

# Financial Reporting Matters

## Credit Crisis Special Report II

Essential Reading for Directors  
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AUDIT

In this special report on the credit crisis, we take the opportunity to address some of the key questions that may arise as board members review and approve the financial statements of their companies for the year ended 31 December 2008, such as what issues to look out for, how they have been dealt with and what has been disclosed to shareholders.

We have also summarised the key best practice guidelines of the AC discussed in the recent ACGC Guidebook in this publication and provided an update on fair value accounting.

The global recession has an extensive effect on businesses and financial reporting. Companies are now confronted with declining revenues, a credit crisis, fraud and a host of other issues. Increasingly, governments are taking unprecedented steps to stimulate their economies and to protect jobs and financial institutions.

Timely and accurate information is critical for financial reporting and decision-making. Beyond planning strategically for the future, it is important for management to fulfil their legal responsibilities, which include aiming for sound corporate governance and risk management practices. Systems to provide financial and other information, which should be clear and transparent to both management and shareholders, need to exist and be properly maintained.

In this special issue, we discuss some of the immediate financial reporting issues which the Board and Audit Committee (AC) members can expect to face during these challenging times. They include: going concern matters; reliability of the estimates of the value of various assets and liabilities on the financial statements; adequacy of disclosures of the inherent uncertainty of those estimates; and potential or actual fraud. We also discuss how estimates of fair values are dealt with in financial accounting and the IASB's plans.

We have summarised some of the key best practice guidelines issued by the Audit Committee Guidance Committee (ACGC). This is to remind AC members of the increasingly high standards required when discharging their responsibilities. It is expected that the standards of corporate governance in Singapore will rise further as AC members begin to adopt best practices.

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## A. Key Financial Reporting Issues for financial year ended 31 December 2008

### Overview of Key Financial Reporting Issues

Have you considered how the credit crisis would affect financial reporting? Would the likelihood of a company ceasing its operations in the foreseeable future impact the presentation of its financial statements?

In this section, we discuss the following key areas that are likely to be affected by the credit crisis:

- i. Going concern assumption
- ii. Significant judgements, estimates and assumptions
- iii. Fair valuation
- iv. Impairment loss on non-financial assets
- v. Investments in quoted equity securities classified as available-for-sale
- vi. Deferred tax assets
- vii. Purchase commitments and onerous contracts
- viii. Provision for restructuring costs
- ix. Sensitivity analysis on financial instruments
- x. Fraud

### i. Going concern assumption

#### What is the going concern assumption?

The “going concern” assumption is one of the fundamental principles used in preparing financial statements. It means that the financial statements of a company have been prepared on the assumption it will continue to operate for the foreseeable future – generally a period of 12 months or more from the year end.

#### Who is responsible for making the assessment?

Management is responsible for assessing whether it is appropriate to prepare financial statements on a going concern basis. Financial statements should be prepared using the going concern assumption unless management intends to liquidate the company, cease trading or if there are no realistic alternatives. In such cases, an alternative basis such as the “liquidation” or “break-up” basis of accounting would be used. This assessment is performed **up to the date the financial statements are issued**.

Directors also have a statutory responsibility under section 201(15)(c) of the Companies Act to state whether, in their opinion, there are reasonable grounds to believe that the company will be able to pay its debts as and when they fall due.

#### Why is it more critical now?

The current economic conditions and the credit crisis have increased the focus on the going concern assumption, often requiring a more extensive review of the supporting evidence than in past years. This may include a review of projected profitability (revenues and costs), cash flow forecasts, sources of financing and whether loan covenants have been breached.

## A. Key Financial Reporting Issues for financial year ended 31 December 2008

### i. Going concern assumption (cont'd)

#### Case study 1

Company A is a manufacturing company that has recently invested significantly in production machinery to achieve higher efficiency and production levels. The investment was financed by a 5-year floating rate loan. Company A also has other short-term loans, which have been refinanced regularly, for working capital purposes.

Due to the current economic conditions:

- Sales have fallen by 50 percent in the fourth quarter of 2008
- Working capital is rapidly decreasing:
  - Key suppliers now require cash deposits upon placing of purchase orders
  - Inventory turnover has decreased due to a lower level of sales
  - Customers are taking longer to pay
  - An important customer is facing financial difficulties
- Refinancing is in doubt due to the credit crisis
- Bank covenants are in danger of being breached in the next 12 months

#### Issues to consider

#### **What must management and directors consider in assessing the appropriateness of the going concern assumption when preparing the financial statements?**

The facts above indicate that management and directors may need to consider a range of issues relating to current and expected profitability, debt repayment schedules and potential sources of funding before it can conclude that the going concern basis is appropriate.

