accounting alert

2006-01: January 12, 2006

Recent Releases on Financial Reporting

The Accounting Standards Council (ASC), the Securities and Exchange Commission (SEC) and the Bureau of Internal Revenue (BIR) have recently released certain requirements and proposed guidance that would have accounting implications on financial statements (FS) for the year ended December 31, 2005 and future periods. These included the following:

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a.	ASC Philippine Accounting Standard (PAS) 101, *Financial Reporting Standards for Non-publicly Accountable Entities* and SEC Memorandum Circular No. 8, Series of 2005, *Adoption of Philippine Accounting Standards*	1
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A. ASC PAS 101, *FINANCIAL REPORTING STANDARDS FOR NON-PUBLICLY ACCOUNTABLE ENTITIES* AND SEC MEMORANDUM CIRCULAR NO. 8, SERIES OF 2005, *ADOPTION OF PHILIPPINE ACCOUNTING STANDARDS*

The ASC has recently approved PAS 101 which gives non-publicly accountable entities (NPAEs) an option **not to apply all or some** of the new PASs and Philippine Financial Reporting Standards (PFRSs) that became effective in 2005. An NPAE that takes such option shall apply PAS 101 for annual periods beginning on or after January 1, 2005. PAS 101 shall be effective for 2005 to 2007 unless revoked earlier.

On December 27, 2005, SEC Memorandum Circular No. 8, Series of 2005, was issued adopting PAS 101 as part of SEC's rules and regulations.

As a general requirement, for FS for periods beginning January 1, 2005, all reporting entities that prepare annual FS in conformity with generally accepted accounting principles in the Philippines shall apply all accounting standards that are effective for those periods. According to ASC, due to the significant number of small and medium-sized entities in the Philippines and the plan of the international standard-setters to undertake a project to develop accounting standards suitable for entities that do not have public accountability, the ASC has decided to give temporary relief to NPAEs.

Important Provisions of PAS 101

Qualifying entities

The temporary relief under PAS 101 is given to entities that qualify as NPAEs. For purposes of PAS 101, an NPAE is an entity **other than the following entities** which are considered to have public accountability:

1. entities required to file FS under SEC Rule 68.1, which include the following:

    a. an issuer which has sold a class of its securities pursuant to a registration under Section 12 of the SRC,

    b. an issuer with listed securities, and

    c. an issuer with assets of at least P50 million and have 200 or more stockholders each holding at least 100 shares of a class of its equity securities;

2. an entity in the process of filing its FS for the purpose of issuing any class of instruments in a public market;

3. an entity that holds assets in a fiduciary capacity for a broad group of outsiders (e.g., a bank, an investment house, a finance company, an insurance company, a securities broker/dealer, a mutual fund and a pre-need company);

4. an entity that is a public utility or similar entity that provides an essential public service;

5. an entity that is economically significant [For this purpose, an entity is considered economically significant if it meets any of these two attributes: (a) total assets of more than P250 million, or (b) total liabilities of more than P150 million, based on consolidated totals, if applicable. These criteria will be reviewed by the ASC when the final international standard on NPAEs is issued, or earlier if necessary]; or

6. an entity that is considered by its primary regulator to have public accountability.

For purposes of PAS 101, an entity that is a subsidiary of a parent that is considered to have public accountability is similarly considered to have public accountability.

Options available to NPAEs

As mentioned earlier, an NPAE has the option not to apply all of the new standards that became effective in 2005 in its general purpose FS for the year ended December 31, 2005. NPAEs that choose to avail of this option shall apply the applicable financial reporting standards **effective as of December 31, 2004** in preparing its general purpose FS for 2005. A list of these standards is presented in the **Attachment** to this Accounting Alert.

On the other hand, an NPAE may opt to apply all or some of the relevant new standards.

Required disclosure

An entity that qualifies as an NPAE shall disclose the basis of preparation of its FS and the specific accounting policies used.

