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FINANCIAL REPORTING MATTERS

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In this issue, we feature the recent requirement by Singapore Exchange for directors to opine on internal controls. We also discuss the practical implications of two changes to accounting standards that will be effective in 2013 – accounting for employee benefits and applying the new consolidation model to real estate investment trusts (REITs).

Directors' responsibilities to opine on internal controls

We discuss the implication of Singapore Exchange's recent requirement for directors to provide an opinion on the adequacy of internal controls.

Changes in accounting for employee benefits

Entities may need to re-look at their existing employee benefits plans as some benefits currently accounted for as short-term may need to be accounted for as long-term benefits.

Would real estate companies end up with a bigger balance sheet?

We share some key factors that drive the analysis when evaluating who effectively has control over real estate investment trusts (REITs) under the new consolidation accounting standard.

International developments

We summarise the new exposure drafts and standards issued by the IASB and other developments affecting current and future IFRS reporters.

Directors' responsibilities to opine on internal controls

Effective from 29 September 2011, the Singapore Exchange (SGX) amended its Listing Manual (LM) to require listed companies' Board of Directors (BOD) to give an opinion on the adequacy of the internal controls (Rule 1207(10)). On 16 April 2012, the SGX also issued an advisory note to provide guidance on compliance with this requirement. We summarise and discuss the implication of this new requirement below.

To strengthen corporate governance practices and foster greater corporate disclosure, SGX issued various amendments to the listing rules on 14 September 2011. One area relates to having an effective system of internal controls. Before this batch of changes, listed companies were already required under the Code of Corporate Governance to disclose their corporate governance practices and give explanations for deviations from the Code in their annual reports. We compare the differences:

What are the differences in this new rule compared with guidelines in the Code of Corporate Governance relating to internal controls?

The Code of Corporate Governance is a "comply or explain" regime. On the other hand, requirements under the listing rules are mandatory. In addition, rule 1207(10) requires the BOD to issue a positive opinion.

SGX Listing Manual	Code of Corporate Governance
Effective for annual reports issued for financial years ending on or after 31 December 2011	Revised Code effective for annual reports relating to financial years commencing 1 November 2012
New Rule 719(1) An issuer is required to have a robust and effective system of internal controls, addressing financial, operational and compliance risks. The audit committee (or other committee) may commission an independent audit on internal controls for its assurance, or where it is not satisfied with the systems of internal controls.	Principle 11, Guideline 11.3 The BOD should comment on the adequacy and effectiveness of the internal controls, including financial, operational, compliance and information technology controls, and risk management systems, in the company's annual report.
New rule 1207(10) For purpose of reporting, an issuer is required to provide an opinion of the BOD, with the concurrence of the audit committee, on the adequacy of the internal controls, addressing financial, operational and compliance risks.	In addition, the BOD should also comment on whether it has received assurance from the CEO and the CFO: (a) that the financial records have been properly maintained and the financial statements give a true and fair view of the company's operations and finances; and (b) regarding the effectiveness of the company's risk management and internal control systems.

"SGX is making a distinct statement: Bland opinions are out.

The bourse operator has lately been issuing queries to firms that have published their annual reports, asking their directors to provide clearer opinions on the health of their firms, in order to comply with new listing rules implemented last September."
The Straits Times 2 May 2012

Additional guidance from SGX issued on 16 April 2012

"The rules could pose some discomfort to company directors … After all, there are inherent risks in any business, regardless of whether it has adequate controls in place.

With these inherent risks come inherent fear, so it is not surprising to see many disclosures … accompanied by disclaimers."
Irving Low, KPMG Singapore's Head of Risk Consulting

Disclosures that are not acceptable

On 16 April 2012, SGX issued an advisory note to provide guidance on compliance with the reporting requirements under Rule 1207(10). Examples of disclosures that are not acceptable are as follows:

"*The Board, with the concurrence of the audit committee, <u>believes that</u> there are adequate internal controls in the Company.*"

"*Based on the reports of the internal and external auditors, the Board, with the concurrence of the audit committee, is of the opinion that, <u>in the absence of any evidence to the contrary</u>,* the system of internal controls in place are adequate in meeting the current scope of the Group's business operations..."

When providing the opinion required under LM 1207(10), the following points should be noted:

(1) It is important that the BOD and the audit committee demonstrate that they have focused **their attention in all three areas of risks**, i.e. financial, operational and compliance risks.

(2) The issuer should **maintain proper documentation** of the deliberations of the BOD and the audit committee.

(a) Where the BOD is satisfied that the issuer has a robust and effective system of internal controls, the disclosure should include **the basis for the opinion**, which may include the scope of review by the BOD and the audit committee.

(b) Where the BOD and/or the audit committee is of the view that controls need to be strengthened or has concerns over any deficiency in controls, the BOD would have to **disclose the areas of concerns** and **how it seeks to address and monitor** the areas of concerns.

(3) The opinion required is in respect of the **Group**'s (i.e. holding company and its subsidiaries) internal controls.

(4) The SGX recommends that this opinion and basis be disclosed in the Directors' Report instead of the Corporate Governance section of the annual report.

Our comments:
We expect the Board of Directors and the audit committee to discuss their considerations of the adequacy of internal controls during their meetings. Proper minutes should be maintained on the factors considered and deliberated by them in arriving at their opinion.

