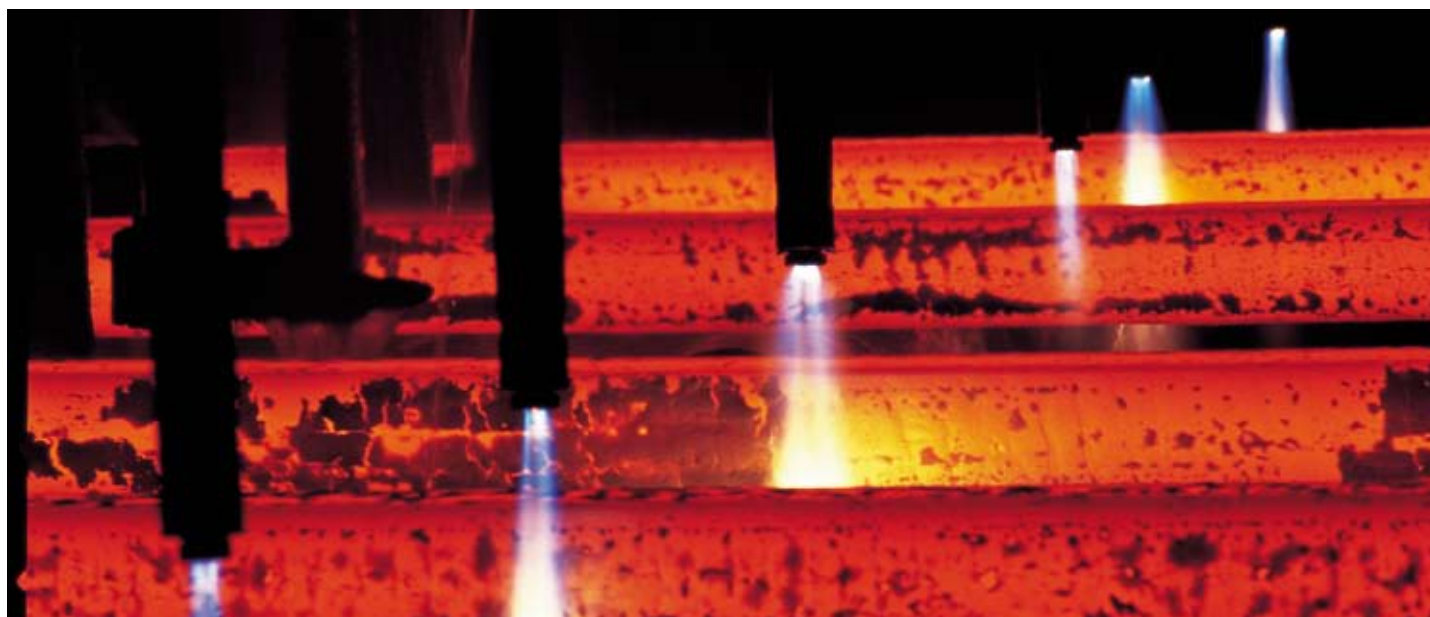
On the other hand, these investments may be material to certain retail investors, and the non-provision of information may be of relative significance to these investors. This is especially true for smaller companies are associated with greater risk, with resource constraints on systems, processes, internal controls and personnel. Thus, as discussed in Para. 23 of the Consultation Paper, the practice in Hong Kong is unique, in that it is the smaller listed companies in the Growth Enterprise Market that are required to provide quarterly reports.

Considering these opposing arguments, the cost of the quarterly reporting process could override its benefits for smaller companies. The overall cost and effort required may be disproportionate given the smaller shareholder base, and company size. For smaller companies, it may be preferable to let market forces dictate the regularity and need for interim reports. If investors value periodic information and certain smaller companies do not provide it, such companies will eventually be disadvantaged in terms of weakened investor interest and possibly poorer stock performance.

Conclusion

Noting the worldwide trend where quarterly reporting is required in mature leading stock markets such as the US, Europe and Canada, it has become an accepted practice that a reasonable cost needs to be incurred to safeguard and enhance the capital marketplace. Thus, our local quarterly reporting requirements should not be completely removed but should be modified, if necessary.

The Consultation Paper is available for download at www.ccdg.gov.sg, and the comment period closed on 28 February 2006.