Management Consideration

The management of an entity is responsible for determining whether it qualifies as an NPAE based on the guidance provided under PAS 101. If the entity qualifies as an NPAE, its management should make a decision on what GAAP to apply in preparing the entity's 2005 FS, specifically whether it shall:

- **apply all** the relevant new accounting standards that are effective beginning January 1, 2005,

- avail of the option **not to apply any** of the new accounting standards, hence, it shall apply the standards that are effective as of December 31, 2004 (see **Attachment**), or

- avail of the option to **apply some** of the new accounting standards, in which case, it should determine which of the standards to apply.

An entity's decision to apply all the relevant new accounting standards that are effective in 2005, even if the entity qualifies as an NPAE, may be the better option to take in certain cases, such as:

- the entity has no complex transactions that would need detailed analysis before the new standards can be applied,

- based on management's initial assessment, the implementation of the relevant new accounting standards would not entail undue hardships or too much cost to the company,

- the company qualifies as an NPAE because it meets one of the attributes for an "economically significant entity" (in which case, its status may change in the succeeding year, i.e., its total assets or total liabilities may increase beyond the prescribed benchmark, hence, the entity may no longer qualify as an NPAE in such future date and, accordingly, will be required to adopt all the relevant standards, most requiring retroactive application); and

- the entity is a unit of a multinational group that is required to prepare financial reporting packages or reconciliation schedules (from local GAAP to IASs/IFRSs) for submission to the head office and its external auditors.

Also, it should be noted that many of the accounting standards that became effective in 2005 are revisions of previous ones. If an NPAE plans not to apply those revised versions, it needs to apply the older versions. Proper evaluation should be made of this seemingly odd situation. An NPAE may also need to consider the comparability of its FS with those of its competitors or peer groups.

Management should make a careful consideration of available options and should document the basis of the option taken. This information (i.e., the basis of the preparation of the FS and the specific accounting policies used) is required to be disclosed in the FS.

B. SEC NOTICE OF AMENDMENTS TO SRC RULES 68 AND 68.1

On November 11, 2005, the SEC issued its Notice of Amendments to SRC Rule 68 and SRC Rule 68.1. The amended SRC Rules 68 and 68.1 are effective for audited annual FS covering periods ending on or after December 31, 2005 and for interim FS starting the first quarter of 2006. A copy of the amended SRC Rules 68 and 68.1 is available at the SEC's website at www.sec.gov.ph.

The more significant revisions incorporated in the rules are the following:

SRC Rule 68

- FS for submission to the SEC should be accompanied by a report of an independent auditor who fully meets the requirements of independence provided under the Code of Ethics for Professional Accountants. Non-compliance will be subject to penalties.

- Existing SEC requirements on accreditation of external auditors of certain entities (e.g., public companies, issuers with registered securities, listed companies and other companies with secondary licenses) and rotation of external auditors (or the signing partner in the case of a firm) every five years have been incorporated in the amended rule.

- Auditor's report issued by an auditing firm should be signed by the certifying partner with his/her signature with indication that he/she is signing for the firm with the firm name printed on the report.

- External auditors are required to issue a supplemental written statement which will state the issuer's total number of stockholders owning 100 or more shares each.

- Penalties are imposed on erring companies in the following cases:

  - material misrepresentation in the FS,
  - any material deviation from GAAP in the Philippines,
  - failure to submit FS audited by a qualified independent CPA,
  - failure to submit a complete Statement of Management's Responsibility for FS, and
  - failure to comply with any other requirements of Rules 68 and 68.1.

  The penalties imposed for the violation of Rules 68 and 68.1 shall be in addition to: (i) the fine imposed for late or incomplete filing, (ii) the suspension or revocation of the primary franchise and/or secondary license, or (iii) the criminal charges filed against the person responsible for the violation.

- SEC shall determine whether the misstatement or incompleteness in the FS is material (e.g., departure from GAAP, amount exceeding 10% of total assets or net income) which shall cause the amendment and re-issuance of the FS. If the misstatements are not material, the company shall submit an addendum to the FS with an Audit Committee Resolution taking up the findings and corrective measures to be taken thereon.

