Center for Board Matters

Audit Committee Bulletin

Issue 1, 2023

EY

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Welcome to the *Audit Committee Bulletin*, which brings you important information on corporate and financial reporting matters

In this issue:

Financial reporting considerations for audit committees in times of great disruption

With the increased challenges arising from macroeconomic events such as inflation and rising interest rates, geopolitical risks, climate change developments and the continuing effects of the COVID-19 pandemic disrupting markets and businesses, sufficient attention needs to be placed on their impact on the company's financial statements. Audit committees (ACs) play an important oversight role in ensuring that these events, trends and macroeconomic factors are adequately considered and appropriately disclosed in the financial statements where relevant.

The Accounting and Corporate Regulatory Authority (ACRA) has also emphasized the importance of these matters in its Financial Reporting Practice Guidance No. 1 of 2022 (the 2022 Practice Guidance) published on 4 November 2022. The 2022 Practice Guidance proposes areas of review focus for 2022 financial statements to guide directors and ACs in reviewing financial statements and highlights key areas where ACs should proactively engage external auditors to help enhance the quality of audits.

In this issue, we summarize and discuss relevant guidance for the ACs' consideration.

Christopher Wong
Singapore Head of Assurance
Ernst & Young LLP

Gajendran Vyapuri
Assurance Partner, Professional Practice
Ernst & Young LLP

Key events, trends and macroeconomic factors impacting 2022 year-end financial statements

As Singapore and the global economy recover from the damaging effects of the COVID-19 pandemic and adapt to the new normal, the year 2022 has seen major global events, trends and macroeconomic factors that have disrupted businesses and threatened to dampen the outlook and growth prospects for Singapore companies in 2023 and beyond. The confounding nature of these matters exacerbates the impact and uncertainties created.

These include geopolitical uncertainty and supply chain disruptions for energy, agriculture and metal commodities from the Russia-Ukraine war and ensuing international sanctions, record levels of inflation in both advanced and emerging economies, the consequential monetary tightening and sharp increase in market interest rate, downturn in global capital markets, volatilities in foreign exchange rates and commodity prices, and elevation in financial stress levels of companies due to rising costs of inputs and labor, funding costs and volatility in valuations.

The recent 2022 United Nations Climate Change Conference (COP27) has also highlighted that climate change is one of the most pressing issues of our time. Locally, the Singapore Green Plan 2023 was launched in February 2021, which aims to strengthen Singapore's commitment to sustainable development and achieve net-zero emissions by 2050. Climate transition risks, such as increasingly onerous carbon pricing schemes implemented in major economies and Singapore, can have significant financial impact on companies that are affected.

The disruptive forces of the events, trends and macroeconomic factors shown in Figure 1 are financially relevant to companies and could materially affect financial statements in areas such as asset costing, impairment risks, fair value accounting, provision for obligations, solvency or liquidity position, revenue recognition, and accounting for modification to contracts. The effects are wide-ranging and may be direct or indirect, depending on a company's facts and circumstances.

In this bulletin, we summarize and explain key financial reporting implications that could arise from these matters for ACs' consideration and discussion with management. They are consistent and complementary with the areas of review focus highlighted by the ACRA in its 2022 Practice Guidance, of which key points are summarized in Figure 2. In Figure 3, we present a summary of the ACRA's suggestions on key areas where ACs should proactively engage external auditors to enhance audit quality in these times of great disruption.

Figure 1

Key events, trends and macroeconomic factors that impact financial reporting

1 Elevated inflation, rising interest rates and impact on capital markets

2 Volatile commodity and energy prices, and supply chain challenges

3 Foreign currency fluctuations

4 Climate change and related risks and opportunities

5 Effects of the COVID-19 pandemic, including continued work-from-home arrangements

6 Geopolitical risks and general economic environment

Figure 2

ACRA's 2022 Practice Guidance: summary of areas of review focus for 2022 year-end financial statements[1]

Accounting impact from geopolitical uncertainties	▸ Provision for onerous contracts and obligations for compensation ▸ Net realizable value of inventories and treatment of unallocated overhead costs ▸ Impairment risks and indicators ▸ Expected credit loss measurement ▸ Assessment of the nature of relationship with investees
Accounting impact from macroeconomic uncertainties	▸ Impact of inflation and rising interest rate on inputs and discount rate used to estimate recoverable amount and fair value of assets ▸ Ability to service debt and interest obligations, and challenges in meeting debt covenants ▸ Impact on the assessment of the company's ability to continue as a going concern
Accounting impact from climate change movements	▸ Impact of carbon tax on bottom line from increase in costs of operations or production ▸ Impact from changing customers' preference toward sustainable products ▸ Economic feasibility of carbon intensive operation or business and potential restructuring needs or discontinuation ▸ Impact on impairment, valuation, estimated useful life and residual value of affected assets ▸ Provisions and contingent liability arising from climate commitments

