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MANAGING PARTNER'S MESSAGE

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In the recent Global Competitiveness Report by the World Economic Forum, Singapore retains its place as the world's second-most competitive economy for the fifth year running. This is a testament to our government, businesses and trade associations to ensure economic efficiency and stability amidst concerns over rising costs, tighter labour policies and slowing growth.

Yet, every day we are reminded of the fragile balance of our society and economy as the regional and global stability is challenged again and again. It has been a rough quarter with China's stock market panic, oil prices slumbering, the ringgit's value plummeting, migrant crises, natural disasters and many other disheartening headlines. Singapore's economy has been affected too as the manufacturing sector contracts and exports declines for consecutive months.

I am confident that Singapore is in the right track toward recovery and prosperity. The announcement of the new Cabinet line-up shows that the Government is putting the right emphasis on economic development. The expansion of the Trade and Industry Ministry and the appointment of many experienced hands echo an understanding of the increasing complexity of economic planning.

This quarter's issue of BDO Connect features many useful articles on the new reporting standards, Singapore's tax incentives as well as the risks businesses may face in the increasingly technological world. We hope you have an enjoyable time reading this issue!

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What is hedge accounting? Why importers might choose to apply hedge accounting

The new financial instrument standard, IFRS 9/FRS 109 *Financial Instruments*, significantly changes the rules for applying hedge accounting. These revised rules make hedge accounting far more achievable than is the case under the current rules.

In this article we look at:

- What is hedge accounting
- Why do entities that are importers want to apply hedge accounting and
- How effectiveness testing is much simpler under IFRS 9/FRS 109.

What is hedge accounting and why do importers want to apply hedge accounting?

The basic premise of IAS/FRS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9/FRS 109 is that all derivatives must be recorded at fair value at each reporting date.

Where an importer purchases inventories priced in foreign currencies, and takes out a forward contract to lock in the foreign currency purchase price, if it **does not apply hedge accounting**:

- The movement in the fair value of the derivative is recognised immediately in profit or loss
- On delivery, inventory is recorded at the spot price paid for the purchases designated in foreign currencies.

If the importer **does apply hedge accounting**:

- The movement in the fair value of the derivative is recognised in other comprehensive income until the derivative is settled
- On delivery, inventory is recorded at the spot price paid for the purchases designated in foreign currencies
- Any balance in other comprehensive income is recognised as part of the cost of the inventory, which means that inventory is recorded at the rate locked in by the forward contract.

Example

1 October 2014

Entity A is an importer of goods. It enters into a contract to purchase goods from an overseas supplier. The goods will be delivered in six months' time and USD 500,000 is payable on delivery.

Entity A does not wish to be exposed to changes in the USD exchange rate. On 1 October 2014, it takes out a forward contract to purchase USD 500,000 in six months' time, at an exchange rate of USD 0.75/CU 1 (CU refers to local currency).

Note: Economic risk management aims to lock in the purchase price for the goods at CU 666,667 (USD 500,000/0.75).

31 December 2014

The forward rate is USD 0.70/CU 1.

The derivative is now an asset worth CU 47,619 [(USD 500,000/0.70)-(USD 500,000/0.75)], representing the gain the holder of the derivative will make by buying US dollars at USD 0.75/CU 1 compared with the market forward price of USD 0.70/CU 1.

Fair value movement of derivative from 1 October 2014 to 31 December 2014 is CU 47,619 [(USD 500,000/0.70)-(USD 500,000/0.75)].

For simplicity, we have ignored the effect of time value of money and any credit/debit value adjustments.

No hedge accounting

The journal entry if hedge accounting is **not applied** is as follows:

	DR	CR
DR Derivative asset	CU 47,619	
CR Profit or loss		CU 47,619

31 March 2015

If the USD/CU exchange rate remains at USD 0.70/CU 1 when the goods are delivered on 31 March 2015, then the journal entries will be:

	DR	CR
DR Inventory	CU 714,286	
CR Cash (USD 500,000/0.70)		CU 714,286

To recognise inventory and cash paid at the USD/CU spot rate at 31 March 2015.

	DR	CR
DR Cash	CU 47,619	
CR Derivative asset		CU 47,619

To derecognise the derivative asset and recognise cash when the derivative is settled.

