

# Corporate Watch

Volume 1 2007

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## Acronyms

CCDG	Council on Corporate Disclosure and Governance	IP	Intellectual Property
ED	Exposure Draft	JTC	JTC Corporation
FRS	Financial Reporting Standards	SGX	Singapore Exchange
HDB	Housing & Development Board	SLA	Singapore Land Authority
IAS	International Accounting Standards	SSA	Singapore Standards of Auditing
IASB	International Accounting Standards Board	URA	Urban Redevelopment Authority
INT FRS	Interpretations of Financial Reporting Standards		

# Balance sheets and profit and loss could look significantly different with FRS 40

FRS 40 *Investment Property* was issued by the CCDG<sup>1</sup> in early 2005. In view of feedback from key stakeholders, including companies in the property industry, the CCDG decided to require companies to adopt FRS 40 only from annual periods beginning on or after 1 January 2007 as it recognised that companies could need more time to review their business models and valuation methods in order to fully embrace the standard. In addition, the investing community may also need time to better understand the impact of FRS 40 on companies' financial statements.

It is well publicised that FRS 40 requires the fair value gains and losses of investment properties be included in the profit and loss<sup>2</sup>. This would certainly create more volatility in the profit and loss account – the key performance measurement yardstick of many companies.

Is this all the impact that one should expect from the adoption of FRS 40? Certainly not. The adoption of FRS 40 has more far-reaching implications to companies, including those companies that own properties but whose activities are not in the property companies (non-property companies).

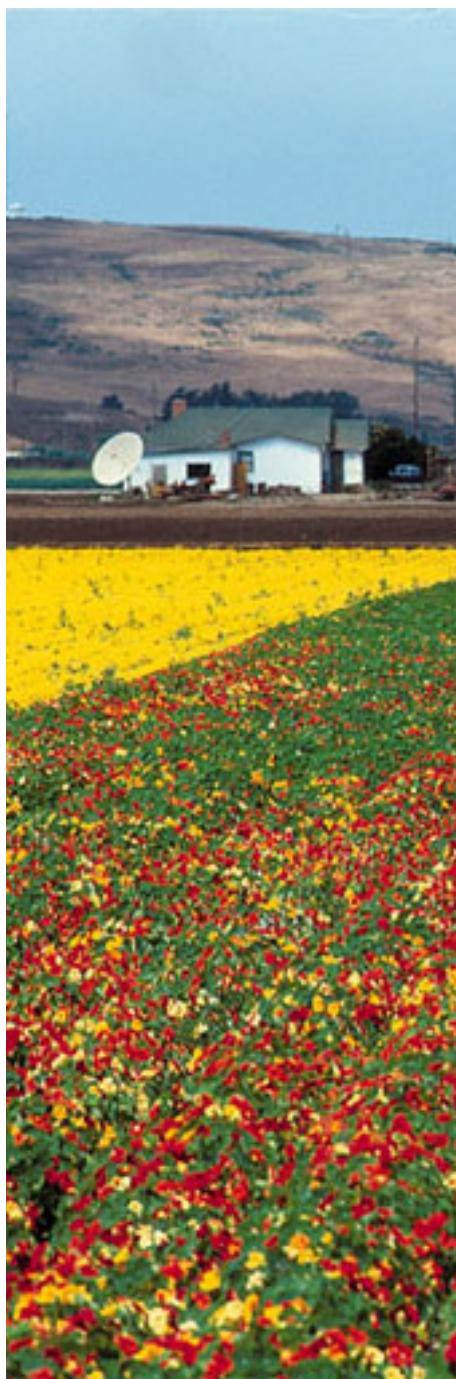
## **The first implication of FRS 40 is that it can create a new class of properties or remove the existing classification of investment properties**

FRS 40 has a wide scope of application. Its application is not restricted to properties that are owned by companies such as investment trusts and property investment companies, whose main or sole activity is the holding of property investments. Instead, it is applicable to all land and/or buildings that are held for capital appreciation or to earn rental. That is to say that if a company currently owns a property (which it is accounted for as a fixed asset) that it derives rental income, there is a high likelihood that it has an investment property that prior to the adoption of FRS 40, not classified and accounted for as an investment property.



<sup>1</sup> CCDG has the authority to issue Singapore FRS which all Singapore incorporated companies are required to comply by virtue of the Companies Act.