1 For details, please refer to ACRA's *Financial Reporting Practice Guidance No. of 1 of 2022 (4 November 2022)*.

Figure 3

ACRA's 2022 Practice Guidance: summary of key areas where ACs should engage external auditors[1]

Risk assessment of company, including fraud risk	▸ Auditor's assessment of fraud risk and the planned audit procedures, evaluation of the company's selection and application of accounting policies, particularly those related to subjective measurements, and incorporating an element of unpredictability in the audit. ▸ Auditor's understanding and assessment of the entity's IT environment, including use of IT and relevant control activities, and the implications of remote working arrangements.
Multi-location audits of group companies	▸ Auditor's approach to discharging their responsibilities as group auditor, including the safeguards surrounding procedures performed remotely and challenges from travel restrictions. ▸ ACs' involvement in resolution of issues from component auditors' refusal to grant access to documents (or auditors' work papers) and enquiries on how the group auditor can discharge their responsibilities in circumstances of severe limitations.
Use of technology in audits	▸ Auditor's use of technology and data analytics to improve audit quality and the impediments to such use. ▸ Managing expectations on the level of assurance provided vis-à-vis the widened scope of audit testing and more in-depth analyses related to the use of technology and data analytics.
Ensure auditor's independence	▸ Audit firm's implementation and monitoring of compliance with revised independence rules[2], including financial independence and personal relationships between the auditor and the company's personnel, processes in place to seek pre-approval of provision of non-assurance services from those charged with governance, identifying independence violations (including regulatory violations), and ensuring that they are properly communicated to the ACs on a timely basis.
Increase transparency of audit inspection findings	▸ Request of Audit Quality Indicators (AQI) data from the auditor and in-depth discussions to assess the audit firm's commitment to audit quality, understand the root causes of reported inspection findings, the remediations taken to avoid recurrences, and the implications to the company's financial reporting and future audit approaches and procedures. ▸ How the auditor ensures that "offshored" or outsourced audit tasks are being appropriately performed and reviewed, and whether sufficient time is spent by the partners and managers during each audit phase to provide adequate oversight.

1 For details, please refer to ACRA's *Financial Reporting Practice Guidance No. of 1 of 2022 (4 November 2022)*.
2 For details on the revised rules, please refer to the *EY Audit Committee Bulletin* (Issue 4, 2022).

EY insights

Key events, trends and macroeconomic factors and their financial reporting implications

1

Elevated inflation, rising interest rates and impact on capital markets

- **Elevated inflation and rising interest rates can have multiple accounting and disclosures implications arising from their impacts on the following:**
  - Company's revenue growth rate, cost structures and profit margins (e.g., higher prices limit sales growth and/or if costs cannot be fully passed on to customers)
  - Volatility of the company's share price and market capitalization
  - Liquidity and counterparty risk exposures of the company
  - Discount rates (an increase due to higher costs of funds) used to incorporate adjustments for time value of money and uncertainties in accounting estimates
- **Asset impairment and estimates based on fair value:**
  - The rise in costs of inputs, expenditures and discount rates can:
    - Pose as indicators (or triggers) of impairment for non-financial tangible and intangible assets (and the cash-generating units (CGUs) they relate to), affect recoverability of deferred tax assets, and result in a significant increase in credit risk of receivables and guarantees.
    - Impact future financial performance and cash flows, prospective financial information and observable market prices. These in turn affect the accounting estimates of the recoverable amounts of assets and CGUs, net realizable value of inventories, amount of deferred tax assets recognized, calculation of expected credit loss and fair value measurements.
  - The heightened uncertainty may also warrant the use of multiple scenarios analyses (e.g., probability weighted expected cash flows) in the development of accounting estimates and affect the related disclosures made on key assumptions, estimation uncertainties and sensitivity analyses.
- **Accounting for liabilities, and contractual obligations and arrangements:**
  - The impact on costs of inputs and expenditures assumptions, and the higher discount rate can affect the recognition and measurement of provisions for obligations relating to reinstatement of lease premises, decommissioning costs, onerous contracts (i.e., where unavoidable costs of meeting the obligations exceed the economic benefits) and pensions, etc. They can also affect timing of revenue recognition where the measurement of progress toward completion of performance obligations depends on budgeted and incurred costs.
  - Companies are reminded to apply the amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* effective in 2022. The amendments require the assessment of unavoidable fulfilment costs when identifying onerous contracts to include all directly related costs, including those that are non-incremental, e.g., depreciation for equipment used.
  - Elevated interest rates also impact the measurement of lease liabilities at lease commencement, and the extent of significant financing component in revenue contracts with advance or extended payment terms.
  - There are also complex accounting requirements to be addressed in instances of contract modifications for customer contracts, leases, debt and derivative hedging instruments, and employee share-based payments arrangements, made in response to the changes in the economic environment.

