Financial Reporting Matters

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AUDIT

This issue of *Financial Reporting Matters* provides an overview of the key changes introduced by FRS 40 *Investment Property,* as well as a summary of the Companies (Amendment) Act 2005 with a focus on the implications of shares with no par value.

In February 2005, CCDG announced that Singapore would adopt FRS 40 *Investment Property* for financial years beginning on or after 1 January 2007. The lead-time of about two years is to give companies and investors time to prepare for the impact of FRS 40 on financial ratios commonly used as indicators of performance. However, early implementation is allowed.

Although FRS 40 is not yet effective, FRS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* requires an entity to disclose the possible impact on initial application of the standard since it has been issued. If the impact is not known or reasonably estimable, the entity should also state this fact.

Under FRS 40, companies can choose to value their investment properties using the fair value model or the cost model. Under the fair value model, all changes in fair value are recognised directly in the profit and loss account instead of through the revaluation reserve. How fair value is determined would be very important, as it will have a direct impact on the profit and loss account. The application of the fair value model would increase the volatility of the earnings of property investment companies and might have an impact on such companies' dividend distribution policy.

Other main changes introduced by FRS 40 include changes in the criteria for identifying investment properties, accounting for transfers and enhanced disclosure requirements.

This issue of *Financial Reporting Matters* also examines the latest Companies (Amendment) Act 2005, which mainly gives effect to the abolition of par value of shares and to allow the use of treasury shares. This Act was passed by the Parliament on 16 May 2005. It is expected to come into operation very soon. We will focus on the implications of shares with no par value in the following pages, and highlight accounting for treasury shares in the next issue to be published in August 2005.

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The fair value model

Under FRS 40, companies can choose to value their investment properties using the fair value model or the cost model.

The definition of fair value as *"the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction"* is not new. What is new is that changes in fair value will be taken to the profit and loss account. Under FRS 40, if an entity chooses to carry its investment property at up-to-date fair value, all movements in fair value from one reporting date to the next will have to be recognised in the profit and loss account. This differs from the current practice of carrying investment property at valuation and taking changes in fair value through a revaluation reserve, subject to certain constraints.

The cost model

FRS 40 allows entities to adopt a policy of carrying their investment properties at cost less depreciation and impairment loss, as if the properties were owner-occupied. There is no difference between the cost model under FRS 40 and the current practice.

Determining fair value

Existing practice

Since the 1980s, many Singapore entities have been adopting the revaluation model under FRS 25 for their investment property and under FRS 16 for their property, plant and equipment. Open market values for most types of real property have been readily obtainable. A review of valuation reports, however, shows inconsistencies in the methodology. Consequently, it is common to have a 'range of values' associated with any property. This could reduce the objectivity of the financial statements when fair value changes are recognised in the profit and loss account.

In addition, factors such as 'rent-free period', 'rezoning of land use' and 'plot ratio revision' also contribute to the 'range of values' in open market values.

Guidance in FRS 40

The fair value of an investment property should reflect market conditions at the balance sheet date. The best evidence of fair value is given by current prices in an active market for similar property in the same location and condition and subject to similar lease and other contracts.

In the absence of current prices in an active market in comparable properties in similar locations, an entity can consider alternative sources of information including the use of discounted cash flow techniques to estimate fair value. The fair value should reflect rental income from current leases and market expectations of future leases under present conditions.

In determining the fair value of an investment property, the entity should not double-count assets or liabilities associated with the property that have been separately recognised. For example, since the fair value of the investment property would normally include items such as lifts and air-conditioning plants, such assets should not be recognised separately as "property, plant and equipment". Conversely, the fair value of the investment property should exclude prepaid or accrued operating lease income as the entity has recognised such an item as a separate asset or liability.

Need for independent valuation

FRS 40 does not require the fair value to be supported by an independent valuation at every reporting date. Entities are encouraged to engage independent valuers who hold recognised and relevant professional qualification and have recent experience in the location and category of the investment property being valued.

Factors to consider in deciding whether to engage an independent valuer include:

- the materiality of the assets to the balance sheet;
- the degree of fluctuation in the market;
- the ease with which a non-expert can make a reasonable estimate of fair value from publicly available information (for example, information on recent transactions involving comparable properties);
- the availability of an employee with relevant qualifications; and
- the expectations of the users of the financial statements.

