

Financial Reporting Matters

Credit Crisis Special Report

AUDIT

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The Chairman of the Trustees of the International Accounting Standards Committee Foundation wrote to leaders of the G20 countries, meeting on 15 November 2008 in Washington, to inform them of the role of the International Accounting Standards Board (IASB) in setting global accounting standards, the issues on fair value accounting and the steps the IASB has taken to address the credit crisis.

In this special report on the credit crisis, we take the opportunity to summarise the Common Principles to Guide Financial Market Reform agreed at the G20 Washington meeting and discuss the steps the IASB has taken to address the credit crisis and fair value accounting.

The letter to the G20 leaders explained that accounting standard-setting is a well-established and supported process that has support from banking supervisory and investor communities. Investors generally support fair value that delivers a picture of what is actually happening. The Trustees believe that any steps taken outside the independent accounting standard-setting process to amend fair value accounting would further undermine already scarce confidence in financial markets. Hence, the letter sought the support of the G20 leaders to reinforce the IASB's efforts and the organisation's independence.

It explained that the IASB had already taken a number of significant steps to improve accounting guidance based particularly on the recommendations of the Financial Stability Forum (FSF) but also of other stakeholders and commentators.

In addition to the steps already taken, the letter also explained two important efforts which the IASB has initiated:

Addressing pro-cyclicality through urgent and focussed dialogue between accounting standard-setters and prudential supervisors: Pro-cyclicality arises from the interaction of accounting standards with the rules on capital requirements, which are also being reconsidered. Addressing the issue of pro-cyclicality is a priority of policymakers and prudential supervisors, who are tasked with ensuring financial stability. At the same time, the primary aim of accounting standard-setters (and securities regulators) is to provide transparency and comparability of financial information for investors and participants in capital markets – an objective which should not be sacrificed.

A high level advisory group to report rapidly: The IASB and the US FASB are establishing a high level advisory group that will comprise senior leaders with broad international experience with financial markets. The group will consider how improvements in financial reporting could help enhance investor confidence in financial markets.

Contents

- Common Principles to Guide Financial Market Reform 2
- Key Steps taken to address Credit Crisis and Fair Value Accounting 4
- Enhancing Guidance on Fair Value in Inactive Markets 5
- Improving Disclosures about Fair Value and Liquidity Risks 6
- Reclassifications of Financial Assets 7

A. Common Principles to Guide Financial Market Reform

The Common Principles agreed at the G20 meeting in Washington lays down a framework for Financial Market Reform which is likely to significantly influence accounting standard-setting in the near future. These Common Principles are:

Common Principles To Guide Financial Market Reform (Agreed at G20 Meeting in Washington on 15 November 2008)

Strengthening transparency and accountability by enhancing required disclosure on complex financial products; ensuring complete and accurate disclosure by firms of their financial condition; and aligning incentives to avoid excessive risk-taking.

Enhancing sound regulation by ensuring strong oversight of credit rating agencies; prudent risk management; and oversight or regulation of all financial markets, products, and participants as appropriate to their circumstances.

Promoting integrity in financial markets by preventing market manipulation and fraud, helping avoid conflicts of interest, and protecting against use of the financial system to support terrorism, drug trafficking, or other illegal activities.

Reinforcing international cooperation by making national laws and regulations more consistent and encouraging regulators to enhance their coordination and cooperation across all segments of financial markets.

Reforming international financial institutions (IFIs) by modernizing their governance and membership so that emerging market economies and developing countries have greater voice and representation, by working together to better identify vulnerabilities and anticipate stresses, and by acting swiftly to play a key role in crisis response.

Action Plan to Implement Common Principles (to be developed by Finance Ministers)

The leaders approved an Action Plan that sets forth a comprehensive work plan to implement these principles, and asked finance ministers to work to ensure that the Action Plan is fully and vigorously implemented.

