Welcome to Audit Committee Bulletin, published to bring you important information on corporate and financial reporting matters.

On 21 November 2019, the Accounting and Corporate Regulatory Authority’s (ACRA) issued its Financial Reporting Practice Guidance No.2 of 2019, which highlights the areas of Financial Reporting Surveillance Program (FRSP) review focus for FY2019 financial statements. Directors should pay closer attention to these areas before approving the FY2019 financial statements (financial year ended between 1 January 2019 and 31 December 2019).

In our annual review of issues of importance to audit committees (ACs), we consider key developments relating to regulatory changes, financial reporting and risk management. We hope this is useful as you prepare for discussions with the board, management and external auditors this financial year-end.

Today’s companies are operating in a transformative age that is shaped by the emergence of disruptive technologies. In our third article, we look at how boards can respond to new opportunities and risks presented by artificial intelligence (AI) and other emerging technologies.

We hope you have an enjoyable read.
ACRA’s FRSP
Areas of review focus for FY2019 financial statements

We explore the areas that the ACRA’s FRSP will be focusing on for FY2019 financial statements review and highlight the areas of review focus that may require more attention by directors before approving the FY2019 financial statements.

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We summarize the focus areas below.

1. New accounting standards that took effect recently

   **SFRS(I) 16 Leases effective on 1 January 2019**

   Under SFRS(I) 16, lessees are required to recognize right-of-use assets with corresponding lease liabilities on balance sheet for most leases. This may significantly impact the lessee’s financial ratios and performance metrics.

   The directors should pay close attention to the following areas when implementing the new lease standard:

   ▶ When ascertaining if a contract is or contains a lease

   ▶ Have the directors determined if the company has the “control” to “direct” the use of the identified asset?

   ▶ Have the directors ensured the completeness of the lease population on hand?
When determining the lease term
- Have the directors considered if the renewal and/or termination option(s) is reasonably certain to be exercised?
- Have the directors paid attention to the significant judgements and estimates made, particularly when the lease contract does not contain specific clauses regarding the renewal, termination or cancellation of the lease?

When deciding the amount of lease liability to be recorded on balance sheet
- Are the unpaid lease payments discounted using an appropriate incremental borrowing rate that reflects the interest rate that the company would pay to borrow:
  (i) Over a similar term to the lease term,
  (ii) With a similar collateral, if any,
  (iii) To obtain an asset of a similar value to the right-of-use asset, and
  (iv) In a similar economic environment, which could be rather judgmental to derive.

Bear in mind that it is generally inappropriate to use one discount rate for all leases, particularly when the identified assets are dissimilar.

When accounting for variable rents payable to JTC Corporation, which are typically revised to reflect changes in market rates, are the lease liabilities measured initially using the market rate at the commencement date of the lease and remeasured subsequently as and when the adjustments to the lease payments take effect? Refer to ISCA Technical Bites – “How are variable rent leases by JTC Corporation treated under FRS 116”

When reviewing the presentation, have the directors ensured that:
- The right-of-use assets and lease liabilities are presented separately, either on the balance sheet or in the notes?
- The interest expense on lease liabilities is presented as a component of finance costs, separate from depreciation charge for right-of-use assets?
- Cash payments for the principal portion of the lease liability are classified within financing activities in the statement of cash flows?

Payments for short-term leases, low value assets and variable amounts not included in the measurement of the lease liability are included within operating activities in the statement of cash flows?

When reviewing the disclosures, are critical judgements in areas such as determining the lease term and discount rate meaningfully disclosed?

Are directors familiar with the transitional options, practical expedients and available exemptions to ease the implementation of this new standard?
The right-of-use assets and lease liabilities recognized may differ depending on whether retrospective approach or modified retrospective approach is adopted.

Have preparers of the financial statements kept a close tab on the agenda decisions concluded, or deliberated by the IFRS Interpretations Committee?

SFRS(I) INT 23 Uncertainty over Income Tax Treatments effective on 1 January 2019
SFRS(I) INT 23 gives more guidance as to when and how to provide for uncertain tax positions.
- When determining the amount to be recorded for uncertain tax provisions, have the directors assumed that the tax authority has a right to examine, and has full knowledge of all relevant information when making those examinations?
- Have the directors critically assess management’s estimates and assumptions used, particularly when making provision for tax treatments that are not probable of being accepted by tax authorities?

