

Corporate Watch

Developments on Corporate Reporting and Governance*
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*connectedthinking

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Acronyms

ACRA	Accounting and Corporate Regulatory Authority
CCDG	Council on Corporate Disclosure and Governance
CDO	Collateralised Debt Obligations
CESR	Committee of European Securities Regulators
CFO	Chief Financial Officer
ED	Exposure Draft
EU	European Union
FASB	Financial Accounting Standards Board
FRS	Financial Reporting Standards
GAAP	Generally Accepted Accounting Principles
IAS	International Accounting Standard
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
MBI	Mortgage-Backed Securities
SME	Small and Medium-sized Entities
TBPCL	Thai Beverage Public Company Listed

Proposed financial reporting standards for small and medium-sized entities

– A case for simplification?

The IASB issued an Exposure Draft of the Proposed International Financial Reporting Standards for Small and Medium-sized Entities (ED IFRS-SME) in February this year. The ED IFRS-SME is designed to provide an alternative to certain SMEs in the form of simpler financial reporting standards and hence lower the compliance costs. In the case of privately-held SMEs with no public accountability, the costs incurred in adopting IFRS may far outweigh potential benefits. The final IFRS-SME is expected to be issued in 2008. Locally, the CCDG has issued an identical and local exposure draft on 7 March 2007 and is likely to adopt the final version of IFRS-SME when it is issued in 2008.

Who can apply IFRS-SME?

The approach of IASB is to allow each individual national jurisdiction to set further eligibility criteria for a SME to adopt the IFRS-SME, except that SMEs with public accountability will not be able to use the IFRS-SME for their financial statements. Consequently, it has not determined a size or other criteria. In Singapore, ACRA will need to determine when a private company (qualifying SME) is eligible to adopt the standard. ACRA will need to consider whether a quantitative criterion is appropriate. In Hong Kong and the United Kingdom, a size criterion is prescribed in their own local SME accounting standards.

Stand-alone accounting document

Although the principles of the ED IFRS-SME are derived from the full IFRS, the ED IFRS-SME runs 225 pages as compared to the 2400 pages or so in the 2007 bound volume of the full IFRS. This has been achieved in part by excluding transactions and topics that are unlikely to concern a qualifying SME and explanations of principles, elaborated guidances and illustrations. The ED IFRS-SME is intended to be a stand-alone single standard. However, where specified in the ED IFRS-SME, SMEs may refer to the full IFRS to account for transactions which are not specifically addressed by it.

What are simplified in the proposed IFRS-SME?

In the ED IFRS-SME, simplifications have been made to a number of areas including recognition and measurement principles and disclosure requirements. These include:

- (i) two, rather than four, categories of financial instruments, namely amortised costs and fair values through profit or loss. Financial instruments measured at fair values will recognise the changes in fair values in the profit and loss account. SMEs which want the option of recognising fair values through equity will have to apply IAS 39 in its entirety. In addition, the derecognition rule of financial instruments is also simplified and derecognition may be achieved more easily under the ED IFRS-SME;
- (ii) associates and joint ventures can be accounted for at cost (instead of equity accounting or proportion consolidation) in the consolidated financial statements. This makes reporting by investors much simpler;
- (iii) review for impairment of goodwill and indefinite-life intangibles are required only when there exists an indicator of impairment instead of the mandatory annual impairment review required in IAS 36;
- (iv) option to recognise development costs in the profit or loss account is allowed instead of capitalisation in IAS 38; and
- (v) absence of IFRS 7-type disclosures on financial instruments. There is no requirement to disclose risk management policies, sensitivity analysis, defaults and breaches. This will likely result in significant reduction in disclosures.

Notwithstanding the proposed simplifications, the ED IFRS-SME has preserved a number of key concepts found in the full IFRS. For instance, fair value concept in the areas of business combinations, impairment assessment, share-based payments, investment properties and financial instruments are still applicable. An exception where the ED IFRS-SME is moving away from the fair value concept is accounting for agriculture. A SME is required to account for biological assets at their fair values only if their fair value are 'readily determinable without undue cost or effort'.

