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Financial Reporting Matters

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AUDIT

Getting ready for changes in financial reporting standards in 2009

A number of new or revised Financial Reporting Standards (FRS) effective from 2009 have been issued and more are expected in the coming months.

In this issue, we focus on the implementation issues for FRS 108 *Operating Segments* and FRS 23 *Borrowing Costs*. We also discuss the accounting rules for first-time application of the new or revised International Financial Reporting Standards (IFRS) which are expected to be adopted in Singapore in the near future.

Contents

In 2006, the International Accounting Standards Board (IASB) announced that it will not require the application of new IFRS or major amendments to existing standards before 1 January 2009. This is to provide a stable platform for the implementation of IFRS around the world.

We are now fast approaching the end of the three-year stable period. A number of new or revised Financial Reporting Standards effective from 2009 have been issued with more expected in the coming months.

Effective for annual accounting periods beginning 1 January 2009, two new accounting standards, FRS 108 *Operating Segments* and FRS 23 *Borrowing Costs* (revised 2007) will be adopted. FRS 108 requires entities within its scope (mainly listed companies) to disclose segment information based on the same information used by top management. The revised FRS 23 requires the capitalisation of borrowing costs and removes the option to immediately expense all borrowing costs.

Other new or revised IFRS and interpretations effective from 2009 have been issued internationally. These are expected to be issued in Singapore with the same effective dates. This publication focuses on the accounting rules for first-time application of the changes.

We also provide an overview of three exposure drafts and discussion papers, and two draft interpretations recently issued by the IASB and the International Financial Reporting Interpretations Committee (IFRIC).

A. FRS 108 *Operating Segments*

FRS 108 *Operating Segments* will supersede FRS 14 *Segment Reporting*, when it comes into effect from 1 January 2009. FRS 108 will require all entities within its scope to adopt the 'management approach' in reporting the financial performance of its operating segments, based on the same segment information as used by top management. Consequently, the segment information disclosed aims to provide the reader insight into how top management manages the entity's operations. If not already covered by the information disclosed by the 'management approach', FRS 108 also requires entities to make other entity-wide disclosures.

Which entities are required to apply FRS 108?

FRS 108 is applicable to entities whose equity or debt securities are publicly traded and those in the process of issuing equity or debt securities in the public securities market.

Consistent with FRS 14, when both the separate and consolidated financial statements of the parent company are presented in a single financial report, only consolidated segment information is to be presented.

What is the 'management approach' to reporting segment information?

FRS 108 does not require the identification of primary and secondary segment reporting formats as previously required by FRS 14. Instead, FRS 108 requires entities to disclose segment information based on the components of the business that management uses to make decisions about operating matters i.e. the 'management approach'.

This 'management approach' differs from FRS 14 in two key aspects:

- The operating segments are determined by management rather than in accordance with the definitions of a financial reporting standard;
- The operating segments could be identified differently by two or more overlapping sets of components. For example, an entity may analyse its domestic operations by product line, while analysing its overseas activities by the location of its operations.

The key to identifying operating segments is to determine who the entity's chief operating decision maker (CODM) is. According to FRS 108.7, the term 'CODM' describes a function rather than a person with a specific title. That function is to allocate resources to and assess the performance of the operating segments of an entity. FRS 108.7 states that often the CODM of an entity is its Chief Executive Officer or Chief Operating Officer, but it may be a group consisting of, for example, the entity's executive directors or others.

What are the measurement rules for segment information to be disclosed?

Before FRS 108, FRS 14 required segment information to be prepared using the accounting principles adopted for the financial statements of the entity. Segment information was therefore an analysis of entity information disclosed in the financial statements, using definitions of segment measures provided for in FRS 14.

FRS 108 requires the amount of each segment item reported to be the measure that is reported internally, irrespective of the basis of preparation for the financial statements. In addition, the segment information is required to be reconciled on an aggregate basis (of all reportable segments) to the amounts reported in the financial statements.

What are the key disclosure requirements?

Qualitative information:
FRS 108 requires disclosure of general narrative information, how reportable segments are identified and a description of the segments. In addition, FRS 108.27 requires the disclosure of how segment profit or loss, and segment assets and liabilities for each reportable segment are measured.