The going concern basis assessment would include a review of the following:

- Forecast of revenues, costs, and profitability for 2009 and beyond
- Forecast of operating cash flows, the negative effect of the expected decline in revenues and the higher working capital needs
- Forecast debt repayment and financing needs, and sources of financing
- Credit worthiness of customers, potential bad debts and credit control
- Reliance on suppliers

Management and directors should also review carefully whether:

- Budgets and forecasts prepared are reliable and at the minimum, cover the period until the next balance sheet date to fulfil financial reporting requirements
- The sensitivity of forecasts of profitability and cash flows to reasonably possible changes have been considered, e.g. interest costs may rise due to the company's weakening financial position, customers may take longer than expected to pay, and restructuring costs may require short-term financing
- Accurate matching of projected cash inflows with outflows on a monthly or quarterly basis is available
- Loan covenants are in danger of being breached, and if so, consider how to negotiate with bankers for continuance or replacement facilities
- There are clauses in loan agreements, which allow bankers to increase interest rates or withdraw facilities, as this could affect the going concern assumption

## A. Key Financial Reporting Issues for financial year ended 31 December 2008

### i. Going concern assumption (cont'd)

In addition to determining the appropriateness of the going concern assumption, management and directors are required to consider the appropriate level of disclosure in the financial statements.

There are three possible outcomes:

Management and directors conclude that the **use of the going concern assumption**:

1. Is **appropriate** and there are **no material uncertainties** that lead to significant doubt on the company's ability to continue as a going concern.
  - The financial statements should be prepared on a going concern basis and there should not be additional disclosure responsibilities.
  - The financial statements may nevertheless include disclosure explaining the conclusion on going concern and how this was reached.
2. Is **appropriate** but there are **material uncertainties** that lead to significant doubt on the company's ability to continue as a going concern.
  - The use of the going concern basis can still be appropriate even when there are uncertain future events that may adversely affect the company's ability to continue operation in the foreseeable future – at least for a period of 12 months after the balance sheet date.
  - In such cases, there must be disclosures within the financial statements explaining the specific nature of the material uncertainties and explaining why the going concern basis has still been adopted.
3. Is **not appropriate**.
  - This fact must be disclosed together with the reasons as to why the company is not regarded as a going concern.
  - In addition, the basis of accounting used (e.g. liquidation basis), and the accounting policies applied in drawing up the financial statements should be amended to explain how the financial statements have been affected.

## A. Key Financial Reporting Issues for financial year ended 31 December 2008

### ii. Significant judgements, estimates and assumptions

#### Why is it critical now?

Companies are required to disclose the significant estimates that could result in material adjustments if actual outcomes differ from expectations.

These requirements are not new. However, the challenge of making estimates in light of rapidly changing market conditions makes judgement more difficult.

Every company needs to consider whether its financial reporting and disclosures are of the right level to meet the expectations of investors and other users.

The following standard disclosures were made in the *draft* financial statements:

*The preparation of financial statements in conformity with FRS requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates.*

*Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimates are revised and in any future periods affected.*

*In particular, information about significant areas of estimation uncertainty and critical judgements in applying accounting policies that have the most significant effect on the amount recognised in the financial statements is included in the following notes: impairment of property, plant and equipment (note a), impairment of goodwill arising on business acquisitions (note b), valuation of financial assets (note c) and recognition of deferred tax relating to uncertain tax issues (note d).*

#### Questions to consider

When reviewing the disclosures on judgements, estimates and assumptions for the current year, directors could consider asking the following questions:

- Which assets and liabilities in the financial statements are estimates which could materially change in the next financial year if actual outcomes differ or expectations change?

The directors should assess, based on their knowledge of the business and the external environment, whether any estimates of assets and liabilities in the financial statements could change materially in the next financial year.

- Have information about the key assumptions and estimates been disclosed in the notes to the financial statements?
- Are there additional disclosures required in the current year given the greater volatility of interest rates, foreign exchange rates and prices of securities and commodities?

Directors should ensure that the information about key assumptions and estimates are disclosed in the notes to the financial statements. In addition, if there are specific assumptions or estimates which are affected directly by the current economic conditions, such information should also be disclosed in the financial statements.

## A. Key Financial Reporting Issues for financial year ended 31 December 2008

### ii. Significant judgements, estimates and assumptions (cont'd)

- What is the basis of the estimates?

Directors could assess the extent to which historical experience has been used, and how management's expectations for future performance have been incorporated into the estimate.

- What are the areas where ongoing reviews of estimates have resulted in changes to previous amounts recorded, and what are the reasons for the change in estimates?

Estimates should be reviewed on an ongoing basis to ensure that they consider the company's latest circumstances. All estimates made, whether new or changes to existing ones, should be supportable.

- Is the level of detail disclosed in the financial statements sufficiently tailored to the circumstances of the company?

Directors could assess this by reading the disclosures in the financial statements and consider whether they are able to understand the assumptions that management have made in arriving at the estimates.

## A. Key Financial Reporting Issues for financial year ended 31 December 2008

### iii. Fair valuation

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

#### Why is it more critical now?

Given the continuing and increased illiquidity experienced in many markets, estimating the fair values of financial instruments may require increased effort and judgement as current observable transaction prices may no longer be available for some instruments.

#### What is the objective of fair value measurement?

The objective of fair value measurement is to arrive at the **price at which an orderly transaction would take place** between market participants at the measurement date.

