KPMG

Financial Reporting Matters

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AUDIT

In this issue, we clarify some general misconceptions about the implementation of FRS 107 *Financial Instruments: Disclosures*. Although this is a disclosure standard, it is important to start considering whether current systems are able to generate the information required for disclosure. For an entity with many subsidiaries, there should be a clear plan to communicate what the required disclosures are and how the information should be compiled.

In Singapore, entities listed on the Singapore Exchange Securities Trading Limited (SGX-ST) will have to comply with FRS 107 for financial statements covering annual periods beginning on or after 1 January 2007.

All other entities will have to comply for annual periods beginning on or after 1 January 2008.

FRS 107 is not an easy standard; the information to meet the disclosure requirements, many of which are new, is unlikely to be readily available from the accounting system of a typical corporate.

For example, there is a requirement to disclose the sensitivity of the results to changes in market risks (currency risk, interest rate risk, and other price risk) as a consequence of a potential change in values of the financial instruments held.

Management needs to determine whether new systems and processes are needed to capture the required data to produce the information for these disclosures.

In this issue, we attempt to dispel some myths relating to FRS 107 and provide an illustrative sensitivity disclosure analysis in the financial statements of a manufacturing entity.

Contents

A. Common myths - FRS 107 *Financial Instruments: Disclosures*

Myth 1
I am a manufacturing company. Therefore, FRS 107 is not applicable to me. Only banks and other financial institutions should apply FRS 107.

FRS 107 is applicable to all entities, regardless of the size or industry, that have financial instruments.

The disclosures are intended:
- to provide information that will enhance the understanding of the significance of financial instruments to an entity's financial position, performance and cash flows; and
- to assist in evaluating the risks associated with these financial instruments, including how the entity manages these risks.

Myth 2
My company does not use forward exchange contracts, interest rate swaps or have sophisticated treasury operations. Thus, FRS 107 is not applicable to me.

FRS 107 will apply to any entity which has financial instruments.

Common financial instruments include cash, trade receivables and payables and borrowings. Examples of risks associated with these financial instruments are:
- credit risk from trade receivables;
- interest risk from floating rate borrowings; and
- foreign currency exchange risk from trade receivables and payables.

Myth 3
My company is not listed on the SGX-ST. Since FRS 107 is only effective for 2008, I don't have to worry about it now.

The standard requires comparative information for the prior year to be disclosed. Although FRS 107 is effective for annual periods beginning on or after 1 January 2008 for companies not listed on the SGX-ST, companies should begin to collect the required disclosure information now.

Myth 4
Since FRS 107 is only about disclosures, I need to worry about this standard only when I am finalising the notes to the annual financial statements.

FRS 107 requires a minimum level of quantitative disclosures with respect to credit risk, liquidity risk and market risk.

Credit risk: an entity has to provide an analysis of the age of financial assets that are past due but not impaired, by class of financial instruments. Implementation Guidance 26 of FRS 107 considers a financial asset to be past due when the counterparty has failed to make payment when contractually due. In the company's individual financial statements, this information may be obtained from the aging analysis of trade receivables provided the aging analysis is done on the same basis as what FRS 107 considers to be "past due". However, to obtain such information on a consolidated basis, the holding company has to ensure that all its subsidiaries report the information on the same basis. Thus, early and clear communication with the subsidiaries is crucial to avoid any confusion at the last minute.

An entity also needs to perform a sensitivity analysis of the effect of movements in market risks (currency risk, interest rate risk, and other price risk) on results as a consequence of the use or existence of financial instruments. It is unlikely that a manufacturing or trading entity would include such an analysis in its internal reporting system. Consequently, the entity has to start collating the information necessary to perform this analysis prior to the finalisation of the annual financial statements. The challenge is magnified for a holding company which has many subsidiaries.

Although FRS 107 is about disclosures, a significant preparation lead time is required for an entity to comply with the requirements of the standard.

B. Illustrative sensitivity disclosure analysis

Requirement of FRS 107

A sensitivity analysis is required under paragraph 40 for each type of market risk that an entity is exposed to at the reporting date. The sensitivity analysis should show the effect on the profit or loss and equity of a reasonably possible changes in the relevant risk variable (e.g., prevailing market interest rates, currency rates or commodity prices). The methods and assumptions used to prepare such analysis should also be disclosed.