New risk disclosure requirements in FRS 107



FRS 107 *Financial Instruments: Disclosures* becomes effective for annual periods commencing on or after 1 January 2007 and 1 January 2008 for listed and non-listed companies respectively. This FRS was developed to provide financial statement users with information about an entity's exposure to risks arising from financial instruments and how those risks are managed. Such information can influence users' assessments of the financial position and financial performance of an entity. Some of these information are currently required to be disclosed by FRS 32 *Financial Instruments: Disclosure and Presentation*. When FRS 107 becomes effective, the corresponding disclosures in FRS 32 will be removed.

FRS 107 applies to risks arising from most types of financial instruments, both recognised and unrecognised. Exceptions include certain interests in subsidiaries, associates and joint ventures, employers' rights and obligations arising from employee benefit plans, contracts for contingent consideration in a business combination (only acquirers are exempted), insurance contracts, and certain share-based payment transactions.

Key Disclosures

Key disclosures required by FRS 107 that were not required by FRS 32 (revised 2004) include:

1. Credit risk disclosures for a loan/receivable designated at fair value through profit or loss, including:
 - a. amount of credit risk mitigation provided by related credit derivatives or similar instruments;
 - b. changes in fair value of the loan/receivable, both during the period and cumulatively, that are attributable to changes in credit risk; and
 - c. changes in fair value of related credit derivatives or similar instruments, both during the period and cumulatively, since the loan/receivable was designated.
2. Methods used to determine changes in fair values of loans/receivables and financial liabilities that are attributable to changes in credit risk.
3. For financial assets reclassified from a category that is measured at cost or amortised cost to a category that is measured at fair value, or vice versa, the amount reclassified and the reason for the reclassification.
4. For a class of financial assets (e.g. accounts receivable) where the associated impairment charge for credit losses is recorded in a separate account (e.g. allowance for impairment) rather than directly set off against the carrying amount of the asset, a reconciliation of changes in that separate account.
5. For loans payable recognised at the reporting date, details of any defaults, carrying amounts of loans payable in default, and whether the default is remedied before the financial statements are authorised for issue. (Currently, FRS 32 only requires these disclosures for those breaches that are not remedied on or before the balance sheet date).
6. Separate disclosure of net gains or losses on each category of financial liabilities and assets (e.g. assets and liabilities at fair value through profit or loss, available-for-sale financial assets, etc.)



7. For fair value hedges, separate disclosure of gains or losses on the hedging instrument and the hedged item.
8. Ineffectiveness recognised in profit or loss that arises from cash flow hedges and hedges of net investments in foreign operations.
9. FRS 39.AG76 stipulates conditions under which financial assets can be initially recognised at a fair value that is different from the transaction price. If such a difference exists, FRS 107 requires disclosure of:
 - a. accounting policy for recognising that difference in profit or loss; and
 - b. aggregate difference yet to be recognised in profit or loss at beginning and end of the period, and a reconciliation of this difference.
10. For certain financial assets where the fair value cannot be measured reliably (e.g. equity instruments that do not have quoted prices in an active market, or a contract containing a discretionary participation feature), disclosure of:
 - a. information about the market for the instruments; and
 - b. information about whether and how the entity intends to dispose of the financial instruments.
11. For each type of risk arising from financial instruments,
 - a. qualitative disclosures of the exposures to risk, including how such exposures arise, the objectives, policies and processes for managing each risk, and the methods used to measure each risk; and
 - b. summary quantitative data about exposures at the reporting date, based on information provided internally to key management personnel.
12. Information on credit risk on each class of financial instruments, including
 - a. description of credit enhancements that reduce credit risk exposure;
 - b. information about the credit quality of financial assets that are neither past due nor impaired;
 - c. carrying amount of re-negotiated financial assets that would have been past due or impaired if not for the re-negotiation;
 - d. analysis of the age of financial assets that are past due as of the reporting date but not impaired;
 - e. analysis of financial assets individually determined to be impaired, including the factors considered in determining impairment;
 - f. description, and an estimate of fair value, of credit enhancements held for financial assets in (d) and (e); and
 - g. for assets recovered by taking possession of collateral or calling on other credit enhancements, disclosure of
 - i. the nature and carrying amount of assets obtained; and
 - ii. policies for disposal or utilisation of assets not readily convertible to cash.