<sup>2</sup> Currently, when a property's market value increases above its cost, the revaluation surplus is included in the revaluation reserve. When a property's market value decreases below its cost, the revaluation deficit is included in the profit and loss.



For companies that prepare company-level only financial statements<sup>3</sup>, they have to account for properties held for rental as investment properties, regardless of whether the lessees are companies within the Group such as its holding company or its subsidiaries. Under the current FRS 25 *Accounting for Investments* which companies apply to account for their investment properties, investment properties exclude properties that are used by the reporting company and/or related companies, ie. holding company and subsidiaries.

### Multi-purpose properties

Common current practice for a property that is partially used by the owner (owner-occupied) and partially rented out (referred as a “multi-purpose property” thereafter) is likely to be as follows:

- If the property is substantially used by the owner, the entire property is accounted for as a fixed asset under FRS 16 *Property, Plant and Equipment*.
- If the property is substantially leased out to non-related parties, the entire property is accounted for as an investment property

Under FRS 40, multi-purpose properties will be required to be “split-accounted for”.

For example, a company owns a 10-storey office building. It houses its key management offices, marketing and other corporate services in eight floors of the building and leases the remaining two floors under operating lease. Under FRS 40, if portions of the property can be separately sold or leased out under a finance lease<sup>4</sup>, the separate portions shall be accounted for differently, depending on what the property is used for. The portion that is used to earned rental is accounted for as an investment property and the portion that is owner-occupied, is accounted for as a fixed asset under FRS 16.

Title to a Singapore property can be sub-divided in order for title to portions of the property to be legally transferred, normally, following a sale and purchase transaction. Even leases of land from government landlords such as the HDB, URA or SLA, with the permission from the authority can be sub-let to another party that could qualify as a finance lease.

The requirement to split-account applies even if the title to the property is not currently sub-divided as FRS 40 requires one to evaluate if the property “can” be separately sold or lease out under a finance lease.

<sup>3</sup> A Singapore-incorporated company is required to prepare and present financial statements that include the transactions of the company. If the company is a holding company (ie. it owns subsidiaries), it is required to prepare and present consolidated financial statements that include transactions of the companies and its subsidiaries and the balance sheet of the company.

<sup>4</sup> The lessor of a property under a finance lease has effectively transferred the risks and rewards of owning the property to the lessee, ie. although the contract is not a legal sale, it is in effect an economic sale of the property.

### **Investment properties where the reporting entity provide ancillary services to its occupants**

FRS 40 allows the holder of an investment property that provide ancillary services to the occupants of the properties to treat the property as an investment property only if the services are insignificant to the arrangement as a whole. The provision of security services to tenants may be considered insignificant while for an entity that owns and manages a hotel, services provided to guests are clearly significant to the arrangement as a whole.

However, the determination of whether the services are insignificant or significant is sometimes not clear-cut and hence judgement would have to be applied. Owners of serviced apartments currently tend to account for these properties as investment properties. Ancillary services provided to their guests are increasingly similar to those offered by hotels. Owners would have to evaluate critically whether these services provided are significant to the overall arrangement. The development of the Integrated Resorts may also pose this issue for owners that plan to provide ancillary services.

### **Investment properties on leasehold land – to be carried at fair value only?**

Having identified that there could be investment properties that were previously not accounted for as investment properties, what are the possible implications to the financial statements of companies?

The financial implication of creating a new class of properties is muted if the investment property portions can continue to be accounted for using the same requirements under FRS 16, ie. at cost less depreciation.

Even if so, for multi-purpose properties, there will be some work involved in allocating cost of the entire property to separate portions. Companies will need to evaluate and determine reasonable bases of allocation of costs, which may include relative total gross floor area, relative total lettable area, relative fair value, etc. This will require some level of judgement but generally straight forward.

So, are investment properties allowed to be accounted for at cost less depreciation in addition to the fair value model, ie., is there a choice over the measurement models?



FRS 40 allows a reporting entity to choose to account for its investment properties using either the cost model or the fair value model, except for interest in leasehold land that are accounted for as investment properties, which are required to be accounted for using the fair value model. It must also apply the chosen model consistently to all its investment properties. When the cost model is chosen, investment properties are accounted for in accordance with FRS 16, like an owner-occupied property. When the fair value model is chosen, investment properties are carried at fair value at every reporting date and the changes in the fair value in any period is included in the profit and loss in that period. The fair value model introduces volatility in the profit and loss of the reporting entity, much like financial assets.

