FOCUS

FINANCIAL INSTRUMENTS, REVENUE AND IFRS CONVERGENCE

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BY
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ISCA REACHES OUT TO THE ACCOUNTANCY PROFESSION

The year 2018 is going to be a watershed year for the Singapore accountancy profession as we embrace full convergence with the International Financial Reporting Standards (IFRS) and two new important accounting standards – FRS 115: Revenue from Contracts with Customers and FRS 109: Financial Instruments. With the objective of reaching out to ISCA members and the profession, ISCA's Financial Reporting Committee (FRC or the Committee) organised an Outreach Seminar on 11 November at the SGX Auditorium focusing on the issues and challenges in practice concerning the three major changes impacting Singapore's financial reporting landscape. It was a momentous morning as the echelons of Singapore's accountancy profession came together to share and to take questions from the audience of accountants in business, practising accountants and academics. Here is a glimpse into some of the more interesting salient matters discussed at the Outreach Seminar.

Chairman of FRC and Professor of Accounting at NUS Business School, Chua Kim Chiu, giving the welcome remarks

Chua Kim Chiu, Chairman of FRC and Professor of Accounting at National University of Singapore Business School, welcomed participants and shared about the work that the Committee does. The work includes initiating and facilitating discussions on emerging accounting issues and practical issues raised by ISCA members; the study of exposure drafts issued by the International Accounting Standards Board, and submission of comment letters featuring Singapore's perspective; the issuance of guidance on emerging local accounting issues, and reaching out to ISCA members via working groups, focus groups and roundtable discussions. In closing, Mr Chua reminded the audience that the clock is ticking towards the 2016 year-end closing, when an opening balance sheet as at 1 January 2017 needs to be prepared under the new SG-IFRS framework (as defined below). He also encouraged fellow members of the profession to come forward and work with the Committee to support the development and application of new accounting standards.

THE NEW FINANCIAL REPORTING FRAMEWORK FOR SINGAPORE-LISTED COMPANIES

Singapore-incorporated companies listed on the Singapore Exchange (SGX) which have issued (or are in the process of issuing) equity or debt instruments for trading in a public market in Singapore will be required to prepare statutory financial statements applying a new Singapore financial reporting framework that is identical to IFRS (SG-IFRS), for annual periods beginning on or after 1 January 2018. Singapore-incorporated companies that are not listed on SGX can also voluntarily apply the framework. For other entities such as real estate investment trusts (REITs), business trusts (BTs) and initial public offering (IPO) aspirants, the applicability of SG-IFRS to these entities will be announced in due course.

(From left) Chairman of ISCA's IFRS Convergence Sub-Committee and EY Partner and Technical Partner, Tan Seng Choon, and PwC Partner and Head of Accounting & Financial Reporting Advisory Services, Chen Voon Hoe, in discussion

ISCA's IFRS Convergence Sub-Committee

Tan Seng Choon, Chairman of ISCA's IFRS Convergence Sub-Committee, expressed his appreciation to the Sub-Committee members comprising practitioners and representatives from the Monetary Authority of Singapore, SGX and Securities Investors Association Singapore. The Sub-Committee was formed to raise awareness about IFRS Convergence among the various stakeholders in Singapore.

Mr Tan, who is Partner and Technical Partner of EY LLP, also conveyed his appreciation to the Accounting Standards Council (ASC) for sharing its valuable inputs in the joint publication issued by the Sub-Committee and ASC. The publication titled "IFRS Convergence – Are you on track?" will be promulgated before the year's end. This publication focuses on assisting the directors and chief financial officers (CFOs) of listed companies in acquainting themselves with IFRS convergence, the key principles underpinning IFRS 1: First-time Adoption of International Financial Reporting Standards and certain potential implications.

Companies transiting to SG-IFRS are required to apply IFRS 1, a standard that specifies how an entity should transition from a previous financial reporting framework to IFRS. Restatement of comparatives may result mainly because the transition provisions in IFRS 1 are generally different from those specified in individual standards that were applied to previous Singapore Financial Reporting Standards (SFRS) financial statements.