Quantitative information:
FRS 108.23-24 requires the entity to report:

- a measure of profit or loss and total assets for each reportable segment;
- a measure of liabilities for each reportable segment, if the information is regularly provided to the CODM;
- particular items about each reportable segment, if the amounts:
  - (a) are included in the measure of segment profit or loss reviewed by the CODM; or
  - (b) are otherwise regularly provided to the CODM, even if not included in that measure of segment profit or loss.

These items include revenues from external customers as well as inter-segment revenue, depreciation, results from the equity method, interests in associates and joint ventures and tax expense.

FRS 108.28 requires reconciliations of total reportable segment revenues, total profit or loss, total assets, liabilities and other amounts disclosed for reportable segments, to the corresponding amounts in the financial statements. All material reconciling items should be separately identified and described.

FRS 108 also requires certain entity-wide disclosures, if this information is not already disclosed under the 'management approach'. Broadly, these include:

- information about revenues derived from its products or services;
- information about revenues from external customers and certain non-current assets, based on their geographical location;
- information about revenues from major customers, if revenues from a single external customer amount to 10 percent or more of the entity's revenues.

For the disclosure of revenues from major customers, FRS 108.34 requires a group of entities known to the reporting entity to be under common control to be considered as a single customer.

What should we do to prepare for the application of this new standard?

FRS 108 is effective for annual reporting periods beginning on or after 1 January 2009. Earlier application is permitted.

FRS 108.36 states that segment information reported as comparative information in the first year of FRS 108 application shall be restated to conform with the requirements of FRS 108, unless the necessary information is not available and the cost to develop it would be excessive. However, given that most of the information is based on the information reported to the CODM, and given that a lengthy implementation period has been allowed, justifying that this information is not available may be difficult.

Although FRS 108 is not effective until 2009, entities applying the standard should now take steps to consider the impact of FRS 108 on their financial statements. Reporting entities should review their current management reporting system, and consider whether improvements are needed before collating comparative information.

B. FRS 23 *Borrowing Costs*

What is the revision?

The revised FRS 23 requires the capitalisation of borrowing costs and removes the option to immediately expense all borrowing costs; an entity is required to capitalise all borrowing costs *directly attributable* to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. A 'qualifying asset' continues to be defined as an asset that necessarily takes a substantial period of time to be ready for its intended use or sale. Examples include manufacturing plants, power generating facilities, and investment properties.

The revised FRS 23 has unusual transitional provisions which will apply to those entities that currently have adopted a policy of expensing all borrowing costs.

When is the revision effective and what do we do on first-time application?

The revised FRS 23 is effective for annual periods beginning on or after 1 January 2009. Earlier application is permitted.

If adoption of the revised standard constitutes a change in accounting policy, an entity should prospectively apply the revised standard to qualifying assets for which the commencement date for capitalisation is on or after the effective date.

In addition, entities are permitted to adopt the new policy retrospectively in the first year of application. However, it should be in accordance with specific transitional provisions which limit the extent of retrospective adjustments that need to be made. In particular, these transitional provisions allow the entity to limit the retrospective adjustments to those borrowing costs which relate to qualifying assets, whose commencement date for capitalisation is on or after a date in the past *chosen* by the entity. This *chosen* past date need not coincide with the start of an accounting period. In most cases, it would be chosen with reference to the start date of the earliest projects for which the entity wishes to capitalise borrowing costs and was able to identify those costs in a sufficiently reliable manner.

These transitional provisions are illustrated in the following.

Worked Example

In previous years, Company X had adopted a policy of expensing all borrowing costs under FRS 23. As a result of the amendments to FRS 23, Company X will need to change its accounting policy. Company X has a December year end and decides not to early-adopt FRS 23. Its first year of application of the new policy of capitalisation is therefore the annual period beginning on 1 January 2009.