13. Sensitivity analyses for each type of market risk to which an entity is exposed at the reporting date, the methods and assumptions used in preparing each sensitivity analysis, and changes from the previous periods in the methods and assumptions.

As part of the FRS 107 project, consequential amendments have also been made to FRS 10, 12, 14, 17, 19, 32, 33, 39, 101, 102, 103 and 104; and INT FRS 105. In particular, the amended FRS 1 now requires disclosure about an entity's capital as follows:

- (a) the entity's objectives, policies and processes for managing capital;
- (b) quantitative data about what the entity regards as capital;
- (c) whether the entity has complied with any capital requirement; and
- (d) if it has not complied, the consequences of such non-compliance.

Incidentally, the Companies (Amendment) Act 2005, which commences on or after 30 January 2006, relaxes certain regulatory requirements with the effect of providing companies with more flexibility in managing their capital. For example, the CA 2005 allows share buyback out of capital as long as a company remains solvent. The capital disclosures in FRS 1 impose accountability on the management of the entity. The Implementation Guidance to FRS 107 provides examples of capital disclosures.

Key Implications

Evidently, FRS 107 requires companies to disclose more information, both qualitative and quantitative, about the risk exposure arising from financial instruments. Although the requirements are effective in 2007 for listed companies and 2008 for non-listed companies, companies should commence the process of information collation early (e.g. the risk disclosures listed in Points 11–13 relating to internally used information and sensitivity analysis) especially when comparative information is required. However, disclosures relating to loan/receivables designated at fair value through profit or loss (e.g. those listed in Points 1 and 2) are likely to impact loans/receivables that are quoted and/or held for trading purposes. As such, it is unlikely to have a major impact on most companies as loans/receivables are usually unquoted and not held for trading purposes, and thus measured at amortised cost.

FRS 107 and the standards amended as a consequence of FRS 107 are available for download from the CCDG website (www.ccdg.gov.sg).

Challenges ahead

In the second *Accountancy/CCH In the Spotlight survey on IAS*, undertaken in February 2006, 150 responses from accountants in public practice were received. The main findings are as follows:

- auditors will take over 40% longer to carry out an audit
- 65% of respondents face an increase in workload
- 70% face increased costs, and 73% say clients will face increased costs as a result
- only 12% of respondents say their clients understand the changes

For more information, please refer to 'News Extra – Auditors under pressure as ISAs start to bite', *Accountancy*, (c) 2006, Croner, CCH Group Ltd. Factiva is the carrier of the information (the archive library of articles).

In Singapore, our Singapore Standards of Auditing are based on the International Standards of Auditing. There have been significant revisions in ISAs (and hence SSAs) in recent years. Most of these changes deal principally with the planning of audits and involve auditors spending more time with clients, and in many cases, are likely to require extra involvement by the auditor.



Amendments to FRS 39 and FRS 104

The CCDG issued the following amendments that are effective for annual periods beginning on or after 1 January 2006:

- Amendments to FRS 39 *Financial Instruments: Recognition and Measurement – The Fair Value Option*
- Amendments to FRS 39, FRS 104 *Insurance Contracts – Financial Guarantee Contracts*.

Fair Value Option

Currently, companies are allowed to measure certain financial assets and liabilities at fair value through profit and loss (the 'fair value option'). This amendment was introduced to address concerns with the existing guidance on the fair value option, such as the issue of subjective fair values and the mismatch that arises when the fair value option is only applied to one part of a matched position.

To address these concerns, the following changes were introduced by the amendment:

Abolition of existing requirement to value embedded derivatives separately from the host contract

If a contract contains embedded derivatives, the whole hybrid contract may be measured at fair value through profit or loss. Currently, embedded derivatives must be separated from the host contract and measured separately at fair value unless the embedded derivative cannot be measured separately. It was observed that for certain complex instruments

(e.g. structured products that have been hedged with derivatives to offset nearly all the risks they contain), the fair value of the combined contract may be significantly easier and more reliably measured than the fair value of the embedded derivatives only.

