

# Corporate Watch

Developments on Corporate Reporting and Governance  
January 2009



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### Acronyms

ASC	Accounting Standards Council
FRS	Financial Reporting Standards
IAS	International Accounting Standards
ICAPS	Institute of Certified Public Accountants of Singapore
IFRIC	International Financial Reporting Interpretations Committee
IFRS	International Financial Reporting Standards
INT FRS	Interpretations of FRS
RAP	Recommended Accounting Practice
SOCI	Statement of Comprehensive Income
SOCE	Statement of Changes in Equity

# The Auditing and Accounting Crisis..... during the financial turmoil

The recent financial crisis is showing no sign of recovery and an impending recession is looming in the horizon. We are currently living in the midst of significant credit crunch, stock market volatility and gloom economic outlook. Such a time certainly posed significant financial reporting issues for many of our clients.

As we close the books for financial year 2008, what are the key accounting issues that we should address? This article seeks to provide you with a summary of the key accounting and auditing considerations

## **Key Issues – Top 10 considerations** (not in order of importance...)

- **Financial instruments/financial assets – Fair value.** Illiquidity continues to lead to difficulties in establishing the fair value of some financial assets. The best evidence of fair value is quoted prices in active markets. Where these are not available, entities use valuation techniques to estimate the fair value. A valuation technique must incorporate all factors that market participants would consider in setting a price. Determining fair value hence requires consideration of current market conditions, including relative liquidity of the market and current credit spreads. If reliance is placed on a value provided by a third party (for example, a bank quote), entities need to understand how the third party has derived that valuation.
- **Financial assets – Impairment.** Entities will need to consider whether current market conditions imply there is objective evidence of impairment for their financial assets. For example, for AFS equity investments, to consider whether there is a significant or prolonged decline in the fair value of the investment.
- **Cash and cash equivalents.** Consider if money market funds that have previously been classified as cash and cash equivalents continue to meet the criteria set out, of being short-term, highly liquid, and readily convertible to known amount of cash and which are subject to insignificant risk of changes in value.
- **Embedded derivatives.** Embedded derivatives whose values were previously immaterial may have become material due to recent events, in particular if the underlying was linked to an event considered to be remote (such as a large change in credit spreads).
- **Non-financial assets.** Consider if the crisis has resulted in an impairment indicator for property, plant and equipment, intangible assets, goodwill, etc (such as decrease in cash flow forecasts or increase in market interest rates) and consider if business plans and other key assumptions (such as growth rates or discount rates) continue to be reasonable and supportable. Entities may not be able to just roll-forward previous impairment calculations, especially if restructuring of businesses is necessary in dire economic situation.

# The Auditing and Accounting Crisis.....

## during the financial turmoil *(continued)*

- **Financial liabilities.** The change in market conditions and business results may bring about breaches of loan covenants, resulting in early debt repayment or margin calls. Review all loan agreements and ensure that all the covenants and conditions are being met. Consider adequate disclosures for breaches in financial statements, even if the breaches have been waived by the banks.
  - **Hedging activities.** Hedge ineffectiveness may be a resulting outcome in this crisis. For example, if entities had designated fair value hedges of fixed rate assets using interest rate swaps, ineffectiveness may arise due to re-pricing of the floating leg of the swap.
  - **Going concern.** Re-assess your business plan and critically evaluate future cash flow projections. The going concern assumption needs to be validated with greater rigour. Consider insolvency implications in the absence of re-financing which raises question about the going concern assumptions. Keep the following on the radar screen:-
    - Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment
    - Excessive reliance on short-term borrowings to finance long-term assets
    - Indications of withdrawal of financial support by debtors and other creditors
    - Adverse key financial ratios
    - Negative operating cash flows
    - Inability to pay creditors on due dates
    - Inability to collect from major debtors
    - Customers of major projects lacking the financing to complete project
    - Loss of major market, franchise, license or principal supplier
    - Concerns with liability of customers
    - History of regularly needing to raise additional funds.
- Rigorous subsequent events review is a must.
- **Fraud risk.** An increase in fraudulent behaviour is a top concern. Management could be facing increasing pressure to meet performance targets and may resort to undesirable behaviour and antics. This may include inappropriately adjusting assumptions and changing judgements; or deliberate attempts to misstate debt covenant-related balances so as to prevent any breach which will result in debt re-call.
  - **Disclosures.** Adequate disclosures need to be made to ensure full transparency. The credit crisis has definitely brought about heightened concerns in relation to liquidity risk and points to the need for entities to more clearly explain to users how the fair value of financial instruments is determined, especially in the absence of an active market. In addition, disclosures of significant judgement, assumptions and estimations used in impairment tests of non-financial assets, including sensitivity analysis, will be of particular relevance in the current volatile environment.