Example

Entity A is a manufacturing entity with S$ as its functional currency. Its financial instruments include cash, trade receivables, trade payables and borrowings. Entity A has a loan of S$1,000,000 at floating interest rates. Entity A's trade receivables and payables include S$756,000 and S$454,000 of US$ denominated trade receivables and payables respectively. The spot rate at reporting date is US$1: S$1.5118.

Based on historical movements and volatilities in these market variables and management's knowledge of the financial markets, Entity A believes that the following movements are reasonably possible over a 12 month period:

- Proportional foreign exchange rate movement of 10 percent depreciation of S$ and a 10% appreciation of S$ against the US$ from the spot rate.
- A parallel shift of +100 basis points /-100 basis points (bp) in interest rates from the year-end rate of 2.76%.

If these movements were to occur, the impact on Entity A's profit and loss account for each class of financial instruments held at the balance sheet is shown below.

		Interest rate risk		Foreign exchange rate risk	
		+10 bp	- 10 bp	+10%	-11%
	Carrying amount (S$'000)	P&L account (S$'000)	P&L account (S$'000)	P&L account (S$'000)	P&L account (S$'000)
Financial assets					
Trade receivables (1)	2,328	-	-	+76	-76
Impact on financial assets before tax		-	-	+76	-76
Tax charge of 18%		-	-	-14	+14
Impact on financial assets after tax				+62	-62
Financial liabilities					
Trade payables (2)	(1,680)	-	-	-45	+45
Borrowings (3)	(1,000)	-10	+10	-	-
Impact on financial liabilities before tax		-10	+10	-45	+45
Tax charge of 18%		+2	-2	+3	-3
Impact on financial liabilities after tax		-8	+8	-42	+42
Net impact		**-8**	**+8**	**+20**	**-20**

Step 1: Calculating the sensitivity disclosure analysis

1. Trade receivables include S$756,000 of US$ denominated receivables.
   - US$ amount at year end = US$500,066
   - Sensitivity to a 10% appreciation of S$ against US$
     = (US$500,066 x 1.5118 x 1.1) – S$756,000
     = + S$75,600
   - Sensitivity to a 10% depreciation of S$ against US$
     = (US$500,066 x 1.5118 x 0.9) – S$756,000
     = - S$75,600

2. Trade payables include S$454,000 of US$ denominated receivables.
   - US$ amount at year end = US$300,304
   - Sensitivity to a 10% appreciation of S$ against US$
     = (US$300,304 x 1.5118 x 1.1) – S$454,000
     = - S$45,400
   - Sensitivity to a 10% depreciation of S$ against US$
     = (US$300,304 x 1.5118 x 0.9) – S$454,000
     = + S$45,400

3. Floating rate borrowing of S$1,000,000
   - Sensitivity to a + / - 100 bp movement in the S$ market interest rates
     = S$1,000,000 x 10 bp/100/100
     = - S$10,000 / + S$10,000

Step 2: Example disclosures in the financial statements

Entity A may disclose the sensitivity analysis in the financial statements in the following way:

- Interest rate risk
  At the reporting date, the Company has a floating rate loan of S$1,000,000. An increase of 100 basis points in interest rates at the reporting date would have decreased profit or loss by S$8,000. A decrease of 100 basis points in interest rates at the reporting date would have increased profit or loss by S$8,000. This analysis assumes that all other variables remain constant.

- Foreign currency risk
  A 10% strengthening of S$ against the US$ at the reporting date would have increased profit or loss by approximately $20,000. A 10% weakening of S$ against the US$ at the reporting date would have decreased profit or loss by approximately $20,000. This analysis assumes that all other variables remain constant.

