

This issue of *Financial Reporting Matters* continues with the financial reporting implications of the Companies Amendment Act 2005 and discusses the impact on the assessment of impairment for receivables following the implementation of FRS 39 from 1 January 2005. This issue also covers the changes in the Code of Corporate Governance 2005 and Singapore Exchange's recent proposed amendments to the listing rules.

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The latest Companies (Amendment) Act 2005 introduced two key changes which are of particular interest in the area of financial reporting: abolishing the concept of 'par value' in share capital and allowing repurchased shares to be held as treasury shares. This Act was gazetted in June 2005 but has yet to come into effect.

The previous edition of *Financial Reporting Matters* discussed the implications of the abolition of par value for shares. This edition focuses on treasury shares and their related accounting impact. With the introduction of treasury shares, the issue of whether a company is able to recognise profit from the buying and selling of its own shares, arises.

This edition also examines the implications following the introduction of FRS 39. Under FRS 39, any allowances made on doubtful debts can pertain only to incurred losses. Consequently, a frequently asked question is the extent the FRS 39 changes the current practice for assessment of allowance for doubtful debts. We discuss the "incurred loss" approach and the practical steps necessary in the assessment of impairment of receivables.

To enhance safeguards on corporate governance, the Code of Corporate Governance released in July 2005 includes changes requiring a listed company's remuneration committee to be made up entirely of non-executive directors, and the Audit Committee to be expanded to ensure that whistle-blowing arrangements are in place. In a similar vein, the SGX had put forth proposals in May 2005 assigning responsibility to the Board and the CEO to ensure the effectiveness of internal controls. These and other key changes and significant proposals are highlighted in this issue.

Companies (Amendment) Act 2005 – a focus on treasury shares

What is the current position? Currently, shares bought back by a company must be cancelled immediately upon re-acquisition.

Why allow treasury shares? The main purpose of allowing treasury shares is to provide companies with greater flexibility in managing their capital structure. This helps reduce their cost of capital. Once the changes take effect, companies will be able to hold the ordinary shares that are bought back as treasury shares, with the company as the registered owner of those shares. Alternatively, a company can choose to cancel the shares that are bought back.

What are the uses of treasury shares? Treasury shares would enable obligations under an employee share option scheme to be met, as companies can now buy back their own shares and hold them in anticipation of the exercise of options. This reduces the operational costs of managing option schemes. Treasury shares can also be sold for cash, or used to fund acquisitions.

Do treasury shares carry any rights? No. The voting, dividend and distribution rights of the shares held in treasury are suspended. However, the company holding treasury shares may participate in bonus share issues and the subdivision or consolidation of shares.

Is there a limit to the number of treasury shares? The number of shares that can be held as treasury shares is limited to 10% of the total number of the company's shares. If this 10% limit is exceeded, the company must dispose of or cancel the excess shares within six months.

How will treasury shares affect the calculation of the percentage of voting rights in a company? Treasury shares are excluded from the denominator in the calculation of the percentage of voting rights in the company.

Example 1

Company A holds 480,000 out of 1,000,000 shares of Company B, ie. 48% of total share capital. Company B then buys back 100,000 shares and holds them as treasury shares. To determine the shareholding of Company A in Company B after the share buy-back transaction, Company A deducts the treasury shares held by Company B from the total issued share capital of Company B, i.e. 480,000 out of 900,000 shares = 53%.

While Company A may hold more than half of the voting rights in Company B, this does not necessarily imply that it has control over Company B. Control (ie. the power to govern the financial and operating policies so as to obtain benefits from its activities) is a matter of fact to be established in each circumstance.

Can treasury shares be shown as investments in the same way as investments in the shares of other companies? No. Under the current Singapore Financial Reporting Standards (specifically FRS 32 (*revised*) *Financial Instruments: Disclosure and Presentation*), treasury shares should be presented in the balance sheet as a deduction from equity and not as an asset.

Example 2A

Company X buys back 1 million out of a total of 10 million issued shares at \$2 each. Assume that \$1.2 million of the \$2 million for the share buy-back was allocated out of capital and the balance of \$0.8 million was purchased out of profit of the company. Also assume that the shares were previously issued at \$1.20 per share.