## Have you acquired a group of assets or a business?

Companies often enter into M&A-type transactions with third parties to purchase long term assets or operations with a view to grow their business. What is purchased can range from a single asset, such as a property or a license to use a technology, to an entire operation with a whole host of assets and liabilities. Some agreements also provide for the transfer of employees while others do not.

For each acquisition, management needs to ask itself whether it is acquiring a business or simply an asset or group of assets. This assessment is critical, as it will determine how the acquisition is accounted for. An acquisition of a business will usually lead to the recognition of goodwill, which under the accounting requirements will need to be tested for impairment annually. In addition, it often leads to the recognition of deferred taxes. The impairment test on goodwill can be a time consuming process, and any potential impairment loss on goodwill is usually sensitive, not only because goodwill is often a large figure in the financial statements, but also because it may question the past decision by management to acquire that business or the price the company paid.

In most cases, it is relatively straight-forward to determine whether a group of acquired assets constitutes a business or not. However, in some cases, this determination is more judgemental, for example when the value of the acquired group is concentrated in just one or a few assets, or when there are little or no existing operations. Consider the following:

- Is the acquisition of an investment property by a real estate company a business acquisition or an acquisition of an asset?
- Could the acquisition of a new technology with the related know how be viewed as an acquisition of a business rather than a licence?
- How about the acquisition by a shipping company in the chartering business of a group of vessels with chartering contracts attached to them?

IFRS 3R, the revised standard on Business Combinations, was published on 10 January 2008 and provides more guidance to help companies determining what constitutes a business. It defines a business as *“an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members or participants.”*

## Have you acquired a group of assets or a business? *(continued)*

It further clarifies that a business consists of inputs and operational processes applied to those inputs that have the ability to create outputs (i.e. sale revenue). We have listed below some of the common difficulties encountered in making that assessment:

**The existence of outputs is not a pre-requisite:** Although businesses usually have outputs, outputs are not required for an integrated set of assets to qualify as a business. This typically concerns enterprises in a development stage, which would generally be considered as a business, provided that they have the employees capable of developing a product. Several factors however should be considered, such as whether planned principal activities have begun, a plan to produce outputs is being pursued, access to customers can be obtained, and the enterprise has the necessary inputs and processes, including employees and intellectual property.

**An integrated set could still qualify as a business even if it is not operated as one:** Whether or not the set was being operated as a business by the seller is not relevant in the assessment. In addition, the acquirer's intention to use the assets or business is also not relevant. What is relevant is that potential buyers could operate that set as a business. One example could be in the IT outsourcing industry where companies may decide to outsource their information technology functions to service providers specialised in that field. The outsourcing of the IT function often comes with a transfer of the company's existing IT assets and employees and could, in some circumstances, meet the definition of a business. The same could work for the outsourcing of a shared services center.

**Not all inputs and processes need to be transferred:** Not all inputs and processes of an integrated set of activities and assets used by the seller need to be transferred to qualify as a business, provided that any potential buyer, could integrate that set with its own operations or easily replace certain inputs / processes to provide a return. An example of it could be in the pharmaceuticals industry when a pharmaceutical company acquires a biotech company with a team of researchers. The biotech company may not have any sales force, but the pharmaceutical company could use its own sales force to market the products developed by the biotech company.