The key aspects of the Action Plan affect financial reporting. They include immediate actions to:

- Address weaknesses in accounting and disclosure standards for **off-balance sheet vehicles**;
- Ensure that **credit rating agencies** meet the highest standards and avoid conflicts of interest, provide greater disclosure to investors, and differentiate ratings for complex products;
- Ensure that firms maintain adequate capital, and set out **strengthened capital requirements for banks' structured credit and securitization activities**;
- Develop enhanced guidance to strengthen banks' risk management practices, and ensure processes look at whether banks are **accumulating too much risk**;
- Establish processes whereby national supervisors who oversee globally active financial institutions meet together and **share information**;
- Expand the **Financial Stability Forum** to include a broader membership;

Finance Ministers have been asked to make specific recommendations on:

- Reviewing and aligning global accounting standards, particularly for complex securities in times of stress;
- Strengthening transparency of credit derivatives markets and reducing their systemic risks;
- Reviewing the mandates, governance, and resource requirements of the IFIs.

Strengthening Transparency and Accountability

Specifically on the area of strengthening transparency and accountability, the G20 leaders agreed on the following actions:

Immediate Actions by 31 March 2009

- The key global accounting standards bodies should work to enhance guidance for valuation of securities, also taking into account the valuation of complex, illiquid products, especially during times of stress.
- Accounting standard setters should significantly advance their work to address weaknesses in accounting and disclosure standards for off-balance sheet vehicles.
- Regulators and accounting standard setters should enhance the required disclosure of complex financial instruments by firms to market participants.
- With a view toward promoting financial stability, the governance of the international accounting standard setting body should be further enhanced, including by undertaking a review of its membership, in particular in order to ensure transparency, accountability, and an appropriate relationship between this independent body and the relevant authorities.
- Private sector bodies that have already developed best practices for private pools of capital and/or hedge funds should bring forward proposals for a set of unified best practices. Finance Ministers should assess the adequacy of these proposals, drawing upon the analysis of regulators, the expanded FSF, and other relevant bodies.

Medium-term actions

- The key global accounting standards bodies should work intensively toward the objective of creating a single high-quality global standard.
- Regulators, supervisors, and accounting standard setters, as appropriate, should work with each other and the private sector on an ongoing basis to ensure consistent application and enforcement of high-quality accounting standards.
- Financial institutions should provide enhanced risk disclosures in their reporting and disclose all losses on an ongoing basis, consistent with international best practice, as appropriate. Regulators should work to ensure that a financial institution's financial statements include a complete, accurate, and timely picture of the firm's activities (including off-balance sheet activities) and are reported on a consistent and regular basis.

Our comments:

We believe the Common Principles and agreed actions towards strengthening transparency and accountability will significantly affect the agendas of the IASB and set financial reporting trends in the near future.

B. Key steps taken to address Credit Crisis and Fair Value accounting

With the support of the G8 governments, the Financial Stability Forum (FSF) proposed three areas for IASB's action – improving accounting and disclosure of off balance sheet vehicles, enhancing guidance on fair value in inactive markets, and improving disclosures about fair value and liquidity risks.

IASB's response to the Credit Crisis

The IASB has responded to these proposals and the current position is summarised below. It has also permitted reclassifications of financial assets.

1. Improving accounting and disclosure of off balance sheet vehicles

The IASB already had two projects under way directly related to off balance sheet vehicles. The **Consolidation** project aims to identify when an entity should be brought on to another entity's balance sheet; and the **Derecognition** project is examining when assets should be removed from the balance sheet. The IASB has given priority to both projects to accelerate their completion and will publish the first proposal for public comment by the end of November 2008. This is not discussed in this issue as the proposals have not yet been issued.

Our comments:

In the meantime, current principles continue to apply based on control - the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. A special purpose entity (SPE) would be required to be consolidated when control arises in substance through the predetermination of the activities of the SPE.

2. Enhancing guidance on fair value in inactive markets

On 31 October 2008, the IASB issued a staff summary and its expert advisory panel's report on fair value measurement when markets are no longer active. This guidance is consistent with US pronouncements. This is discussed in Section C of this publication.

3. Improving Disclosures about Fair Value and Liquidity risks

On 15 October 2008, the IASB released its proposals to improve financial instrument disclosures, including fair value and liquidity risk disclosures. This is discussed in Section D of this publication.