- SEC Memorandum Circular No. 14, Series of 2003, requiring companies to obtain approval on the use of functional currency was rescinded. Instead, a notification to the SEC shall be made by a company intending to apply the provisions on functional currency reporting under PAS 21, *The Effects of Changes in Foreign Exchange Rates*. (However, there is now a proposed SEC Memorandum Circular that would replace this rescinded Circular – see section C below.)

SRC Rule 68.1

- The Chairman of the Board of covered corporations should sign the Statement of Management's Responsibility for FS even if he/she is not one the company's executive officers. (Under SRC Rule 68.1, in addition to the Chairman of the Board, the Statement of Management's Responsibility should be signed also by the Chief Executive Officer and the Chief Financial Officer.)

- The interim FS required to accompany registration statements need not be audited. However, in case of an IPO, such interim FS should be audited by an accredited external auditor.

- For fiscal years ended December 31, 2005 and subsequent up to November 30, 2006, a comparative format of only two years (instead of three years) may be filed to give temporary relief to covered companies. The requirement for the presentation of three year comparatives shall resume for the year end reports beginning December 31, 2006 and onwards.

- For mutual funds or investment companies, additional disclosure is required on the amount of net asset value per share and the basis for its computation.

C. SEC MEMORANDUM CIRCULAR NO. 1, SERIES OF 2006, *GUIDELINES ON THE FILING OF FUNCTIONAL CURRENCY FS*

Further to the amendment to SRC Rule 68 in relation to the rescission of the SEC Memorandum Circular No. 14, Series of 2003 (see section B above), the SEC has issued, on January 11, 2006, Memorandum Circular No. 1 that provides guidelines on the filing of functional currency FS. A copy of this Memorandum Circular is posted at the SEC's website at www.sec.gov.ph.

Below are some of the significant provisions of the SEC Memorandum Circular:

- The company's determination of its functional currency should be made in accordance with PAS 21.

- A company that files with the SEC FS in functional currency other than the Philippine peso for the first time should submit to the SEC a prior notification that it shall file such functional currency FS, with an assessment that supports the determination of its functional currency. If there is a change in the company's functional currency, a prior notification shall also be made including the reasons for the change.

- The notification, signed by the company's chief executive officer and chief financial officer and notarized, shall be filed within 45 days after the end of the year in which the company first files functional currency FS (prior to filing of FS for that year) or, in the case of a change in functional currency, within 30 days after the end of year in which the change occurred.

- The company's notification (both in the case of a first filing of functional currency FS and a change in functional currency) should be accompanied by a letter from the company's external auditor indicating his/her assessment that the company's determination of its functional currency has been made in accordance with PAS 21.

  In the case of a change in functional currency, the submission of the required notification is without prejudice to any objection that the SEC may raise on the proposed change in functional currency taking into account the previous representations by the company and the principles set forth under PAS 21.

- A company using a functional currency other than the Philippine peso that presents FS expressed in Philippine peso should submit both functional currency FS and Philippine peso FS prepared using the translation provisions of PAS 21.

D. PROPOSED BIR REVENUE REGULATIONS ON THE USE OF FUNCTIONAL CURRENCY OTHER THAN THE PHILIPPINE PESO

There is a proposed Revenue Regulations pending approval which will regulate the use of functional currency other than the Philippine peso in FS that will be submitted to the BIR and in the books of accounts that will be maintained for internal revenue tax purposes.

Important Provisions

- The proposed Revenue Regulations (RR) requires an entity to determine its functional currency after due consideration of certain factors presented in the proposed RR. Once determined, such functional currency shall be used by the entity and shall not be changed unless certain requirements are complied with.

- A 70% threshold is set as a presumptive level in determining the functional currency of an entity. Hence, an entity whose revenues and cost and expenses, denominated in one currency, comprise at least 70% of its transactions for the immediately preceding year can use such currency as its functional currency after complying with certain requirements, including obtaining SEC approval and notifying the BIR on the use of such functional currency.

- Formal approval from the BIR on the use of the functional currency is not required. However, formal notification to the BIR is necessary and will be done through submission of a copy of the SEC approval to the appropriate unit of the BIR (i.e., RDO, LTDO, LTS).

- All entries in the income tax return (ITR), as well as all other tax returns, should be in Philippine peso.