## Have you acquired a group of assets or a business? *(continued)*

### **A purchase of a single asset may be the purchase of a business if substantive operational processes are acquired at the same time:**

This is a common pitfall, whereby companies may not realise when they purchase a single asset that they may have purchased a business.

This is typically the case for some industries such as the investment property and the shipping industry, where the acquisition of a property or a vessel could meet the definition of a business if it is accompanied by substantive processes. Such substantive processes could include lease management, the selection of tenants/customers and investment decisions. The existence of charter contracts (outputs) transferred with a vessel in the shipping industry could be an indication that a business has been acquired but would not be sufficient per se to conclude on the assessment.

Similarly, arrangements where intangible resources are being acquired, such as a technology, know how or a R&D project, should be analysed to determine whether a business has been purchased or simply an intangible asset. Is the acquisition for a finished product or for a whole process? Could the technology or R&D project be managed as a business by any potential buyer or does it require other inputs/processes that could not be easily obtained by any potential buyer?

The existence of substantive processes would generally be best evidenced when employees have been transferred together with the asset.

### **In situations where uncertainty exists, IFRS 3R provides the following framework for making this determination:**

- Identify the elements in the acquired group.
- Assess the capability of the acquired group to produce outputs.
- Assess the impact that any missing element have on a potential buyer's ability to produce outputs with the acquired group.

In the end, it is important to note that determining whether the acquisition of a group of assets is the acquisition of a business or not can be a complex exercise and is a matter of judgement, based on the individual facts and circumstances of each transaction.

# PricewaterhouseCoopers (PwC) high level summary of the Audit Committee Guidance Committee Booklet - Observations of interesting control and governance issues

## Introduction

In October 2008, the Audit Committee Guidance Committee (ACGC) released a guidebook to provide practical guidance and recommendations on best practices for Audit Committees (ACs) listed on the Singapore Exchange. ACs are allowed to exercise judgement on the way the guidelines are used. The guidelines are not meant to be prescriptive.

Much of the Booklet's content summarises commonly executed best practices seen in many ACs. It is unlikely that ACs will stop doing anything that they currently do; there are nonetheless some new perspectives or areas of focus that ACs may feel that they want to adopt.

These are our observations of some of the more interesting control/governance issues noted in the Booklet. These are the views of PricewaterhouseCoopers (PwC), and should not be held out as a definitive view of the ACGC's Booklet which comprises 182 pages. We do not accept any responsibility for anyone relying on these viewpoints and would recommend anyone intending to act on ACGC's recommendations to refer directly to the Guidebook.

## AC Composition

- The AC should comprise at least three Non-Executive Directors with the majority (plus Chairman) being independent.
- The AC should have a Non-Executive Chairman who would not normally be an AC Chairman.
- The AC should place strong emphasis on AC training.
- The AC should include two members who should be financial experts as "interpreted" by its Board.
- The AC should develop a formal initiation program for Non-Executive Directors to understand the business.

## Section 1 – Internal Controls

- Directors need to be clear about how an AC, Board committees, or others, provide the comfort to the Board to allow the latter to give a view of the organisation's full internal controls i.e. a Board that is able to look beyond Internal Controls for Financial Reporting – knowing what the full list of all key internal controls is, how the Board can gain comfort on the effectiveness of such controls annually and how this comfort can be documented.
- It is recommended that Internal Audit (IA) should coordinate/oversee "other" controls, monitor functions (such as legal, security, health, safety and Quality Assurance), and provide some form of report to the Board, possibly as part of the need for comfort noted above.
- AC should seek enhanced accountability and arrange for the CEO and CFO to sign-off on controls (design and effectiveness), and to receive feedback on any Control Self Assessments (used in-house to support the 'C-Suite' sign-off) which should be tested by External and Internal Audits.