SFRS(I) 15 Revenue from Contracts with Customers effective on 1 January 2018
In implementing SFRS(I) 15, directors must understand the intricacies of the related concepts, such as control, performance obligations, timing of recognition, costs incurred to fulfil a contract. The directors should pay close attention to the following areas:
- Has management developed a robust system, and processes to identify variable consideration, such as incentives, penalty, discounts, rebates or refunds, holistically and completely?
- Are the financial effects of time value of money accounted for when a significant financing component exists due to payment in arrears or in advance? Are the resulting interest income or expense presented separately from revenue?
• When borrowing costs are incurred for properties that take a long time to construct but are ready for sale in their uncompleted state, have the directors ensured that the borrowing costs are not capitalized for both sold and unsold units? Refer to ISCA’s Technical Bites – “Capitalisation of borrowing costs – Agenda Decision March 2019”.

• Have the directors monitored closely IFRIC’s agenda decisions, assessed their impacts and implemented changes, if any, as soon as possible?

• Are accounting policies disclosed by each material revenue streams and customized to the company’s circumstances?

• Have directors ensured that the disclosures in the financial statements are consistent with the information provided in other parts of the annual report, and with the information provided to the analysts?

SFRS(I) 9 Financial Instruments effective on 1 January 2018

When valuing investments in unquoted equities at fair value

• Have directors critically assessed the assumptions used by management in those valuations?

• Have directors obtain independent professional valuations, particularly where these investments are significant and there is no in-house expertise?

When measuring expected credit losses (ECL) using provision matrix, which applies historical loss rates and involves judgments and estimates

• Have the directors considered grouping debts that share similar credit risk characteristics, for examples based on geographical region, customer rating, product and customer type?

• Have the directors determined how far back the historical data should be collected that is relevant to the future period over which debts will be collected?

• Have the directors considered forward-looking information that could affect future credit losses?

2. Impairment assessment and valuation

Directors should pay close attention to the impairment tests conducted by management, especially if the company is in an industry with challenging outlook. The areas to focus on include:

• Are the future cash flows incorrectly projected to perpetuity, rather than to the remaining useful life of the property, plant and equipment (PPE) when conducting impairment test on PPE?

• Are the projected future cash flows incorrectly discounted using the company’s current borrowing rate, the country’s inflation rate, or the government bonds’ interest rate, without any adjustment to reflect the risks specific to the asset(s) when computing the recoverable amount of an asset?

• Are the key assumptions such as revenue, gross margin and growth rate used overly optimistic? Have the directors compared the projected cash flows to the current and past years’ actual cash flows, and future growth plans?

• Is sensitivity analysis disclosed where headroom is small and carrying value of the asset is material?

3. Business acquisitions

Directors should pay close attention to the following when accounting for business acquisitions:

• Are intangible assets appropriately identified and recognized separately from goodwill?

• Was an accredited professional valuer engaged to perform the purchase price allocation (PPA) exercise when there is no in-house specialist to perform the PPA?

• Have the directors paid attention to the scope of the valuation service, which should include identifying specific intangible assets, and assessing management’s assumptions used to value them?

• Is the acquisition date appropriately determined?
Year-end issues for audit committees

In our annual review of developments affecting audit committees (ACs), we consider the key developments relating to regulatory changes, financial reporting and risk management.

What can your board do to manage geopolitical risk and uncertainty so that your company can continue to trade profitably?

The global trade environment today is in a state of flux, posing both risks and opportunities to businesses. The rise in protectionist policies, the outbreak of trade wars and Brexit are all indicators of a new trade landscape. As doing business across borders becomes more complex and uncertain, companies face magnified risks. The upheaval in the trade landscape could potentially expose a company to new risks arising from its customer base, operational structure, regulatory responsibilities, supply chain and tax planning arrangements. Just as one would prepare for any business risks and black swan events, geopolitical risks must be considered within the company’s overall enterprise risk management framework.