The decision to involve independent valuers periodically is not an accounting policy and may be changed as circumstances change. For example when the property market is reasonably stable and there are frequent transactions in comparable properties for which information is readily available, the entity may adopt a practice of engaging independent valuers once every three years and estimating changes in fair value by other methods in the intervening periods. However, when the market has been unusually volatile or has become less liquid during the financial year, it may be necessary to obtain additional valuation information from independent valuers even if the entity may have obtained independent valuation in the previous financial year.

Guidance issued by the International Valuation Standards Committee

The International Valuation Standards Committee, a non-government organisation member of the United Nations issued a set of International Valuation Standards ("IVS") with statements of application and guidance notes in April 2003. The standards explain the various concepts of valuation including the concepts of "market value", "depreciated replacement cost", "net selling price" and "net realisable value". The section on valuation of real property for financial reporting purposes is particularly relevant for purposes of complying with FRS 40.

The statements of application and guidance notes such as International Valuation Application 1 *Valuation for Financial Reporting;* and Guidance Note 1 *Real Property Valuation* are also useful for management in formulating their instructions to professional valuers.

Characteristics of investment property

Compared to FRS 25, FRS 40 has clearer guidance on what is an investment property. In summary, it should contain all the following attributes:

Property types	• land; • building; • land and building; or • part of any of the above.
Forms of rights to use	• outright ownership; • lessee under a finance lease; or • lessee under an operating lease.
Purpose of interest	• to earn rentals; and/or • for capital appreciation; but not for: • use in the production or supply of goods or services or for administrative purposes; or • sale in the ordinary course of business.

Examples of investment properties

The following are examples of properties that meet the definition of investment properties in FRS 40:

- Land held for long term capital appreciation
- Land for which an entity has not determined whether it will use the land as owner-occupied property or for short-term sale in the ordinary course of business
- Building owned by the entity and leased out under one or more operating leases
- Building that is vacant but is held to be leased out under one or more operating leases
- Existing investment property that is being redeveloped for continued future use

Examples of properties that are not investment properties

On the other hand, the following properties do not meet the definition of investment property under FRS 40:

- Property acquired exclusively for development and resale (such property is accounted for under *Inventories*)
- Property being constructed on behalf of third parties (such property is accounted for under FRS 11 *Construction Contracts*)
- Owner-occupied property (such property is accounted for under FRS 16 *Property, Plant and Equipment*)
- Property that is leased to another entity under a finance lease
- Property being constructed or developed for future use as investment property (such property is accounted for under FRS 16)

Dual use properties

In Singapore, it is common for some properties to have dual uses i.e. a part of the property is held to earn rentals and another part is held for use in the production or supply of goods and services.

In the case of dual use property, only the portion that could be sold or leased out under a finance lease separately should be classified as investment property. If that portion could not be be sold or leased out under a finance lease separately, the entire property is classified as investment property, only if the portion that is owner-occupied is insignificant compared to the entire property.

No guidance or definition of the meaning of "insignificant" is given in FRS 40. In determining whether the owner-occupied portion is insignificant, an entity should assess the area occupied on a property-by-property basis with reference to value and/or usable floor space. As a rule of thumb, an owner-occupied portion that is below 5% of the measure used generally will be considered insignificant.

Examples of dual use properties	Examples of portions that might be classified as investment property	Examples of portions that often cannot be classified as investment property
Hotel complex	Separate retail premises Office block	Hotel bedrooms Restaurant facilities within the hotel complex Kiosks in the reception hall
Airports	Separate buildings within the airport perimeter, such as hotels, warehousing, airline office blocks, courier facilities	Retail concessions in the airport terminal

Provision of ancillary services to tenants of a property

In the case where the owner of a property provides ancillary services to tenants, the owner has to consider whether the services provided are insignificant to the arrangement as a whole before classifying the property as an investment property. The standard provides two examples of properties where ancillary services are provided:

- An owner-managed hotel is an owner-occupied property and not an investment property because the ancillary services provided form a significant component of the arrangement.
- An office building where security and maintenance services are provided by the owner is an investment property because these ancillary services form an insignificant component of the arrangement.

Classification difficulties arise when properties fall between these two extreme examples such as serviced apartments, business centres and hotels managed by third parties. The standard acknowledges that judgement is required in assessing whether the definition of investment property is met, and requires an entity to develop criteria that are applied consistently in making that assessment. Such criteria should be disclosed when the classification is difficult.

Leasehold property

Under FRS 40, a lessee of an operating lease is able to classify the property interest as an investment property if the interest meets the definition of an investment property and the fair value model is adopted.