The ED IFRS-SME continues to require SMEs to measure and recognise defined benefit plans, share-based payments and deferred taxes; and prepare cashflow statements. SMEs are also required to consolidate subsidiaries. IASB considered simplifications in these areas but decided to align them to the full IFRS as users of the financial statements are likely to find these measurement and/or disclosure requirements useful.

Will SME and all stakeholders benefit from the ED IFRS-SME?

The ED IFRS-SME is expected to reduce compliance costs for SMEs. However, SMEs, which are subsidiaries of a listed group, although not precluded to apply the proposed standard, may continue to prepare the IFRS compliant financial statements to avoid costs in converting IFRS-SME compliant financial statements to full IFRS compliant statement for group reporting purposes. For SMEs that are rapidly expanding its operations and/or pursuing access to capital markets (for example in an IPO or other fund raising activities), they would necessarily incur higher cost of transition into the full IFRS framework. At a higher level, bearing in mind that Singapore companies are already in compliance with the full FRS which is based on IFRS, further modifications to the recognition and measurement principles may be seen to be taking several steps backwards towards high quality financial reporting. In addition, the financial statements of SMEs prepared under IFRS-SME may not be comparable with other companies in Singapore (including SMEs) that are on the full FRS framework.

SMEs should take the opportunity to evaluate the costs and benefits of adopting the IFRS-SME prior to the issuance of the final version expected in 2008.

Between the GAAPs

– Is a common accounting language wishful thinking?

The magazines holders on the window ledge are filled with copies of glossy annual reports received from the clients. Looking through the various reports, we see US GAAP's 'Profit before tax', China GAAP's 税前利润 and French GAAP's 'Profiter Avant L'impôt'. Intuitively, profit is profit, but is it always the case?

Thinking back, the foreign companies have traditionally used their respective country's GAAP in their annual reports. To make meaningful comparisons among the three sets of annual reports, adjustments from one GAAP to another is required. Such reconciliations eliminate differences in accounting treatments arising from applying each country's GAAP so as to adopt consistent interpretation and arrive at comparable information. It seems that different countries have different interpretation of profit.

In Singapore, there are a handful of foreign incorporated and Singapore listed companies that have stayed true to their respective national GAAP such as the Thai Beverage Public Company Limited (TBPCL) which prepared its annual reports in accordance with Thai GAAP. The TBPCL also presented a reconciliation to IFRS which outlined differences between Thai GAAP and IFRS, such as non-recognition of derivative financial instruments and the recognition of revaluation surplus of investment property in equity. Under IFRS, derivative financial instruments are required to be recognised and fair value changes of investment properties are recognised in the income statement.

In such a scenario, professional assistance needs to be sought from two parties, namely one with Thai GAAP expertise and another possessing IFRS expertise.

Converging towards IFRS

Given the various GAAP differences that exist between countries, it is much to our delight when we note that 100 countries (including Australia, Russia, the 25 European Union member states, and several countries in Middle East and Africa) are converging towards IFRS. This is good news for companies intending to raise cross-border funding in various parts of the world. Perhaps, going forward, the tedious reconciliation exercise need not be done when different jurisdictions are on the same IFRS platform.

This move towards a common set of principles-based accounting standards will result in more transparent financial reporting and greater consistency across the global capital markets. Companies will incur lower cost of compliance since only one set of financial statements can be used for filings in multiple jurisdictions. This is expected to facilitate cross-border fund raising, positioning the company as an international player.

With more countries embracing IFRS convergence readily, a recent research by PwC shows that these countries are in different stages of IFRS adoption with some having selective adoption strategies. This results in differences in IFRS reporting, meaning that even though these countries are said to be converging with IFRS, there are still temporary differences in accounting treatments between countries. In our exercise advising clients on similarities and differences between national GAAP and IFRS, more vigilance needs to be exercised when comparing different GAAPs even though they are converging to IFRS. We caution you to be careful not to assume that no reconciliation is required.