AC considerations:

Geopolitical uncertainty is unlikely to abate in the near future. For the AC, it is critical to understand the management’s approach, which at its core involves a process of understanding, preparing for and acting on geopolitical events:

- Who is responsible for identifying, monitoring and interpreting geopolitical events, and their impact on trade, within the organization?
- Is the management using scenario planning to identify and mitigate potential threats to the organization’s ability to trade internationally?
- Is the organization financially resilient to withstand a significant supply chain disruption or another crisis linked to geopolitical events?
- What processes does the organization have in place to monitor developments and identify any opportunities that may emerge from a changing trade landscape?
Are board members aware of the new regulatory developments in 2019?

The Revised Code of Corporate Governance (2018 Code)

Listed companies are required to apply the 2018 Code to annual reports for the financial year commencing 1 January 2019. Some changes introduced include the downward revision of shareholding threshold from 10% to 5% for director independence, and the majority of board of directors to be independent directors (from “at least half” previously) if the chairman is not independent.

In addition, certain baseline market practices are shifted to the SGX Listing Rules for mandatory compliance, some with modifications made. For instance, the board not only needs to comment on the adequacy and effectiveness of its internal controls and risk management systems, they are now required to disclose material weaknesses identified and steps taken to address them.

The AC is also required to comment in the annual report whether the internal audit function is independent, effective and adequately resourced. Additionally, the company must announce reason(s) if no dividend is declared or recommended. A recap to the key changes introduced to the 2018 Code can be found in Issue 1, 2019 of this publication.

AC considerations:

Considering the significant focus regulators are placing on corporate governance, ACs should be updated on the following:

- Steps taken by the company to comply with the 2018 Code.
- Effectiveness of the management’s process to monitor the company’s compliance with regulatory developments.
- If the management has engaged advisers to assist with its compliance.
Does your board have up-to-date knowledge of accounting principles and practices to perform an effective high-level review of the financial statements?

Two new accounting standards – SFRS(I) 16 Leases and SFRS(I) INT 23 Uncertainty over Income Tax Treatments are effective for annual periods beginning on or after 1 January 2019.

**SFRS(I) 16 Leases**

SFRS(I) 16 requires lessees to recognize on their balance sheet lease liabilities and corresponding right-of-use assets (ROUAs) for all leases, unless exempted. SFRS(I) 16 requires future lease payments to be discounted using an appropriate discount rate.

**AC considerations:**

AC should discuss with the management key accounting policies that the company elects, the impact on their processes and controls, and how the management intends to communicate these decisions to the stakeholders.

The discount rate that will be applied in determining ROUAs when adopting SFRS(I) 16 is a current hot topic of discussion among ACs, management and auditors. The discount rate applied directly impacts the present value of lease liabilities, the corresponding ROUAs, interest expenses and other related financial metrics.

The determination of discount rate has proven to be challenging in practice as it involves significant judgment and assumptions by the management. ACs should ensure that these assumptions and the supporting data are adequately evaluated and documented to promote accountability and auditability.

**SFRS(I) INT 23 Uncertainty over Income Tax Treatments**

SFRS(I) INT 23 addresses how to reflect uncertainty in the recognition and measurement of income taxes. SFRS(I) INT 23 clarifies that companies should assume that the taxation authority will examine amounts it has a right to examine and has full knowledge of all related information when making the examinations.

In other words, a company is required to assume a 100% detection risk. In the recognition and measurement of uncertain tax positions, companies must consider the probability that a taxation authority will accept an uncertain tax treatment according to tax law and tax practice. If the company concludes that it is probable that the tax treatment will be accepted by the tax authority, then it will measure all applicable taxes consistently with its income tax filing. Otherwise, it recognizes the effect of uncertainty on a case-by-case basis using either (a) the most likely amount or (b) the expected value.

**AC considerations:**

Applying the interpretation could be challenging for companies, particularly those that operate in more complex multinational tax environments. ACs should also understand from the board and management what are the processes and procedures established to obtain information, on a timely basis, that is necessary to apply the requirements in the SFRS(I) INT 23 and make the required disclosures.

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We highlight the following recurring issues, which we believe ACs should also focus on for the current year-end financial reporting.