Both the BOD and the audit committee would need to be able to demonstrate that there is a structured framework that supports and validates the opinion issued.

Some questions that management and the audit committee need to address are:

- Are we aware of the key risk exposures in all our material entities?
- Are there adequate, robust and effective controls in place to mitigate these risks to an 'acceptable' level?
- Do we have a consistent understanding and application of what risks are considered 'acceptable' and to what degree/extent?
- Do we have comprehensive assurance mechanisms that cover all of these key risk areas, and are these mechanisms adequate?
- Do these assurance mechanisms reflect that the controls are adequate, robust and effective?

Internal and external auditors' role in internal control

There sometimes are misconceptions that directors can rely solely on the work of external and internal auditors express their opinion on internal controls.

The external auditors' responsibility is to express an opinion on the financial statements based on their audit. Auditing standards require the external auditor to identify and assess the risks that the financial statements might be materially misstated. In making those risk assessments, the auditor considers internal control in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control.

For the external auditors, they typically consider aspects of internal control relating to key financial risks and compliance risks, but not every single risk that has been identified.

Internal auditors usually would focus more on operational risks, in addition to financial and operational risks. However, internal auditors usually carry out cyclical audits on specific areas and may not cover all key risks within each audit cycle.

How can we help?

Benefits of engaging KPMG Risk Consulting:

- *Review "what matters"*
- *Eliminate bulk of unnecessary information to the audit committee*
- *Reduce risk of "things being missed out" in the sea of information submitted*
- *Provide a succinct dashboard that captures critical indicators of the risks and results*

Since the implementation of the requirement from September 2011, some of our observations of the Board of Directors' consideration in forming their opinion on internal controls are:

- Assurance comes primarily from management, and there are not enough independent reviews of the adequacy and effectiveness of the controls.
- Too many risks are identified, and there is no entity wide perspective.
- Management/operational owners are not familiar with risk concepts.

Where the external auditors, in the course of their audit, identify any deficiencies in internal control that merit the management or Board of Directors' attention, these will be communicated to them.

Depending on the needs of individual Board of Directors, the external auditors and our risk advisory functions can work with the Board of Directors by expanding their scope of audit to cover specific areas of internal control or to implement a full scope of board assurance framework to identify and prioritise risks, identify gaps in the existing internal control and report analysis and assessment results to the BOD.

Changes to accounting for employee benefits

In September 2011, ASC issued revised FRS 19 *Employee Benefits* (FRS 19R). FRS 19R is identical to revised IAS 19, issued by the IASB in June 2011, with the same effective date for annual periods beginning on or after 1 January 2013. The most significant change in FRS 19R relates to pension plans which are defined benefit plans, and thus is of limited impact for Singapore entities who participate in the Central Provident Fund (CPF) state plan, which is a defined contribution plan. We focus our discussion on the other changes relating to the distinction between short-term benefits and other long-term benefits, as well as termination benefits.

Why is there a need to revise the accounting for employee benefits?

"Many companies have defined benefit pension commitments entered into long ago that can now represent their largest single financial liability. The amendments to IAS 19 … will ensure that investors and other users of financial statements are fully aware of the extent and financial risks associated with those commitments, in particular by requiring the surplus or deficit of a pension fund to be shown in the financial statements. At the same time the amendments help to separate out the background noise of changes in pension liabilities from the underlying financial performance of the core business."
Sir David Tweedie, then IASB chairman, commenting on the announcement to issue the revised IAS 19.

IAS 19R was issued as a result of the IASB's limited scope improvements to IAS 19. The IASB is currently reviewing its future agenda for the next three years, and a comprehensive review of the accounting for employee benefits is one potential topic being considered.

The primary reason for issuing IAS 19R is to improve the accounting for **defined benefit plans** by:

- eliminating the option to defer recognition of re-measurement gains and losses (known as the 'corridor method'); and
- requiring re-measurements to be presented in other comprehensive income, so as to separate these changes from the results of an entity's day-to-day operations.

In Singapore, most entities participate in the state plan, namely the Central Provident Fund (CPF). The CPF scheme is a form of **defined contribution plan**, and is not affected by the changes.

Accordingly, we focus our discussion on other changes that have wider implications to Singapore entities in the area of the distinction between short-term and other long-term employee benefits, as well as termination benefits.

Short-term employee benefits – change in definition

*The (IASB) Board's objective in defining the scope of the short-term employee benefits classification was to identify the set of employee benefits for which a **simplified measurement approach** would not result in measuring those benefits at an amount different from the general measurement requirements of IAS 19.*

Under FRS 19, the classification of employee benefits drives its accounting.

- Accounting for short-term employee benefits is relatively straightforward. The entity recognises the undiscounted amount of short-term employee benefits expected to be paid in exchange for that service.
- Accounting for other long-term employee benefits involves projecting future cash flows, estimating the number of employees and the benefits that are forfeited in the event of termination of employment, and discounting back to get the present value of the liability.

The current FRS 19 defined 'short-term employee benefits' as those benefits due to be settled (i.e. paid) within 12 months after the end of the period in which the employees render the related service. 'Other long-term employee benefits' are defined by default as being all employee benefits other than short-term employee benefits, post-employment benefits and termination benefits. FRS 19R defines short-term employee benefits as follows:

Extracts from FRS 19R

8 Short-term employee benefits are employee benefits (other than termination benefits) that are expected to be settled wholly before twelve months after the end of the annual reporting period in which the employees render the related service.