4. Permitting reclassification of financial assets

On 13 October 2008, the IASB issued an amendment to permit the reclassification of some financial assets from fair value through the profit or loss or from the available-for-sale category. Reclassifications were allowed under US GAAP, but not under IFRS before the amendment. This amendment was to provide a level playing field with US companies. This is discussed in Section E of this publication.

C. Enhancing Guidance on Fair Value in Inactive Markets

Final Report of IASB's Expert Advisory Panel about measuring and providing disclosure of financial instruments when markets are inactive (Information and Educational Guidance)

An expert advisory panel was formed by the IASB to deal with the recommendations of the Financial Stability Forum in its report, *Enhancing Market and Institutional Resilience*. In this exercise, practices used by experts in measuring financial instruments when markets were inactive, were identified.

Refer to IFRS Briefing Sheet – Issue 111 for details.

The expert advisory panel's report is summarised below.

What is fair value accounting trying to achieve?

The principles of fair value measurement in IAS 39 aims to arrive at the price which an orderly transaction would take place between market participants at the measurement date. A forced or distressed sale is not considered an orderly transaction.

All relevant market information that is available has to be considered to achieve fair value measurement. When using a valuation technique/model, the principle is to maximise the use of observable inputs and minimise the use of unobservable inputs.

What happens when a market becomes inactive?

An active market is one in which transactions are taking place regularly on an arm's length basis. Judgement based on entity-specific facts and circumstances is needed to ascertain how regularly transactions are carried out.

Quoted prices in active markets for the same financial instrument are the most representative of fair value and cannot be ignored. When markets are inactive, transaction prices can be used as inputs but it should be noted that they are not determinative of fair value. However, it is also not appropriate to conclude that all market activity in inactive markets represent forced or distressed sales.

Regardless of the valuation technique/model used, an entity must include appropriate risk adjustments that market participants would make, such as for credit and liquidity.

What is management's role in fair value estimation?

When valuation techniques/models are used, they are typically based on internal assumptions of future cash flows, risk-adjusted discount rates, inputs for credit and liquidity risks.

The inputs to these techniques/models could be based on observable market data or unobservable inputs. Where significant adjustments are required on available observable inputs, it might be more appropriate to use a mark-to-model approach instead (based primarily on unobservable inputs). In some other cases, multiple sources might be used to collectively provide the best estimate of fair value.

In order to determine the weighting of inputs, management has to decide which inputs provide greater information about the fair value and are more relevant in developing a reasonable estimate.

Can broker quotes and pricing services still be used?

In active markets, broker quotes or prices from pricing services typically reflect a good estimate of fair value. However, in inactive markets, brokers/pricing services may rely more on models. An entity should place less reliance on quotes that do not reflect the result of market transactions.

The nature (indicative vs binding) of the quote should also be considered when weighing the available evidence.

D. Improving Disclosures about Fair Value and Liquidity Risks

Exposure Draft *Improving Disclosures about Financial Instruments: Proposed Amendments to IFRS 7*

Refer to IFRS Briefing Sheet – Issue 109 for details.

The proposed amendments to IFRS 7 *Financial Instruments: Disclosures* result from current market conditions, which have increased the focus on the need for transparency regarding entities' financial instruments and the significance of those instruments to an entity's financial position, performance and cash flows.

In response, the IASB has held various consultations with users, preparers and auditors of financial statements on the effectiveness of disclosures required by IFRS 7.

This Exposure Draft *Improving Disclosures about Financial Instruments – Proposed amendments to IFRS 7* (ED) is the IASB's response to recommendations of the Financial Stability Forum and reflects discussions by the IASB's Expert Advisory Panel on measuring and disclosing fair values of financial instruments when markets are no longer active.

In Singapore, the ASC has also issued the same exposure draft, for comment by 14 November 2008. The IASB expects to issue the final amendments in the first quarter of 2009, with a proposed effective date for annual periods beginning on or after 1 July 2009.

Fair Value Measurement Disclosures: Introduction of a Fair Value Hierarchy

The ED proposes disclosure requirements for fair value measurements using a three-level fair value hierarchy that reflects the significance of the inputs used in measuring fair values. The proposed fair value hierarchy is made up of the following levels:

Level 1 – fair values measured using quoted prices in active markets for *identical* instruments

Level 2 – fair values measured using quoted prices in active markets for similar instruments or using other valuation techniques for which all significant inputs are based on observable market data

Level 3 – fair values measured using valuation techniques for which any significant input is not based on observable market data.