The fair value of a financial asset in an inactive market is assessed using a valuation technique if the financial asset is quoted in an inactive market, is unquoted or if there is objective evidence indicating that the use of an accounting technique is more appropriate.

The involvement of directors in fair valuation issues varies from company to company but some issues that directors should consider are:

#### Questions to consider

- How do we obtain the fair value in an inactive market?

In an active market, the quoted market price for an identical instrument is the best estimate of fair value. An active market is one in which transactions take place regularly on an arm's length basis.

In an inactive market, however, the fair value of a financial asset is assessed using a valuation technique. Determining that a market is not active requires judgement.

When using a valuation technique, prices of actual transactions should be taken into account, although they might require significant adjustment based on unobservable data.

- How do we obtain the fair value when forced transactions are observed?

Forced transactions can include forced liquidations or distress sales. It is not an orderly transaction and does not form part of a fair value measurement. An orderly transaction is one that involves market participants that are willing to transact and allows for adequate exposure to the market.

Even when a market has become inactive, it is not appropriate to conclude that all market activities represent forced transactions. Determining whether a particular transaction is forced requires judgement and a careful review of the evidence.

## A. Key Financial Reporting Issues for financial year ended 31 December 2008

### iii. Fair valuation (cont'd)

- What do we do when relevant observable market data does not exist?

When relevant observable market data does not exist, or when observable inputs require significant adjustment based on unobservable inputs, fair values are determined using a valuation technique based primarily on management's internal assumptions about future cash flows and appropriate risk-adjusted discount rates. The valuation technique used should reflect appropriate risk adjustments that market participants would make for credit and liquidity risks.

In some cases, multiple inputs from different sources might collectively provide the best evidence of fair value. These inputs are then weighted depending on the extent to which they provide information about the fair value of the instrument and are relevant in determining a reasonable estimate of fair value.

- Should we continue to use broker quotes and information from pricing services?

Such price information might be inputs when measuring fair value. Companies should place less reliance on quotes that do not reflect the result of market transactions and the nature of the quote (e.g. whether it is an indicative price or a binding offer) should be considered when weighing the available evidence.

## A. Key Financial Reporting Issues for financial year ended 31 December 2008

### iv. Impairment of non-financial assets

#### Why is it critical now?

Impairment testing is an area where significant judgement is required, and the current economic conditions only increase the complexity involved.

Indicators of possible impairment include situations where the carrying amount of the net assets of a company exceeds its market capitalisation and where there are significant adverse changes affecting the business. As a result, under the current economic conditions, it is more likely that many companies will be required to carry out detailed impairment testing of non-financial assets.

#### Case study 2

Company A manufactures and sells pharmaceutical products. It has significant machinery in various locations and also owns patents on vaccines. Two years ago, it acquired a small biotech firm and recorded goodwill (excess of purchase price over the fair value of the net assets acquired) of \$100 million. The premium was paid since the acquisition was projected to increase sales to emerging markets and enable Company A to become a top player in vaccines.

However, due to operational issues, the projections did not materialise. In addition, the government of the country in which Company A operates has announced its intention to reduce the healthcare budget. This has a direct impact on the price that Company A is able to charge for its products. Revenue is also expected to decline significantly over the next few years as patents on a few of its popular vaccines expire.

#### Accounting requirements

Non-financial assets should not be carried in the balance sheet at more than its recoverable amount. Recoverable amount is the higher of the cash flows receivable from (a) selling the asset or (b) earning net revenues through the use of the asset (accountants call this "value in use").

For companies that are capital-intensive, such as in case study 2 where there are significant assets in the form of machinery, patents and goodwill, impairment of non-financial assets is an area that will require attention from directors.

Questions that directors could ask in their review might include:

#### Questions to consider

- Whether there is a "triggering event" that indicates that impairment testing is required?

When there is a triggering event that indicates the possible impairment of tangible and intangible assets, impairment testing is required. Current economic conditions themselves do not necessarily constitute a triggering event; however, circumstances caused by those conditions, such as a company's shares trading at a significant discount to its book value, or a fall in forecast cash flows, are considered impairment triggers.

Some assets, such as goodwill, are subject to mandatory testing for impairment at least on an annual basis, irrespective of whether there is any indication of impairment.

#### **iv. Impairment of non-financial assets (cont'd)**

- Was the calculation of value in use updated to reflect current economic conditions?

A company may have already carried out its annual testing of impairment on goodwill earlier in the year. However, if new indicators of impairment have risen subsequent to the earlier testing date, companies may need to perform additional impairment testing at the end of the financial year.

In current economic conditions, the use of cash flow forecasts is extremely important. Areas to consider include:

- Revision of revenue assumptions to reflect current expectations (such as the change in government policy)
  - Changes in the cost base
  - Projection of growth rate beyond the period where detailed forecasts are available and how maintainable earnings should be determined
- Did management reassess the discount rates compared to those used in previous periods?

The cash flow from future use of the assets need to be discounted to its present value. In current economic conditions, the market price of risk has increased, and clearly one would expect to see a corresponding increase in the discount rate.

- Did management cross-check the reasonableness of its value in use calculation?