- **Current and non-current classification of liabilities, use of the going concern assumption and interest rate hedges:**
  - Companies that are significantly leveraged and dependent on debt financing must critically evaluate the impact of rising interest cost and volatility in their share prices and asset values on their ability to: i) service debt and interest obligations; and ii) comply with relevant debt covenants (e.g., leverage, interest coverage and loan-to-value ratio requirements). These impact the current and non-current classification of loans, and the use of the going concern assumption in preparing financial statements.
  - More in-depth assessments, scenario analysis and consideration of how the combination of risk factors can impact the company's solvency may be required. They must also be adequately reflected in disclosures on the company's exposure and management of liquidity and interest rate risks, and any material uncertainty surrounding its ability to continue as a going concern.
  - Consequential changes in existing interest rate hedging strategies and/or elevated ineffectiveness of existing hedges would impact the hedge accounting applied by the company and earnings volatility.

Additional considerations

- Companies should also monitor **borrowing costs** directly attributable to the acquisition, construction or production of a qualifying asset that need to be capitalized as part of the asset's historical cost. The rise in borrowing costs may render previous treatments to expense such items on grounds of immateriality inappropriate in the circumstances.
- Companies with **foreign operations in emerging markets with very high inflation** should monitor the relevant inflation rates where they operate and determine if they have become **hyperinflationary**, which triggers the application of IAS 29 *Financial Reporting in Hyperinflationary Economies*, a complex accounting standard. It is notable that Turkey became hyperinflationary for IFRS reporting during 2022, and while Sri Lanka is not yet determined to be hyperinflationary, close monitoring is necessary[3].
- Companies that have or plan to capitalize on the emerging **crypto-assets and token funding markets** for investments or diversifying their funding sources must recognize and respond to the unique specific and systematic risks and volatilities involved, such as counterparty risks of crypto-exchanges, custodians and heightened fraud risks. There are also additional accounting and valuation challenges that require significant judgments due to the lack of dedicated accounting standards and the fact that it is still an emerging field[4].

3 The summary of countries that are hyperinflationary for IFRS purposes as at October 2022 and countries that should be monitored is available here.
4 Please refer to EY publication, *Applying IFRS - Accounting by holders of crypto assets* (updated October 2021), for related accounting guidance.

2

Volatile commodity and energy prices, and supply chain challenges

- The **higher cost base of assets** (such as inventories, property, plant and equipment and intangible assets) due to an increase in input costs of commodities will increase the impairment risk.
- As explained under the "Elevated inflation, rising interest rates and impacts on capital markets" section, companies also need to consider their **impact on key inputs** such as expected revenue growth, cost of sales and profit margins used to develop accounting estimates for asset impairment, provision for obligations, and measure of progress of revenue contracts, etc.
- As companies enter into more **hedging transactions using derivatives and long-term contracts** to manage price volatility, they will need to address earnings volatility and valuation requirements resulting from contracts that require application of fair value accounting as well as the complexities involved in any hedge accounting applied.
- Companies **exposed to price volatility** through related derivatives and sale and purchase contracts must also consider:
    - Liquidity implications from potential margin calls
    - Possible ineffectiveness in price hedges and related hedge accounting impacts
    - Increase in credit and market price risk adjustments in fair valuation of instruments
    - Treatment of "own-use" commodity contracts that can be net settled in cash but are no longer held for use and sale in the normal course of business
    - Updates to financial risks management disclosures for consequential material changes in commodity price risk exposures and management policies
- Where supply chain challenges and disruptions lead to significant delays in fulfilment of customers' orders, there could be provisions required to recognize any **obligation to pay damages for delayed or canceled deliveries** to customers.

