

# Corporate Watch

Developments on Corporate Reporting and Governance  
August 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

## Earnings per share – Changes on the horizon

Earnings per share (EPS) is a key performance indicator used by many analysts and investors to assess the health and profitability of a company. Any changes to EPS can potentially affect investors' assessment of a company and their confidence level in the company. As a result, these changes can impact the share price of that company.

In August 2008, IASB issued an exposure draft on proposed amendments to IAS 33 *Earnings per share* (ED) that proposes changes to the computation of EPS. This article highlights the key amendments proposed by the ED.

1. *For basic EPS, the weighted average number of shares only includes instruments with the right to share currently in profit or loss.*

For example, consider debt instruments that are compulsorily convertible to shares after period end, and do not allow debt holders to participate in profits (e.g. via dividends) prior to conversion. Under the existing IAS 33, the shares issued upon conversion should still be included in current period basic EPS because conversion is assured and is merely pending the passage of time.

Under the ED, however, these shares are excluded from basic EPS. According to the ED, these shares should be excluded because they do not provide the holder with the right to share in the profit of the current period. Conversion only occurs in the following period.

If any such instruments are currently held, the proposed exclusion of these instruments will result in a lower weighted average number of shares and a higher EPS number under the proposed revision.

2. *Potential ordinary shares are not considered in the computation of diluted EPS if they are measured at fair value through profit or loss (FVPL).*

Under the existing IAS 33, diluted EPS is adjusted to take into account the effects of dilutive potential ordinary shares (such as share options with below-market exercise prices), regardless of the measurement basis of these options. Under the ED, these adjustments are no longer required if the instruments are accounted for at FVPL.

Non-FVPL potential ordinary shares will continue to impact diluted EPS computation as they did under the existing IAS 33. However, the ED requires diluted EPS to be computed based on the assumption that these instruments are issued at period-end market prices. This is in contrast to the existing IAS 33 which assumes that these are issued at average market prices during the period for the diluted EPS computation. Whether this will result in a positive or negative impact on EPS will depend on whether the average price or the period-end share price is higher.

## Earnings per share – Changes on the horizon *(continued)*

### 3. *Additional requirements for participating instruments and two-class ordinary shares are prescribed in the ED.*

The ED defines a participating instrument as an instrument that gives the holder the right to participate in dividends with ordinary shares according to a predetermined formula. For example, certain preference shares that pay dividends may qualify as participating instruments.

The ED contains new requirements to disclose a separate EPS for each type of participating instrument and each class of ordinary shares. The ED requires profit to be allocated to each type of instrument based on the contractual terms, and the allocated profit is then used to compute basic and diluted EPS for each type of instrument.

Due to the emphasis given to EPS by investors and analysts, it is useful for companies to have an understanding of the factors that impact basic and diluted EPS. The changes proposed by the ED will impact EPS in the future. An understanding of these changes will help companies to assess and explain to investors the impact of these changes to the EPS of the company.

# Will a single revenue recognition model achieve consistency in the myriad revenue contracts?

There is an enormous philosophical divide between US GAAP and IFRS when it comes to revenue recognition. The proposed merger of the two called for a reinvention resulting in the converged revenue standard that is expected to go some way in eliminating the 200 different pieces of US (*rule based*) guidance as well as to replace the existing IFRS (*principle based*) guidance in IAS 18, 'Revenue' and IAS 11, 'Construction'.

The Discussion Paper – “Preliminary Views on Revenue Recognition in *Contracts with Customers*” (DP) may potentially change the timing and amount of revenue recognition for companies. No change comes without challenge! The proposals in the DP, designed to improve consistency and comparability in financial reporting across international borders, may have far reaching implications for people, processes, and systems.

## What are the biggest proposed changes?

The discussion paper takes a balance sheet view of revenue and proposes that the contract is comprised of **contract assets** (the right to receive payment) and **contract liabilities** (the obligation to perform under the contract). Revenue is recognized when either the net contract liability is reduced or the net contract asset has increased, both as a result of the entity discharging its contract liabilities by performing.