# PricewaterhouseCoopers (PwC) high level summary of the Audit Committee Guidance Committee Booklet

## - Observations of interesting control and governance issues *(continued)*

### **Section 1 – Internal Controls** *(continued)*

- ACs need to learn the language of “significant deficiencies” to discuss control weaknesses. ACs should review management’s Fraud Framework and anti-fraud programmes. The AC should consider the need to have a member who is knowledgeable about IT systems, or to use a panel of experienced persons to review the IT area and who can play an enabling role in IT governance.
- IA should be directed to undertake system development, and pre- and post implementation reviews. ACs should focus more on Entity Level Controls.

### **Section II – Risk Management (RM)**

- At least one member of the AC should have experience related to oversight of RM functions.
- ACs should build consensus among Board members/management on “acceptable risk levels” (risk appetites).
- The AC should assess whether the RM framework is adequate and possibly use consultants to conduct an independent review.
- ACs should promote a risk aware culture and
  - Engage management on their “near-miss programme”.
  - Understand financial and complex instruments.
  - Receive presentations of management tracking and hedging strategies.
- ACs should focus more on assessing Business Continuity Planning processes.

### **Section III – Internal Audit (IA)**

- The AC should understand IA’s use of the COSO (Committee of Sponsoring Organisation of the Treadway Commissions) framework.
- IA should conform to IIA standards (standards prescribed by the Institute of Internal Auditors Standards and Code of Ethics).
- IA reports to AC should cover
  - Independent, objective assurance.
  - Confirmation of resource levels.
  - Emerging trends and practices.
- The AC should assess IA’s ability over specialist areas such as in IT treasury or derivatives, or risk management areas.

### **Other sections – In Overview**

- Section IV - Financial Reporting
- Section V - External Audit (EA)
- Section VI - Others
  - IPT
  - Meetings
  - Performance assessment
  - Whistle-blowing

# Other developments in Singapore Accounting Standards

## A) FRS/INT FRS issued (Current as at 1 December 2008)

### **3 July 2008 - Amendments to FRS 102 Share-based payment: Vesting Condition and Cancellation**

The Accounting Standards Council (ASC) has issued Amendments to FRS 102 Share-based payment: Vesting Condition and Cancellation. The amendments clarify that vesting conditions are service conditions and performance conditions only. Other features of a share-based payment are not vesting conditions. It also specifies that all cancellations, whether by the entity or by other parties, should receive the same accounting treatment. The amendments are effective **from 1 January 2009** onwards.

### **22 August 2008 - Amendments to FRS 32 Financial Instruments and FRS 1 Presentation of Financial Statements**

The above amendments were issued to improve the accounting for particular types of financial instruments that have characteristics similar to ordinary shares but are at present classified as financial liabilities. The amendments to FRS 32 require entities to classify certain types of financial instruments as equity, provided they have particular features and meet specific conditions. The amendments are effective from **1 January 2009** onwards.

### **22 September 2008 - INT FRS 116 Hedges of a Net Investment in a Foreign Operation**

INT FRS 116 applies to an entity that hedges the foreign currency risk arising from its net investments in foreign operations and wishes to qualify for hedge accounting in accordance with FRS 39. The main expected change in practice is to specify that the presentation currency does not create an exposure to which an entity may apply hedge accounting. Consequently, a parent entity may designate as a hedged risk only those foreign exchange differences arising from a difference between its own functional currency and that of its foreign operation. This would eliminate the possibility of an entity applying hedge accounting for a hedge of the foreign exchange differences between the functional currency of a foreign operation and the presentation currency of the parent's consolidated financial statements.

The interpretation is effective for annual periods beginning on or after **1 October 2008**.

## Other developments in Singapore Accounting Standards *(continued)*

### A) FRS/INT FRS issued *(continued)*

#### **9 October 2008 - Amendments to FRS 101 and FRS 27 for determining cost of an investment in separate financial statements**

This amendment allows first-time adopters of SFRS to use a deemed cost of either fair value or the carrying amount under previous accounting practice to measure the initial cost of investment in subsidiaries, jointly controlled entities and associates in the separate financial statements.