In July 2005, the CESR issued a Technical Advice which stated that the US, Canadian and Japanese GAAPs are equivalent to IFRS, subject to remedies¹. This goes to say that they are not 100% equivalent yet but that day will come. Besides US, Canadian and Japanese GAAPs, what about the other GAAPs? CESR is now conducting a more extensive exercise via its CESR's Consultation Paper, April 2007, to determine equivalence of third country's GAAP on a world wide basis.

Where Singapore stands

How does Singapore fare in terms of our assessment as being IFRS-equivalent? Singapore accounting standards, known as FRS, are almost completely harmonised with IFRS and are applicable to all entities. Singapore generally adopts new or amended IFRS within a three month period but there are exceptions, one being FRS 40 *Investment Property*. IAS 40 was issued in year 2000 and effective for financial periods commencing 1 January 2001 while FRS 40 was issued in year 2005 and effective for financial periods commencing 1 January 2007. As of today, there are no timing differences between IFRS and Singapore FRS. The bigger task ahead of Accounting Standards Board (to replace the CCDG in 2007/2008) is to present to CESR that the Singapore FRS is equivalent to IFRS despite the identifiable differences such as differing finance lease requirements and the one-off revaluation exemption from periodic revaluation for Property, Plant and Equipment, both under Singapore FRS. Based on the Consultation Paper, the Singapore standard setter, the CCDG (or Accounting Standards Board when effective) will be required to submit

¹ This Technical Advice is the result of EU's mandate to CESR to determine IFRS-equivalent standards for listing purposes in the European securities market. Since 1 January 2007, AIM, the London Stock Exchange's international market for smaller growing companies, allows all AIM companies to report under UK GAAP, US GAAP or IFRS.

an assessment of whether disclosures and measurement principles required by Singapore FRS are materially the same as IFRS and where they are not, an assessment of the differences.

Based on the developments described above, it is encouraging that many countries have indicated their convergence towards IFRS. However, business advisors including us at PricewaterhouseCoopers should be careful in arriving at the conclusion that reconciliations are no longer required as being IFRS equivalent does not mean the same.

Going global

Today, with the convergence towards IFRS well underway, at least now when a CFO compares Singapore GAAP with China GAAP, he/she should expect more similarities than before, since China has now made a formal announcement in February 2006 to converge with IFRS, more similarities should swing by among the various GAAPs without the need for reconciliation.

That leaves one missing link in relation to US GAAP. Is US GAAP moving closer to IFRS or vice versa? It is promising that in February 2006, the US FASB and IASB signed a Memorandum of Understanding in which they *'each acknowledged their commitment to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. Both standard setters pledged to use their best efforts (a) to make their existing financial reporting standards fully compatible as soon as is practicable and (b) to co-ordinate their future work programmes to ensure that once achieved, compatibility is maintained.'*

While Corporate Singapore awaits the birth of a global accounting standard, on 30 April 2007, the EU and the US signed an agreement which seeks to ensure conditions for US GAAP and IFRS to be recognised in both jurisdictions without the need for reconciliation by 2009 or possibly sooner.

Looking at the above developments, in the not too distant future, bean counters and CFOs alike can look forward to profit being profit, with nothing between the cracks and certainly nothing between the GAAPs, regardless of the business or accounting language that we may speak.

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Are fair values truly fair?

– Navigating the path of fair valuation under Financial Reporting Standards

Many investors, directors and management, without specialist financial accounting or valuation background, do not really have the expertise to understand, evaluate and use the fair value information required by the accounting standards to be included in the financial statements of businesses. There exist significant changes in this area that investors, directors and management alike must be aware of. Extra care should be exercised when such information on the financial statements are relied upon for investment and other decisions by readers of financial statements.