- Any **unallocated overhead costs** arising from unusually low utilization of production facilities due to disruption to the supply of inputs should be expensed when incurred and not capitalized as costs of the inventories produced.
- Companies must also evaluate the implications to the **net realizable values of inventories** that have become slow-moving or obsolete as a result of these delays in order fulfillment.

3
Foreign currency fluctuations

- Changes in monetary policies by many governments to manage rising inflation have resulted in significant fluctuations in the exchange rates for major world currencies such as the US dollar, British pound and Japanese yen. These can impact the **reported earnings and equity of companies with significant foreign currencies exposure and foreign operations**, such as through:
  - Foreign exchange gains and losses on revaluation of monetary items (e.g., cash, receivables, payables and loans)
  - Gains and losses on remeasurement of non-monetary items that are measured at fair value (e.g., investment securities and properties)
  - Currency translation differences arising from foreign operations such as foreign subsidiaries and associates

These also have "knock-on" effects on the company's **ability to comply with debt or contractual covenants**.

- Future sales and purchases denominated in foreign currencies will affect **budgets and expectations on future profitability**. These have accounting and disclosures implications on accounting estimates such as recoverable amounts of assets similar to those discussed in the sections on "Elevated inflation, rising interest rates and impacts on capital markets" and "Volatile commodity and energy prices".

4

Climate change and related risks and opportunities

- There has been an **increase in stakeholders' focus on climate-related issues**, including the need for consistency between a company's climate and sustainability reporting and commitments, and the financial statements.
- The **financial reporting considerations for ACs related to climate change and the related risks and opportunities** are provided and discussed in the previous issue of the *Audit Committee Bulletin*[5], EY publication *Applying IFRS – Accounting for climate change*[6], and the technical bulletin on the topic issued by the Institute of Singapore Chartered Accountants (ISCA)[7]. Notable matters discussed include:
  - Changes in estimated useful life, residual value and decommissioning plans of assets
  - Estimating financial impact resulting from energy transition, decarbonization commitments and higher costs from carbon tax and pricing for asset impairment and expected credit loss calculations
  - Provision for environmental or emissions-related obligations, including potential constructive obligations arising from public commitments made
  - Classification and measurement of climate or sustainability factors-linked financial instruments
  - Disclosure considerations for material climate-related assumptions, estimates and judgments

Monitoring developments

Climate change and sustainability matters and the related reporting issues are evolving at a faster pace than before. It is critical that companies, particularly those in priority sectors such as energy, resources and agriculture, **closely monitor ongoing developments** on issues that are financially relevant and could impact the financial statements. These may include developments on:

- Sustainability and climate reporting requirements
- Environmental and emissions regulations
- Carbon tax and pricing
- Decarbonization strategies and commitments toward the use of renewable energy sources
- Green financing and investments

5 "Climate change – Financial reporting considerations for audit committees," *EY Audit Committee Bulletin*, Issue 2, 2022, © 2022 Ernst & Young LLP.
6 "Accounting for Climate Change (updated December 2022)", *Applying IFRS*, December 2022, © 2022 EYGM Limited
7 "Technical Bulletin 1 – Addressing Climate-Related Risks in Financial Statements and Audits of such Financial Statements", *ISCA Technical Bulletin*, 28 October 2022, © 2022 Institute of Singapore Chartered Accountants

5
Effects of the COVID-19 pandemic, including continued work-from-home arrangements

- The pandemic and its ongoing effects on businesses have impacted the operating and working models of companies to varying extents. They have also **changed how some companies use leasing arrangements** for offices and other premise of business.
- These trigger considerations relating to the **accounting and disclosures of lease assets and liabilities**, such as:
  - The impairment assessments and fair value estimates of right-of-use assets (ROUA), of which expected use and economics have changed or curtailed
- The application of lease modification accounting for restructured leasing arrangements
- The treatment of COVID-19 related rental rebates and concessions from lessors and, in some cases, government bodies

For further details on these and other **COVID-19 financial reporting considerations**, please refer to the relevant EY publications on Applying IFRS[8].

Safeguards needed

Companies must continue to exercise caution and implement **necessary safeguards against additional risks and complexities that work-from-home arrangements** can have on the company's accounting processes and system of internal accounting controls.

