Transforming Financial Reporting – For Better or For Worse?

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Financial reporting has transformed in the last two decades, as accounting standards have evolved to meet the demands of a global economy. But have the changes been for the better?

Financial statements based on sound financial standards are meant to inform investors, industry and regulators. The accounting standards are meant to ensure the relevance, consistency and reliability of financial statements, and improve the comparability of financial reports across companies.

Two decades ago, financial statements were relatively easy to read and understand. Today, even accountants have difficulty understanding them.

Take OCBC Bank, one of Singapore's largest banks, for instance. For financial year (FY) 2002, its financial statements "prepared under the historical cost convention, modified by the revaluation of certain treasury instruments to market value" were a modest 71 pages.

Fast forward to FY 2018, and OCBC's financial statements report has nearly doubled to 135 pages. More worrying than the growing paper bulk of the statements is the density of the content, which will leave many readers in a tizzy. Consider that the "Summary of Significant Accounting Policies" in OCBC's financial statements has ballooned from less than four pages in 2002 to a staggering 23 pages in 2018.

Changing accounting standards

The sheer amount and speed of change in the business and regulatory environment over the years have exacerbated the increasing complexity of accounting standards.

Singapore Financial Reporting Standards (International) or SFRS(I), the accounting standard for listed companies issued by the Accounting Standards Council, currently comprise 41 Standards, 20 Interpretations, 14 Implementation Guidance and 29 Illustrative Examples.

These standards and their documents are not static. They are continually evolving. Even before a revised accounting standard is issued, numerous amendments would have been introduced to existing standards.

SFRS(I) 9 Financial Instruments, for example, has its beginnings in 1986 as International Accounting Standard (IAS) 25 Accounting for Investments. In 1998, it became IAS 39, then International Financial Reporting Standard (IFRS) 9 in 2009. The latest amendment involves the reclassification of financial assets from four categories (financial assets at fair value through profit or loss, held-to-maturity investments, loans and receivables, available-for-sale financial assets) to three categories (fair value through profit or loss, amortised cost, fair value through other comprehensive income), and the introduction of the Expected Credit Loss model for impairments.

In another example, SFRS(I) 16 Leases, was first published as IAS 17 Leases in 2003. Leases were then classified as either finance or operating leases. In 2019, this distinction was removed. All leases are now recognised by the lessee as assets and liabilities, as opposed to being able to expense off lease payments if it is an operating lease under the old standard.

The prize for the most significant and complex change must go to the mandating of fair value accounting in Singapore in 2003. It is a concept which started without too much fanfare then but has since grown so complex that it challenges even trained accountants. The ramifications of fair value accounting have been previously covered in this column (See "Bring Back Conservatism" by Willie Cheng in the Q2 2019 issue of *Directors Bulletin*).

Confidence in financial statements

While the range and complexity of accounting standards and their application may be hard to comprehend, the irony is that the diligent reader that does understand the financial statement may end up losing confidence on its reliability in portraying reality.

One reason is that many of the standards require estimates and judgement calls to be made that can be wide off the mark, even when done in good faith.

This is especially so in fair value accounting. Over time, a myriad of methods to apply fair value have been experimented. The latest three-level framework in SFRS(I) 13 Fair Value Measurement allows management to game the numbers with Level 2 (Indirectly Observable) and Level 3 (Not Observable) inputs.

The second reason is that the standards may not be accurate despite all the hard work put into setting and refining them.

For example, the Hyflux saga exposed an inadequacy in SFRS(I) 1-32. The company raised S$400 million from perpetual preference shares in 2011 and S$475 million in perpetual capital securities in 2014. These instruments paid dividends and would ordinarily be classified as financial liabilities. However, the instruments gave the company the right to defer the cash payment indefinitely and thus could be classified as equity under SFRS(I) 1-32. If Hyflux had to reflect the nearly S$270 million dividends paid between 2011 and 2017 as "interest", the reported pre-tax profit of S$156 million for that period would have turned into a loss of S$113.7 million.

It is hard to ask the layman to have faith in the accuracy of financial statements when "true and fair" actually relates to the prevailing accounting standards, which change from year to year. In fact, the accounting standards did change in a major way in 2018 when listed companies had to transition from FRS to SFRS(I). (See "'True and Fair' in Times of Change" by Gerard Tan, in the Q1 2019 issue of *Directors Bulletin*).

Resetting standards

To be fair, accounting standards are being developed and changed in response to the rapidly changing business needs. However, it is simply impossible to establish rules for every conceivable product, service and business transaction type.

It is time for the accounting profession to hit the reset button and go back to basics.

The industry has to take a good, hard look at those standards which are overly complex, and single out those which allow for gaming of the system. Companies should not be able to hide behind the complex web of rules. Financial statements should be, as far as possible, easily understandable, with notes to financial statements written in plain English. ■