Company X identifies that in the recent past, it has been involved in three projects to construct qualifying assets; projects A, B and C, and that borrowing costs incurred on these projects during the construction period can be identified as follows:

	Commencement date of qualifying activities	Borrowing costs eligible for capitalisation		
		2007	2008	2009
Project A	1 June 2007	$100	$300	$35
Project B	1 April 2008	-	$80	$120
Project C	1 March 2009	-	-	$65

Worked Example (continued)

Choice of transitional provisions open to Company X:

Company X can choose whether or not to make retrospective adjustments in its 2009 financial statements. If it chooses to make retrospective adjustments, it needs to decide from which past designated date it will adopt the new policy.

	Impact on financial statements for the year ended 31 December 2009	
Transitional choices:	Current year amounts (2009)	Retrospective adjustments to the comparative amounts
Option 1: prospective application from 1 January 2009	Company X would only capitalise the borrowing costs relating to project C of $65 as this is the only project for which the capitalisation under FRS 23 commences on or after the effective date of the new policy. All other borrowing costs incurred in 2009 would be expensed.	No adjustments would be made to the comparatives for 2008 or the opening balances as at 1 January 2009.
Option 2: retrospective application from e.g. 31 March 2008 (being a date which is after the start of project A but before the start of project B)	Company X would capitalise the borrowing costs relating to projects B and C (i.e. $185 in total) as these are the only projects for which the capitalisation under FRS 23 commenced on or after the designated date (being 31 March 2008). The borrowing costs relating to project A in 2009 would be expensed.	The comparative income statement and balance sheet for 2008, and opening balances at 1 January 2009 would be re-stated to reflect the capitalisation of borrowing costs of $80 relating only to project B. There will be no adjustments to the opening balances at 1 January 2008.

C. Summary of Changes and First-time Application Rules

In this section, we provide a brief summary of various new or revised IFRS and IFRIC interpretation effective from 2009 which have been issued internationally, focusing on the transitional provisions.

Revised IAS 1 *Presentation of Financial Statements*

For more details, refer to IFRS Briefing Sheet – Issue 74.

Brief summary

The revised International Accounting Standard (IAS) 1 will supersede the current version of IAS 1. The two main changes in this revision are:

(a) Introduction of the concept of 'total comprehensive income'; these are changes in equity during the period other than those changes resulting from transactions with owners in their capacity as owners. This can be presented in one of two formats.

(b) Requirement for the presentation of a statement of financial position (formerly the balance sheet) at the beginning of the earliest comparative period following a change in accounting policy, the correction of an error or the re-classification of items in the financial statements.

First-time application

The revised standard is effective for annual periods beginning on or after 1 January 2009. Earlier application is permitted with disclosure of this fact. Comparative information would also need to be presented in the same set of financial statements using the same format.

IFRIC 13 *Customer Loyalty Programmes*

For more details, refer to IFRS Briefing Sheet – Issue 69.

Brief summary

IFRIC 13 describes 'customer loyalty programmes' as programmes in which entities grant award credits as incentives to customers to buy their goods or services. Common examples are airline and hotel loyalty schemes and credit card reward schemes. The customer can redeem the award credits for free or discounted goods and services. The goods or services may be provided directly by the entities granting the award (e.g. as the waiver of next year's annual credit card fee by a credit card company) or by third parties (e.g. specified stores or restaurants honouring retail vouchers obtained through redemption of credit card points).

IFRIC 13 does not cover the accounting for incentives granted outside a sales transaction. These include freely distributed discount vouchers, or arrangements where customers are granted financial assets (e.g. such as cash-back arrangements.)

IFRIC 13 concluded that customer loyalty programmes should be accounted for by taking a multiple sales approach, i.e. by deferring some of the revenue received from the initial sales transaction, to be recognised as revenue as and when the entity provides the goods or services promised under the customer loyalty programme.

First-time application

IFRIC 13 is effective for annual periods beginning on or after 1 July 2008 with earlier application permitted. If an entity had previously accrued for the cost of supplying awards (as is the common practice), the adoption of IFRIC 13 would be treated as a change in accounting policy with retrospective application required, unless impracticable.

It should be noted that in practice, entities need only apply IFRIC 13 to customer loyalty programmes in existence if the effect is material.

