ACRA Regulatory Updates and Initiatives [Observations from Financial Reporting Surveillance Programme (FRSP)]

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Agenda

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Study, sample selection

Financial statements (FS) with modified audit opinions

Findings from reviews of FS

Lack of knowledge/expertise (Case study 1)

+

Shortcuts that lead to non-compliant outcomes (Case study 2)

+

Beyond technical errors (Case study 3)

- ✓ ACRA collaborating with IVAS[1]-FRSP for business valuations
- ✓ ISCA's financial reporting guidance on real estate valuations

1 IVAS: Institute of Valuers and Appraisals of Singapore (established under Singapore Accountancy Commission)

Study on FS with modified audit opinions

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Financial statements (FS) of SG-incorporated listed companies filed @ 31 Oct 19

	FY2016	FY2017	FY2018
No of companies	584	564	560
Received modified audit opinions	35 (6%)	49 (9%)	48 (9%)

A high % of FS with modified audit opinions

=>Shareholders have no reliable financial data to make decisions

Study on FS with modified audit opinions

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	FY2016	FY2017	FY2018
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1 **7 companies** received clean audit opinions in **subsequent FS** (FY2017 & FY2018)

2 **3 companies** with modified audit opinions for **5 years or more** @ FY2016 received **clean audit opinions** for FY2018

3 **Companies that newly received** modified audit opinions **reduced** from 23 (FY2017) **to 10 (FY2018)**

Study on FS with modified audit opinions

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Financial statements (FS) of SG-incorporated listed companies filed @ 31 Oct 19

	FY2016	FY2017	FY2018
No of companies	584	564	560
Received modified audit opinions	35 (6%)	49 (9%)	(9%)
Average (Maximum) no. of issues qualified	3(6)	3(12)	2(7)

7 FS with indication of material non-compliance(s) with accounting standards were selected for review

Wrapping up the third review cycle of FRSP

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Categories of findings

Lack of knowledge/ expertise

Shortcuts that leads to non-compliant outcomes

Beyond technical error

Some common findings (more will be shared at AC pitstop on 26 May 2020)

- ✓ Models and assumptions in impairment tests (Case Study 1)
- ✓ Valuation of preference shares issued with options and redemption features
- ✓ Use of blanket policy that does not comply with accounting standards (Case Study 2)
- ✓ Presentation of cash flows within operating, investing and financing activities
- ✓ Transaction that does not reflect commercial substance
- ✓ Possible intention for accepting modified audit opinion and adjust in future FY (Case Study 3)

Case study 1 – Lack of expertise (1)

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Fact Pattern

- The Group has one subsidiary, Co A (CGU 1) that delivers maintenance services in Singapore
- In 2017, the Group acquired Co B (CGU 2) that sells in RMB spare-parts used in similar maintenance services in China. Goodwill of S$15m from acquisition was allocated entirely to CGU 2
- The Group performed impairment test on CGU 2's goodwill at end of 2018

Key assumptions used for CGU 2's impairment test:

- Discount rate 10% (CGU 1's discount rate)
- Cash flow projections based on approved financial budget/forecast, stopped at Year 3

	2018		2019
	Budget	Actual	Forecast
Gross Margin	12%	8%	14%
Growth rate	3%	1%	5%

- At end of 2018, goodwill was S$15m, PPE was S$2m, other working capital asset was S$3m
- Management concluded no impairment as CGU 2's VIU of S$17m exceeds carrying amount of S$15m

Case study 1 – Lack of expertise (2)

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Some anomalies to be identified:

- **Goodwill allocation**: allocate some to CGU 1 that benefit from the synergies?
- **Gross margin and growth rate**: verifiable and supportable?
- **Discount rate**: reflect risks specific to different CGUs? adjusted for country risk?
- **Carrying amount of CGU**: should be S$20m, rather than S$15m?
- **Forecast period**: 3 years sufficient, consistent with industry cycle?
- **Foreign currency cash flows**: estimated in the currency to be generated and discounted using discount rate for that currency?