The impact on the income statement when there is no hedge accounting is as follows:

	2014	2015
Gain/loss from derivatives	CU 47,619	-
Profit or loss	**CU 47,619**	-

The impact on the balance sheet when there is no hedge accounting is:

	2014	2015
Inventory	-	**CU 714,286**

This obviously does not reflect the economic hedge objective which was to protect Entity A from price volatility on known purchases. The carrying amount of the inventory does not reflect the economic risk management to lock in the purchase price at CU 666,667.

Hedge accounting

In order to record the hedging effect on the price of inventory, Entity A would have to apply hedge accounting. While still following the basic requirement that all derivatives must be recorded at fair value at each reporting date, for 'cash flow' hedges, hedge accounting allows any gain or loss on the derivative to be deferred by making an entry into equity (other comprehensive income (OCI)).

The journal entry at 31 December 2014 if hedge accounting is applied is as follows:

	DR	CR
DR Derivative asset	CU 47,619	
CR Hedge reserve (OCI)		CU 47,619

To recognise the derivative at fair value and the changes in equity (OCI).

When the goods are delivered and paid for on 31 March 2015, the journal entries are:

	DR	CR
DR Inventory	CU 714,286	
CR Cash (USD 500,000/0.70)		CU 714,286

To recognise inventory and cash paid at the spot rate at 31 March 2015.

	DR	CR
DR Cash	CU 47,619	
CR Derivative asset		CU 47,619

To derecognise the derivative asset and recognise cash as the derivative is closed out.

	DR	CR
DR Hedge reserve (OCI)	CU 47,619	
CR Inventory		CU 47,619

To reclassify the gain in OCI to inventory.

The impact on the statement of profit or loss and other comprehensive income when hedge accounting is applied is as follows:

	2014	2015
Gain/loss from derivatives	-	-
Profit or loss	-	-
Equity (OCI)	**CU 47,619**	**(CU 47,619)**

The impact on the balance sheet when there is hedge accounting is applied:

	2014	2015
Inventory	**-**	**CU 666,667**

(Note: This example assumes all the hedge effectiveness criteria are met and the hedge is 100 per cent effective.)

When the hedging transaction is recorded, the hedging gain or loss is reclassified from OCI against that hedged item (i.e. inventory). This results in the carrying amount of inventory being recorded at CU 666,667, reflecting the aim of economic risk management which is to lock in the purchase price at CU 666,667.

Effectiveness testing is much simpler under IFRS 9/FRS 109

Hedge accounting under IAS/FRS 39 is very difficult, with numerous rules laid out as to the criteria that entities must satisfy in order to qualify for hedge accounting. One of the most troublesome criteria that has prevented entities from applying hedge accounting under IAS/FRS 39 is the strict 80-125 per cent hedge effectiveness test.

IAS/FRS 39 contains very strict rules around hedge effectiveness in terms of requiring both:

- A hedging relationship to sit within an 80-

125 per cent effectiveness band, and

- Very strict rules as to how effectiveness will be calculated (which includes the mandatory requirement to perform both forward and backward looking mathematical effectiveness tests).

Effectiveness testing under IFRS 9/FRS 109

The new standard, IFRS 9/FRS 109, has simplified the hedge effectiveness testing criteria and has removed the 80-125 per cent highly effective threshold, as well as the mandatory requirement to perform forward and backward looking mathematical effectiveness tests.

Under IFRS 9/FRS 109, if derivatives are entered into for the same quantity, timing and pricing index as the forecast sales or purchases (i.e. the '**critical terms match**'), it may be sufficient to only carry out a forward looking qualitative test, without the need to perform any further mathematical calculations.

Example

Entity B has forecast purchases of USD 1million in six months' time. It does not wish to be exposed to changes in the USD exchange rate so it enters into a foreign exchange forward contract to purchase USD 1million in six months' time. Assume that credit risk is not expected to deteriorate significantly.

Effectiveness testing is satisfied by the 'critical terms match' test. The critical terms of the hedged item, being the forecast purchases, matches the critical terms of the derivative, i.e.:

- Same quantity – USD 1million
- Same underlying risk – USD/CU exchange rate
- Timing match - settlement date of the contract matches the timing of the purchases in USD.

Effective date and early adoption

Although IFRS 9/FRS 109 does not come into effect until 1 January 2018, it can be early adopted.