- The FS to accompany ITRs should show a column for the functional currency amounts and another column for the parallel translation in Philippine peso. Such FS should be accompanied with an external auditor's report covering the foreign currency FS and the parallel translation in Philippine peso. (Foreign currency FS without such parallel translation for submission to the SEC can be presented to the BIR for stamping.)

- Entities that qualify to use functional currency other than the Philippine peso should maintain their books in functional currency with parallel translation in Philippine peso using the exchange rate on transaction dates. They should also maintain peso subsidiary books using historical peso rates needed to determine their tax liabilities. Both books/records should be registered with the BIR in accordance with existing rules.

- Preparation of functional currency FS should be in accordance with the procedures prescribed under the proposed RR.

- NOLCO and excess MCIT can still be carried forward in the income tax computation of a taxpayer that has switched to a functional currency other than the Philippine peso. Such NOLCO and excess MCIT shall be translated into the functional currency using the closing PDS rate as of the balance sheet date in the year before the change to functional currency. Subsequent translation of the balance of such NOLCO and MCIT should use the same closing PDS rate on such date.

Pending Issues and P&A Comments

It can be noted that certain provisions of the proposed RR are inconsistent with the most recent rules of the SEC on the use of functional currency. Also some issues have arisen relating to some provisions of the proposed RR which are pending clarification by the BIR. Presented below are some of these issues and our comments on how to handle them pending obtaining clarification from the BIR.

1. *Issue:* Currently, the use of functional currency no longer requires approval of the SEC. Mere notification to the SEC is required. But the proposed RR still includes provisions regarding the submission to the BIR of a copy of the SEC approval.

   Comment: The SEC will no longer issue a formal approval on the use of a functional currency by qualified entities, hence, no such SEC approval can be submitted as part of the BIR's requirements. In this case, we believe that a copy of the notification letter submitted to the SEC, preferably stamped "received" by the SEC, can instead be submitted to the BIR.

2. *Issue:* The proposed RR uses a 70% threshold. SEC Memorandum Circular No. 1 (see Section C above), on the other hand, no longer makes reference to the 70% threshold but instead requires an entity to determine its functional currency in accordance with PAS 21 which does not set any quantitative threshold.

   Comment: The proposed RR indicates that the 70% threshold is set only as presumptive level. It also provides other factors that should be considered in determining whether the entity is qualified to use a functional currency other than the Philippine peso. Those other factors for consideration are consistent with PAS 21 provisions. Accordingly, if the circumstances of the entity are in accordance with PAS 21 (even if its revenue and cost and expense levels are below the 70% threshold), it should conclude that its functional currency is other than the Philippine peso and should use such functional currency both for financial and tax reporting purposes.

3. *Issue:* All entries in the income tax return (ITR), as well as all other tax returns, should be in Philippine peso.

   Comment: The peso amounts in the ITR (and in other tax returns) can be interpreted as either: (a) the peso amounts arrived at by translating the appropriate functional currency revenue and expense amounts into Philippine peso using the prescribed rates, or (b) the original Philippine peso amounts plus any revenues and expenses arising from non-Philippine peso transactions and balances translated into the Philippine peso at prescribed rates.

An issue regarding this matter has been raised by various interested groups and parties during dialogues and discussions with the BIR. In those forums, the BIR has made known that it will require the presentation of the peso amounts determined under item (b) above which amounts can be taken or prepared from the entity's books which are now required to contain parallel translation in Philippine peso, as well as from its peso subsidiary books.

The implications of this position of the BIR relating to the use of a functional currency other than the Philippine peso are the following:

- For SEC filing, the entity shall prepare a set of FS in functional currency using GAAP in the Philippines (including PAS 21).

  As mentioned earlier, for SEC reporting, the entity does not have to show parallel amounts in Philippine peso. However, if the entity presents FS expressed in Philippine peso, it should submit both functional currency FS and Philippine peso FS prepared using the translation provisions of PAS 21.

  In accordance with existing SEC regulations, this set of FS should be audited.