*The distinction between short-term and other long-term employee benefits depends on when the entity **expects** to settle (i.e. pays) the benefit.*

Insights – How might this change affect you?

Given the change in focus from when a benefit is due to be settled to when settlement is expected to occur, and the introduction of 'wholly' into the definition of short-term employee benefits, our first impression is that entities may need to re-look at their existing benefits to determine the appropriate classification under this new definition.

We expect that some benefits currently classified as short-term may need to be reclassified to other long-term.

Entities need to exercise more judgement in estimating future behaviour of employees and future cash flows and the appropriate discount rate to compute the obligations for other long-term employee benefits.

Illustrative Example 1 – Short-term employee benefits or other long-term employee benefits

Facts

Co A awards a bonus to its employees in respect of their service in Year 1. The employees are entitled to draw on the bonus payable to them from the middle of Year 2.

However, the applicable tax rule is that employees will pay a lower level of tax on their bonus if they draw their bonus only after the end of Year 3.

Current FRS 19

The bonus provision at the end of Year 1 would have been classified as 'short-term employee benefit' as the employees could have drawn their full entitlement in Year 2.

FRS 19R

If the entity expects any of the bonus at the end of Year 1 not to be drawn in Year 2, then the bonus provision will be classified as 'other long-term employee benefits'. The entity will need to consider separately the presentation of the provision as either a current or non-current liability, applying the usual classification criteria in FRS 1.

Termination benefits – change in recognition rules

The amended standard removes the concept of 'demonstrably committed' as the basis for recognition of termination payments.

Instead, the IASB decided that the factor determining the timing of recognition is the entity's inability to withdraw the offer of termination benefits.

Termination benefits are a separate category of employee benefits under FRS 19 because the event that gives rise to the obligation to pay the employees is the termination of employment, rather than employee service.

Under the current FRS 19, termination benefits are recognised when the entity is demonstrably committed to either:

(a) terminate the employment of an employee or group of employees before the normal retirement date; or

(b) provide termination benefits as a result of an offer made in order to encourage voluntary redundancy.

Under FRS 19R, an entity recognises a liability for termination benefits as follows:

Extracts from FRS 19R

165 An entity shall recognise a liability and expense for termination benefits at the earlier of the following dates:

(a) when the entity can no longer withdraw the offer of those benefits; and

(b) when the entity recognises costs for a restructuring that is within the scope of FRS 37 and involves the payment of termination benefits.

(I) Termination benefits payable due to an entity's decision to terminate employees' employment.

The entity can no longer withdraw the offer when the entity has communicated to the affected employees a plan of termination meeting all of the following criteria.

(a) It is unlikely that significant changes to the plan will be made.

(b) The number of employees whose employment is to be terminated, their job classifications or functions and their locations and the expected completion date are identified.

(c) The termination benefits that employees will receive are established in sufficient detail that employees can determine the type and amount of benefits they will receive when their employment is terminated.

(II) Termination benefits payable due to an employee's decision to accept an offer of termination.

The entity can no longer withdraw the offer at the earlier of:

(a) when the employee accepts the offer; and

(b) when a restriction (e.g. a legal, regulatory or contractual requirement or other restriction) on the entity's ability to withdraw the offer takes effect

Insights – How might this change affect you?

The changes in respect of the recognition requirements for termination benefits are relevant to all entities that incur termination benefits, although they will be most significant to those entities that carry out restructurings as terminations are often associated with those events.

Employee termination benefits payable as part of a wider restructuring will now be recognised at the same time as the other restructuring costs. This simplifies accounting and allows an entity to have a comprehensive view of all restructuring related costs recognised at the same time.

Illustrative Example 2 – Termination benefits or benefits for future service (Adapted from FRS 19R illustrative example)

Facts
As a result of a recent acquisition, an entity plans to close a factory in 10 months and, at that time, terminate the employment of all its 120 employees at the factory. The entity will pay $10,000 per employee as termination benefit upon termination.

However, to complete some contracts, the entity needs to retain some employees until the closure of the factory in 10 months' time. Accordingly, the entity announced to all its employees that employees who stay and render services until the closure of the factory will each receive $30,000.

The entity expects 20 employees to leave before closure, and 100 employees to stay until the date the factory is closed.

Therefore, the total expected cash outflows =
$3.2 million (i.e. 20 employees * $10,000 + 100 employees * $30,000).

Termination benefits
Termination benefits = 120 employees * $10,000 = $1.2 million.

These represent the benefits payable as a result of the entity's decision to close the factory and terminate their employment, regardless of whether the employees stay and render service until the closure of the factory or they leave before closure.

Assuming the entity is not able to withdraw the offer, $1.2 million would be recognised at the earlier of the date of announcement or when any related restructuring costs are recognised.

Benefits in exchange for service
Benefit in exchange for future services = 100 employees * ($30,000 - $10,000) = $2 million.

These represent the incremental benefits that employees will receive if they provide services for the full ten-month period.

The entity accounts for this $2 million as short-term employee benefits, and thus discounting is not required. Accordingly, an expense of $200,000 per month (i.e. $2 million over 10 months) is to be recognised over the service period of 10 months.

When the revised standard is first adopted

FRS 19R is effective for annual periods beginning on or after 1 January 2013, and generally requires retrospective application.