For more information:

If you would like more information, BDO has a range of publications on IFRS 9, including the latest ***IFRS in Practice 2016 IFRS 9*** **at** [BDO International | IFRS in Practice]

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Helping Singapore SMEs to grow roots and wings

Small and medium-sized enterprises ("SMEs") play a pivotal role in contributing to the economic growth of Singapore. Taking cognizance of this, the Singapore Government has continued to place strong emphasis on the development of the SME sector to ensure that they are able to achieve momentous growth and compete effectively in the domestic and international arena.

It came as no surprise that the SMEs were yet again, one of the main beneficiaries of Singapore's Budget 2015. The introduction of the new International Growth Scheme was amongst the slew of tax incentives (together with other non-tax incentives) to encourage SMEs to grow and venture beyond Singapore's comfortable but limited domestic economy.

International Growth Scheme ("IGS")

Why?

The IGS made its debut in Singapore's Budget 2015 and was introduced with the aim of helping Singapore build a pipeline of new globally competitive companies to diversify its economic landscape. The IGS is targeted at Singapore companies with high growth potential to support them in their internationalisation efforts, whilst anchoring their key business activities and headquarters in Singapore.

What?

Companies that are awarded with the IGS incentive will enjoy a 10% concessionary tax rate for a period not exceeding 5 years on their qualifying incremental income from qualifying activities, in excess of a base income. The base income and income from its non-qualifying activities will be taxed at the prevailing corporate tax rate of 17%.

It was recently clarified by the International Enterprise Singapore ("IES"), also the appointed government agency to administer the IGS, that qualifying activities refer to commercial activities that are aligned with the company's international growth plan. Qualifying activities are such as:

- Agricultural and aqua cultural technology services and activities
- Business services and activities (including consultancy, management, marketing, publishing)
- Consumer related services and activities (including retail and wholesale)
- Education and related services and activities (including schools, training centres)
- Engineering and technical services and activities (including laboratory, consultancy and research and development)
- Entertainment, leisure, recreation and tourism related services and activities (including conferences, exhibitions and hospitality)
- Headquarter services and activities
- Industrial design development, production, services and activities (including precision engineering)
- Environmental services and activities
- Infrastructure services and activities
- Financial services and activities
- Healthcare related services and activities (including pharmaceutical, veterinary, medical and wellness)
- International trade services and activities
- Industrial related services and activities (including retail and wholesale)
- Information and communications services

and activities (including internet, data centres, and e-commerce)

- Manufacturing and related services and activities (including tooling and assembly)
- Professional services and activities (including accounting and legal services)
- Rental and leasing services and activities
- Transport and logistics services and activities (including air, land and sea)

The list above is not exhaustive and any activities that are not listed above may still be considered by the IES on a case-by-case basis.

As mentioned above, the concessionary tax rate would only apply to the qualifying incremental income from qualifying activities, in excess of a base income. It was also clarified that the base income would be ascertained in the following manner:

- In the case of a company which had at any time during the period of 3 years immediately before the date of its approval, carried out one or more of the qualifying activities, the base income would be the average annual net profit before tax (as shown in the company's audited accounts) derived from the carrying on of the qualifying activities during that said period; and
- In the case of a company which had not carried out any of those qualifying activities during the period of 3 years immediately before the date of its approval, the base income would be zero.

Who?

To be eligible for the IGS incentive, the company must at the very least, fulfil the following conditions:

i. Must be incorporated and resident in Singapore;

ii. Must have its global headquarter based in Singapore

iii. Must have an established track record with international presence;

iv. Must have a sound and ambitious internationalisation growth plan; and

v. Must be able to create economic spin-offs for Singapore such as creating job opportunities for Singaporeans to gain greater international exposure and helping other non-related Singapore companies secure projects overseas.

The IES may impose additional considerations on a case-by-case basis.

When?

The approval window for interested applicants would be from 1 April 2015 to 31 March 2020 (both dates inclusive).

All in all, it appears that the regulatory authorities have heeded the SME sector's call not to make the qualifying conditions too onerous or prescriptive such that it would undermine the efficacy of the new scheme and preclude deserving SMEs from qualifying for the said scheme.

Breaking into new markets overseas takes time and businesses typically require a gestation period to become operationally profitable. Whilst the option to extend the 5-year incentive period does not appear to be available at this juncture, it is hoped that the option would become available to the IGS companies before the expiry of the incentive to give them a longer runway to benefit from the scheme.