Additional cross-checks that are commonly used include:

- Comparing total value in use for all assets to book and revalued amounts
- Reconciling total value in use for all assets to market capitalisation
- Comparing the implied earnings multiples resulting from the value in use calculation to market multiples for the company, comparable quoted companies and if any, comparable transactions

## A. Key Financial Reporting Issues for financial year ended 31 December 2008

### v. Investments in quoted equity securities classified as available-for-sale

Quoted equity securities that are held for an indefinite period of time without an intention to resell for short-term profits are normally classified as available-for-sale (AFS) financial assets. These equity securities are measured at fair value. Unrealised fair value gains or losses are recognised and deferred in equity (recognised in other comprehensive income) until they are disposed of or impaired.

#### When is an AFS equity security impaired?

An AFS equity security is impaired when there is objective evidence which indicates that the cost of the equity security may not be recovered. An AFS equity security is also considered to be impaired if there has been:

- A significant decline in the fair value of the instrument below original cost; or
- A prolonged period over which the fair value of the instrument has been below original cost.

The accounting standard does not elaborate on what is considered “significant” or “prolonged”.

#### Why is it critical now?

Given the recent significant decline in equity prices, a company with AFS equity securities would need to assess whether any of these securities is considered to be impaired.

#### Case study 3

Company A has a 10 percent interest in Company B, a quoted security listed on the Singapore Exchange. Company A intends to hold the investment in Company B for an indefinite period of time and it has no intention to resell for short-term profits.

Company A has classified its investment in Company B as an AFS financial asset.

As at 31 December 2008, the fair value (represented by the quoted bid price) of Company B's shares was \$1.50 per share as compared with the original acquisition cost of \$2.00 per share, representing a decline of 25 percent. Company B's share price has been trading at around \$1.50 per share for the past six months. The historical volatility of Company B's share price for the past 5 years is approximately 30 percent. Recent financial analyst reports indicate a target price range of \$1.80 to \$2.50 for Company B's share.

Company A assessed the recoverability of the investment based on internally established criteria. Based on the assessment, Company A concluded that the decline in fair value below cost is not considered to be significant or prolonged and thus, the investment is not impaired. Therefore, the unrealised holding loss remains in equity and is not charged to profit or loss.

The financial statements for the year ended 31 December 2008 reflected a fair value loss of \$1 million in fair value reserve, under shareholders' equity. This is equal to approximately 10 percent of profit for the year.

## A. Key Financial Reporting Issues for financial year ended 31 December 2008

### **v. Investments in quoted equity securities classified as available-for-sale (cont'd)**

#### **What should the directors consider when validating the reasonableness of the estimates made by management?**

#### **Issues to consider**

It is important to understand the impairment criteria established by management for assessing whether a decline below cost is “significant” or “prolonged” and consider whether the criteria are reasonable and supportable based on relevant facts and circumstances.

The share price of an investment could be a relevant supporting criterion if it increases shortly after the reporting date or has a high level of volatility.

After looking at the basis underlying the criteria established, it is important to consider whether the unimpaired share price is reasonable and sensible in light of available market evidence. This could be performed by comparing the cost with relevant factors, for example:

- Recent financial analysts’ target price range and outlook
- The net assets per share of the investee; or the fundamental value of the investee
- The earnings multiples, such as price-to-earning ratios, implied by the acquisition price

In case study 3, since the historical volatility of Company B’s share price is approximately 30 percent, the decline does not appear to be significant. The decline of six months would not be considered to be prolonged.

## A. Key Financial Reporting Issues for financial year ended 31 December 2008

### vi. Deferred tax assets

#### What is a deferred tax asset?

A deferred tax asset is an asset on a company's balance sheet that may be used to reduce the income tax expense of subsequent periods. Unused tax losses is an example of a deferred tax asset.

Whether a company can get benefits in the future from its unused tax losses depends on its ability to generate future profits to absorb the prior year losses. Therefore, a deferred tax asset is recognised only to the extent that it is probable that future taxable profit will be available to utilise the asset.

For example, if a company recognises a deferred tax asset of \$3 million on its balance sheet, it means the company assumes that it is likely that it will have at least \$17.6 million of taxable profits (based on the latest Singapore corporate tax rate) in future years to fully utilise the benefits.

#### Why is it more critical now?

Due to the declining trend in profitability of companies in light of the current economic crisis, a company that recognises a deferred tax asset would need to assess carefully whether it is probable that sufficient future taxable profits will be generated to offset the tax losses.

#### Case study 4

Company D sells a line of branded goods for consumers through its retail operations in various locations in Singapore.

At 31 December 2008, the Company has an aggregate loss carry forward of \$3 million that is still unused. This loss was incurred during the developmental stage when the company was establishing its brand. Under the Singapore tax law, such losses can be carried forward indefinitely unless there is a substantial change in the shareholders and their shareholdings.

The Company was profitable in each of the last 3 years (2005, 2006 and 2007), generating average annual taxable profits of \$10 million. This year, the Company managed to breakeven despite the recent drop in consumer spending. Company D expects that it could return to profitability from 2011 and therefore believes that it is probable that future taxable profits will be available to utilise the unused tax losses.