Find out more

First Impressions: Employee Benefits is a publication produced by KPMG International Standards Group. This publication considers the requirements of the amended IAS 19 *Employee Benefits*. It includes a discussion of the key elements of the new requirements and highlight areas that may result in a change of practice. Examples are provided to assist in assessing the impact of implementation.

This publication may be downloaded free of charge at:
http://www.kpmg.com/global/en/issuesandinsights/articlespublications/first-impressions/pages/first-impressions-employee-benefits.aspx

Would real estate companies end up with a bigger balance sheet?

The inclusion of the principal versus agent guidance in the new accounting standard on consolidation FRS 110 *Consolidated Financial Statements* reopens the controversial issue of who effectively has control over real estate investment trusts (REITs).

Singapore REITs are typically managed by their sponsors' wholly-owned subsidiaries. The REIT sponsor, usually the entity that injects the initial portfolio of properties at the date of listing, tends to retain a significant but less than the majority stake in the REIT.

Currently all listed Singapore REITs are structured as externally-managed trusts. What this means is that on creation, the structure is designed such that the decision-making authorities over the relevant activities are delegated to an external Asset manager. Therefore, the assessment of voting rights becomes non relevant when determining who has control over a REIT as the rights to direct the relevant activities are established by contractual arrangement.

Relevant activities of a typical REIT

According to FRS 110, the relevant activities of a typical REIT are those activities that significantly affect the REIT's total return. These activities include:

- the acquisition and divestment of properties within the investment guidelines
- the management of a portfolio of properties (e.g. asset enhancement, asset redevelopment, minimise property expenses, attracting new tenants, improving rental rates, maintaining high occupancy)
- the management of the debt-equity financing mix; and
- the management of the financial risks (e.g. interest rate and foreign exchange risks).

The day-to-day property management functions such as leasing, accounting, marketing, promotion, coordination and property management for the properties are usually outsourced to a Property manager which carries out the activities under the supervision of the Asset manager. The Property manager is usually also wholly-owned by the sponsor.

The Asset manager is typically the key decision maker in a REIT structure. Because the Asset manager is related to the sponsor, the question is whether the manager is using its delegated power:

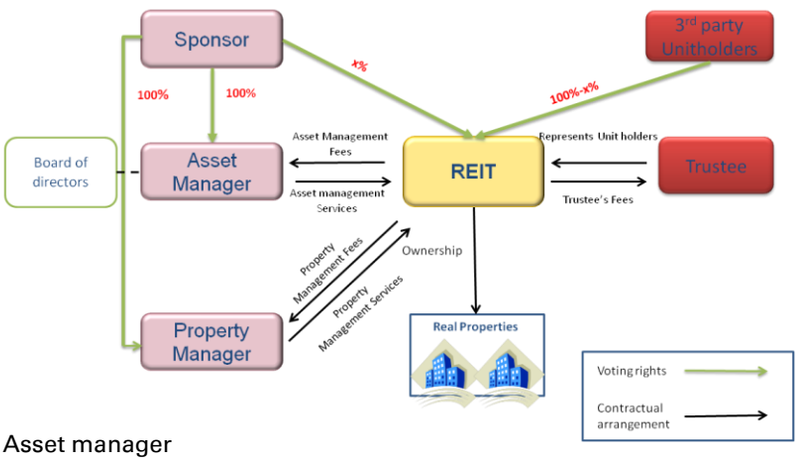
- to affect the returns of the sponsor, in which case the sponsor group is the principal and will consolidate the REIT; or
- to affect the returns of the unitholders as a class (i.e. all unitholders including the sponsor), in which case the manager is an agent for all unitholders and the sponsor may not consolidate the REIT.

FRS 110 includes the explicit concept of delegated power which means that sponsors now have specific literature to refer to when assessing their relationship with the REITs under the group's management.

However, the guidance involves many indicators, much judgement, and few bright lines – all of which will make it a challenge to operationalise. The aim of this article is to help sponsors focus on what we believe to be the key factors that drive the analysis. Whilst the analysis cannot be reduced to a simple quantitative process, we believe that a focus on key factors will help to provide a framework to operationalise the model.

Typical REIT Structure

The following diagram illustrates the relationship between a typical REIT, the sponsor, the Asset manager, the Property manager, the Trustee and the third party unitholders.



Asset manager

The Asset manager, typically wholly owned by the sponsor, makes decisions about the acquisition and divestment of properties within the investment guidelines. The manager also sets the annual operating budget for the management of the properties, makes decisions about enhancement and redevelopment of existing properties and decides the debt-equity financing mix and the hedging strategies of the REIT to optimise yield.

Board of Directors (BOD)

The BOD is the BOD of the Asset manager. Typically, a REIT will state in its annual report that the BOD is responsible for the overall management and corporate governance of the Asset manager and the REIT. Under Singapore regulations, independent directors should make up at least one-third of the Board. An independent director is defined as one who has no relationship with the company, its related corporations[1], its 10 percent shareholders[2] or its officers that could interfere, or be reasonably perceived to interfere, with the exercise of the director's independent business judgement with a view to the best interests of the company.

Property manager

The Property manager, typically wholly owned by the sponsor, manages the properties based on the parameters set in the annual operating budget and the strategic direction provided by the Asset manager.