As most financial instruments have embedded derivatives, restrictions were put in place to prevent this amendment (i.e. allowing hybrid contracts to be entirely measured at fair value) from causing the fair value option to be applied to an excessively wide variety of financial instruments. This amendment is not applicable if:

- a. the embedded derivative does not significantly affect the cash flows; or
- b. it is clear that separation of the embedded derivative is prohibited (e.g. in the case of a prepayment option associated with a loan that permits the holder to prepay the loan for approximately its amortised cost).

Allowing wider use of the fair value option to improve relevancy

Financial assets and liabilities may be designated at fair value through profit or loss at initial recognition if this will result in more relevant information because:

- a. this significantly reduces, or eliminates, an accounting mismatch between assets and liabilities and the associated gains and losses;
- b. the financial assets and/or liabilities are part

of a group that is managed and evaluated on a fair value basis in accordance with a documented risk management or investment strategy, and information about the group is provided internally on this basis to the entity's key management.

Financial guarantee contracts

This amendment requires financial guarantee contracts to be accounted for under FRS 39 as follows:

1. Initial recognition at fair value; and
2. Subsequent measurement at the higher of:
 - a. the amount determined in accordance with FRS 37 *Provisions, Contingent Liabilities and Contingent Assets*; and
 - b. the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with FRS 18 *Revenue*.

However, if the issuer of a financial guarantee contract had previously asserted explicitly that it regards the contract as an insurance contract and had used the accounting applicable to insurance contracts, the issuer may elect to apply either the above treatment or the treatment in FRS 104. This election is available on a contract-by-contract basis; however, the election is irrevocable. The purpose of this is to allow credit insurance contracts to be dealt with under FRS 104, provided that the above criteria are met.

Latest development

3 May 2006 – The CCDG issued INT FRS 108 *Scope of FRS 102*.

FRS 106 *Exploration for and Evaluation of Mineral Resources*



FRS 106 *Exploration for and Evaluation of Mineral Resources* is applicable for annual periods beginning on or after 1 January 2006. The purpose of this FRS is to specify the financial reporting for exploration and evaluation expenditures, which have been excluded from the scope of FRS 16 *Property, Plant and Equipment* and FRS 38 *Intangible Assets*.

FRS 106 requires such assets to be initially measured at cost. The degree to which a particular expenditure can be associated with finding specific mineral resources determines whether it can be capitalised. Examples of expenditures that may be capitalised include acquisition of exploration rights, topological, geological, geochemical and geophysical studies, exploratory drilling, trenching, sampling, the evaluation of the technical feasibility and commercial viability of extraction, as well as provisions for any removal or restoration obligations incurred as a result of the exploration and evaluation process.

After initial recognition, the assets can be measured using either the cost or the revaluation model. The revaluation model in FRS 16 should be applied to tangible assets; while the model in FRS 38 should be applied to intangible assets.

When the technical feasibility and commercial viability of extracting a mineral resource cease to be demonstrable, an exploration and evaluation asset shall no longer be classified as such and should be assessed for impairment.

Assessment of such assets for impairment in accordance with FRS 36 *Impairment of Assets* should also be carried out when indicators of impairment exist. The following examples of indicators are specified in FRS 106:

1. Exploration period has expired or is nearing expiry, and is not expected to be renewed.
2. Substantive expenditure on further exploration and evaluation is neither planned nor budgeted for.
3. Exploration and evaluation in a specific area have not led to the discovery of commercially viable quantities of mineral resources, and the entity has decided to discontinue such activities in that specific area.
4. Sufficient data exists to indicate that the carrying amount of the exploration and evaluation asset is unlikely to be recovered in full.

FRS 106 also requires entities to determine accounting policies for allocating exploration and evaluation assets to cash-generating units (or groups of cash-generating units) for the purpose of assessing impairment. Each cash-generating unit (or group of cash-generating units) should not be larger than a segment determined in accordance with FRS 14 *Segment Reporting*.

FRS 106 requires specific disclosures on exploration and evaluation assets, including:

1. accounting policies for such assets;
2. amounts of assets, liabilities, income, expense, as well as operating and investing cash flows, arising from exploration and evaluation activities; and
3. disclosures required by FRS 16 and FRS 38 for tangible and intangible assets respectively. For this purpose, exploration and evaluation assets should be treated as a separate class of assets.

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