Company D's financial statements for the year ended 31 December 2008 reflected a deferred tax asset of \$3 million, representing 5 percent of total assets.

#### Questions to consider

The following are some questions that directors could consider when validating the reasonableness of the estimates made by management:

- How far forward did management look when considering the expected availability of profits?
- Is the forecast of future profits updated to take into account the current expectations of future conditions?
- Is it able to support the continued recognition of deferred tax assets?

## A. Key Financial Reporting Issues for financial year ended 31 December 2008

### **vi. Deferred tax assets (cont'd)**

Since Company D has a track record of profits in the recent past and there is no evidence to suggest that it will continue to make losses for many years, it would be acceptable for Company D to continue to recognise the deferred tax asset arising from the unused tax losses.

Conversely, a company which has a recent past history of losses would need to have more convincing evidence that there will be future profits. In such a case, it may be appropriate to set a time horizon, e.g. 3 to 5 years, when forecasting future profits.

Disclosures of the evidence supporting the initial or continued recognition of deferred tax assets will be particularly important given the general market expectation of losses or a declining trend of profitability in the near future.

## A. Key Financial Reporting Issues for financial year ended 31 December 2008

### vii. Purchase commitments and onerous contracts

#### When are contracts considered onerous?

A contract is onerous if the unavoidable costs of meeting the obligations exceed the economic benefits to be received in the future.

For instance, a company entered into a contract to buy a machine for \$10,000 before the year end. It may be able to sell the machine for only \$8,000 in the future, after incurring a selling cost of \$500. This purchase commitment is an onerous contract as the unavoidable cost (\$10,000) exceeds the economic benefit (\$8,000 less \$500); and provision is required for the potential loss of \$2,500.

Onerous contracts can arise from purchase commitments of goods or services. The purchase commitments can be purchases of inventories for resale (such as crude oil, metals, commodities and other goods), or inventories for own use (such as in manufacturing or construction projects), or capital items (such as property, plant and equipment and investment property) entered into at high prices. Onerous contracts can also arise from unavoidable rental or lease payments on factory premises or equipment, arising from closure or restructuring/streamlining exercises, resulting in vacant factory premises under a non-cancellable lease.

#### Why is it more critical now?

With prices declining during these difficult times, some companies will be faced with purchase commitments that are onerous contracts.

#### Case study 5

**Company A, a manufacturer of chocolates, has a contract to purchase cocoa beans at a cost of US\$3,300 per ton. Assuming that the market price of cocoa beans has fallen to US\$2,800 per ton, is the contract to purchase the cocoa beans onerous?**

The contract to purchase is not onerous unless the expected selling price of the final product (the chocolate) is less than the unavoidable cost of producing the chocolate.

#### Case study 6

**Company C decided to relocate its operations to another factory. The operating lease on the old factory is non-cancellable and cannot be sub-leased to another user. Does the operating lease constitute an onerous contract?**

The operating lease constitutes an onerous contract as the unavoidable costs of meeting the obligation under the contract exceed the economic benefits to be received in the future. Hence, Company C should recognise a provision for the best estimate of the unavoidable lease payments.

## A. Key Financial Reporting Issues for financial year ended 31 December 2008

### viii. Provision for restructuring costs

#### Why is it more critical now?

Restructuring of companies or groups, such as closure of factories or retrenchment, has become more prevalent as businesses are reorganised due to the difficult economic conditions.

This means that a provision for the costs associated with restructuring, such as the costs of retrenchment and settling existing contracts should be made when management commits to a fairly explicit plan and announces it. This includes providing for losses on onerous contracts, where the unavoidable costs of fulfilling the contract exceed the expected economic benefits.

This is a fairly complex accounting area and there are many practical implications and accounting requirements, including those relating to the impairment of assets, if production or other facilities are closed at the same time. Accounting advice should be obtained as appropriate.

#### Case study 7

At Company A's recent Board meeting, the Board decided that Company A would undergo a restructuring exercise as part of its strategic plan to cushion the effects of the economic downturn to the company. The restructuring includes liquidating and disposing of several subsidiaries and retrenching staff.

#### **a. Will Company A need to provide for the liquidation or retrenchment costs associated with the restructuring exercise?**

Company A will need to provide for the liquidation or retrenchments costs associated with the restructuring exercise if management has committed to a fairly explicit plan and announced it.

#### **b. If the restructuring plans are formalised subsequent to year end, is the provision for restructuring costs still necessary?**

If explicit restructuring plans are formalised subsequent to year end, Company A would not yet meet the conditions at the year end. Hence, no provision is required but specific disclosures will be necessary.

#### When does a constructive obligation exist?

Specific to provisions for restructuring costs, a constructive obligation exists when the restructuring plan has been formally communicated to those who will be affected.

## A. Key Financial Reporting Issues for financial year ended 31 December 2008

### ix. Sensitivity analysis on financial instruments

Companies are required to report on the risk exposures arising from their financial instruments. This includes quantitative disclosures on how their profit or loss would be affected if market conditions were to fluctuate.