This may make sense conceptually; however, the practical reality is more complicated. The first area to consider is what the proposals mean by 'performing'. Each contract will need to be broken into *performance obligations* (the promise to transfer an asset – either a good or service). Performance obligations are similar to the concept of deliverables and components of an arrangement but may be wider than those seen in current practice. Revenue is recognized as **control** of the promised asset for each of the obligations is passed from the seller to the buyer.

## Will a single revenue recognition model achieve consistency in the myriad revenue contracts? *(continued)*

A few of the more noteworthy changes proposed by the DP are highlighted below:

Change proposed by the DP	What it may mean for your company?	Example
<p><b>Transfer of control Vs. Risks and rewards</b></p>	<p>The focus on the transfer of assets via control may change many existing revenue models. Current revenue standards consider risks and rewards criteria for recognition. The proposed model could have a considerable impact if control of an asset transfers at a different time than the transfer of risks and rewards. Collectability could potentially impact the measurement of the contractual rights, but may not by itself preclude revenue recognition.</p>	<p>Tool Co sells power tools. Tool Co allows customer to return the tools within 30 days of purchase and to receive a full refund. Customer controls the tool at the point of delivery, at that time the tool is the customer's asset and Tool Co no longer has enforceable rights to it. Under the new model, revenue would be recognized on transfer of control of tools whereas under the current model, revenue recognition occurs only when the significant risk and rewards criteria in FRS 8 Para 14 are met.</p>
<p><b>Companies may no longer use the percentage-of-completion method as a separate revenue recognition model</b></p>	<p>This proposed model may have a fundamental impact on accounting for some construction and other long-term contracts, including certain service arrangements. The percentage-of-completion method may no longer exist as a separate and distinct revenue recognition model. A company may only recognize revenue for its activities (consistent with current percentage-of-completion method) when those activities concurrently satisfy performance obligations through the transfer of assets to the customer (e.g., the customer controls the in-process work product or there is a continuous transfer of assets to the customer).</p>	<p>A ship yard company building a ship often applies percentage-of-completion accounting and recognizes revenue as the ship is built currently. Under the new model, since the control of the ship transfers when it is finished, building of the ship represents inventory, and revenue is recognized only when the ship is complete and control is transferred to the customer.</p>

## Will a single revenue recognition model achieve consistency in the myriad revenue contracts? *(continued)*

Change proposed by the DP	What it may mean for your company?	Example
<p><b>The transaction price will be allocated to separate performance obligations such as a warranty or a right of return</b></p>	<p>Current practices of accruing warranty costs at the time of revenue recognition may be eliminated. Instead, a warranty may be considered a performance obligation to which a portion of the total consideration will have to be allocated and then recognized as revenue as the warranty obligation is satisfied. The financial statement impact of this change may not be significant, but it is likely that detailed system changes would be required.</p>	<p>Revenue of a contract of \$100 is allocated as: - Equipment : \$82, Installation service :\$10 and Warranty : \$8</p> <p>Currently, revenue of \$100 would be recognised on meeting criteria in FRS 18 para 14 and a provision for warranty expense would be made. Under the <b>new</b> model, if control of goods is transferred Day 1 and installation service provided on Day 5, then the \$82 would be recognised as revenue on Day1, \$10 on Day 5 and \$8 over the period of the warranty.</p>

The underlying concept in the Boards proposal is that contracts should drive the earnings process directly. However this fundamental premise of the Boards' proposal raises a question as to "whether or not contracts truly reflect the economic reality of the business relationships they define?" Business contracts are a highly flexible vehicle for documenting the compensation and performance commitments of two parties in an economic exchange. Contracts are not explicitly set up as accounting vehicles, but they could be.

Companies should analyze the potential effects of the proposed model on their current business activities, including those surrounding contract negotiations, budgeting/forecasting, systems changes, taxes, and other related revenue recognition processes and make strategic decisions about revenue recognition that align with their overall business strategy today.

# Exposure draft on tax – Is it too taxing?

The IASB finally issued an exposure draft (ED) on accounting for tax after a long-drawn process. The current standard has long been criticised and this ED was anticipated by many to resolve current inconsistencies as well as to provide a simplification.

Is this ED then a welcomed relief for many?