	Purchased out of capital	Purchased out of profit	Total
Cost of 1 million shares bought back	\$1,200,000	\$800,000	\$2,000,000
Brokerage costs	\$12,000	\$8,000	\$20,000
Total cost of shares bought back	\$1,212,000	\$808,000	\$2,020,000

The 1 million shares bought back may either be cancelled or held as treasury shares. In both cases, total equity after the buyback is the same.

	Before share-buyback	Scenario 1		Scenario 2	
		Shares bought back are cancelled	Shares bought back are held in treasury		
			Presentation method (1)	Presentation method (2)	
Share capital	\$12,000,000 (10m shares)	\$10,788,000 (9m shares)	\$12,000,000 (10m shares)	\$10,788,000 (9m shares)	
Retained profits	\$6,000,000	\$5,192,000	\$6,000,000	\$5,192,000	
Reserve for own shares	-	-	(\$2,020,000) (1m shares)	-	
Total equity	\$18,000,000	\$15,980,000	\$15,980,000	\$15,980,000	

FRS 32 states that treasury shares should be presented as a deduction from equity. However, it does not mandate a specific method of allocating treasury shares within equity.

Under the Singapore Companies Amendment Act 2005 ("the Act"), when shares are purchased and cancelled, a company should reduce its share capital for the proportion of the shares that are purchased out of capital of the company, and reduce its retained profit for the proportion of shares that are purchased out of profit of the company.

Since the Act is silent on the accounting for shares purchased and held as treasury shares, we believe that it is sufficient to present the total cost of treasury shares as a deduction from equity and shown as a separate component of equity (presentation method 1 above). It is not necessary to present it in the same way as for shares bought back and cancelled (presentation method 2).

How does a company account for transaction costs incurred in issuing or buying back its own shares?

In Example 2A, transaction costs are deducted from the share capital and retained profit using the same proportion used for allocating the share buy-back. Singapore Financial Reporting Standards do not specify the component of equity from which such transaction costs should be charged against. Hence, there are two other options:

- Present the transaction costs as a deduction from share capital; or
- Present the transaction costs as a deduction from retained profits.

Can a company recognise any gain on upward changes in fair value of its treasury shares?

No. Changes in the fair value of treasury shares are not recognised. A company records its treasury shares at the cost of buying back the shares. This initial cost recorded is not subsequently re-measured and will only be de-recognised on disposal/cancellation of the treasury shares.

Can a company make a profit from re-issuing treasury shares?

No. Purchases and sales of the company’s own shares are transactions with shareholders. They do not give rise to gains or losses for the company. Consideration paid or net proceeds received should be presented as a movement in shareholder’s equity.

Example 2B

Following from Example 2A above, Company A subsequently sells the treasury shares for cash.

The gain/(loss) on sale of the treasury shares should not be recognised in the profit and loss account. Instead, it is recognised as a movement in total shareholder’s equity.

		Scenario A	Scenario B
	Shares bought back at \$2 and held as treasury shares	Subsequent sale of treasury shares at \$2.50	Subsequent sale of treasury shares at \$1.50
Share capital	\$12,000,000 (10m shares)	\$12,000,000 (10m shares)	\$12,000,000 (10m shares)
Retained profits	\$6,000,000	\$6,000,000	\$6,000,000
Reserve for own shares	(\$2,020,000)	-	-
Gain/(loss) on disposal of treasury shares ¹	-	\$480,000 (Proceeds \$2.5m less cost \$2.02m)	(\$520,000) (Proceeds \$1.5m less cost \$2.02m)
Total equity	\$15,980,000	\$18,480,000	\$17,480,000

¹ Any gain on disposal of treasury shares is not payable as dividends under the Companies Act.

How do treasury shares affect Earnings per Share computation?

The number of treasury shares held should be deducted from the number of shares in issue when determining the weighted average number of shares outstanding for purposes of computing the basic and diluted EPS.