The use of the fair value model for property held by a lessee under an operating lease can be elected on an asset-by-asset basis. It is therefore acceptable to have one leasehold property classified as investment property and another as operating lease under FRS 17 *Leases,* even if both properties are otherwise identical. However, if any operating lease is classified as investment property, the fair value model must be adopted for that operating lease and for all other investment properties held by the entity.

Transfers to and from investment property

FRS 40 contains specific rules in terms of timing of transfers to and from investment property. The standard has a variety of rules on how to measure the transfer and where to recognise the difference between the carrying amount and fair value at the date of transfer. They are summarised in the tables on the following page.

		Timing of transfer	Measurement rules
Transfers into investment property	Property is being constructed or developed for future use as investment property	Transfer to investment property when construction is complete. However, if an existing investment property is being redeveloped for future use as investment property, it is not reclassified as owner-occupied property during redevelopment.	Account for the development under FRS 16 until construction or development is complete. If the fair value model is adopted, the transfer to investment property is at fair value. The difference between the fair value at the date of transfer and the carrying amount is taken to the profit and loss account. If the cost model is adopted, the transfer is at cost.
	Property is currently being held as inventory	The transfer cannot be recognised until an operating lease has actually commenced, irrespective of whether management has made a firm decision to keep the property for the longer term.	If the fair value model is adopted, the transfer to investment property is at fair value. The difference between the fair value at the date of transfer and the carrying amount is taken to the profit and loss account. If the cost model is adopted, the transfer is at the carrying amount under FRS 2.
	Property is currently being used by the owner	The transfer is recognised at the end of owner-occupation.	If the fair value model is adopted, the transfer to investment property is at fair value. In this case, any difference between the carrying amount of the property and its fair value is accounted for as revaluation adjustment under FRS 16. If the cost model is adopted, the transfer is at the carrying amount under FRS 16.
Transfers out of investment property	The property is being redeveloped with a view to sale	The transfer to inventory is recognised at the time the redevelopment commences.	If the property was previously measured using the fair value model, the fair value at the date of the transfer becomes the deemed cost of the inventory under FRS 2. If the property was previously measured using the cost model, the carrying amount at the date of the transfer is the cost of the inventory under FRS 2.
	The property will be sold in its current state	The investment property is reclassified only when it meets the criteria of "held for sale" in accordance with FRS 105 *Non-Current Assets Held for Sale and Discontinued Operations*.	On initial classification as "held for sale", the investment property is remeasured at the lower of its carrying amount and fair value less costs to sell. Any loss as a result of remeasurement is taken to the profit and loss account.
	The entity intends to change the use of the investment property to owner occupied or to redevelop the property for own use	The transfer is recognised at the commencement of owner-occupation.	If the property was previously measured using the fair value model, the fair value at the date of the transfer becomes the deemed cost of the property under FRS 16. If the property was previously measured using the cost model, the carrying amount at the date of the transfer is the cost of the property under FRS 16.

Disclosure requirements

The disclosure requirements under FRS 40 are more extensive compared to existing practice. They include the need to make the following new disclosures:

- Whether, and under what circumstances are property interests held under operating leases classified and accounted for as investment property if an entity applies the fair value model.
- The criteria an entity uses to distinguish investment property from owner-occupied property and from property held for sale in the ordinary course of business when the classification is difficult.
- The methods and significant assumptions applied in determining the fair value of investment property, including a statement as to whether the determination of fair value was supported by market evidence or was more heavily based on other factors (which the entity shall disclose) because of the nature of the property and lack of comparable market data.
- A reconciliation between the valuation obtained for investment property and the adjusted valuation included in the financial statements when the valuation obtained is adjusted significantly for the purpose of the financial statements.
- A detailed reconciliation between the carrying amounts of investment property at the beginning and end of the period, with comparatives.

Transitional provisions

Entities planning the implementation of FRS 40 should decide whether the fair value model or the cost model of accounting would be more appropriate.