The amendment also removed the definition of the cost method from FRS 27 and replaced it with a requirement to always present dividends as income in the separate financial statements of the investor. Finally, when a parent reorganizes the structure of its group by establishing a new entity as its parent, the amendment requires, under certain conditions, that the new parent measures its cost of investment in the original parent, based on its share of net assets in the original parent's separate financial statements. The amendment will apply for annual periods beginning on or after **1 January 2009**.

#### **14 October 2008 - Improvements to Financial Reporting Standards 2008 issued**

The improvements include changes in presentation, recognition and measurement requirements plus terminology and editorial changes. Most of the amendments are effective for annual periods beginning on or after **1 January 2009**.

#### **30 October 2008 - Amendments to FRS 39 and FRS 107 to permit reclassification of financial assets**

The Accounting Standards Council has adopted the recent amendments to IAS 39 and IFRS 7 made by the IASB, which permit reclassification of certain financial instruments in rare circumstances. Companies would be allowed to apply these amendments **from 1 July 2008 if the reclassification is made prior to 1 November 2008**, or from the date of the reclassification if the reclassification is made after 1 November 2008.

The amendments to IAS 39 allow the reclassification of certain financial assets previously classified as 'held-for-trading' or 'available-for-sale' to another category under limited circumstances. Various disclosures are required where a reclassification has been made. Derivatives and assets designated as 'at fair value through profit or loss' under the fair value option are not eligible for this reclassification.

## Other developments in Singapore Accounting Standards *(continued)*

### **B) Exposure Drafts/Discussion Papers (Current as at 1 December 2008)**

#### **28 August 2008 - Exposure draft for Proposed Improvements to FRSs – 2008**

The proposals range from guidance added to the Appendix of IAS 18 Revenue, on how to determine whether an entity is acting as a principal or as an agent, to changes in wordings to clarify the meaning and remove unintended inconsistencies between IFRSs. Unless otherwise specified, the proposed effective date for the amendments is for annual periods beginning **on or after 1 January 2010**, although entities are permitted to adopt them earlier.

#### **28 August 2008 - Proposed amendments to FRS 33 Simplifying Earnings Per Share (EPS)**

The exposure draft proposes amendments which, if implemented, would simplify the calculation of EPS and increase transparency for users of financial statements. In particular, the proposals aim to:

- provide a clear principle to determine which instruments should be included in the EPS calculation;
- clarify the EPS calculation for particular instruments, such as contracts to sell or repurchase an entity's own shares and participating instruments; and
- simplify the EPS calculation for instruments that are accounted for at fair value through profit or loss.

#### **25 September 2008 - Proposed amendments to FRS 105 Non-current Assets, Held-for-Sale and Discontinued Operations**

The exposure draft proposes a change to the definition of discontinued operation and additional disclosure about components of an entity that have been disposed of or are classified as held-for-sale (regardless of whether they meet the discontinued operation definition). Under the proposed changes, a discontinued operation could only be an operating segment (as defined by FRS 108) or a business acquired exclusively with a view to resale. The proposed definition could result in fewer items being presented as discontinued operations than at present.

## Other developments in Singapore Accounting Standards *(continued)*

### **B) Exposure Drafts/Discussion Papers *(continued)***

#### **25 September 2008 – Additional exemptions to first-time adopters - Proposed amendments to FRS 101 First-time Adoption of Singapore Financial Reporting Standards**

The exposure draft proposes new exemptions on selected areas (oil and gas assets, operations subject to rate regulation, classification of leasing contracts accounted for in accordance with INT FRS 104) for first-time adopters of FRS, to ensure entities applying FRSs for the first time, will not face undue cost or effort in their transition process.

#### **22 October 2008 – Exposure draft of proposed amendments to FRS 107 in light of current market conditions**

The current market conditions have heightened concerns about liquidity risk and emphasised the need for more detailed explanations of how an entity has determined the fair value of financial instruments.

ASC invites comments on the Discussion Paper issued by IASB:  
22 October 2008 Preliminary views on financial statement presentation  
(Comments should be received by 14 February 2009)

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