#### Why is it more critical now?

With the current market conditions being so volatile, risks such as interest rate, currency, commodity and equity price risks have increased and hence, financial instruments are exposed to more risks and uncertainty.

Companies will need to consider a wider range of *reasonably possible* outcomes in market risks when preparing the sensitivity analysis. Reasonably possible changes are “what-if” scenarios; they are not remote or “worst-case”, but are relative to the economic environment in which the company operates and are based on assumptions about the future.

The current uncertainty increases the level of judgement needed when making these types of assumptions. Therefore, directors should ensure that the sensitivity analysis disclosures provide adequate information about the company’s exposure to risks.

The involvement of directors in sensitivity analysis disclosures varies from company to company, however, it would be useful for directors to be more involved under current economic conditions.

#### Questions to consider

- Are there any changes in the methods and assumptions used in preparing the sensitivity analysis as compared to the previous financial year? Have these changes been disclosed in the financial statements?
- Is the amount of reasonably possible changes (e.g. percentage points used for disclosure of the interest rate sensitivity analysis) appropriate for the company given the current economic conditions?

The appropriate amount of change should be determined by taking into account:

- The extent to which interest rate would reasonably fluctuate
  - The time frame over which the effects of changes are considered to be reasonably possible until the company next presents these disclosures, which is usually its next annual reporting period
  - The historical movements and volatilities in market variables
  - Management’s knowledge of the financial markets
- Do the directors have any reasons to believe that the sensitivity analysis in financial statements is not representative of a risk inherent in a particular financial instrument? Has this fact been disclosed in the financial statements?

This can occur when a financial instrument contains terms and conditions whose effects are not apparent from the sensitivity analysis.

## A. Key Financial Reporting Issues for financial year ended 31 December 2008

### x. Fraud

#### **Pressure and incentives for fraudulent financial reporting**

The risk of fraud has grown as a result of increased market pressures due to the credit crisis and deteriorating economic conditions.

In terms of financial reporting, directors should consider whether:

- Fraud has affected the assets and liabilities of the company
- Transactions, events or the economic conditions have affected the financial statements
- The effects on the financial statements have been presented in a way that gives a true and fair view of the financial position, results and cash flows for the financial year

Fraudulent financial reporting could arise due to pressures or incentives from:

- Debt repayment schedules or covenant requirements
- Third-party expectations of the company's financial performance, e.g. analysts' reports on consensus earnings
- Compensation arrangements for senior management

#### **Setting a culture of honesty and ethical values at the top**

Due to the characteristics of fraud, it is important that management and those charged with governance of the company, place a strong emphasis on fraud prevention and deterrence.

This involves encouraging a culture of honesty and ethical behaviour by setting a proper tone at the top and establishing appropriate internal controls to prevent, deter and detect fraud.

#### **What actions can directors take to set the right tone?**

Some actions that directors can take include:

- Reviewing systems and controls in areas identified as having a higher risk of fraudulent activity, particularly revenue recognition and cash balances
- Reviewing large transactions with a view to consider whether the accounting treatment for significant or complex transactions reflects the commercial reality and the underlying economics of the transaction
- Reviewing management's response to complaints and other confidential reports of concerns about questionable accounting and suspected fraud

When directors and management notice signs of potential fraud, they should investigate the reasons until they are satisfied with the explanations.

#### **Signs of potential fraud**

Examples include:

- Significant difference between net profit and cash generated from operations
- Significant and unusual deterioration in cash position
- Unexplained turnover of senior management, key employees in financial reporting and key sales and business segment management
- Financial performance which is significantly out of line with industry or specific companies in the same or a similar industry
- Large and complex transactions and large one-off transactions
- Acquisition of other companies where the acquiree's business does not complement or support the company's existing business.

## B. Corporate Governance issues – ACGC Guidebook

### Release of ACGC Guidebook

On 30 October 2008, the ACGC released the ACGC Guidebook to provide greater direction and practical guidance to ACs in key areas, which include composition of AC, internal controls, risk management, internal audit, financial reporting, external audit and other duties and responsibilities of the AC. The Guidebook can be downloaded from the following website:

[http://www.mas.gov.sg/resource/fin\\_development/corporate\\_governance/Final%20inside%20text%20241008cast.pdf](http://www.mas.gov.sg/resource/fin_development/corporate_governance/Final%20inside%20text%20241008cast.pdf)

The issuance of this Guidebook represents a significant milestone in the local corporate governance scene as it sets out best practices in key areas. AC members should be mindful of the high standards demanded when discharging their responsibilities given the increasing adoption of the best practices set out in the Guidebook in Singapore.

### Why is the Guidebook timely in addressing the challenges?

Corporate governance disasters could have been averted if independent directors had been more rigorous in asking their CEOs tough questions, demanding answers, and when needed, blowing the whistle. In these turbulent times when many large companies simply collapse overnight, the roles of independent directors and the AC seem to offer little security to stakeholders and the public. Nevertheless, it is in this challenging business environment that independent directors and members of the AC are required to be more vigilant in discharging their duties to shareholders, the Board, and other stakeholders.