The use of current values (including fair values) is fairly widespread through the IFRS which the Singapore FRS are based on, as a requirement under the respective standards and others, as an optional alternative to historical cost. The evolution of more prevalent use of fair values is derived by the needs of investors. Current values of assets and liabilities, instead of their historical values, are seen to be more relevant in some areas. Instead of how much was the historical cost to acquire an asset, it is now how much cash can the asset be exchanged for? Current values allow users to evaluate alternative uses of resources more effectively, as well as better estimate future cash flows. The income statement or revaluation reserves reflect the holding gains on which management's performance are also being evaluated.

In late 2006, PricewaterhouseCoopers surveyed more than 50 buy-side and sell-side investment professionals in the major investment centres in Europe and North America on their use of the balance sheet in their analysis of companies' performance and their measurement bases that best suit their needs¹.

Generally, the results of the survey show that current values are much more useful for highly liquid financial assets. Areas of concerns include the use of current value measurement on illiquid assets and many liabilities: Is management using the changes in current value estimates to mask operating results? Will the cost of implementing current values outweigh the benefits? Whose role is it to estimate the current value of the enterprise – investors' or management's? Is management able to provide reliable estimates of fair value?

¹ Full survey findings are included in the report 'Measuring Assets and Liabilities: Investment Professionals' View' which can be obtained from www.pwc.com/ifrs

Reliability of fair valuation

One of the concerns of the investment professional is firstly, the need for management to evaluate how they can determine fair values reliably and secondly, for users of financial statements to evaluate management's fair valuation exercise.


What is fair value? Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Hence, it is based on the existence of a market that is fairly active and liquid. This is not always the case in real life. Take for example instruments such as collateralised debt obligations or mortgage-backed securities. While a market may exist, this market may not be very liquid and is often dominated by just a few players. If a large chunk of these instruments are put up for sale, the spreads between bid and offer price quoted may vary significantly due to the lack of liquidity. This situation worsens when there is a market downturn or a liquidity crisis. In the absence of an active and liquid market, entities will have to rely on a 'marked to model' basis to derive a fair value.

Marked-to-model fair valuation

'Marked-to-Model' valuation is a highly judgemental exercise generally regarded even by valuers as an art rather than a science. Inter-alia, 'Marked-to-Model' valuation is highly subjective as it tends to rely on a set of input assumptions and forecasts which may not be directly verifiable to observable market data. Just to name a few obvious judgemental parameters: projected revenue/cash flow growth, discount rate and terminal value assumptions. These require prediction of future events and possible outcomes. In reality though, different management, economists or valuers often possess varied views of the future.

It is worthy to note that different views on the sensitive parameters such as the discount rate and terminal value calculation can produce significantly different valuation results. As illustrated in Table 1, a percentage change in discount rate and terminal growth rate can result in a material difference in the valuation estimates.

Table 1

	Year				
	1	2	3	4	5
Projected cashflow over next 5 years	100,000	115,000	132,300	152,100	174,900
	Scenarios				
Terminal growth rate	1%		2%		
Discount rate	11%		10%		
Computed results					
- Terminal value	1,766,490		2,404,875		
- Enterprise value	1,532,477		1,493,238		
 Difference in value = \$349,997, 23%					

Disclosures under accounting standards

The accounting standards recognise the judgemental selection of assumptions and sensitivity to key parameters in the 'Marked-to-Model' exercise. While the standard setters work towards issuing more specific guidelines on fair value measurements, the current standards do require the disclosures of key assumptions, judgements and estimates in the financial statements where fair values of these assets are not obtained from observable market prices. The rationale of requiring these disclosures is rather obvious.

Action plans for investors, directors and management

As seen from above, to prepare, review and understand valuation models (as different assets generally have different models), a significant level of investment in specialised training is required. Prudent management and audit committee members should seek appropriate professional help when appraising material assets in the financial statements of their fair values. Even in such instances, the valuation methodologies and the underlying assumptions and inputs must be rigorously tested for their robustness by the management. Investors and other stakeholders should have a good understanding and be mindful of the areas of subjectivity in fair valuation. Most importantly, they need to know the right questions to ask management.

With this as a backdrop, whether you are an investor, director or management, you should be mindful that navigating the path to fair valuation is indeed a difficult trek to make.

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