In this article, we will explore the key changes and what will be the impact to your business in Singapore.

## 5 key changes that might impact you

- 1. Changes definition of Tax Basis.** The tax base of assets (now referred to as “tax basis”) is the tax deduction that is available when the asset is sold at balance sheet date. Management’s expectation about the manner of recovery (“use” or “sold”) of the asset is no longer applicable. The manner of recovery will determine the applicable tax rate instead.

In Singapore, for a property, plant and equipment (“PPE”) that qualifies for full capital allowance, the tax basis at the purchase date is also its cost. The tax base in subsequent balance sheet dates will be the tax written down value. There is no change to the current treatment.

For a PPE that does not qualify for tax deduction, given that there is no capital gains tax in Singapore, there will be no impact on taxable profit arising from the sale of this PPE. Hence, the effect will be as if the tax basis is equivalent to its carrying amount.

This also may be good news for some who have been accounting for deferred tax liability on the fair value uplift on their investment properties (“IP”). Under the ED, as there is no capital gains tax imposed upon sale of the IP, the tax basis of the IP will be equivalent to the carrying amount. Hence, there is no need to provide for deferred tax liability on the fair value uplift.

### *Is this good news for you too?*

- 2. Removes initial recognition exemption.** The exception in the current standard is removed. When assets with a tax basis that is different to its costs on acquisition, entity will need to recognise a corresponding deferred tax using a complicated model.

Under local context, the impact of removal of the initial recognition exemption might not be significant for a PPE that has non-qualifying cost, as the tax basis on sale will be equivalent to the carrying amount (see point 1 above).

## Exposure draft on tax – Is it too taxing? (continued)

However, from the perspective of a Singapore entity with overseas subsidiaries, it is worthwhile to spend a little more time in understanding what this model is all about through a simple example as follow:-

Entity A acquires a PPE from Entity B for \$1,000. The tax base that is available to Entity A (and all other market participants) is \$800, and the acquisition is not a business combination. Assume the tax rate is 20%.

Under current FRS 12,

- Initial recognition exemption applies, hence, no deferred tax liability (“DTL”) is provided on the temporary difference

• DR. PPE	\$1,000
CR. Cash	\$1,000
CR. DTL	\$ 0

Under this ED,

- The asset is reflected with the highest tax basis to market participants and also requires a provision of DTL and corresponding discount for the difference

• DR. PPE	\$1,000
DR. Discount	\$ 40
CR. Cash	\$1,000
CR. DTL	\$ 40 {(\$1,000-\$800) x 20%}

***Is this a simplification of the current standard in accounting for such temporary difference? What do you think?***

- 3. Accounting for Uncertain tax positions.** Current and deferred tax assets and liabilities are to be measured using the probability-weighted average amount of all possible outcomes, assuming the tax authorities have full knowledge of all relevant information. Any uncertainty about whether the tax authorities will accept the submitted tax return will have to be included in the measurement.

This proposed change will have an impact on your business. Previously, under the current FRS 12, companies generally record liabilities for uncertain tax positions that are not probable to be sustained by using either a probability-weighted average method or a single-best-estimate approach.

This ED will take away the recognition threshold of ‘probable’ and also the single-best-estimate approach. In other words, all entities will have to adopt a probability-weighted average approach for all uncertain tax positions, notwithstanding that the position was probable to be sustained in the first place.

## Exposure draft on tax – Is it too taxing?

*(continued)*

***This proposed change may be seen by some as unduly onerous. Many are concerned with how their tax regulators will view such provisions. What about you?***

- 4. Exemption for “outside basis” differences related to foreign subsidiaries.** Only investments in foreign subsidiaries and joint ventures will qualify for the exception from recognising deferred tax on unremitted earnings. Domestic subsidiaries and joint ventures, as well as associated companies, no longer qualify.

Locally, there is no additional tax payable for a Singapore parent company receiving dividends from a Singapore subsidiary, as the dividends are tax exempt. Hence, the impact for this may not be too extensive for a Singapore entity.

However, for situations where companies cannot recover their investment in a tax-free manner within the same country, computing deferred taxes for this outside basis differences may be complex.