Judgement would be required in assessing which inputs are significant to the fair value measurements.

The proposed fair value hierarchy broadly is consistent with the hierarchy in U.S. FASB Statement of Financial Accounting Standards No. 157 Fair Value Measurements.

Scope of Liquidity Risk Disclosures

The ED proposes modifying the definition of liquidity risk and accordingly amending IFRS 7 to require liquidity risk disclosures only for financial liabilities that will result in an outflow of cash or another financial asset.

It also proposes requiring disclosures of a maturity analysis for derivative liabilities and non-derivative liabilities, based on how an entity manages the liquidity risks associated with those exposures. This could be based on the contractual maturities, or on expected maturities, if the liabilities are managed in that way.

Our comments:

We expect many entities around the world, particularly those directly affected by the current credit condition, to voluntarily disclose the above information in their 31 December 2008 annual reports.

E. Reclassifications of Financial Assets

Amendments to IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 7 *Financial Instruments: Disclosures*

Refer to IFRS Briefing Sheet – Issue 108 for details.

On 13 October 2008, the IASB issued the amendments to IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 7 *Financial Instruments: Disclosures* to allow reclassifications of certain financial assets carried at fair value (fair value through profit or loss (FVTPL) category or available-for-sale (AFS) category) to categories that are carried at amortised cost or AFS, provided certain criteria are met and on-going fair value related disclosures are made.

The Accounting Standards Council (ASC) in Singapore has decided that the amendments are appropriate for Singapore companies and has therefore issued the amendments to FRS 39 and FRS 107 with the same effective dates and transition requirements.

What are the key changes to FRS 39?

Amendments to FRS 39: Financial Instruments: Recognition and Measurement

Reclassification out of FVTPL (Fair Value Through Profit or Loss)

A financial asset classified as held for trading (HFT) that meets the definition of loans and receivables (L&R) at the date of reclassification can be reclassified to the L&R category or available-for-sale (AFS) category if the entity has the "intention and ability to hold the financial asset for the foreseeable future or to maturity". See FAQ 1 on page 9.

The value recognised on reclassification is the fair value on the date of reclassification which will become the asset's new cost base. Any gains/losses recognised in profit or loss are not reversed.

A financial asset classified as HFT which does not meet the definition of L&R may be reclassified only in "rare circumstances". See FAQ 2 on page 10. For such financial assets:

- Debt and equity instruments may be classified into AFS.
- Debt instruments may be reclassified into held-to-maturity (HTM) if the financial asset meets all the criteria for classification as HTM, including the tainting rules in IAS 39.9.

A summary of the financial assets permitted for reclassification out of FVTPL subsequent to the amendments to FRS 39 are as follows:

		Transfer to:				
		Reference	FVTPL	L&R	HTM	AFS
Transfer from:	FVTPL – derivatives	FRS 39.50(a)	N/A	X	X	X
	FVTPL – designated at FVTPL	FRS 39.50(b)	N/A	X	X	X
	FVTPL – non-derivative trading assets that meet L&R definition	FRS 39.50(c) & 39.50D	N/A	√ Foreseeable future or to maturity	X	√ Foreseeable future or to maturity
	FVTPL – non-derivative trading assets that do not meet L&R definition (in rare circumstances only)	FRS 39.50(c) & 39.50B	N/A	X	√ If meets definition of HTM and tainting period has ceased	√

Reclassification out of AFS (Available for Sale)

A financial asset held in the AFS category that meets the definition of L&R at the date of reclassification can now be reclassified to the L&R category if the entity has the "intention and ability to hold the financial asset for the foreseeable future or to maturity". See FAQ 1 on page 9. Previously, only debt instruments could be reclassified out of AFS into HTM at the end of the tainting period - as explained in FRS 39.54.

The value recognised on reclassification is the fair value at the date of reclassification which will become the asset's new cost base. Any gains/losses recognised in other comprehensive income are accounted for in accordance with FRS 39.54.