Entities operating customer loyalty programmes within the scope of IFRIC 13 should assess whether IFRIC 13 would have a material impact on their financial statements and consider their implementation plans. In particular, it would be advisable to consider whether:

- data is being accumulated in order to apply IFRIC 13 retrospectively in its first year of application; and
- changes to systems and procedures for recording data in the loyalty programmes would be advisable to facilitate compliance with the Interpretation on an ongoing basis.

Revised standard IFRS 3 *Business Combinations* (2008) and amended standard IAS 27 *Consolidated and Separate Financial Statements* (2008)

Refer to *IFRS Briefing Sheet* – Issue 81 for details.

Brief summary

IFRS 3 (2008) is the outcome of the second phase of the IASB and the U.S. Financial Accounting Standards Board's (FASB) business combinations joint project. This phase reconsidered the application of acquisition accounting for business combinations.

The main changes from IFRS 3 (2004) are:

- All items of consideration transferred by the acquirer are measured and recognised at fair value at the acquisition date, including contingent consideration.
- The acquirer can elect to measure any non-controlling interest (NCI), previously termed 'minority interest'), at fair value at the acquisition date, or at its proportionate interest in the fair value of the identifiable assets and liabilities of the acquiree; on a transaction-by-transaction basis.
- Transaction costs incurred by the acquirer in connection with the business combination do not form part of the business combination transaction. As such, they are expensed as incurred. However, if they relate to the issuing of debt or equity securities, then they are accounted for under the financial instruments standard.

The main changes from IAS 27 (2003) are as follows:

- When an acquisition is achieved in successive share purchases (step acquisition), the identifiable assets and liabilities of the acquiree are recognised at fair value when control is obtained. The gain or loss is recognised in profit or loss for the difference between the fair value of the previously held equity interest in the acquiree and its carrying amount.
- Acquisitions of additional NCI after control is obtained, and disposals, of equity interests while retaining control are accounted for as equity transactions.
- A transaction resulting in a loss of control results in a gain or loss being recognised in profit or loss.

First-time application

Both IFRS 3 (2008) and IAS 27 (2008) are effective for annual periods beginning on or after 1 July 2009. Earlier application is permitted for annual periods beginning on or after 30 June 2007 provided that the entity applies both revisions in the same period and discloses that fact.

The carrying amounts of any assets and liabilities are not adjusted if they arise under business combinations prior to the application of IFRS 3 (2008).

The amendments in IAS 27 (2008) apply retrospectively except for:

- The requirement to attribute total comprehensive income between controlling and NCI even if this results in NCI having a negative balance.
- Accounting for changes in ownership interests after control is obtained
- The re-measuring from carrying amounts to fair value of any retained NCI upon a loss of control.

Amendments to IFRS 2 *Share-based Payment – Vesting Conditions and Cancellations*

Refer to *IFRS Briefing Sheet* – Issue 84 for details.

Brief summary

The original definition of vesting conditions in IFRS 2 (2004) described them as including service and performance conditions. However, it was unclear how other conditions related to share-based payment arrangements should be treated. Examples include:

- Requirement for an employee to contribute to an employee share purchase plan (ESPP).
- Requirement for an employee to hold shares of an entity for a specified period in order to be eligible for participation in a share-based payment grant.

This amendment to IFRS 2:

- Clarifies the definition of vesting conditions
- Introduces the concept of 'non-vesting conditions'
- Requires 'non-vesting conditions' to be reflected in grant date fair value
- Provides the accounting treatment for non-vesting conditions and cancellations

First-time application

The amendments to IFRS 2 (2008) apply retrospectively to annual periods beginning on or after 1 January 2009. Earlier application is permitted, with disclosure of that fact required.

Amendments to IAS 32 *Financial Instruments: Presentation* and IAS 1 *Presentation of Financial Instruments – Puttable Financial Instruments and Obligations Arising on Liquidation*

Refer to *IFRS Briefing Sheet* – Issue 86 for details.

Brief summary

On 14 February 2008, the IASB issued this much awaited amendment allowing certain instruments that would normally be classified as liabilities to be classified as equity if and only if they meet certain conditions. The amendments cover two categories of instruments issued by an entity. They are:

- a puttable financial instrument; or
- an instrument, or components of instruments, that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only upon liquidation.