Prior to the 2003 revision to IAS<sup>5</sup> 40 *Investment Properties*, in respect of leases of land, they cannot be treated as investment properties if the title of land is not passed to the lessee by the end of the lease term, as such leases are considered as operating leases under IAS 17 *Leases*. The revised IAS 40 on which FRS 40 is identical to, allows (but does not require) an interest in a property, including land, that is held under an operating lease, to be accounted for as an investment property, provided that the property meets the definition of an investment property and the lessee (ie. the reporting entity) uses the fair value model.



<sup>5</sup> IAS is the acronym of International Accounting Standard which is a subset of International Financial Reporting Standards. Singapore FRS is substantially based on IFRS.

In Singapore, a substantial portion of properties are held under leases of land from government agencies such as the URA, HDB and JTC with tenures ranging from 30 to 99 years, often making a large upfront payment for the leases. In 2003, the CCDG considered the issue of accounting of such “purchases” of long term leasehold interest land and were of the opinion that in jurisdictions like Singapore, these leases should be accounted for as finance leases<sup>6</sup>. Hence, the CCDG made an amendment in adopting IAS 17 for the Singapore equivalent FRS 17 in that title of the leasehold interest in land is not required to pass from the lessor to the lessee for the lease to be considered a finance lease.

With this background in mind, how does one apply FRS 40 for interest in long-term leasehold land?

There are a number of possible treatments depending on principally two possible views:

Under View 1, the outcome of application of FRS 40 follows closely those companies that are required to apply (IFRS). Proponents of this view advocate minimal departure from IFRS. If a FRS is word-for-word the same as its IFRS equivalent, the outcome of applying the FRS and IFRS should result in an identical outcome. A Singapore company should account for its interest in leasehold land that is an investment property exactly the same way as a UK or Hong Kong<sup>7</sup> company accounting for similar interests. This would enhance the level of

comparability and transparency in financial statements, in exchange for more confidence and enhanced attractiveness to investors.

Under View 2, the classification of leases is a deliberate departure from IFRS made by CCDG after due consideration. If these leases are considered finance leases under FRS 17, this classification should be consistently carried forward for the application of FRS 40. To change the classification of the leases in the application of FRS 40 do not add credibility on the departure in FRS 17 in the first stance and is confusing to investors.

In addition, it is most likely that the non-property companies would be most affected if View 1 is adopted. This is because in contrast to property companies<sup>8</sup>, non-property companies generally account for their properties as fixed assets using the cost model. These properties are likely to be multi-purpose properties as mentioned earlier. To require non-property companies to account for their properties using the fair value model would increase compliance cost, increase volatility in their profitability and might not necessary provide more relevant information for their investors.

The above issue should be clarified on a priority basis by the CCDG as FRS 40 is effective from 1 January 2007. Both views have their merits and the CCDG should deliberate and consider the implications to the various stakeholders.

	View 1				View 2	
	Alternative 1A		Alternative 1B		Classification	Measurement
	Classification	Measurement	Classification	Measurement		
Interest in long-term leasehold land	Investment property	Fair value model only	Prepaid lease	At cost, amortise cost to profit and loss on a straight line basis over lease period	IP	Either cost model or fair value model
Building		Either cost model or fair value model	IP	Either cost model or fair value model		

<sup>6</sup> Letter from CCDG to International Accounting Standards Board (IASB) dated 23 April 2003, available at the CCDG website: [www.ccdg.gov.sg](http://www.ccdg.gov.sg).

<sup>7</sup> Listed companies in the UK and Hong Kong are required to apply IFRS from 1 January 2005.

<sup>8</sup> Property companies in almost all cases account for their investment properties using the fair value model as fair values of the properties are more relevant to the investors than their depreciated cost.

**Deferred income taxes on fair value gains and losses of investment properties – included in profit and loss now**

Another important implication of the adoption of FRS 40 is the accounting for the deferred income taxes on the fair value gains and losses of investment properties.

Under FRS 12 *Income Taxes*, in addition to current income tax<sup>9</sup>, a company is required to account for the future tax consequence of a current transaction or event (deferred income tax) as and when the transaction or event arises. This is to ensure that there is proper matching of the timing of the recognition of a transaction or event and its applicable tax effect.