Decisions Need to be Made

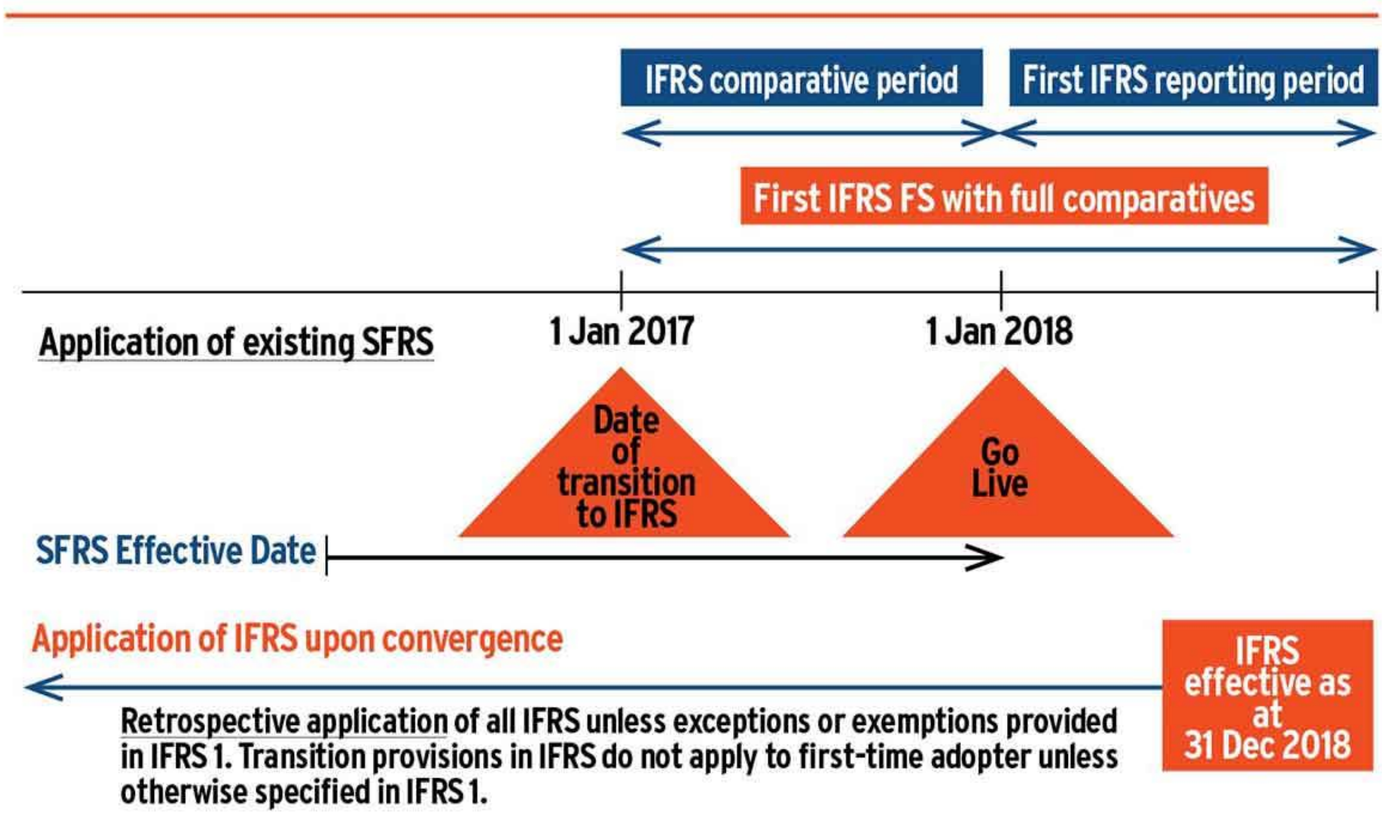
Mr Tan highlighted that IFRS convergence entails more than just the substitution of the letter “S” with an “I” preceding “FRS” as a series of decisions will have to be made throughout the transition process. For instance, in the application of IFRS 1, decisions on the reliefs and exemptions to invoke will have to be made and such decisions could potentially have a significant impact on financial statements for many years down the road. Hence, it is important for companies to understand that the conversion to SG-IFRS is not merely an accounting exercise but a change management exercise involving everyone from the board of directors to finance personnel.

Revisit Accounting Policies; Benefit from Transitional Reliefs

On IFRS convergence, companies can take the opportunity to perform a holistic review of their accounting policies under the new SG-IFRS framework and can potentially benefit from certain transitional reliefs in IFRS 1. For instance:

+ Companies can elect to use fair value as the deemed cost of property, plant and equipment (PPE) and investment property on transition to SG-IFRS;
+ Companies that are now applying the revaluation model to account for their PPE (or fair value model for investment property) can revisit their accounting policies and decide again whether to elect the cost model going forward, and
+ Companies that have cumulative translation losses can consider electing the relief in IFRS 1 to “zerorise” all cumulative translation differences in the reserves, such that any gain or loss on subsequent disposal of the foreign operations will exclude the “zerorised” translation differences.