***Is this a cause of concern for your overseas subsidiaries which might have subsidiaries and joint ventures within the same country?***

- 5. Introduces concept of valuation allowances and classification of current and non-current deferred tax assets and liabilities.** Deferred tax assets and liabilities are to be classified as current and non-current based on the classification of the related non-tax asset or liability. Gross deferred tax assets, together with a valuation allowance, are disclosed in the financial statements.

Currently, DTA is only recorded when it is probable that the DTA will be realised in the foreseeable future. Also, deferred tax assets and liabilities are classified as non-current.

The approach proposed in this ED is aligned to the US GAAP approach.

The impact of this proposed approach is unlikely to be significant, as the net amount of DTA recorded will be similar to the DTA recorded under the current standard.

***Will the recording of a gross DTA and the classification of current versus non-current improve transparency of the financial statements?***

***Things aren't looking that simple after all. From what we have heard so far from some adventurous ones who have read the ED and have started mulling over it, accounting for tax continues to be taxing (if not more!) on the preparers and the readers...***

## Other accounting developments

### A) FRS/ INT FRS issued (Current as at 1 August 2009)

#### **8 April 2009 - ASC issues Amendments to FRS 107: Improving disclosures about financial instruments**

The Accounting Standards Council ('ASC') has issued the aforesaid amendment which increases the disclosure requirements about fair value measurement and reinforces existing principles for disclosure about liquidity risk. It introduces a three-level hierarchy for fair value measurement disclosure and requires some specific quantitative disclosures for financial instruments in the lowest level in the hierarchy. This amendment is effective for accounting period starting on or after **1 January 2009** with no comparatives for the first year of application.

#### **8 April 2009 - INT FRS 118 Transfer of Assets to Customers**

INT FRS 118 applies prospectively to transfers of assets from customers received on or after **1 July 2009**, although some limited retrospective application is permitted. The interpretation clarifies the accounting for arrangements where a customer provides an item of property, plant and equipment (or in some cases cash which must be used to acquire or construct an item of property, plant and equipment) which must be used either to connect the customer to a network or to provide an ongoing service. This is particularly relevant to the utility sector with the provision of the service being that of, for example, gas or electricity.

#### **23 April 2009 - Amendments to INT FRS 109 and FRS 39- Embedded Derivatives**

This amendment clarified that companies making use of the October 2008 reclassification amendment (allowing to reclassify particular financial instruments out of the 'at fair value through profit or loss' category in specific circumstances) need to assess at the date of reclassification the existence of embedded derivatives and account for them separately, if necessary. The amendment and is required to be applied for annual periods ending on or after **30 June 2009** and is retrospective.

#### **22 June 2009 - Revised versions of FRS 103 - Business Combinations and FRS 27 - Consolidated & Separate Financial Statements**

**FRS 103 (revised)** continues to apply the acquisition method to business combinations, with some significant changes. For example, all payments to purchase a business are to be recorded at fair value at the acquisition date, with some contingent payments subsequently remeasured at fair value through income. Goodwill may be calculated based on the parent's share of net assets or it may include goodwill related to the minority interest. All transaction costs will be expensed.

## Other accounting developments *(continued)*

**FRS 27 (revised)** requires the effects of all transactions with non-controlling interests (previously known as minority interests) to be recorded in equity if there is no change in control. They will no longer result in goodwill (when acquiring non-controlling interests) or gains and losses (in situations of partial disposal without loss of control).

The standard also specifies the accounting when control is lost. Any remaining interest in the entity is remeasured to fair value and a gain or loss is recognised in profit or loss. The revised standards are effective for the periods beginning on or after **1 July 2009**.

### **22 June 2009 - Improvements to Financial Reporting Standards 2009 issued**

The ASC has issued 'Improvements to IFRSs', a collection of amendments to 12 standards as part of its program of annual improvements. Most of the amendments are effective for annual periods beginning on or after **1 January 2010**.

### **B) Exposure Drafts/Discussion Papers (Current as 1 August 2009)**

#### **7 May 2009- Derecognition – Proposed Amendments to FRS 39 and FRS 107**

The proposals aim to improve derecognition requirements for financial instruments and states that derecognition occurs if an entity no longer controls a financial asset or no longer has an obligation to settle a financial liability. The exposure draft envisages that many of the derecognition outcomes will be similar to those under existing FRS 39, with notable exceptions being transfers involving readily obtainable financial assets. It is also proposing to enhance disclosure requirements.