Trustee

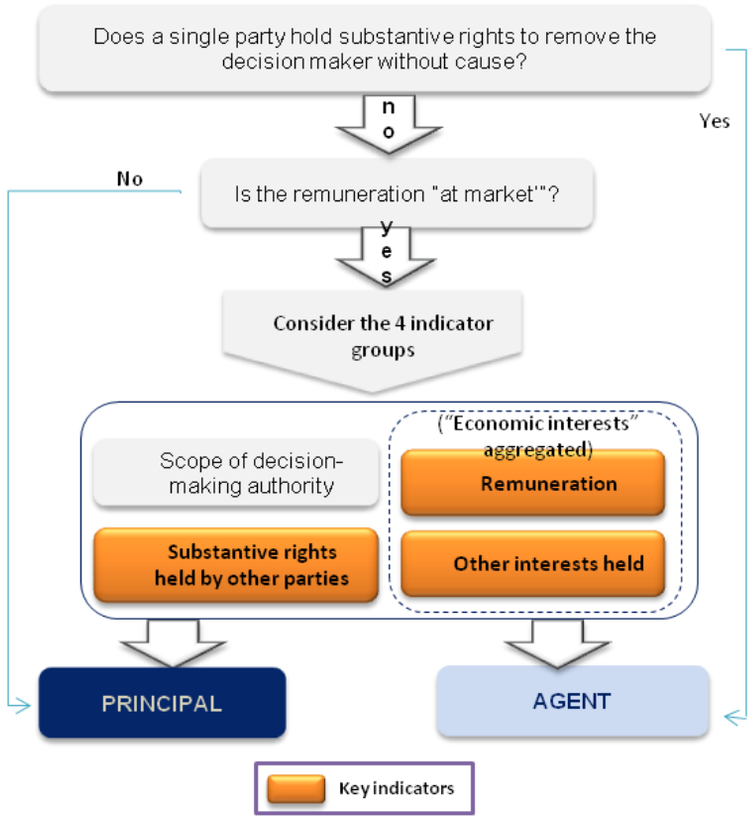
The Trustee of the REIT is typically a financial institution that is independent from the sponsor group. The Trustee has a fiduciary duty to safeguard the rights and interests of all unitholders. It is the legal owner of the assets of the REIT and hence, controls the disbursement of funds and signs all legal documents involving the REIT. It also has the legal ability to veto the Asset manager's decisions without cause.

[1] The term "related corporation", in relation to the company, shall have the same meaning as currently defined in the Companies Act, i.e. a corporation that is the company's holding company, subsidiary or fellow subsidiary.

[2] The term "10 percent shareholder" shall refer to a person who has an interest or interests in one or more voting shares in the company and the total votes attached to that share, or those shares, is not less than 10 percent of the total votes attached to all the voting shares in the company. "Voting shares" exclude treasury shares.

Principal or agent

The diagram below illustrates the steps that are followed by a decision maker when analysing whether it is acting as a principal or an agent.



Assessment of two indicators

In the context of a typical REIT structure, it appears that the analysis will come down to a combined assessment of just two indicators – substantive rights held by other parties and the sponsor group's aggregate economic interest in the REIT.

Rights held by others

Rights to be considered in this assessment include rights to remove the Asset manager (i.e. kick-out rights) and rights that could restrict the Asset manager's discretion over the relevant activities of the REIT. Relevant activities are activities that significantly affect the REIT's returns.

The focus of the assessment is whether those rights are substantive as FRS 110 requires one to look at substantive rights only. For a right to be substantive, the holder must have the practical ability to exercise that right. The standard provides a number of factors to consider in assessing whether a right is substantive:

a) barriers (economic or otherwise) that will prevent the holder (or holders) from exercising the right
b) benefits (economic or otherwise) that will encourage the holder (or holders) to exercise the right
c) number of parties required to exercise
d) conditions that narrowly limit the timing of exercise
e) absence of a mechanism allowing exercise; and
f) inability to obtain the information necessary for exercise.

Observations

In the context of a typical REIT structure, we believe that the following rights are critical to the assessment:

1. kick-out rights held by the unitholders
2. veto right held by the trustee; and
3. participating right held by the BOD of the Asset manager.

Determining whether these rights are substantive requires judgement. It appears that these are not simple yes/no tests. Judgement is required to determine the weight to be assigned to each right in the overall assessment.

When applying this judgement, it appears that the weight to be assigned to the participating right is closely linked to the strength of the corporate governance structure of the REIT. We would generally expect the rights held by others to be stronger in a structure with stronger corporate governance practices.

In a typical REIT structure, the presence of the three rights identified above is intended to limit conflicts of interest between the sponsor group and the REIT, thereby ensuring that the Asset manager uses its power to benefit all unitholders and not solely to benefit the sponsor group.

However, it is debatable as to what extent the presence of those rights actually helps to limit conflicts of interest between the sponsor group and the REIT.

1) Kick-out rights held by the unitholders
   A simple majority of the unitholders present and voting at a general meeting could remove the Asset manager without cause and there are mechanisms in place that allow and facilitate the unitholders to exercise their rights. However, the dispersed unitholdings by investors in a typical REIT structure makes it difficult, in practice, for the non-sponsor related unitholders to act together to remove the Asset manager.