The following table summarises the transition rules and the adjustments on transition:

	Current policy	Policy under FRS 40	Transitional provisions
Where the current policy is at valuation	At valuation	Fair value model	Transfer any revaluation reserve existing at the date of first adoption to the opening retained earnings. Not required to, but comparatives may be restated.
	At valuation	Cost model	Account for the change in accounting policy retrospectively in accordance with FRS 8. Any revaluation reserve existing at the date of first adoption is reversed to restate the property at historical cost. The accumulated depreciation is recorded retrospectively by adjusting the opening retained earnings.
Where the current policy is at cost	At cost	Fair value model	Ascertain the fair value of the property at the date of transition, e.g. 1 January 2007, and adjust the carrying amount of the property at that date to the fair value. The difference between the fair value and the carrying amount under the cost model is adjusted against the opening retained earnings. Comparatives are not allowed to be restated if the fair value of the investment properties had not been previously disclosed.
	At cost	Cost model	No adjustment.

Conclusion - the cost model or the fair value model?

Considerations

Upon transition to FRS 40, an entity has a choice between the cost model and the fair value model, irrespective of whether the current accounting policy is at cost or at valuation.

In exercising this one-time choice, management may wish to consider the following three points:

- The cost model gives rise to a predictable profit and loss impact in the periodic depreciation charge whilst the impact of the fair value model is dependent on fluctuations in the fair value. Such fluctuations may be predictable to the extent of the yield of the property, but may not be predictable with regards to the capital appreciation portion. The volatility of earnings might have an impact on the dividend distribution policy of the entity.
- The fair value model will have impact to measures such as bank covenants, directors' profit sharing agreements, performance share plans that are based on reported profits or losses.
- The fair value model pre-supposes the ability to reliably determine the fair value of an investment property on a continuing basis.

To reiterate, the adoption of the fair value model or the cost model is a policy choice. Therefore, once either model has been chosen, any change from one to the other needs to meet the requirements of FRS 8. The standard states that it is highly unlikely that a change from the fair value model to the cost model will result in a more appropriate presentation. This indicates that a decision to adopt the cost model would be hard to justify any time after the first time adoption of FRS 40.

Companies (Amendment) Act 2005 – a focus on no par value

Main changes introduced by the Act

Two of the changes introduced by the Companies (Amendment) Act 2005 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. The Act significantly amends the rules regarding share capital and share transactions.

The other main changes are:

- introducing an alternative capital reduction process which does not require court sanction;
- providing additional circumstances with which financial assistance may be provided, e.g. where not more than 10% of the company's paid-up capital and reserves is involved, or where it is approved by a unanimous resolution of shareholders;
- allowing share-buyback to be funded out of capital so long as the company is solvent; and
- introducing a more effective and efficient statutory form of merger and amalgamation process.

We discuss the implication of abolishing the concepts of "par value" in this issue and the implication of treasury shares in the next.

Shares with no par value

What is the current position?

Currently, all shares issued by a company must have a par value, which is the minimum amount of money that shareholders are statutorily required to put into the company. The nominal value must also be disclosed in a return of the allotment to be lodged with the Accounting and Corporate Regulatory Authority.

Why is there a need to change?

The Act provides that shares of a company will have no par or nominal value. The main reason for the change is that the par value could be misleading as it bears little relation to the underlying economic value of the share.

In analysing a company's capital structure, a more meaningful measure is the total consideration paid for or payable on the shares, which would include the nominal value and the share premium. Par value restricts a company from issuing additional capital at a price which amounts to a discount when the real value of the shares falls below par.

The abolition of par value would give Singapore-incorporated companies greater flexibility to raise and maintain capital and to structure their capital and debt provided that there is full disclosure.

Can I still issue shares with a par value?

No. The no-par value system will be mandatory in Singapore, unlike in some jurisdictions where it is optional. Upon commencement of the amendment, all companies in Singapore will not have a par value for their shares.

New shares issued after the abolition of par values will have the total consideration received recorded as share capital.

What happens to the share premium account when the proposed change becomes effective?

On the appointed date, any amount standing to the credit of a company's share premium account and capital redemption reserves will become part of the company's share capital.

The balance standing to the credit of a company's share premium account may only be used in the following manner:

- Providing for premium payable on redemption of debentures or redeemable preference shares issued before the appointed date.
- Writing off preliminary expenses of the company and expenses incurred before the appointed date in connection with any issue of shares of the company.
- Paying up fully paid bonus shares pursuant to an agreement made before the appointed date.
- Paying up the balance unpaid on shares issued before the appointed date.
- Paying dividends declared before the appointed date, if such dividends are satisfied by the issue of shares to the shareholders.

If a company wishes to use their share premium account existing before the date of amendment for any of the above transactions, it will be necessary to maintain a memorandum of share capital and the balance of the share premium account at the date of amendment, and update it for any movement.