In tandem with other tax incentives and initiatives by the Government (e.g. increased funding support), it is hoped that the IGS will give Singapore SMEs sufficient courage to take the leap of faith and go international!

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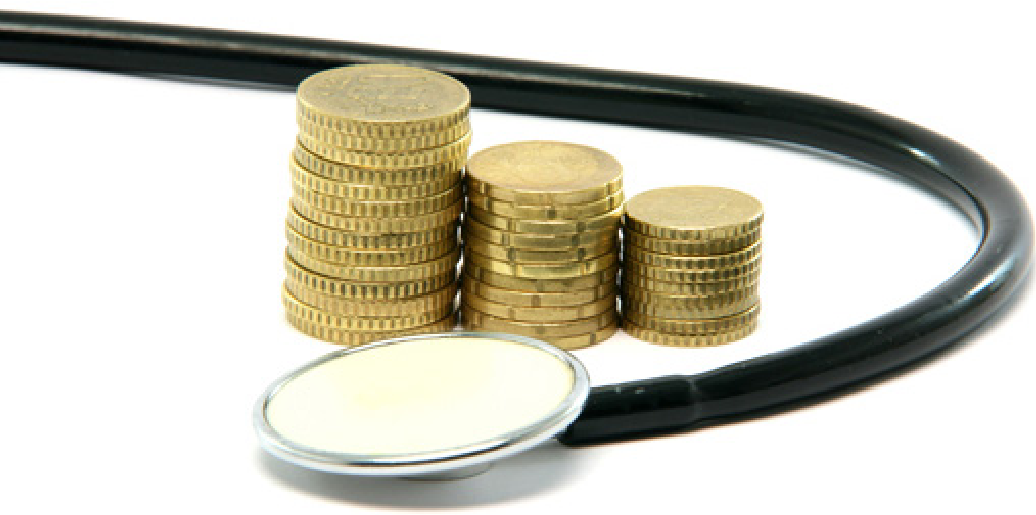
How ratio analysis can help in understanding the financial health of a company

When it comes to understanding a company's financial health, analysing the quantitative numbers in the financial statements is one of or perhaps the most important aspect of the process. However, the sheer amount of numbers within the financial statements can often be overwhelming for many. Analysis might as a result end up disorganised and less useful for the decision-making process. This is where ratios can come in to assist and structure the analysis process.

What are ratios and why should it be used?

While ratios maybe somewhat unfamiliar to many, financial ratio analysis is neither too technical nor complicated. Ratios are simply the comparison of the relative size and relationship between two numbers. In fact, ratios are commonly analysed in the business world. For example, profit margin is a ratio of profit before tax to revenue that measures how much profit before tax is made for every dollar of revenue generated.

One aspect that ratios can really facilitate is the understanding of the relative changes between two numbers. While it is easy to understand when the two numbers move in the opposite directions (i.e. one increases and the other decreases), it is not so in the case whereby both numbers move in the same direction. Take for example, a company that has assets of $80 in 20X1 and $100 in 20X1; liabilities of $40 in 20X1 and $50 in 20X2. By purely comparing the increases, the increment in assets of $20 is more significant than the increment in liabilities of $10. This should mean that the company has better ability to meet the financial obligations when they fall due and financially healthier as a result. However, the utilisation of ratios as a means of comparison would reveal that the proportion of liabilities to



assets remained at 50% and did not vary in both years. Therefore, ratios can paint a completely different picture and allow for a more accurate understanding of the company's financial health than just a simple comparison of numbers or of their increment.

Conclusion

Though it is easy to compute since it is the division of two numbers, picking the appropriate numbers to compare is of utmost importance to ensure that the ratio makes sense. The general principle to the selection of the numbers is to ensure that the two numbers have direct causation between the two. For example, comparing marketing cost and utilities may not be that relevant as increasing marketing activities, and hence its cost, would not directly increase utilities. Comparing profit after tax to equity (return on equity) is more useful to understand how much profit the company is able to generate per dollar of equity invested. If this sounds overly complex, one can cut through the clutter and utilise some more commonly used ratios that would be sufficient to analyse the company's financial health.

Lastly, ratios provides little information of the company's performance unless it is compared with something else. What does it mean when liabilities to assets ratio is 50%, besides knowing that the company's assets is half funded by liabilities? Therefore, there is a need to benchmark the ratios to that of fellow industrial peers in order to understand how well the company is ran in comparison to fellow competitors.