For example, deferred income tax is required to be accounted for interest income that are recognised in the profit and loss but only taxed on a receipt basis; fair value gains and losses on financial assets recognized in the profit and loss or fair value reserve but only taxed when the profit is realised.

For an investment property, while its fair values is usually derived using the market comparison approach, all things being equal, one cannot dismiss that an increase in the fair value of the property is a representation of an expected increase in the future rental stream and/or proceeds from the ultimate disposal of the property, taking into consideration time value of money and risk of the asset.



<sup>9</sup> Current income tax liability is the amount of income tax that is expected to be paid to the tax authorities within 12 months of the balance sheet date.

Gross cash flows	Yearly after acquisition						Sum of > 6
	1	2	3	4	5	6	
Expected at acquisition	8	9	10	12	12	10	233
Expected at end of Year 1	NA	10	13	13	13	12	241

Consider the following example:

A property with a useful life of 50 years cost \$100 million at acquisition and has an expected overall annual yield of 8%. The owner intends to hold the property over the next 50 years for rental. This means that the discounted future cash flows from rental arising from the property over the next 50 years would be \$100 million. Assuming that after one year, the fair value of the property increases to \$110 million and the yield is to be maintained at 8%, there will be an expected increase in the future cash rental inflow from the property.

The projected gross cash flows from the property at acquisition and after one year (Year 1) may look as follows: Assuming that the market condition remains the same, the fair value of the property at the end of Year 2 is expected to decrease by \$1.2 million to \$108.8 million, presenting the present value of the future cash flows that can be generated from the property.

The above table demonstrates that if no deferred tax (DT) is accounted for in Year 1 and Year 2, the effective tax rate of the company would not make sense at 9% and 23% respectively.



	With accounting for DT		Without accounting for DT	
	Year 1	Year 2	Year 1	Year 2
Rental income	8.0	10.0	8.0	10.0
Fair value gains / (losses)	10.0	-1.2	10.0	-1.2
Profit for year (A)	18.0	8.8	18.0	8.8
Current income tax	1.6	2.0	1.6	2.0
Deferred income tax	2.0	-0.2	0.0	0.0
Total tax expense (B)	3.6	1.8	1.6	2.0
Effective tax rate (B)/(A)	20%	20%	9%	23%

In the above example, it is assumed that the property will be held to the end of the useful life for rental. If the property is planned to be disposed in say, five years' time, the total expected increase in future cash flows would be split into those that will be receivable as rental and those that will be received as sales proceeds. This is because different tax rates could apply, depending on the nature of the receipt. In Singapore, rental income is taxed at the corporate tax rate, currently at 20% and there is generally no capital gain tax on sale of investment properties.

Hence, using the same numerical example above, assuming that the company has concrete plans to dispose of the property six years after its acquisition, the total increase in fair value of \$10 million at the end of Year 1 may be analysed into increase in cash flows of \$2 million from Year 2 to Year 6 and \$8 million thereafter. The total deferred tax to be accounted for in Year 1 would then be \$0.4 million, representing the sum of 20% on \$2 million and 0% on \$8 million. Having said this, companies generally may not be able to foresee the time line for planned disposal of the property. Hence, we would expect that companies would then apply the corporate tax rate to the total of the fair value increase of the property.

If the investment property is situated on a freehold land, the accounting standard<sup>10</sup> allows the use of rate applicable to the ultimate disposal of the property as it can be envisaged that the receipt of the increases could be perpetually deferred.

As mentioned earlier, the requirement of accounting for deferred tax for fair value gains and losses is a requirement under FRS 12, not the new FRS 40 that is effective from 1 January 2007, ie the accounting for deferred tax is not new. So what exactly is the fuss about?