Example 3

Company K buys back 1 million out of a total of 10 million issued shares on 30 November 2005, after the effective date of the Act. Assume there is no other change in capital structure for the year ending 31 December 2005.

For purposes of calculating basic earnings per share, the number of ordinary shares outstanding during the period is:

10 million shares in issue for 12 months	=	10,000,000
Less: 1 million treasury shares for 1 month	=	(83,333)
Number of ordinary shares outstanding during the period		9,916,667

Impairment of receivables under FRS 39

What is the position before FRS 39?

Prior to the implementation of FRS 39, entities might have made general provision for doubtful debts based on a set percentage of the receivable balances having certain characteristic (e.g. based on the number of days overdue). Under FRS 39, such allowance can only be made to the extent that they relate to incurred losses.

Certain entities such as banks and finance companies may be required by its regulators, to set aside a general allowance based on a certain formula under specific circumstances. Any allowance that is in excess of those relating to incurred loss is not allowed under FRS 39.

How different is the impairment approach under FRS 39?

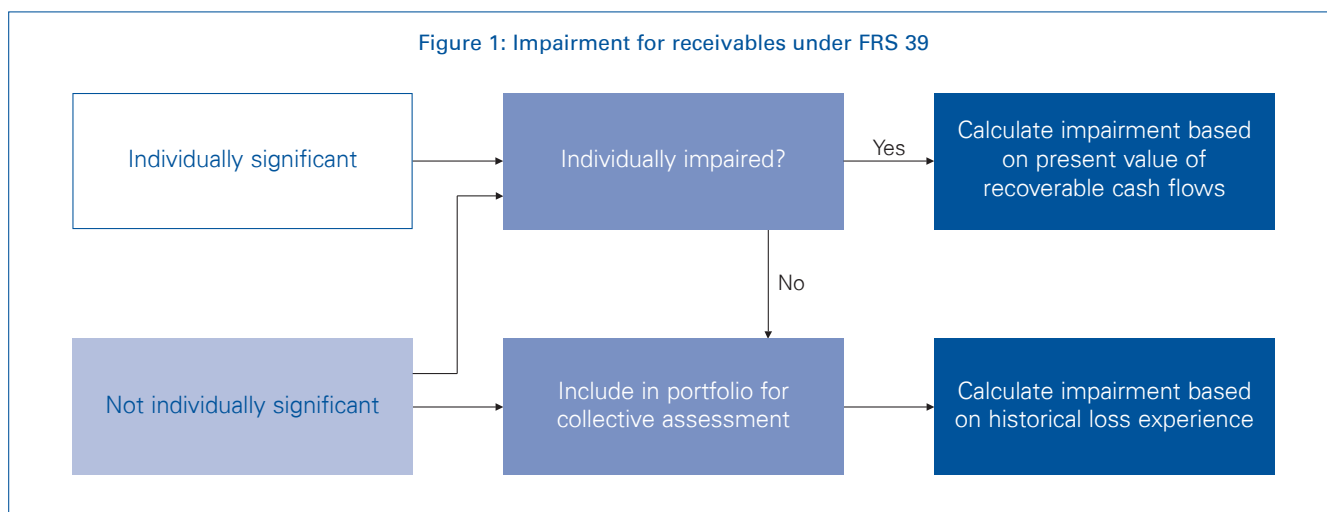
FRS 39 takes an “incurred loss” approach to impairment. This means that impairment loss should be recognised when, subsequent to the initial recognition of the receivable, an event has happened which causes the receivable to be impaired. Expected losses as a result of future events, no matter how likely, are not recognised.

How do we determine impairment under FRS 39?

Impairment for receivables under FRS 39 involves the following :

- **Significant debtors**
For individually significant debtors, perform **individual** assessment of whether objective evidence of impairment exists. If no impairment loss is deemed necessary, such debtors are included in a portfolio of debtors with similar risk characteristics and are subject to collective assessment.
- **Insignificant debtors**
For debtors that are not individually significant, perform **collective** assessment of whether objective evidence of impairment exists. However, if there is objective evidence that an individual insignificant debtor is impaired, impairment loss should be recognised individually for this debtor.