C. Developments in international standards and interpretations

Meetings of the IASB – July and August 2007

Refer to *IFRS in Brief* Issue 37 and 38 for details

IASB's projects overview

Refer to *IFRS Briefing Sheet* Issue 72 for details

At the July and August 2007 meetings, some key projects discussed were:

- The joint venture project – some significant tentative decisions made include:
  - an additional requirement to disclose the financial statement reporting date of the joint venture, and when it differs from that of the venturer, the reason for that difference;
  - an additional requirement to disclose any restrictions on the ability of the joint venture to transfer funds to the venturer; and
  - not requiring the investment in joint venture to be re-measured at fair value when the investor loses joint control but still retains significant influence:
- Annual improvement process – significant proposals to amend existing standards include:
  - IAS 1 *Presentation of Financial Statements* to clarify the criteria used in determining the classification of derivatives as current or non-current;
  - IAS 10 *Events after the Balance Sheet Date* to clarify that dividends declared after the reporting date are not recognised as liability because there is no present obligation;
  - IAS 34 *Interim Financial Reporting* to improve consistency with IAS 33 *Earnings Per Share* by requiring only entities within the scope of IAS 33 to disclose earnings per share in interim financial statements;
  - IAS 38 *Intangible Assets* to clarify that an entity should recognise an expense for advertising or promotional activities provided in exchange for goods or services when the benefit of the goods or services are available to the entity; and
  - IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* to clarify that if an entity loses control of a subsidiary as part of a committed sale plan then it would classify such subsidiary's assets and liabilities as held for sale.

IFRIC Draft Interpretation D21 *Real Estate Sales*

Refer to *IFRS Briefing Sheet* Issue 70 for details

Comments end 5 October 2007

This draft interpretation proposes guidance on the accounting for revenue from the sale of real estate before construction is completed. The draft interpretation proposes guidance to determine whether the revenue from such agreements should be accounted for in accordance with:

- IAS 11 *Construction Contracts* , i.e., meeting the definition of a construction contract; or
- IAS 18 *Revenue* , i.e., treated as a sale of goods (constructed real estate).

The proposed consensus is that IAS 11 would apply only if an agreement meets the definition of a construction contract, i.e., by providing "construction services to the buyer's specifications". Alternatively, IAS 18 would apply if such an agreement is for the sale of goods.

The draft interpretation provides indicators to assist entities in determining whether a real estate sales agreement meets the definition of a construction contract or whether it is an agreement for the sale of goods.

CCDG has issued an identical exposure draft in Singapore on 23 July 2007 with comments due by 5 September 2007.

IFRIC 13 *Customer Loyalty Programmes*
Refer to *IFRS Briefing Sheet* Issue 69 for details

This interpretation addresses the accounting for customer loyalty programme award credits granted as part of sales transactions. It requires programmes within its scope to be accounted for as a separately identifiable component of revenue. It addresses:

- how this component should be measured and
- when this revenue should be recognised.

The interpretation precludes accounting for these programmes by recognising all revenue immediately and recognising a provision for any incremental costs of fulfilling the obligation under the award.

Consequently, an entity must defer the recognition of revenue attributable to the award credits. The consideration received or receivable from the customer is allocated between the item sold and the award credit granted based on their fair values.

IFRIC 13 is effective for annual periods beginning on or after 1 July 2008. Earlier application is permitted.

If the initial application of IFRIC 13 results in a change in accounting policy, the entity is required to retrospectively applied IFRIC 13 in accordance with the requirements in IAS 8.

The KPMG International publications covered in this issue are:

- IFRS in Brief: issue 37 and 38
- IFRS Briefing Sheet: issues 69 to 73

This section provides a highlight, particularly the relevance of international developments in the local context, of our international publication – *IFRS in Brief* and *IFRS Briefing Sheet*. You can access the electronic version as follows:

IFRS in Brief:
http://www.kpmg.com.sg/newsletters/ifrs_in_brief.html

IFRS Briefing Sheet:
http://www.kpmg.com.sg/newsletters/ifrs_briefing_sht.html

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

Jeremy Hoon
Partner - Professional Practice Department
Tel: +65 6213 2608
jeremyhoon@kpmg.com.sg

KPMG
16 Raffles Quay
#22-00 Hong Leong Building
Singapore 048581
Tel: +65 6213 3388
Fax: +65 6225 0984