Learning points for ACs:

- Seek external help if no expertise in-house, when asset value is material
- Helpful to have accounting/audit practitioner(s) within ACs
- Ensure senior auditors spent time and challenge mgt assumptions rigorously

ACRA collaborating with IVAS-FRSP

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1 Working together

- IVAS-FRSP provides expert advice to ACRA on business valuation and impairment tests for financial reporting
- Extended MOU on 5 Jul 19

3 Practice guidance for FY19 FS

Challenging economic outlook + Rising number of M&A deals

ACs to focus on impairment, business valuation

2 Experience from two pilot cases

Areas covered:

1. Valuation of unlisted preference shares (PS) issued with put, call options and redemption features
2. Impairment test of assets in specialised industry

Learning points for ACs:

- Valuation model failed to reflect redemption feature market participants normally consider
- Valued unlisted PS based on value of listed PS with significantly different terms
- If management adjust assumptions given to valuer, assess reasonableness and impact

ISCA's guidance on real estate valuation

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Published in Nov 2019 (https://isca.org.sg/tkc/fr/financial-reporting-guidances/)
Objective: Facilitate compliance with FRS

Common painpoints :

- Valuation is inadequate, e.g.
  - Prepared for purpose(s) other than financial reporting (e.g. financing)
  - Extent (desktop versus full review)
  - Inappropriate bases of value (e.g. market value vs fair value)
- Auditor keeps asking same questions
- Company not want to be involved

Areas covered in Guidance:

- **Proposed content of valuation report**
  -> contains info required by auditors to comply with auditing standards
- **Responsibilities of valuer, auditor and company to achieve compliance with accounting standards**

Case study 2 – Short cut that leads to non-compliant outcome (1)

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Fact Pattern

- The Group customises large equipment for sale, and recognises revenue "over time"
- Contract terms:
  - The Group's customers paid 15% advance upfront, with milestone payments based on work done
  - If its customers default milestone payments, the Group has the right to forfeit advance

*FS under review

2014	2015	2016*
10 customers defaulted payments => $100m advance forfeited	Refunded $20m to 2 customers (for not meeting quality/ specifications)	$80m forfeited advance in P&L (20% of pre-tax profit) due to defaults in 2014

Case study 2 – Short cut that leads to non-compliant outcome (2)

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Company's response

"Our policy is to retain 100% of forfeited advances as potential claim liability for 2 years. 2 years is the period over which most customers will initiate arbitration/claim."

ACRA selected one customer contract to understand how policy works

- In 2014,
  - customer defaulted payment due to financial difficulty
  - customer did not raise dispute on quality/specifications -> no basis for claim
  - the Group wrote down partially constructed inventory by $6m in 2014 (loss)
- In 2016
  - customer did not initiate any claim after two years
  - the Group recognised forfeited advances of $5m in 2016 (income)

No basis to postpone

Case study 2 – Short cut that leads to non-compliant outcome (3)

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	2014	2015	2016
P&L impact	(90m) loss *inventory write down*	-	80m gain *forfeited advance*

True & fair?

Historical trend: Refunded only 20% of forfeited advance

Learning points for ACs:

- Assess whether blanket policy is supportable (e.g. results in outcome similar to case-by-case assessments)
- Review movements of major provisions to identify over/(under) provision and re-assess policies when necessary

Case study 3 – Beyond technical errors (1)

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Fact Pattern

<u>Qualified Auditor's Opinion in FY2016</u>

"…management had not recognised a **reversal** of impairment loss on property, plant and equipment amounting to $5 million ….

This is not in compliance with FRS 36 *Impairment of Assets*."

PPE using cost model @ 31 Dec 16
Carrying amount: **$25 million**
(net of accumulated impairment loss of $6m)
Valuer's report: **$30 million**

<u>Notes to FY2016 FS</u>

"Management had considered it appropriate not to recognise a reversal of impairment loss on these amounts which had no direct bearing on the operating performance of the Group and the Company."

Why not reverse?

Case study 3 – Beyond technical errors (2)

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ACRA reviewed FY2017 FS.

- The Group recognised $5m reversal of impairment loss in FY2017 => profit in FY2017.
- Had reversal been correctly recognised in FY2016, the company would report a loss in FY2017.

	FY2016	FY2017
(Loss) /Profit as reported	(S$19m)	$2m*
(Loss) had reversal been recognised in FY2016	(S$13m)	(S$3m)

* After recognising gain of $5m from reversal of impairment

The Company on watch list since FY2015.

Learning points for ACs:

- Resolve issues expected to be qualified by auditors
  – to work with management to put through adjustments
  – if not adjusted, will be taken as directors' position
- ACRA will consider other implication -> may affect outcome/sanction

Thank You!