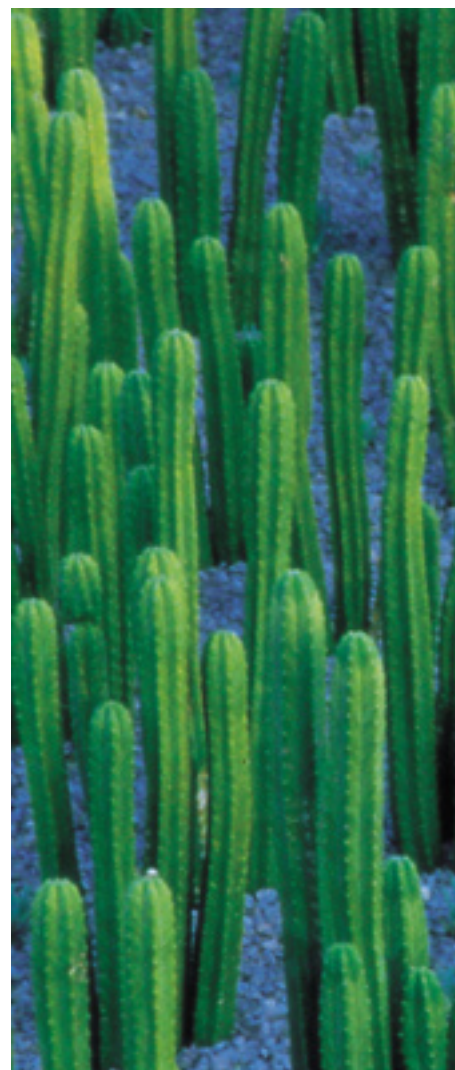
<sup>10</sup> INT FRS 21 Income Taxes - Recovery of Revalued Non-Depreciable Assets

In Singapore, it is generally acknowledged that companies do not account for deferred income taxes on revaluation gains of investments properties. As the revaluation gain of an investment property is accounted for in the revaluation reserve, under FRS 12, the related deferred tax would be accounted for against the revaluation reserve. (similar to fair value gains of available-for-sale investment). Therefore, the amount of deferred tax vis-à-vis the net asset value of companies would generally be less significant and may be immaterial.

However, under FRS 40, the changes in fair value is required to be included in the profit and loss account and generally, the amount of profit and loss for the year is only a fraction of the net asset value of many companies, especially the property owning companies. Therefore the deferred tax expense on fair value gains would be more material on adoption of FRS 40.

There is also murmuring of a couple of arguments against accounting for deferred taxes. First, the entire increase in the fair value should be attributable as “capital gain” and hence the capital gain tax rate (which is nil in Singapore) is applicable. Second, the fair value of properties could be determined on a net-of-tax basis. Whilst no attempt is made in this paper to examine the merits of these arguments against the accounting for deferred tax, what remains clear is that the application of IAS 12 (in which FRS 12 is identical) by other jurisdictions such as the UK, Hong Kong, Australia and Malaysia, has resulted in the recognition of deferred taxes on similar investment properties. It is really hard to envisage Singapore to be unique whereby the accounting profession and the valuation specialists adopt a completely difference stance. Using today’s key buzz words such as “global accounting language”, “consistency in interpretation”, “comparability” and “transparency”, it is quite clear that investors could rightly challenge all concerns for making that stance.

This article was first published in ICPAS Singapore Accountant, March/April 2007.



### Latest Developments

7 March 2007 – The CCDG issued ED FRS for Small and Medium-sized Entities. Comments should be sent by 1 September 2007. For more details, please refer to <http://www.ccdg.gov.sg>.

7 March 2007 – The CCDG issued ED Proposed Amendments to FRS 24 *Related Party Disclosures*. Comments should be sent by 25 April 2007. For more details, please refer to <http://www.ccdg.gov.sg>.

Public Seminar

# Financial Reporting Update

11 May 2007, 9 am to 5 pm, Meritus Mandarin Singapore  
 Fee: \$600 (PwC clients); \$700 (public rate)



To date, three new Financial Reporting Standards (FRS), two amendments to FRSs and six new Interpretations to FRSs have been issued that are applicable to financial years commencing on or after 1 January 2007. Looking at the International Accounting Standards Board (IASB) work plan, there will be at least 10 standards issued/amended by the end of 2008 with some already issued as exposure drafts. In addition, the members of International Financial Reporting Interpretation Committee (IFRIC), IASB interpretative body that reviews IFRSs, have made certain interpretations of the existing IFRS without issuing new interpretations (Singapore equivalent - INT FRS) as IFRIC does not view that the IFRSs are unclear or there is expected divergent practices in the absence of further guidance. This seminar highlights the changes, developments and decisions relating to accounting standards so as to provide participants a practitioner-level understanding of the implications to financial results, work procedures and processes. It includes:

#### New Standards

- FRS 40 Investment Properties
- FRS 108 Operating Segments
- INT FRS 111 FRS 102 Group and Treasury Share Transactions
- INT FRS 112 Service Concession Arrangements

#### Exposure Drafts

- ED INT FRS Customer Loyalty Programmes
- ED Proposed Amendments to FRS 24 Related Party Disclosure
- ED FRS Small and Medium Entities

#### Hot Topics & IASB/IFRIC Developments such as:

- Items under IASB Annual Improvement
- Convertible debts – Debt/equity and current/non-current classification by issuer
- Joint Ventures – Removal of proportionate consolidation of indirect interest in joint ventures
- Liabilities – Reflection of uncertainty about the amount or timing of settlement in measurement, rather than in recognition criteria

## Who should attend?

Company directors, Chief Financial Officers, Financial Controllers, Finance Managers, Financial and Tax Accountants, Financial Analysts and anyone who is involved in any aspect of financial or corporate reporting.

## Seminar Leaders

The seminar will be led by the following partners and senior managers of PricewaterhouseCoopers Singapore (PwC):

**Choo Eng Beng** is an Assurance partner with PwC and also a Global Accounting Consulting Services partner, with over 13 years experience in public accounting. He is also with the Professional Standards Group (PSG) in charge of corporate reporting, involved in providing internal and external advisory services, as well as training and guidance to members of the Assurance Department. Eng Beng also spent two years in PwC London dealing with matters concerning IFRS such as quality of application, training, marketing and communication with the IASB.

**Kok Moi Lre** is an associate director with our Assurance Department with over 15 years experience in public accounting. She develops internal guidance and internal/external training materials for accounting standards and corporate reporting matters. She also speaks regularly at internal workshops and public seminars in these areas. Prior to being a full-time technical manager, Moi Lre was a senior audit manager with extensive experience in auditing public-listed companies.

**Chew Tong Gunn** is a senior manager in Assurance Department. Tong Gunn holds a Doctor of Philosophy (Ph.D) from Monash University, Australia. Over the past 13 years, she has been involved in various aspects of accounting including audit, commerce, academia and regulatory where she was directly involved in accounting and auditing standard setting at the ICPAS. At PwC, she is involved in internal/external corporate training and internal/external accounting advisory. She also sits on various committees of the CPA Australia (CPAA) and Institute of Certified Public Accountants of Singapore (ICPAS), including the Board of Examiners Committee (ICPAS), Council (CPAA), Editorial Committee (CPAA) and SAA Committee (ICPAS).

## Registration Form

# Public Seminar: Financial Reporting Update

11 May 2007, 9 am to 5 pm, Meritus Mandarin Singapore

Fee: \$600 (PwC clients); \$700 (public rate) includes lunch, seminar kit and 5% GST

Please register the following person(s) for Financial Reporting Update Seminar

Name	Designation	Email
Mr/Ms		
Mr/Ms		
Mr/Ms		
Mr/Ms		

Company \_\_\_\_\_

Address \_\_\_\_\_

Contact person \_\_\_\_\_ Tel \_\_\_\_\_ Fax \_\_\_\_\_ Email \_\_\_\_\_

A cheque (no. \_\_\_\_\_) for S\$ \_\_\_\_\_ made payable to "PricewaterhouseCoopers" is enclosed.

Registration can be made by telefax at (65) 6236 3300 but will only be confirmed upon receipt of registration form and cheque.

Registration can also be made by mailing the registration form to  
PricewaterhouseCoopers at 8 Cross Street #17-00 PWC Building Singapore 048424  
Attn: Siti Fatimah/Maimunah

### Note:

**Cancellation Policy:** If you are unable to attend, a replacement is welcome. For cancellation received in writing at least seven (7) days before the seminar, a full refund will be made. No refund (or full rate will be charged) if a cancellation occurs less than 7 days before the seminar date. Notice of cancellation must be made in writing to us.

**Award of Certificate:** Certificate of Attendance will be awarded on successful completion of the workshop.

**Reservation Hotline:** For registration and reservation enquiries, please call Ms Siti or Maimunah at (65) 6236 3957/3

**On-Site Training:** You can also have this course presented at your organisation to meet your specific needs. For information, please call Kok Moi Lre at (65) 6236 3049.

The organiser reserves the right to change the venue, date and programme due to circumstances outside our control.

<http://www.pwc.com/sg>

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