2) Veto right held by the trustee
   The role of a trustee in a typical REIT structure is to provide independent oversight so as to limit conflicts of interest between the Asset manager and the owners (all unitholders). However, the division of responsibilities between the Asset manager and the Trustee is not entirely clear. Although the regulation imposes on the Trustee a fiduciary duty to ensure that the Asset manager acts in the best interest for all unitholders and the Trustee has the power to veto the decisions of the Asset manager, in practice, trustees could be seen as custodians and, therefore, conduct more of a compliance-type role to ensure that the Trust Deed and relevant laws and regulations are complied with.

3) Participating right held by the BOD of the Asset manager
   The BOD of the Asset manager is appointed by the shareholders of the Asset manager, typically the sponsor. Under the Companies Act, the BOD owes fiduciary duties to the Asset manager and not to the unitholders of the REIT.

   However, the terms of reference of the Asset manager's BOD require the BOD to look after the interest of the unitholders of the REIT. These responsibilities are usually communicated to the unitholders in the prospectus at the date of listing of the REIT. There appears to be a common understanding of that role in the marketplace.

   The directors are not appointed by the unitholders and the laws do not appear to impose on the directors a fiduciary duty to act in the best interest of the unitholders of the REIT. This remains a problematic area on the corporate governance front.

It should be noted that issues surrounding the effectiveness of the governance structure of Singapore REITs in reducing the principal-agent conflict between the external asset manager and the REIT unitholders were also heavily debated in recent times.

Aggregate economic interest

Aggregate economic interest refers to remuneration and other interests in the REIT attributable to the sponsor group (e.g. investments in units and guarantees) in aggregate.

FRS 110 requires an evaluation of the *variability and magnitude* associated with the aggregate economic interest in the REIT relative to the total variability of returns from the REIT. This evaluation is made primarily on the basis of returns expected from the activities of the REIT, but consideration should also be given to the maximum exposure to variability of returns.

Of these measures, it appears that the variability associated with the expected level of returns is the primary measure of aggregate economic interest. Other measures (magnitude and maximum exposure) however, are important in analysing marginal cases.

Observations

The assessment of variability of returns from the REIT is likely to be a challenging task due to the complex fee structures used in the industry. Based on our experience, fees paid to the sponsor group include asset management fees, property management fees, project management fees, leasing commission and transaction related fees such as acquisition and divestment fees. The fees are usually based on different benchmarks, which complicate the calculation. The common benchmarks are value of properties under management, revenues, net property income, net income and value of properties acquired or sold.

The standard does not include a mathematical formula that could be used to calculate variability of returns. Affected sponsors would have to develop a reasonable model to determine the expected level of return and the extent of exposure to variability of returns from the REIT.

What is clear in the standard is that the greater the magnitude of, and variability associated with its aggregate economic interest, the more likely it is that the sponsor group is a principal and therefore is required to consolidate the REIT.

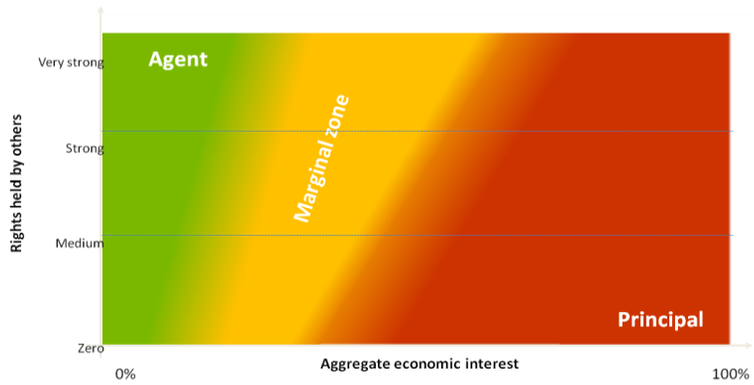
Trade-off between rights held by others and aggregate economic interest

The indicators are required to be considered together. The standard appears to suggest that the stronger the rights held by other parties, the more aggregate economic interest can be accepted. Conversely, the weaker the rights held by other parties, the less aggregate economic interest can be accepted while still being considered an agent.

The chart on the following page provides a way of visualising a general scheme for the result of combining different strengths of each indicator:

- in the green zone, the combination of strong rights held by others and low aggregate economic interest suggests that the management role is an agency role
- in the red zone, the combination of weak rights held by others and high aggregate economic interest suggests that the management role is a principal role
- in the marginal zone, the indicators do not give a clear answer.

For cases that fall into the marginal zone, the sponsor will need to consider certain other aspects to determine if its management role is an agent or a principal role. The question of where the marginal zone starts and finishes is not clear; there are no bright lines.



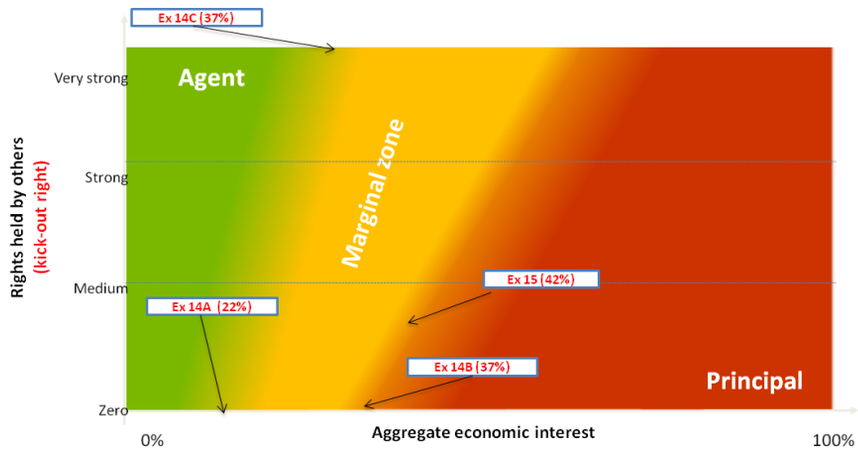
Combining the two indicators

The standard (as well as the *Effect Analysis* published by the IASB in September 2011 and republished in January 2012) provides examples of combinations of **solely kick-out rights** and aggregate economic interest, as shown below. From these examples (see table below), some fixed points about certain combinations can be derived.