### Is the AC equipped with the knowledge and experience?

Issues such as the going concern basis of accounting and liquidity risks, valuations of assets (both financial and non-financial) and derivatives, and the reasonableness of provisions are becoming key areas of concern in these troubled times. The AC requires relevant knowledge and experience in these areas to discharge its responsibilities effectively and in a timely manner. It is essential to have the right mix of committee members with the relevant experience and skill sets, committee independence and leadership, understanding of the company's strategy and financial risks, and adequate support for the AC.

### Is the system of internal controls adequate in preventing and detecting fraud and error?

The demands of the financial crisis, liquidity and cash flow issues, possible resource constraints, and pressures to meet performance expectations have stretched the finance team to their maximum. The risk of fraud to meet performance expectations or the risk of error as a result of resource constraints following restructuring could occur in some companies. The importance of an effective system of internal controls has therefore increased to an unprecedented level.

The AC should seek assurance on the design and operating effectiveness of internal controls from management, internal auditors, any external consultants and external auditors to discharge its responsibilities effectively. In assessing the adequacy of the system of internal controls, the AC should consider issues such as:

- Whether the internal auditors will be reviewing management's assessment of internal controls over financial reporting
- Whether the internal auditors have identified any control deficiencies that could increase the risk of misstatements due to fraud or error
- Whether the company has a formal code of conduct
- Whether segregation of duties is adequate
- Whether there are adequate controls over the approval and monitoring of special transactions (e.g. related party transactions and the use of special purpose vehicles)

Appendix B1 of the Guidebook sets out a list of high-level questions that the AC can pose to management and internal auditors.

## **B. Corporate Governance issues – ACGC Guidebook (cont'd)**

### **What if there is a fraud?**

If there is evidence of fraud, according to Listing Rule 719, the AC should discuss the facts of the case with external auditors and seek legal advice. The AC should also escalate the issue to the Board at an appropriate time.

The AC may consider the following in the assessment of the risks of fraud:

- Management's characteristics and influence over control environment
- Economic and regulatory environment in which the company operates
- Operating characteristics and financial stability

Appendix B4 and B5 of the Guidebook provide examples of red flags and warning signals that the AC should be mindful of respectively.

In the current financial crisis, companies may be subject to an unprecedented level of risks. The Board may delegate the oversight responsibility of risk management to the AC.

### **Are the risk management systems of the company adequate?**

The AC should consider the following in the assessment of the adequacy of risk management systems in the company:

- Risk strategy
- Risk structure
- Measuring and monitoring procedures
- Risk portfolio

Appendix C2 of the Guidebook provides a list of high-level questions that the AC may consider discussing with management to identify risks that the company faces and to assess if the existing risk management systems are adequate.

### **Are the internal auditors effective?**

The Companies Act requires the AC to review the scope and results of the internal audit procedures. In the current financial crisis, the effectiveness of internal controls, both operational and financial, are of utmost importance as companies are required to meet expectations. The AC usually relies on the internal audit function to assess if the internal controls put in place are effective. The following are some points the AC may consider in assessing the effectiveness of the internal auditors:

- Whether the internal auditors have the necessary experience and resources to meet their objectives
- Whether the internal audit plan is adequate
- Whether the internal audit procedures cover operational and financial areas

Appendix D4 of the Guidebook sets out a list of questions to assist the AC in evaluating the effectiveness of internal audit function. The AC may also conduct private discussions with the internal auditors to understand the challenges faced. Appendix D5 of the Guidebook provides a list of questions that could be raised with the internal auditors in the private discussions.

### **How could the external auditors assist to ensure the integrity of the financial statements?**

In the early stages of the external audit, the AC should obtain a copy of the external auditors' audit plan to have an overall understanding of the scope, extent and approach to the external auditors' work. This will help the AC to understand the external audit coverage as well as ensure that all key financial statement risks are considered during the audit process. In addition, the AC may also request the external auditors to perform additional procedures in high risk areas.

## C. IASB's response to the credit crisis – an update

The IASB is continuing its efforts to address the financial reporting issues arising from the current global economic crisis. Subsequent to our first Credit Crisis Special Report issued in November 2008, the IASB has taken the steps summarised below to respond to the crisis.

### Formation of the Financial Crisis Advisory Group (FCAG)

The IASB and the FASB jointly set-up the FCAG, to consider how improvements in financial reporting could help enhance investor confidence in financial markets. It will also help identify significant accounting issues that require urgent and immediate attention by the boards, as well as issues for longer-term consideration.

The group includes recognised leaders from the fields of business and government with a broad range of experience in international financial markets. The group is expected to conclude its activities within six months. The first meeting took place in London on 20 January 2009. At that meeting, a wide range of issues were discussed.

### Accounting for off-balance sheet vehicles

Refer to IFRS Briefing Sheet Issue 119 for details

#### What is the issue?

To address situations where some entities may not have accounted for all the entities they control, such as some special purpose entities used for securitisation transactions, the IASB has accelerated its project on consolidation.