Figure 1 illustrates the above:



How do I carry out the individual assessment?

Where there is objective evidence of impairment, the entity must determine the recoverable amount of the debtor. Impairment loss is the shortfall between the existing carrying amount and the recoverable amount.

Assessment of objective evidence of impairment should be done at each reporting period.

The recoverable amount is the present value of the expected future cash flows (both principal and interest) discounted at the **original effective interest rate** of the debtor. For short-term receivables, discounting may not be necessary if the effect is not material. Where the receivables are collateralised (e.g. secured on a property), the fair value of the collateral less cost to sell, should be included in the computation of the recoverable amount.

The impairment loss may be recognised by writing down the receivable directly or by setting up an allowance account. Deferred tax should also be considered.

Why is there a need to perform a collective assessment?

Collective assessment of impairment is normally carried out on individually insignificant debtors, as well as significant debtors who have been individually assessed for impairment, and no impairment loss has been recognised.

When is a second collective assessment necessary?

A second collective assessment is performed to identify latent losses which exist in a portfolio of debtors with similar risk characteristics, but who have yet to be individually identified. The entity need not perform the additional collective assessment if it does not have a portfolio of debtors with similar risk characteristics.

How do I carry out the collective assessment?

The following steps illustrate a possible approach to performing collective impairment test for receivables:

Step 1: Determine an approach to stratify the debtors into portfolios of similar debtors

The portfolios of similar debtors should share similar credit risk characteristics that are indicative of the debtor's ability to pay.

For example, the entity could stratify its debtors based on its credit risk evaluation or grading process which considers the following:

- Types of debtors (e.g. individual versus corporate)
- Geographic location (e.g. by country)
- Industry segment
- Type of collateral
- Aging profile

Step 2: Obtain the historical loss data and stratify the debtors according to Step 1

The historical loss experience provides an objective evidence of impairment for the portfolio of debtors, and is only a starting point for quantifying the collective allowance.

The entity should determine the acceptable period of historical loss data required based on the capabilities of its information system and the stability of the business and economy for the period under consideration.

Any historical losses that are not representative of future credit losses should be excluded (e.g. write-offs due to billing system errors).

Step 3: Derive a historical loss rate using a logical and consistent method

Formula-based approaches or statistical methods may be used to determine the historical loss rate for a portfolio of similar debtors. One method, the “flow-through” method, tracks the proportion of outstanding debts that flow from one aging category to the next, until it is written off as “bad”. Another method, the “emergence period” method recognises that there will be a period between the occurrence of a specific impairment event and the time when the entity identifies that it has occurred.

The appropriate method to use depends on the nature of the entity’s business and the capabilities of its information systems. In addition, the method should not result in the immediate write-down of the receivable at the same time that the receivable is recognised. Entities may also wish to back-test the historical loss rate to assess the accuracy and appropriateness of the method used.

Entities that have limited historical loss data are allowed to use peer group experience of a comparable portfolio of similar debtors.

Step 4: Adjust the historical loss rate to reflect current conditions

The historical loss rate is adjusted using current observable data to reflect the effects of current trends and conditions. At the same time, the effects of conditions that exist in the historical period but do not exist currently, should be removed.

Observable data includes changes in unemployment rates, property prices, commodity prices, payment status etc.

Step 5: Apply the adjusted historical loss rates to current period’s portfolio of debtors

To obtain the collective allowance required for a reporting period, the historical loss rate is applied to that period’s receivable balances, stratified in the same manner as that used in deriving the historical loss rate.

The receivable balances for the period under assessment should exclude the **gross** amount of debtors which have been individually assessed for impairment.

Code of Corporate Governance 2005

The Code of Corporate Governance 2005 ("the revised Code") was released by the Ministry of Finance on 14 July 2005. The revised Code replaces the existing Code issued in 2001 and incorporates the recommendations made by the Council on Corporate Disclosure and Governance after a public consultation exercise late last year. The revised Code continues to be a reference for best practice and is not mandatory.