#### **8 April 2009 - Exposure Draft Income Taxes**

The proposals more closely align IFRS and US GAAP in some areas. For example, the definition of tax basis, the presentation and classification of deferred tax assets and liabilities, and the deferred tax consequences of investments in subsidiaries and associates. The ASC has also proposed significant new guidance in connection with tax uncertainties and the deferred tax consequences of the initial recognition of an asset or liability. If adopted, the standard will replace the existing requirements in FRS 12, 'Income taxes'.

## Other accounting developments *(continued)*

### **17 June 2009 - Exposure Draft on Amendments to INT FRS 114 Prepayment of a Minimum Funding Requirement**

Within accounting for defined benefit assets, entities are, in some circumstances, not permitted to recognise some prepayments for minimum funding contributions as an asset. The ASC has issued an exposure draft of proposed amendments to INT FRS 114 'FRS 19 – The limit on a defined benefit asset, minimum funding requirements and their interaction', to remedy this unintended consequence, by requiring prepayments in appropriate circumstances to be recognised as assets.

### **17 June 2009 - Exposure Draft on Fair Value Measurement**

Guidance on measuring the fair value of some assets, liabilities and equity instruments has been added to IFRSs piecemeal over many years, is dispersed across many FRSs and is not always consistent. The ED proposes to establish a single source of guidance for all fair value measurements; to clarify the definition of fair value; and to enhance disclosures about fair value. The ED does not introduce new fair value requirements and does not change the measurement objectives in existing FRSs.

**22 July 2009 – Exposure Draft on Financial instruments: Classification and measurement** The exposure draft proposes a fundamentally new model for the classification and measurement of financial instruments. This exposure draft is the first phase in a longer process to improve and simplify the accounting requirements for financial instruments in light of recent financial crisis, resulting in the eventual replacement of FRS 39. In this phase, the ASC is proposing that financial instruments will be classified into two measurement categories: fair value or amortised cost. Debt instruments (assets or liabilities) will be available for classification into the amortised cost category if they meet both of the following criteria:

- they contain only basic loan features; and
- they are managed on a contractual yield basis.

All other debt instruments will be measured at fair value through profit and loss. All investments in equity instruments will be carried at fair value. For equity investments that are not held for trading, an irrevocable election can be made to recognise all income and fair value movements (including dividends) through other comprehensive income rather than profit or loss.

## Other accounting developments *(continued)*

### **ASC invites comments on the Discussion Paper issued by IASB:**

#### **8 April 2009 - Discussion Paper - Preliminary views on Leases**

The Discussion Paper discusses a possible new approach to lease accounting. It proposes that lease accounting should be based on the principle that all leases give rise to liabilities for future rental payments and assets (the right to use the leased asset) that should be recognized in an entity's statement of financial position. This approach is aimed at ensuring that leases are accounted for consistently across sectors and industries. There are no discussions yet regarding the method of transition or the effective date.

#### **24 June 2009 - Discussion paper on Credit Risk in Liability measurement**

Recent developments in the financial markets have led to increased concerns about gains that result from changes in the value of an entity's liabilities. In response to this, the ASC published a discussion paper on the role of credit risk in liability measurement often referred to as 'own credit risk'. The issue of 'own credit risk' has relevance to other ASC projects, in particular in the accounting for financial instruments, insurance, fair value measurement and provisions, contingent liabilities and contingent assets. The discussion paper is

## Contact us

For any comments or further information, please contact our team in Corporate Reporting:

Yeoh Oon Jin  
Singapore Assurance Leader  
oon.jin.yeoh@sg.pwc.com  
(65) 6236 3108

Chen Voon Hoe  
Partner, Accounting Consulting Services  
voon.hoe.chen@sg.pwc.com  
(65) 6236 7488

Kok Moi Lre  
Partner, Accounting Consulting Services  
moi.lre.kok@sg.pwc.com  
(65) 6236 3178

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