FRS 110 Application Example	Fee	Performance fee	Interest held	Removal right	Variability of aggregate economic interest[3]	Agent/ Principal?
13	1%	-	10%	None	1% + 10% x 99% = 11%	Agent
14A	1%	20% over unspecified hurdle	2%	With cause only – zero weight	1% + 20% x 99% + 2%x (80%x 99%) = 22%	Agent
14B	1%	20% over unspecified hurdle	20%	With cause only – zero weight	1% + 20% x 99% + 20%x (80%x 99%) = 37%	**Principal**
14C	1%	20% over unspecified hurdle	20%	Without cause and held by a Board – very strong	1% + 20% x 99% + 20%x (80%x 99%) = 37%	Agent
15	1%	10% over unspecified hurdle	35%	Largely dispersed –weak	1% + 10% x 99% + 35%x (90%x 99%) = 42%	**Principal**
Effect analysis p.27	Immaterial (inferred)	Immaterial (inferred)	45%	None (inferred)	45%	**Principal**

Although these examples do not provide bright lines, they do narrow the areas in which significant judgement is required to operationalise the model. By presenting them in the format below, the concept of a marginal zone between agent and principal becomes clearer. However, we do not suggest that such a chart can be used as a quantitative tool, but merely illustrates the basic idea.

[3] In FRS 110 (and the Effect Analysis), the examples do not quote figures for aggregate economic interests. The variability is calculated based on the approach discussed in the KPMG publication: Applying the consolidation model to fund managers.



When no kick-out rights exist, based on the figures derived from FRS 110's examples, the changeover from agent to principal occurs between approximately 22 and 37 percent (the marginal zone between Examples 14A and 14B).

When stronger kick-out rights exist, a higher variability might still support an agent outcome. For instance, Example 14C has without-cause, board-level, kick-out rights (considered very strong) and can withstand 37 percent aggregate economic interest, while still being deemed an agent. In Example 14B, which has the same variability but no kick-out rights, the manager is deemed a principal.

When kick-outs right are held by a widely dispersed group, based on the figures derived from FRS 110's example 15, a 42 percent aggregate economic interest would indicate that the manager is a principal.

Observations

In the context of a typical REIT structure, unitholders typically have the right to remove the Asset manager by way of a resolution passed by a simple majority of unitholders present and voting at a general meeting, with no unitholders including the Asset manager and its related parties, being disenfranchised.

If we ignore the rights held by the Trustee and the BOD of the manager and focus the assessment only on kick-out rights, a 42 percent aggregate economic interest held by the sponsor group would point towards consolidation by the sponsor as the remaining unitholdings are typically widely dispersed.

The Trustee's veto right and the BOD's participating right will help to strengthen the sliding-scale strength of "rights held by other parties" as the assessment ultimately needs to consider all relevant aspects and factors, even if they cannot be adequately included in the two-dimensional graph.

Marginal zone – factors to consider that could help frame the judgment

If a case falls within the marginal zone, then a reasoned judgement as to whether the sponsor group is a principal or an agent would be required. Factors to consider include the following:

Factors	Indicates no control (Agent)	Indicates control (Principal)
De *facto* power (if voting rights are relevant, remaining unitholdings are widely dispersed and Sponsor group can vote)	Low percentage of voting interest	High percentage of voting interest
Availability of replacement for manager	There are other managers willing and able to provide the services and take on other interests held by the incumbent sponsor and manager.	There is no other manager willing or able to provide the services or take on other interests held by the incumbent sponsor and manager.
Other contractual relationships (e.g. master lease agreement, income support, trademark)	No other contractual relationships exist between the group and the fund that would constrain the removal of manager or increase the group's exposure to variability of returns.	Other contractual relationships between the group and the REIT exist that would significantly constrain the removal of manager or significantly increase the group's exposure to variability of returns.
Expected magnitude of aggregated economic interest	Lower	Greater
Likelihood of the expected performance level applied in the variability calculation not being reached in all periods	Likely	Unlikely
Maximum exposure to variability of returns	Lower	Greater
Alignment of manager's and investors' interests - fees (e.g. Hurdle rate - manager more sensitive to changes in fund returns, Performance fees paid cannot be clawed back, Gross-basis management fee in a geared property fund)	Strong alignment	Weak alignment
Alignment of manager's and investors' interests - others (e.g. holds subordinated residual interest and provides credit enhancement)	Strong alignment	Weak alignment

Concluding remarks

It remains to be seen how preparers and stakeholders will ultimately address this issue and what threshold of unit holdings would be considered acceptable for non-consolidation.