Sooner than You Think



For December year-end entities, financial year 2018 will be the first SG-IFRS reporting year with 1 January 2017 as the date of transition, whereby an opening balance sheet and 2017 comparatives under SG-IFRS need to be prepared. Given the magnitude of the IFRS conversion exercise, it is important that companies embark on the impact assessment as soon as possible.

Financial Instruments: Am I Not Impacted At All?

Chen Voon Hoe, Chairman of ISCA's Financial Instruments Working Group, provided participants with insights into the key issues of FRS 109 and impact to preparers, focusing from an angle of a corporate. Mr Chen, who is Partner and Head of Accounting & Financial Reporting Advisory Services, PwC LLP, had the audience's undivided attention when he brought them through an amazing journey into the nuances and impact of FRS 109 on corporates. Following are some highlights of his presentation.

Under Phase 1: Classification and Measurement, a comparison of FRS 39: Financial Instruments: Recognition and Measurement and FRS 109 seems to suggest that there is "no difference" – at least on the surface. Loans and receivables (LAR) and Held-to-Maturity (HTM) of FRS 39 appear to fit into Amortised Cost classification of FRS 109. Both FRS 39 and FRS 109 each has Fair Value Through Profit or Loss (FVTPL) classification, and Available for Sale (AFS) of FRS 39 appears similar to Fair Value Through Other Comprehensive Income (FVOCI) of FRS 109. But unlike FRS 39, FRS 109 requires examination of an entity's business model for managing the financial asset, and the contractual cash flow characteristics of the financial asset before concluding on the classification. In short, the process to undertake before arriving at a classification conclusion is significantly different, unlike FRS 39 where management had more flexibility. Hence, a reassessment of some of the classifications will be required.

Trade receivables, the biggest item on most corporate books, would normally by default fall under LAR classification of FRS 39. However, under FRS 109, one cannot assume amortised cost classification because both the business model test and the solely payments of principal and interest test (SPPI test) must be satisfied. For example, some factored trade receivables (non-recourse) may not qualify for amortised cost classification, falling into the FVTPL classification instead.

Mr Chen highlighted that the biggest change will be for financial instruments classified under AFS. Any debt AFS financial instruments will have to be re-evaluated under the Business Model and SPPI tests. Equity instruments will by default fall under FVTPL classification but companies can for equity instruments not held for trading, make an irrevocable election at initial recognition to present subsequent changes in fair value in other comprehensive income. This sounds similar to AFS but the difference here is that recycling is not allowed, even upon disposal, and only dividends are recognised in profit or loss.

FRS 109 requires impairment based on expected credit loss which will result in a provision even for new loans. However, FRS 109 allows a practical expedient to provide for trade receivables based on lifetime expected credit loss instead of evaluating whether there has been a significant increase in credit risk. However, companies will still need to calculate the expected credit loss rates for all receivables and not just those defaulted receivables and ensure the incorporation of forward-looking information as required by FRS 109.

Mr Chen ended his presentation by sharing that hedge accounting under FRS 109 will be significantly simplified and most companies would be encouraged to adopt hedge accounting going forward in view of increasing market volatility.

APPLYING THE "NEW" REVENUE STANDARD: CONSTRUCTION OF INDUSTRIAL EQUIPMENT

Shariq Barmaky, Chairman of ISCA's Revenue Working Group, and Regional Managing Partner, SEA Audit of Deloitte & Touche LLP, expounded on the complex and judgemental areas when applying the five-step revenue recognition principles from the context of the industrial equipment sector. Although *prima facie* the five-step application appears simple enough, there are a lot of areas of complexity where professional judgement is required. One crunch question is when to recognise revenue and whether there is going to be any change in the timing of revenue recognition when implementing FRS 115.

Under Step 1: Identify contracts with customers, when any of the three criteria stipulated under paragraph 17 of FRS 115 are met for two or more contracts entered into "at or near the same time", an entity is required to combine those contracts and account for them as one. This is important because it impacts the amount and timing of revenue recognition. If two contracts are considered separate, the loss from the first contract cannot be deferred until profits from the second contract are recognised. The three stipulated criteria require a consideration from a substance perspective. The third criterion of whether the goods or services promised in the contracts are a single performance obligation was included to avoid the possibility that an entity could effectively bypass the requirements for identifying performance obligations depending on how the entity structures its contracts. Entering into contracts at or near the same time is also a necessary condition for contracts to be combined and application of judgement is required in determining whether a contract is entered into "at or near the same time". Lastly, contracts with related parties should also be combined if there are interdependencies between the separate contracts with those related parties.