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Technological risk & cyber security: protection, intervention, challenges, damages & scorecard

As information technology (IT) becomes an integral part to gain a competitive edge, companies are operating in an increasingly complex digital environment. Organisations rely on IT, yet the trust they place in IT is constantly challenged by data leakage, system weakness, fraud and corruption. This article aim to provide an introduction to several concepts and definitions of IT-related threats and counter measures.

Technological risks are threats that are inherent from the technology itself, created internally due to negligence or complacency, attracted from external sources, environmental disasters such as floods, and in some cases due to employees who are not empowered with knowledge in cyber security.

Cyber Security refers to the assets that are related to information technology and the security measures used to protect them. Cyber security covers a wide spectrum and could include but not limited to the following:

- Application Security: Distribution, installation and privilege to execute applications.
- Database Security: Rights to access the data stored in a database or the reports generated.
- Appliance Security: Firewall, proxy, VPN, wireless access points, etc.
- End Point Security: Log in accounts for laptops, desktop, mobile devices, etc.
- Facility Security: Access to facilities such as server room, data centres, server cabinets, etc.
- Physical Security: NAS, SAN, server, tablets, portable hard disk, USB keys, UPS, etc.
- Backup Security: On-time and complete system backup with the added assurance to restore.
- Disposal Security: Storage, transport, destruction of information carrying media.

Security bears the risk of being compromised due to defects in technology such as software bugs, physical locations, system backdoors, hacking, malicious attacks, spoofing; and human negligence, ignorance and complacency.

Protection is the process of assessing the risk profile of the IT assets and the formulation of a set of security measures to prevent the risks identified from being exploited. It involves a set of framework, processes, hardware, software, techniques and practises deployed to patch, fix and protect systems, data and services. The objective is to prevent IT assets from unauthorized access, accidental damages and even technology obsolescent.

The protection process begin with an IT audit, followed by a project to scope and plan for the remediation of the risks identified by the audit process. The remediation process involves the application of upgrades, patches, hotfixes, firmware, closing up of firewall ports and turning off un-used server services. The project will complete with a Penetration Test to ensure that the new security measures put in place are effective and according to the scope of the project.

Intervention usually occurs after a security incident which is defined as the event when a security system is compromised. The objective is identify the IT assets affected, contain the damages and evaluate the losses. Computer Forensic technology is usually deployed to identify the sources and events leading to the incident. Electronic Discovery techniques will then be utilized to assess the extent of the losses and damages. The evidence collected will be organized and stored for presentation should there be a legal engagements, or for the purpose of supporting the reformulation of the security measures for further hardening of the systems.

Challenges in cyber security faced by the CEO, COO and CFO of SMEs are the lack of an internal IT team with the technical skillset for an end to end engagement of such projects from IT audit all the way to the completion of the penetration test. SMEs also face difficulties in training their employees on cyber security awareness and how their daily work could expose their systems to higher risks

Financial impact of breaches in cyber security is usually high with the least expensive total cost for a company reported at USD750,000. Training and awareness programs are reported as having a positive effect on employees' sensitivity and awareness about the protection of information.

Training & Awareness program is the starting point to engage cyber security so that employees are made aware of their roles in protecting IT assets. An IT audit should follow so that the employees who are trained can assist to identify the risks and help in the remediation process.

A cyber security balance scorecard maps the security program with a focus on the customer or stakeholder while emphasizing competitive advantage and operational efficiency. This is one path to strategically achieve information security excellence with a management objective in mind.

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CYBER SECURITY SCORECARD

The Future of Budget Accommodation

All eyes are on Asia when it comes to tourism growth and opportunities. In 2013, Asia Pacific recorded the highest relative growth rates, of which the SEA region saw phenomenon growth with a 10.5% increase in international tourist arrival of 93.1 million and USD 107.4 billion worth of international tourism receipts.

With rising disposable consumer income amongst Asia Pacific consumers, particularly in emerging economies such as Indonesia and Malaysia, more are choosing to travel within the region, taking more frequent but shorter trips to destinations nearer to home.

Coupled with a growing preference for budget flight carriers and accommodation options to sustain traveling habits, this has stimulated rapid growth in the budget end of the travel scale.

BDO conducted a study from the Asia Pacific region to better understand consumer preferences and behavior towards the growing trend of budget accommodation in Asia Pacific.

To view the full report, it is now available on BDO Singapore website.

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