A summary of the financial assets permitted for reclassification out of AFS subsequent to the amendments to FRS 39 are as follows:

		Transfer to:				
		Reference	FVTPL	L&R	HTM	AFS
Transfer from:	AFS - financial assets that meet L&R definition	FRS 39.50E	N/A	√ Foreseeable future or to maturity	X	N/A
	AFS – financial assets that do not meet L&R definition *	FRS 39.54	N/A	X	√ If meets definition of HTM and tainting period has ceased	N/A

* This ability to reclassify was previously allowed and is still allowed subsequent to the amendment

What cannot be reclassified out of the fair value categories?

Prohibited reclassifications

With the amendments, the financial assets carried at fair value, which can now be reclassified out of FVTPL and AFS, are those described above.

Derivatives carried at fair value, and financial assets designated as FVTPL upon initial recognition will continue to be carried at FVTPL and cannot be reclassified.

Financial liabilities carried at FVTPL cannot be reclassified to amortised cost.

EIR computation - subsequent increase in recovery of cash flows

Effective Interest Rate (EIR) calculation

Subsequent to the reclassification of a financial asset, if the future expected cash flows increase as a result of increased recoveries, the entity must:

- adjust the EIR from the date of the change in estimate; and
- recognise the change in expectation in profit or loss over the remaining holding period in interest income.

The change in estimate is not recognised immediately in profit or loss. See FAQ 5 on page 11.

Effective date and transition requirements

Effective date and transition

There is a "one-time" opportunity to make reclassifications retroactively. This opportunity to retroactively reclassify applies only to reclassifications actually made prior to 1 November 2008.

Reclassifications can be made retroactively to 1 July 2008 if the reclassification decision is made before 1 November 2008. Any reclassification made on or after 1 November 2008 must be recognised from the date the reclassification is made.

What are the key changes to FRS 107?

Amendments to FRS 107 *Financial Instruments: Disclosures*

If an entity reclassifies a financial asset out of the FVTPL or AFS categories, then the amended IFRS 7 requires the following to be disclosed:

- (a) In the period in which a reclassification occurs, the amount reclassified into and out of each category.
- (b) For each reporting period until de-recognition of the reclassified financial asset, the carrying amounts and fair values of all financial assets that have been reclassified in the current and previous reporting periods.
- (c) If the financial asset was reclassified due to rare circumstances, then the facts and circumstances indicating the situation was rare.
- (d) For the reporting period in which the financial asset was reclassified, the fair value gain or loss on the financial asset recognised in profit or loss or other comprehensive income in that reporting period and in the previous reporting period.
- (e) For the reporting period in which the financial asset was reclassified and each reporting period until the financial asset is de-recognised, the fair value gain or loss that would have been recognised in profit or loss or other comprehensive income if the financial asset had not been reclassified, and the gain, loss, income and expense recognised in profit or loss. ***This effectively requires disclosure of the comprehensive income (profit or loss, and other comprehensive income) from the date of reclassification until de-recognition.***
- (f) The EIR and estimated amounts of cash flows the entity expects to recover, as at the date of reclassification of the financial asset.

Practical application in Singapore and some relevant FAQs

Practical application in Singapore

Although the amendments to allow retroactive reclassification from the HFT category (fair value) to the L&R category (amortised cost) from 1 July 2008 received wide publicity around the world, there has been little impact in Singapore and very few companies actually applied the amendments. Even where it was applied, the effect was not considered to be significant.

Frequently Asked Questions (FAQs)

“Intention and ability to hold for the foreseeable future”

Q1: How is “intention and ability to hold for the foreseeable future” defined?

A1: There is no definition of this term in the amendments. Judgement will need to be exercised in determining whether the requirement is met in the individual circumstances of each situation.

For example, if management does not have the intention to sell the non-derivative financial asset today but may sell when the market price of the asset recovers, this would indicate that management does not have the intention to hold the financial asset for the foreseeable future.

In applying this requirement, entities should to identify a clear and consistent accounting policy on how they interpret this term and the accounting policy determined should be disclosed in accordance with FRS 1. Entities are also encouraged to implement robust policies and procedures, including documentation of management’s intention and assessment of their ability to hold the financial asset for the foreseeable future.