**Significant judgments and estimates**

Assumptions, estimates, and judgments have taken on an increasingly important role in the preparation of financial statements. In this current economic environment, other areas of concern include, but are not restricted to, impairment of tangible and intangible assets, working capital allowances such as allowance for doubtful debts and inventory write-down, and recognition of deferred tax assets.

**AC considerations:**

AC should concentrate on how sensitive the financial figures are to variations in the assumptions used, and whether any estimates of the financial figures could materially change in the next financial year if actual outcomes differ or expectations change. Given volatile market conditions, companies should consider a wider range of reasonably possible outcomes when performing sensitivity analysis on their cashflow projections used to support asset valuations and asset impairment assessments.

ACs should emphasize on the process established by management to develop its judgments and estimates. They should also consider the process of setting the key assumptions and whether such assumptions are appropriately documented.

**Impairment assessments**

As part of the financial close, assets that are not measured at fair value through earnings such as goodwill, intangibles, fixed assets, receivables and equity investments, need to be assessed for possible impairment that would require the recognition of impairment losses. Companies are also required to assess whether prior year impairment write-downs of assets other than goodwill have reversed in the current period and if the impairment should be written back. Depending on the applicable accounting standards and presence of impairment indicators or evidences, a variety of quantitative assessments that rely on the management’s judgments and estimates regarding the assets’ future recoverability may be required.

**AC considerations:**

ACs should ensure companies put in place a robust process for impairment assessment as the process requires the management to exercise significant judgment when assessing the appropriateness of the recoverable amounts of the assets and the underlying key assumptions.

ACs should also consider whether the company’s current impairment assessment and communication process already incorporates leading practices summarized in the following page.
Leading practices of impairment assessment and communication process

1. Escalate to the highest levels of the company

Impairment testing often relies on the estimated value of assets by discounting estimated future cash flows using appropriate discount rates. Although calculations supporting the impairment or valuation of significant assets can be complex, the board can review the cash flows and assumptions used in calculations prepared by management or experts for material assets, bearing in mind the board’s knowledge of the business, its assets, the environment that the company operates in, and the prospects of the business.

The board and AC should critically assess whether the management and finance team have adequate skills to deal with impairment issues.

2. Ensure integrity of process with reasonable and supportable forecasting information and inputs

The latest analyses of economic and industrial trends and current market conditions should be reflected in the financial projections and discount rates used.

It is vital that the management applies internally consistent and coherent assumptions across impairment tests and vis-à-vis information used for internal management and decision-making purposes.

Past budget variances and economic life of assets in current market conditions should be critically assessed for implications to the current forecasts.

Furthermore, market values of assets deserve specific attention in current market conditions. The impairment assessment process also requires the management to consider and rationalize significant gaps between book value and market value, if available.

3. Communicate relevant information that stakeholders need

Sufficiently detailed and bespoke disclosures on impairment are critical to successful impairment reporting.

It is important to tell a “complete” story about assets that are at risk, and the events and circumstances leading up to the impairment losses.

Past surveys on financial statements users indicate that the most valued disclosures include those relating to commercial reasons and events that led to the impairment losses, management’s view of the future of the business that is reflected in cash flow projections (e.g., sales and margin trends, market share and sales volume, growth rates), sensitivity analyses performed for key assumptions, and other key assumptions used (e.g., discount rate).

4. Integrate with capital management and strategic planning

The impairment testing process for assets should not be viewed in isolation “for accounting purposes only”. Companies should strive to leverage and integrate the assessment of impairment as part of its wider strategic planning and capital allocation processes. Doing so can instil a greater sense of accountability in capital allocation and ensure that impairment accounting outcomes are sufficiently reflective of how the company evaluates its capital investment decisions.

Furthermore, structural differences between rates of return used by the company to make capital investment decisions, investment hurdle rates based on company’s cost of funds vis-à-vis market-based discount rates that reflect the risks specific to the assets used for impairment assessments should be evaluated to anticipate and manage the risks of asset impairments.
AC considerations:

Liquidity is a key consideration in assessing a company’s ability to continue as a going concern. The factors that the AC may consider in its assessment include cash flow forecasts, capital management requirements, debt repayment, and regulatory or contractual restrictions on cash funding. ACs should robustly challenge the reasonableness of the key assumptions used by the management in its assessment of the companies’ ability to continue as going concern, including review of the cash flow forecast and revalidating the companies’ ability to meet its debt commitments and debt covenants.