Under Step 3: Determine the transaction price, the transaction price is defined as the amount of consideration to which an entity expects to be entitled in exchange for transferring goods or services. The objective of determining the transaction price at the end of each reporting period is to predict the total amount of consideration to which the entity will be entitled from the contract. FRS 115 specifically requires an entity to estimate the amount of variable consideration to which it will be entitled by using either the expected value method or the most likely amount method, depending on which method the entity expects to better predict the amount of consideration to which it will be entitled. This specific requirement to estimate the amount of variable consideration promised in a contract is a change from FRS 18: Revenue, whereby variable considerations would generally be recognised as revenue only as and when they occur or can be measured reliably. One caveat in the determination of variable consideration is the requirement to apply constraint whereby revenue is recognised only to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

From the context of real estate developers, two key areas are addressed below. Because what is shared here in this article is just the tip of the iceberg, we will – in separate write-ups – articulate the other issues and challenges discussed by the speakers during their presentation and the Q&A session.

APPLYING THE "NEW" REVENUE STANDARD: REAL ESTATE DEVELOPERS

Reinhard Klemmer, Deputy Chairman of ISCA's Revenue Working Group, and Partner and Technical Head of KPMG Singapore, provided participants with an in-depth look into some practical issues when applying FRS 115 from the perspective of the real estate developers industry. Under FRS 115, the famous question of whether to recognise revenue over time (that is, percentage of completion method) or at a point in time (that is, completed contract method) for real estate developers has been addressed and there is much consistency between the new requirements and what is currently done in Singapore. However, Mr Klemmer cautioned that when it comes to the actual implementation, there are still some aspects that may warrant changes. Below are some key highlights of Mr Klemmer's presentation.

(From left) Prof Chua; Chairman of ISCA's Revenue Working Group and Deloitte & Touche Regional Managing Partner, SEA Audit, Shariq Barmaky, and Deputy Chairman of ISCA's Revenue Working Group and KPMG Singapore Partner and Technical Head, Reinhard Klemmer, sharing their thoughts

For the real estate developers industry, FRS 115 paragraph 35(c) on the enforceable right to payment for performance completed to date is a key condition for recognising revenue over time. This is very much dependent on the legal environment in which the sale takes place, especially in jurisdictions with case laws. FRS 115 takes the view that the right to payment must be legally enforceable, that is, the developer must be able to take the buyer to court and request for payment for work done to date. In addition, the "payment" or compensation required must not only include costs incurred by the developer but also a reasonable profit margin. Mr Klemmer shared that there were past instances whereby the developer had chosen to take back the property from the buyer and on-sell that to another buyer in an environment where property prices were on the rise. This does not negate the fact that the developer has the right to take the buyer to court and request for compensation for performance to date. However, this practice might change going forward, with the ongoing changes to property market sentiments in recent years.

One final point that we wish to highlight here is that under FRS 115, there is no automatic link between revenue and cost. Under INT FRS 115: Agreements for the Construction of Real Estate, revenue from sales of properties under development is recognised by reference to the stage of completion using the percentage of completion method when the entity determines that all the five criteria set out in paragraph 14 of FRS 18 are met continuously as construction progresses. The requirements of FRS 11: Construction Contracts are generally applicable whereby contract revenue and contract costs are to be recognised as revenue and expenses respectively by reference to the stage of completion and the contract activity at the end of the reporting period. Under FRS 115, costs are generally expensed unless they qualify for asset recognition. FRS 115 clarifies that only costs that give rise to resources that will be used in satisfying performance obligations in the future and that are expected to be recovered are eligible for recognition as assets. Hence, an entity is precluded from deferring costs merely to normalise profit margins throughout a contract by allocating revenue and costs evenly over the life of the contract. Mr Klemmer illustrated the input method and output method for measuring progress with an example, highlighting the potential implications on profit margins assuming that the budgeted costs to complete the property development project remains constant. Because there is no automatic link between revenue and cost, the accounting policy choice of measuring progress (that is, input method or output method) towards complete satisfaction of a performance obligation may have an impact on the profit margin over time.

If you were thinking that it would be business as usual come 2018, you might want to have a re-think. Yes, the changes will come and you should avoid getting it done only at the last second in a big rush. So, what are you waiting for?

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