The amendments define a puttable instrument as "*...a financial instrument that gives the holder the right to put the instrument back to the issuer for cash or another financial asset or is automatically put back to the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder.*"

First-time application

The amendment is effective for annual periods beginning on or after 1 January 2009. Earlier application is permitted, provided an entity discloses this fact. It also needs to apply the related amendments at the same time.

Singapore has yet to adopt this amendment and therefore, it is unlikely that Singapore entities would be able to apply the amendment now since this is a change from the current accounting standards.

D. Developments in IFRS and Interpretations

In addition to the issuance of several new and revised IFRS as discussed above, we highlight below three exposure drafts (ED) and discussion papers (DP), two draft interpretations and other international developments.

Exposure Draft of Proposed Amendments to IFRS 1 and IAS 27 – *Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate*

Refer to *IFRS Briefing Sheet* – Issue 79 for details.

This proposed amendment originally affected only first-time adopters of IFRS, by permitting a first-time adopter of IFRS to measure the cost of its investments in subsidiaries, jointly controlled entities or associates at a 'deemed cost' in its separate financial statements.

However, following comments from respondents, this exposure contains two significant proposals that would affect all companies and not only companies that are first-time adopters of IFRS.

The first proposal requires dividends received by an investor from a subsidiary, jointly controlled entities or associate to be recognised as income in the separate financial statements of the investor, without the need to determine whether these arises from pre or post-acquisition profits. In addition, the ED proposes that an impairment test is required if the investor received dividend income from that investment during the reporting period, regardless of whether any indicators of impairment exist.

The second proposal includes new guidance on accounting for the formation of a new parent as part of the reorganisation of an existing entity when the existing entity becomes a wholly-owned subsidiary of the new parent.

The comment deadline to the IASB was 26 February 2008. In Singapore, the Accounting Standards Council (ASC) issued the same ED, with a deadline for comment by 4 February 2008.

Exposure draft of Proposed Amendments to IFRS 2 and IFRIC 11 – *Group Cash-settled Share-based Payment Transactions*

Refer to *IFRS Briefing Sheet* – Issue 80 for details.

Currently, neither IFRS 2 nor IFRIC 11 determines whether group cash-settled share-based payment arrangements should be attributed to the entity that receives the goods or services.

This proposed amendments to IFRS 2 clarify that an entity receiving the goods or services from suppliers should apply IFRS 2, even if the entity has no obligation to make the required share-based cash payments related to such goods or services. If a parent has an obligation to make the required cash payment to employees of its subsidiary, then the subsidiary would measure the services on the basis of the fair value of the corresponding liability incurred by the parent. It would also have to recognise any changes in the fair value of that liability in profit or loss.

The deadline for the comments to the IASB was 17 March 2008. In Singapore, the ASC had also issued the same ED, with a deadline for comment by 4 February 2008.

Draft Interpretation D23 *Distributions of Non-cash Assets to Owners*

Refer to *IFRS Briefing Sheet* – Issue 85 for details.

This draft interpretation proposes accounting guidance in respect of unconditional and non-reciprocal distributions of non-cash assets to owners in their capacity as owners. This is commonly termed 'dividends-in-specie'. The proposals apply to both the consolidated and separate financial statements of the entity making the distribution, but does not address the accounting treatment by the recipient of the distribution.

D23 proposes that such dividend payable be measured at fair value. Any difference between the carrying amount of the assets distributed and the amount at which the dividend payable is recorded would be recognised in profit or loss as a separate line item when the assets are distributed.

The IFRIC has invited comments on the draft interpretation by 25 April 2008. In Singapore, the ASC issued the same draft interpretation, and the deadline for comments was 14 March 2008.

Draft Interpretation D24 *Customer Contributions*

Refer to *IFRS Briefing Sheet* – Issue 83 for details.

In some industries, providers of access to goods or services may receive contributions of property, plant and equipment (PPE). These are used to acquire/construct PPE, which is used to provide access to a supply of goods or services to customers.