Communication with stakeholders is also important, in particular for companies with going concern uncertainty, as such indicators can result in a shift of the market’s perception of financially distressed companies. The market valuation is significantly altered from a focus on both income statement and balance sheet to a balance sheet-only focus. With stakeholders continuing to press for increasingly deeper levels of engagement, companies should:

• Communicate their strategies to address the going concern issues clearly and consistently in all statutory filings, announcements, presentations and press releases.
• Seek to provide relevant, accurate and timely disclosure, such as a comprehensive analysis of the industry, strategies, markets, outlook, position, performance and trends. They should also describe how these results relate to competitors or peers and explain why their performances are better or worse.
• Establish a crisis communication plan that not only minimizes the potential impact that negative information may cause and have on the perceptions of the company, but also allows the company to present its version of the situation or issue to manage rumors or speculation.
How can your board respond to new opportunities and risks presented by AI and other emerging technologies?

Today, companies are operating in a transformative age, shaped by the emergence of disruptive technologies that are transforming sectors, overturning traditional business models and enabling ambitious start-ups to seize market share from more established players.

Disruptive technologies such as artificial intelligence (AI), blockchain, cloud, data analytics, the internet of things, robotic process automation and virtual reality are reshaping the business landscape. Boards should monitor these technological developments, with particular attention to AI. While AI presents the company with opportunities to innovate, grow and manage commercial threats such as cyberattacks and fraud, it is also a source of new ethical, legal and programming risks that need to be managed against a backdrop of declining public trust in large institutions.

Boards face two significant technology-related challenges. The first is balancing the demands of digital transformation with running day-to-day operations; the second is ensuring that the board is composed of the right people with the right competencies to navigate an era of technological change.
To address these challenges, boards should:

1. **Approach digitalization as a holistic issue**

   Today, the digital strategy of a company is in effect, its organizational strategy, since it requires all its people to change how they think and behave. The company may even need to cannibalize its own business as part of its reinvention process. Nevertheless, the use of disruptive technologies should not be an end in itself: intended outcomes should be clearly aligned with organizational goals and targets.

2. **Review the composition of the board**

   Board members need to have sufficient knowledge and experience to question the management on disruptive technologies. It may be appropriate to appoint a non-executive director who is specifically dedicated to digitalization.

3. **Establish governance structures**

   This gives the board visibility of how the company is both capturing the benefits and mitigating the risks associated with disruptive technologies. A C-level executive should have responsibility for executing the company’s digital strategy and report to the board on important emerging technological issues. Governance could be further boosted by having a dedicated technological committee or the appointment of a Chief Ethics Officer.

4. **Pay attention to emerging frameworks, policies and legislation**

   Awareness of the evolving regulations relating to the application of AI ensures that the company has the right balance between algorithmic transparency and accountability.

5. **Assess the likely impact of disruptive technologies, especially AI, on the workforce**

   The company’s strategic workforce plan should reflect how technology will affect existing roles and consider solutions for attracting and retaining people with specialized technological skills in future. Since AI tends to be associated with job losses, boards should be sensitive around how they communicate new technology rollouts within the company to avoid affecting morale and unsettling staff.

6. **Request an external review of the company’s “black box” (machine learning system).**

   A review can determine whether outputs from the system are as expected and assess whether proper controls exist to monitor the system as it evolves over time.

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**Five key questions for boards**

1. Is the board aware of the emerging disruptive technologies and how they are applied, both within the organization and externally?

2. Does the board understand why the organization has chosen to apply disruptive technologies to its own business and the risks these technologies pose?

3. Does the board include members with competent digital skills? If not, how will they be recruited?

4. What are the governance structures in place to manage ethical issues and address the challenge of AI algorithmic bias?

5. Has the board considered how disruptive technologies could impact the organization, in terms of the jobs, skillsets required and overall workplace experience?
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