Currently, listed companies are required to disclose in their annual report whether their corporate governance practices comply with the principles of the Code, and explain any deviations from the guidelines of the Code. The revised Code retains the "Principle" and "Guidelines" sections but includes a "Commentary" section. Companies are not required to disclose and explain deviations from the Commentaries.

The revised Code will take effect for Annual General Meetings ("AGMs") held on or after 1 January 2007. The main changes are summarised below:

Whistle-blowing arrangements

Expanded role of the Audit Committee

The role of the Audit Committee ("AC") has been expanded to ensure that arrangements are in place for staff of the company to raise concerns, in confidence, about possible improprieties in matters of financial reporting or other matters. The AC should also ensure that the independent investigation of such matters and appropriate follow-up action are taken.

Accountability on remuneration matters

Composition of the Remuneration Committee

Under the revised Code, the Remuneration Committee ("RC") should comprise **entirely** of **non-executive** directors, the majority of whom, including the Chairman of the RC, should be independent. The current Code only requires a majority of non-executive directors.

Role of the Remuneration Committee

Currently, the RC makes recommendations on specific remuneration packages for each executive director and the CEO, if he is not an executive director. Under the revised Code, the RC will make recommendations on the remuneration packages for each director (both executive as well as non-executive directors). It will also review the remuneration of senior management.

The revised Code also removes an existing recommendation that the RC should consult the Chairman of the Board before submitting its recommendations to the Board. This is because the Chairman of the Board should not be involved in the deliberations of the RC.

Independence and appointment of directors

Independence from substantial shareholders

The revised Code clarifies that the Chairman of the Nomination Committee ("NC") should be independent of the substantial shareholders of the company.

Process for selection and appointment of new directors

The revised Code recommends that the process for the selection and appointment of new directors to the Board be disclosed. This will ensure greater transparency in the nomination process. This disclosure is not required under the current Code.

Scope of the director's duties

The revised Code recommends that the company should send a formal letter to each director upon his appointment, setting out his duties and obligations. This is to ensure that the director understands the scope of his duties and obligations.

External auditor's duties at AGM

Communications with shareholders

The revised Code clarifies that the external auditor should be present at the AGM to answer only questions related to its work in conducting and preparing the auditor's report.

Key recommendations in the commentaries

Lead independent director

Where the roles of the CEO and the Chairman are combined or undertaken by the same individual, it will be a good practice to appoint a lead independent director. The revised Code recommends that companies appoint an independent non-executive director to be the lead independent director, where the Chairman and the CEO:

- is the same person; or
- are related by close family ties; or
- are both part of the executive management team.

The lead independent director addresses concerns of shareholders which are not properly resolved/cannot be resolved by the Chairman, CEO or Finance Director.

Limit on proxies for nominee companies

To encourage greater participation from shareholders at AGMs, in particular from institutional investors, the revised Code recommends that companies amend their articles of association to avoid imposing a limit on the number of proxies for nominee companies. Without this limit, more shareholders who hold shares through nominees can attend AGMs as proxies.

Proposed amendments to SGX Listing Manual - May 2005

The Singapore Exchange Ltd ("SGX") has proposed a number of amendments to the Listing Manual in its consultation paper issued on 30 May 2005. The proposed amendments aim to raise corporate governance standards and promote good regulatory practices amongst listed companies. A summary of the key proposed amendments is set out below.

Changes to enhance corporate governance

Composition of the board of directors- foreign issuer

Currently, a foreign issuer is required, upon listing, to have at least **two** independent directors, one of whom must be resident in Singapore. The proposed amendments require the foreign issuer to have at least two independent directors resident in Singapore, and either a qualified Singapore advisor, or another resident director, or a resident executive. The proposed amendment will apply both upon listing and after listing.

Composition of the board of directors- all listed companies

It is also proposed that a listed company should have two independent **non-executive** directors on a continuing basis and not just upon listing. When implemented, existing listed companies will have up to two years to comply with this change.

Directors' opinion on interim financial results

To strengthen the company's accountability for interim financial results, the SGX proposes that the directors provide a "**negative assurance**" on the interim financial results, i.e. the board of directors is required to provide a confirmation that, to the best of their knowledge, nothing has come to the attention of the board of directors which may render the interim financial results to be false or misleading.