For example, an entity constructs a manufacturing plant located some distance from the electricity network. In order to get access to the electricity network, the entity may either:

- Construct the infrastructure (cables, poles etc.) from the plant to the network itself and then transfer these assets to the electricity access provider (customer contribution);
- Request the electricity access provider to construct the infrastructure facilities and reimburse it for the costs (cash contribution).

The entity would then be charged for the electricity consumed at the plant based on its usage.

The proposed consensus is that the PPE is recognised as an asset only if the entity determines that the PPE meets the definition of an asset and also meets the related recognition criteria set out in the Framework.

The IFRIC has invited comments on this draft interpretation by 25 April 2008. In Singapore, the ASC issued the same draft interpretation, and the deadline for comments was 14 March 2008.

IASB Discussion Paper – *Financial Instruments with Characteristics of Equity*

Refer to IFRS Briefing Sheet – Issue 88 for details.

The IASB recently published a DP on *Financial Instruments with Characteristics of Equity*. The DP is the first stage of the IASB's project to improve and simplify the requirements in IAS 32 *Financial Instruments: Presentation*. Stakeholders around the world have raised two broad classes of criticisms of the current requirements:

- the principles in IAS 32 are difficult to apply
- the application of those principles can result in an inappropriate classification of some financial instruments

This DP project is a modified joint project between the IASB and the FASB. On 30 November 2007, the FASB published a Preliminary Views document on *Financial Instruments with Characteristics of Equity* (FASB document). The goal of this DP is to solicit the views of interested parties on whether the proposals in the FASB document are a suitable starting point for the IASB's deliberations.

All three approaches in the FASB document rely on the definition of a basic ownership instrument, which is different from the requirements under IAS 32. As a result, *the application of any of these approaches would have a significant impact under IFRS*. This DP provides a comparison between the requirements under the IAS 32 and the approaches proposed in the FASB document.

The IASB has invited comments on the proposals contained within the DP by 5 September 2008. In Singapore, the ASC is expected to issue this DP for comments shortly.

U.S. Securities and Exchange Commission proposes amendments to foreign private issuer reporting requirements

Refer to *IFRS Briefing Sheet* – Issue 87 for details.

On 13 February 2008, the U.S. SEC agreed to propose changes to its current filing requirements for foreign private issuers. Key aspects of the proposal include accelerating due dates for annual reports filed on Form 20-F and adding disclosures in Form 20-F.

Meetings of the International Accounting Standards Board – December 2007, January 2008 and February 2008

Refer to *IFRS in Brief* - Issues 42 to 44 and *IFRS Briefing Sheet* – Issue 82 for details.

At the recent meetings of the IASB, there were tentative decisions made on several projects, including:

- First Annual Improvements – Of the 41 proposals contained in the ED, the Board tentatively decided that six proposals would not be included in the final release, due to the additional work still required. These include the proposed amendment to IAS 17 *Leases* relating to classification of leases of land and buildings.
- Provisions – The Board reaffirmed the proposal in the ED that a liability should be measured at the amount "*the entity would rationally pay to settle the present obligation or to transfer it to a third party on the balance sheet date*". The Board also confirmed its previous decision to remove the probability recognition criteria.
- Earnings per share – The Board had tentatively decided to amend the calculation of diluted EPS for options, warrants and their equivalents. The IASB is currently drafting the exposure draft on the proposed amendments to IAS 33.
- Common control transactions – The Board decided to add a project on common control transactions to its active agenda.

For a useful summary of the status of the current IASB projects, refer to IFRS Briefing Sheet – Issue 82. It reflects significant discussions in the IASB, up to and including those that took place at its December 2007 meeting and those IASB publications that have been published up to and on 17 January 2008. The project summaries set out a description of each project and the major areas of existing IFRSs which may be affected by the project. IASB documents related to the project are identified, together with the latest estimates of the timing to completion.

The KPMG international publications covered in this issue are:

- IFRS in Brief: Issues 42 to 44
- IFRS Briefing Sheet: Issues 79 to 88

This section provides highlights of our International publications – *IFRS in Brief* and *IFRS Briefing Sheet*. You can access the electronic version at:

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

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