“Rare circumstances”

Q2: The amendments allow reclassification of non-derivative financial assets that would not have met the definition of L&R out of trading only in “rare circumstances”. What constitutes “rare circumstances”?

A2: The amendments do not define the term “rare circumstances”. However, the IASB issued a press release with the amendments which states, “*The deterioration of the world’s financial markets that has occurred during the third quarter of this year is a possible example of rare circumstances cited in these IFRS amendments and therefore justifies its immediate publication. Today’s action enables companies reporting according to IFRSs to use the reclassification amendments, if they so wish, from 1 July 2008.*”

In addition, the Basis for Conclusions 104D accompanying the amendments state that “rare circumstances arise from a single event that is unusual and highly unlikely to recur in the near term.”

If an entity reclassified a financial asset based on rare circumstances, it will be necessary for the entity to document the rare circumstance that occurred and the specific event that caused the rare circumstances as well as articulate and document the date that these circumstances arose, in their judgement.

Sale of financial assets classified as loans and receivables

Q3: If an entity subsequently sells an asset that has been reclassified to L&R, what impact does this have on past or future reclassifications?

A3: There is no restriction similar to the tainting rules for sales of HTM assets that limits post-reclassification sales of items classified or reclassified as L&R. Therefore, there is no automatic consequence of the sale as would apply for financial assets sold from the HTM category.

If financial assets are classified or reclassified as L&R and subsequently are sold, then this may cast doubt on the reliability of assertions by management that the entity has the intention and ability to hold those or other reclassified financial assets as L&R for the foreseeable future or until maturity and, more generally, that other assets are not held for the purpose of selling in the near term.

Computation of original EIR at the date of reclassification

Q4: On 31 October 2007, an entity acquired a bond at its par value of \$1,000. The bond pays a 2% coupon and matures in 5 years. At inception, the entity classified the bond as a HFT financial asset.

At 31 October 2008, the market is no longer active and the fair value of the bond has declined to \$800 because the principal and interest are no longer expected to be fully recovered and the market rate for an instrument with similar risk characteristics is significantly higher. The entity only expects to recover \$950 of its principal at maturity date.

The entity would like to reclassify the bond from HFT to L&R under the basis that the bond now meets the definition of L&R and it intends and has the ability to hold the instrument for the foreseeable future. How does the entity account for the reclassification?

A4: At the date of reclassification, the fair value of the financial asset of \$800 becomes the asset’s new cost base under the L&R category. The EIR that exactly discounts these expected cash flows at the date of reclassification is 3.5%.

This new EIR becomes the bond’s original EIR which is then used to amortise the difference between the amortised cost of the bond at the date of reclassification and its expected redemption value at maturity date.

Accordingly, the amortised cost of the bond will accrete as follows:

Date	Amortised cost brought forward \$	Interest income at original EIR of 3.5% \$	Coupons \$	Amortised cost carried forward \$
31/10/2008	800	28	-	828
31/10/2009	828	29	-	857
31/10/2010	857	30	-	887
31/10/2011	887	31	-	918
31/10/2012	918	32	-	950

Subsequent increase in recovery of cash flows

Q5: On 31 October 2010, the entity subsequently expects to recover 100% of the principal, i.e. \$1000. How does the entity account for the subsequent increase in the estimated increase in the recovery of the cash flows?

A5: In accordance with the revised FRS 39.AG8, any subsequent increases in the estimated future cash flows as a result of increased recoverability of the financial asset should be recognised as an adjustment to the EIR from the date of the change in estimate.

The revised EIR that exactly discounts the revised expected cash flows to the current amortised cost of the bond (\$887) as at 31 October 2010 is 6.2%. This revised EIR is then used to amortise the residual difference between the amortised cost of the bond and its expected redemption amount at maturity date. Accordingly, the amortised cost of the bond will accrete as follows:

Date	Amortised cost brought forward \$	Interest income at revised EIR of 6.2% \$	Coupons \$	Amortised cost carried forward \$
31/10/2011	887	55	-	942
31/10/2012	942	58	-	1000

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