What should be recorded when shares are issued to acquire shares of another company?

With no par value, the merger relief provisions for share swaps and group reconstructions will be repealed.

Where shares are issued to acquire a controlling stake in another company, the accounting standard on business combination requires the acquirer to record the consideration as the fair value of the shares issued. If the shares are quoted, the published price is normally used. If the shares are not quoted, then valuation methods would be necessary.

How would expenses incurred in connection with issuing shares (e.g. an IPO) be recorded?

With no par value and therefore no share premium account, the provision relating to the writing off share issue expenses against the share premium account is no longer available. However, the accounting standard on disclosure and presentation of financial instruments generally allows share issue expenses to be accounted for as a deduction from the share capital raised to the extent they are incremental costs directly attributable to the equity transaction that otherwise would have been avoided.

Developments in international standards and interpretations

Financial instruments

Amendment to IAS 39 *Financial Instruments: Recognition and Measurement* - Cash Flow Hedge Accounting of Forecast Intragroup Transactions

Effective: Annual periods beginning on or after 1 January 2006

For entities in the industrial and commercial sectors, forecast sales or purchases of inventories between entities in a group with a subsequent sale of the inventory to an external party are common.

With this amendment to IAS 39, an entity is allowed to use hedge accounting for the foreign currency risk of highly probable forecast intragroup transactions that meet the following criteria:

- the hedged item is denominated in a currency other than the functional currency of the entity entering into the hedge; and
- the foreign currency risk related to the transaction will affect the consolidated profit and loss account.

Details of the amendment can be found in the KPMG International publication, *IFRS Briefing Sheet issue 21.*

IFRIC draft interpretations D15 *Reassessment of Embedded Derivatives*

This draft interpretation addresses the issue of whether an entity should update the assessment of embedded derivatives throughout the life of the contract.

The consensus is that once an initial determination is made, an entity is generally not required to reassess whether separation of embedded derivatives is necessary.

Details of this amendment can be found in the KPMG International publication, *IFRS Briefing Sheet issue 20.*

US SEC regulation

US SEC's Final Rule for First-time Adopters of IFRS

The US SEC has published a final rule that provides a one-time relief to entities adopting IFRS. Instead of the normal requirement to present three years of certain primary financial statements, the final rule allows a first-time adopter of IFRS to provide only two years of financial information.

We believe that the final rule is also applicable to entities using a national GAAP from a country that has a convergence programme with IFRS. Thus, an entity currently preparing its financial statements based on Singapore Financial Reporting Standards would be eligible for the relief under the final rule when it adopts IFRS for the first time.

For more details, refer to *IFRS Briefing Sheet issue 22.*

Proposed amendments to IFRS 2

IFRIC draft interpretations D16 *Scope of IFRS 2*

CCDG has also issued a similar exposure draft and comments are due by 18 June 2005.

This draft interpretation addresses whether IFRS 2 applies to transactions in which the consideration received appears to be less than the fair value of the instruments granted.

The draft interpretation proposes that such transactions are within the scope of IFRS 2. The rationale is that when the identifiable consideration received appears to be less than the fair value of the equity instrument granted or liability incurred, it indicates that other consideration has been or will be received.

For more details, refer to *IFRS Briefing Sheet issue 25.*

IFRIC draft interpretations D17
IFRS 2 - *Group and Treasury Shares*

CCDG has also issued a similar exposure draft and comments are due by 18 June 2005.

In the case where the subsidiary's employees are granted shares or share options of its parent, IFRS 2 *Share-based Payment* requires the group to recognise an expense and a corresponding increase in equity. However, IFRS 2 is silent on the accounting treatment for such share-based payment transactions in the separate financial statements of the subsidiary.

This draft interpretation proposes guidance on how to account for such share-based payment in the separate financial statements of the entity receiving the services.

Under the draft interpretation, an obligation to transfer equity instruments of another group entity should be classified as a cash-settled share-based payment in the financial statements of the entity incurring the obligation to deliver the consideration. This means that the corresponding credit is to liability when the expense is recognised.

The draft interpretation proposes accounting treatment for the following examples:

- where the parent entity grants rights to its equity instruments directly to employees of its subsidiaries; and
- where the subsidiary grants to its employees rights to equity instruments of its parent.

For more details, refer to *IFRS Briefing Sheet issue 24.*

For other developments relating to international standards, refer to KPMG International publication, *IFRS in Brief issue 13* and *IFRS Briefing Sheet issue 23.*

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

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