On a related area, there are concerns that some entities may have stopped accounting for assets they still control.

#### What is the IASB's response?

It has proposed new guidance that would require consolidation when an entity has the power to generate returns from its investment in another entity, and would require extensive disclosures in respect of an entity's involvement with structured entities that are not consolidated.

The IASB is also looking to review and clarify when entities should stop accounting for assets transferred to other entities.

These two projects are expected to be completed by the second half of 2009.

### Disclosure of financial instruments

#### What is the issue?

To measure the impairment on debt instruments, there are different accounting rules depending on whether these are classified as AFS (accounted for at fair value with changes in fair value deferred in equity) or held-to-maturity (accounted for at amortised cost) or loans and receivables (accounted for at amortised cost).

### C. IASB's response to the credit crisis – an update (cont'd)

#### What is the IASB's response?

To address comments raised at the public round table meetings with the IASB and the FASB, the IASB had proposed that entities with investments in debt instruments disclose how the pre-tax profit or loss would have been affected had such investments been accounted for through profit and loss.

However, following an urgent public consultation process, the proposal has been aborted due to practical issues and its complexity. Individual companies can voluntarily adopt its disclosure principles.

#### Addressing fully other financial instrument issues

#### What are the issues?

##### Impairment of AFS equity securities

Investments in quoted AFS equity securities are presently considered to be impaired based on "significant" or "prolonged" criteria as well as other criteria. Any impairment loss recognised on AFS equity securities is charged to the income statement (profit or loss) and cannot be reversed.

Subsequent upward changes in fair value will be recognised in equity (other comprehensive income), and not in the income statement (profit or loss).

##### Fair value option

Existing financial reporting requirements allow certain financial assets to be recognised at fair value, with the fair value changes being recognised immediately in the income statement. Once a financial asset is classified as such, there are very limited situations where financial assets can be reclassified in or out of the "fair value through profit or loss" category.

Under recent market conditions, commentators have questioned the extent to which financial assets and financial liabilities should be measured at fair value, and in particular the extent to which changes in fair value should be recognised immediately in profit or loss. Some view current market prices as artificially low.

#### What is the IASB's response?

The Boards are discussing how existing accounting requirements relating to financial assets may be changed. The first is to examine impairment triggers and whether to allow reversals of impairment losses for AFS equity securities.

The second is to consider whether reclassifications out of the fair value through profit or loss category should be relaxed further.

These proposals will involve significant changes to the existing requirements but as a matter of urgency, the Boards have agreed to fast track the project.

## D. Common financial accounting terms and abbreviations explained

- **Available-for-sale (AFS) equity securities**  
Investments in stock issued by another company. They are reported at fair values and any unrealised gains or losses are reported in equity (not in profit or loss). When the securities are sold, the realised gains or losses are recorded in profit or loss. Prior to sale, the unrealised losses are not recorded in profit or loss unless the AFS equity securities are considered to be impaired.
- **Arm's length transaction**  
A transaction that is conducted under free market conditions in which each party acts in its own self-interest.
- **Cash-generating unit**  
The smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.
- **Discounted cash flow (DCF) model**  
An approach describing a method of valuing a project, company, or asset using the concepts of the time value of money. All future cash flows are estimated and discounted to give their present values. The discount rate used is generally the appropriate cost of capital, and may incorporate judgements of the uncertainty (riskiness) of the future cash flows.
- **Held-to-maturity assets**  
Long term securities that a company has decided to hold until its date of maturity. They are reported at amortised cost (a cost-based figure), less any impairment losses (see below).
- **Impairment loss**  
A loss that occurs when the recoverable amount (see below) of the asset is less than its book amount.
- **Materiality**  
An accounting and auditing concept describing the importance of an amount, transaction or a discrepancy to the financial statements.
- **Present value**  
The value calculated today of an amount to be received in the future, based upon a discount rate.
- **Price-to-earnings ratio**  
The market price of a share divided by its earnings per share.
- **Recoverable amount**  
The value of an asset, either the price it would fetch if sold, or its value in use (see below), whichever is the larger figure.
- **Sensitivity analysis**  
A technique of investment analysis whereby different values of certain key variables are tested to see how sensitive the results are to possible changes in assumptions. It is a method of evaluating the riskiness of an investment.
- **Triggering event**  
An occurrence which initiates the need for an impairment test.
- **Value in use**  
The worth of an asset in use by the company and this is usually derived by discounting the net cash flows expected to be received from that asset.

**D. Common financial accounting terms and abbreviations explained (cont'd)****• IASB – International Accounting Standards Board**

An independent, private sector, not-for-profit accounting standard setter based in London. It publishes accounting standards in a series of pronouncements called International Financial Reporting Standards (IFRSs).

**• FASB – US Financial Accounting Standards Board**

A private, not-for-profit organization to develop accounting standards (US GAAP) within the United States.

**• FRS – Singapore Financial Reporting Standard**

Accounting standards issued by the Singapore's Accounting Standards Council (ASC) which are closely modelled after the IASs and IFRSs issued by the IASB.

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