- The entity shall also prepare another set of FS in Philippine peso using another financial reporting framework (which, with respect to accounting for the effects of changes in foreign exchange, should follow the BIR requirements).

  As mentioned earlier, this set of FS for filing with the BIR should present a column for the functional currency amounts and a column for the parallel translation in Philippine peso.

  In accordance with the proposed RR, this set of FS should be audited.

We are not in total agreement with the position taken by the BIR on this issue and we continue to try to make a point on this matter with the tax authorities. However, in the absence of any formal clarification from the BIR, an entity using a functional currency other than the Philippine peso should consider following the provisions of the proposed RR and the position taken so far by the BIR for tax reporting purposes. This also applies to entities that started filing functional currency FS under the previous rules (i.e., prior to the issuance of SEC Memorandum Circular No. 1 and the proposed RR). This is to avoid any exposure to penalties that may be imposed for noncompliance.

For that matter, it is also emphasized that the taxable income, which is required by the BIR to be expressed in Philippine peso, of an entity using a functional currency should continue to be determined in accordance with the provisions of the Tax Code and pertinent tax rules and regulations.

We will continue to monitor the developments at the BIR on the above issues and we recommend that entities affected by the proposed RR do the same. We will give you updates as additional information becomes available.

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Should you have any questions on the new accounting standards or should you need assistance on matters covered in this Accounting Alert, please contact the P&A engagement partner assigned to your company, or send an e-mail to any of the following partners of the Firm:

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Attachment

The following are the financial reporting standards effective as of December 31, 2004 applicable to NPAE under PAS 101:

1. Framework for the Preparation and Presentation of FS;
2. SFAS 1(rev), *Presentation of FS;*
3. SFAS 4 (rev), *Inventories;*
4. SFAS 8, *Accounting for the Effects of Changes in Foreign Exchange Rates;*
5. SFAS 8A, *Deferral of Foreign Exchange Differences (an amendment of SFAS 8);*
6. SFAS 10, *Summary of Generally Accepted Accounting Principles on Investments;*
7. SFAS 13 (rev), *Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies;*
8. SFAS 18, *Generally Accepted Accounting Principles on Stockholder's Equity;*
9. SFAS 22 (rev), *Cash Flow Statements;*
10. SFAS 24, *Retirement Benefit Costs;*
11. SFAS 25, *Borrowing Costs;*
12. SFAS 26, *Construction Contracts;*
13. SFAS 28, *Revenue;*
14. SFAS 10/IAS 10, *Events After the Balance Sheet Date;*
15. SFAS 12/IAS 12, *Income Taxes;*
16. SFAS 16/IAS 16, *Property, Plant and Equipment;*
17. SFAS 17/IAS 17, *Leases;*
18. SFAS 20/IAS 20, *accounting for Government Grants and Disclosure of Government Assistance;*
19. SFAS 22/IAS 22, *Business Combination;*
20. SFAS 24/IAS 24, *Related Party Disclosures;*
21. SFAS 26/IAS 26, *Accounting and Reporting by Retirement Benefit Plans;*
22. SFAS 27/IAS 27, *Consolidated FS and Accounting for Investments in Subsidiaries;*
23. SFAS 28/IAS 28, *Accounting for Investments in Associates;*
24. SFAS 31/IAS 31, *Financial Reporting for Interests in Joint Ventures;*
25. SFAS 35/IAS 35, *Discontinuing Operations;*
26. SFAS 36/IAS 36, *Impairment of Assets;*
27. SFAS 37/IAS 37, *Provisions, Contingent Liabilities and Contingent Assets; and,*
28. SFAS 38/IAS 38, *Intangible Assets.*

The following standards, which were effective as of December 31, 2004, were excluded from the above list since these apply to entities with public accountability, such as listed entities, banks or insurance companies:

1. SFAS 19, *Summary of Generally Accepted Accounting Principles for the Banking Industry;*
2. SFAS 27, *Accounting and Reporting for the Non-life Insurance Industry;*
3. SFAS 29, *Earnings per Share;*
4. SFAS 30, *Interim Financial Reporting; and,*
5. SFAS 31, *Segment Reporting.*