Directors' opinion on internal controls system

The SGX also proposes that the directors and the Chief Executive Officer ("CEO") of the listed company provide a confirmation that:

- Responsibilities for staffing internal control functions are explicitly assigned;
- Procedures exist for assessing the effectiveness of the company's internal controls;
- Channels for reporting significant risk and internal control matters to the Board and CEO are clearly specified; and
- Nothing has come to the attention of the Board and CEO with regards to internal controls that would have a materially adverse effect on the company.

What is being proposed could be considered to be less onerous compared to requirements in other jurisdictions. For example, under the US Sarbanes-Oxley Act, the CEO and the chief financial officer are required to certify that they are responsible for maintaining the company's internal controls and present the management's assessment of the effectiveness of internal controls.

Appointment of compliance advisor	Under the proposed amendments, certain companies may be required by the SGX to appoint a “compliance advisor”. These include small to medium size enterprises and overseas companies who are new to Singapore rules and regulations; and companies which have breached the listing rules.
Changes to reporting requirements	
Dilution of interest in subsidiary	The current listing rule requires the listed company to obtain shareholders approval for a material dilution of interest in a principal subsidiary. The proposed amendment clarifies that the total dilution effect on the company should include the dilution arising from the disposal of shares in the subsidiary, which is undertaken in conjunction with the issue of shares by that subsidiary.
Disclosure of names of accounting firms	Currently, listed companies have to disclose the names of accounting firms for all Singapore-incorporated subsidiaries. To make this rule less cumbersome for companies, SGX proposes that a listed company is not required to disclose, in its annual report, the names of accounting firms for insignificant Singapore-incorporated subsidiaries.
Post-listing financial results of debt issuers	A new rule will be introduced to require the post-listing financial results of the debt issuer to be prepared in accordance with approved accounting standards i.e. Singapore FRS, IFRS, US GAAP or other such standards as approved by the Monetary Authority of Singapore.
Placement of new units by REITs	A new rule will be introduced to set out the circumstances under which a placement of new units by a REIT may be made without specific approval of unit-holders in a general meeting.

Developments in international standards and interpretations

Financial instruments

Amendment to IAS 39 *Financial Instruments: Recognition and Measurement – The Fair Value Option*

Effective: Annual periods beginning on or after 1 January 2006

Under the current IAS 39, entities may designate any financial asset or financial liability as measured at fair value through profit or loss. Many constituents were concerned that an unrestricted fair value option may be used inappropriately.

The amendment restricts the above designation of financial assets or financial liability to situations where the following conditions apply:

- the designation results in more relevant information; or
- a contract contains one or more embedded derivatives.

Detailed guidance is provided in the standard as to the situations where the above criteria will be met.

At the date of application of the amendment for the first time, entities are required to de-designate any financial assets or financial liabilities that were previously designated at fair value through profit or loss, but do not qualify for such designation under the amendment.

Details of the amendment can be found in the KPMG International publication, *IFRS Briefing Sheet* issue 27.

Exploration for and evaluation of mineral resources

Amendments to IFRS 6 *Exploration for and Evaluation of Mineral Resources* and IFRS 1 *First-time Adoption of International Financial Reporting Standards*

The International Accounting Standards Board (IASB) developed IFRS 6 to permit an entity to develop an IFRS accounting policy for exploration and evaluation expenditure based on current national GAAP accounting policies, as they recognised that a comprehensive project in this area was not feasible in the near term. IFRS 6 is to be effective from 1 January 2006.

The amendments provide relief for early adopters of IFRS 6 not only from presenting the comparative disclosures under IFRS 6, but also from applying the recognition and measurement requirements of IFRS 6 to the comparative period in their first IFRS financial statements.

For more details, refer to *IFRS Briefing Sheet* issue 28.

For other developments relating to international standards, refer to KPMG International publication, *IFRS in Brief* issues 14 and 15 and *IFRS Briefing Sheet* issue 26.

Should you wish to discuss any matter highlighted in this publication, please contact:



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