6
Geopolitical risks and general economic environment

- The **financial reporting considerations for ACs related to the Russia-Ukraine war**, the various ensuing international sanctions imposed on Russia and Belarus by many governments, including Singapore, and the related economic implications are discussed in the previous issue of the *Audit Committee Bulletin*[9] and the EY publication on *Applying IFRS – Accounting considerations for the war in Ukraine*[10]. Please refer to these publications for guidance.
- Companies should be mindful that the **uncertainty in the global and Singapore economic outlook in 2023 and beyond** could be further impacted by additional factors such as the extent and duration of the anticipated global economic recession, and developments in geopolitics and international relations between advanced economies (e.g., US and key European nations), China and Russia that have serious implications for international trade and capital markets.

The planned increase in Singapore's Goods and Services Tax (GST) in 2023 and 2024, and upcoming developments in the fiscal and taxation policies of many countries (including Singapore) in response to their agreement to the OECD/G20 BEPS 2.0[11] also pose challenges and impetus to future business changes. These add uncertainty and could affect expectations about a company's future financial performance and cash flows, which are inputs to the various accounting estimates and disclosures discussed in this bulletin.

8 EY publications on Applying IFRS: *Accounting considerations of the coronavirus pandemic (Updated April 2021)*; *Disclosure of COVID-19 impact; Impact of coronavirus on APMs and disclosures*; *Accounting for COVID-19 related rent concessions (Updated June 2022)*; and *Impairment considerations for lessees that plan to reduce their real estate.*

9 "Accounting and financial reporting implications of the military conflict in Ukraine", *EY Audit Committee Bulletin*, Issue 3, 2022, © 2022 Ernst & Young LLP

10 "Accounting considerations for the war in Ukraine (updated March 2022)", *Applying IFRS*, March 2022, © 2022 EYGM Limited

11 The Organisation for Economic Co-operation and Development (OECD)/Group of 20 nations (G20) Inclusive Framework on Base erosion and profit shifting Pillars 1 and 2 (BEPS 2.0)

Concluding remarks

While the financial reporting considerations shared in this bulletin can help AC members in their engagement with the management and auditors, they are not intended to be exhaustive and comprehensive as these considerations are continuously evolving. There could be additional considerations depending on the unique facts and circumstances of each company.

The multiple and confounding nature of events, trends and macroeconomic factors disrupting businesses will give rise to heightened uncertainty, which can pose significant challenges in reliably estimating future cash flow forecast, based on which many accounting estimates are developed. The management will need to set aside adequate time and resources to tackle these challenges ahead of reporting timelines. Accordingly, AC members, in their discussions with the management, should seek a good understanding of the complex accounting and financial reporting areas affecting the upcoming financial statements and how the management plans to address them.

ACs, boards and management must also exercise due care to ensure that the financial reporting considerations and judgments are made consistently and robustly across financial statements items, based on current and reliable internal and external information, and incorporate assistance from independent experts where necessary in complex areas such as determining fair values and recoverable amounts of assets.

Last but not least, the more the uncertainties, the more information users of financial statements would need to understand the impact of these matters on the financial statements. It is imperative that disclosures surrounding the key judgments applied, the estimation uncertainties surrounding key assumptions, inputs and related sensitivity analyses are augmented to be commensurate with the magnitude of the business disruptions and heightened level of risks and uncertainties at the reporting date.

Contact us

If you would like to know more about EY Assurance services, please contact:

Christopher Wong
Singapore Head of Assurance
+65 6309 6935
christopher.wong@sg.ey.com

Gajendran Vyapuri
Assurance Partner - Professional Practice Director
+65 6309 6075
gajendran.vyapuri@sg.ey.com

Contacts

Consumer Products and Retail
Terry Wee
+65 6309 6013
terry.wee@sg.ey.com

Emerging and Private Enterprise
Sam Lo
+65 6309 8093
sam.lo@sg.ey.com

Financial Services
Wilson Woo
+65 6309 6750
wilson.woo@sg.ey.com

Health Care, Public Sector and Manufacturing
Adrian Koh
+65 6309 6275
adrian.koh@sg.ey.com

Real Estate, Hospitality and Construction
Nelson Chen
+65 6309 6974
nelson.chen@sg.ey.com

Resources and Transportation
Jonathan Tan
+65 6309 6148
jonathan.tan@sg.ey.com

Technology, Media and Telecommunication
Chan Yew Kiang
+65 6309 6564
yew-kiang.chan@sg.ey.com

Climate Change and Sustainability Services
Simon Yeo
+65 6309 6845
simon.yeo@sg.ey.com

The Singapore Assurance Partners listed above are from Ernst & Young LLP.

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APAC No. 12003081
ED None.

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