Given the current effective date of 1 January 2013, it is important to start the assessment sooner rather than later. However, the ongoing interpretation of the standard at the global level is likely to impede this process.

Should there be a need to consolidate a REIT, leverage ratio or gearing of the sponsor group is expected to be affected as REITs typically have a higher gearing as compared to their sponsors. This may increase the risk of breaching debt covenants. If such a breach becomes probable, the sponsor may need to:

- renegotiate debt covenants with lenders
- secure replacement funding; or
- develop alternative financing plans.

Furthermore, management and employee remuneration may change if the bonus schemes have targets that are based on metrics derived from the consolidated financial statements such as returns on assets. If impacted, sponsors may need to adjust their remuneration policies and targets.

Disclosures

Regardless of the conclusion reached, it is important to note that significant judgements and assumptions made in determining whether the power arising solely from the management role is deemed to be used in the capacity of a principal or an agent is one example of situations in which FRS 112 requires disclosure.

Furthermore, if the REIT is considered a structured entity under FRS 112, the sponsor would need to provide extensive qualitative and quantitative disclosures about the nature of its interest and the nature of the risks of the structured entity.

International developments

IASB / FASB update status of convergence projects

"National rules acted as an impediment to the free flow of capital, they increased costs for multinational companies and they created opportunities for regulatory arbitrage.

The answer was, of course, to raise the bar internationally and to develop a single set of high quality and globally-accepted accounting standards.

Perhaps the most eagerly anticipated decision is whether and how the United States will incorporate IFRSs into its own financial reporting regime. "

On 16 May 2012 Michel Prada, Chairman of the IFRS Foundation Trustees, addressed the 2012 IOSCO conference, in Beijing, China

On April 2012, the IASB and FASB (the 'Boards') issued a joint progress report on the Boards' convergence activities, for consideration at the April 2012 meeting of G20 Finance Ministers and Central Bank Governors. The progress report:

- identifies **mid-2013** as the new target for completion of major work on convergence
- explains how the Boards plan to pursue convergence; and
- summarises convergence efforts to date.

The Boards remain focused on their four major convergence projects listed below.

1) Financial instruments
   - With the IASB's decision to reconsider some classification and measurement requirements, the prospects for closer alignment in this area have improved.
   - The Boards are reaching agreement on nearly all key impairment issues, and plan to issue exposure drafts in the second half of 2012.
   - The Boards have still not agreed on hedge accounting.

2) Revenue recognition
   - The Boards' deliberations to date have resulted in agreement on all key issues.

3) Leases
   - The Boards' current focus is on the profit or loss profile over the life of a lease, and whether all leases should be accounted for in the same way.

4) Insurance contracts
   - The Boards are making further efforts to narrow differences before they issue their next due process documents.

For more information, you may refer to KPMG's International publication *In the Headlines* May 2012, Issue 2012/06.

Annual Improvements to IFRS: 2009 to 2011 Cycle

On 17 May 2012, the IASB issued the fourth batch of annual improvements to make necessary, but not urgent, amendments to IFRS. The amendments encompass six amendments to five standards.

The amendments are effective for annual periods beginning on or after 1 January 2013, and are to be applied retrospectively.

The amendments are mainly minor clarifications or removals of unintended inconsistencies between IFRSs.

The amendment to FRS 1 *Presentation of Financial Statements* may be of particular interest. The amendment clarified that in the event of a change in accounting policy, reclassification or restatement, a third balance sheet (as at the beginning of the preceding period) is only required if the change has a material effect on the information in the third balance sheet. In addition, related notes to the third balance sheet need not be presented.

In Singapore, as at 15 June 2012, the ASC had yet to issue the amendments.

A new cycle of proposed improvements to IFRS

On 3 May 2012, IASB issued the fifth batch of proposed annual improvements to make necessary, but not urgent, amendments to IFRS. In this batch, there are 11 proposed amendments to 10 standards.

Most of the proposed amendments are proposed to be effective for annual periods beginning on or after 1 January 2014, and are to be applied retrospectively. The proposals are currently open for comments until 5 September 2012.

The proposed improvements are:

Standard and subject	Key proposed change
IFRS 2 *Share-based Payment* Definition of 'performance condition' and 'service condition'	To clarify the basis on which a 'performance condition' can be distinguished from a 'non-vesting condition'.
IFRS 3 *Business Combinations* Classification and measurement of contingent consideration	To clarify that an entity applies IAS 32 *Financial Instruments: Presentation* to determine the classification of contingent consideration in a business combination as a financial liability or equity.
IFRS 8 *Operating Segments* Disclosures on aggregation	To require the disclosure of judgements in applying aggregation criteria in identifying operating segments.
Reconciliation of total assets	To clarify that the reconciliation of total of reportable segments' assets to the entity's assets is only required if a measure of segment assets is regularly provided to the entity's chief operating decision maker.
IFRS 13 *Fair Value Measurement* Measurement of short-term receivables and payables	To permit entities to continue to measure short-term receivables and payables that have no stated interest rate at invoice amounts, if the effect of discounting is immaterial.
IAS 1 *Presentation of Financial Statements* Current/non-current classification of liabilities	To clarify that for an existing loan due within 12 months to be classified as non-current, the entity must have the discretion to refinance or roll over the loan with the same lender, and on the same or similar terms.
IAS 7 *Statement of Cash Flows* Classification of capitalised interest	To clarify that the classification of capitalised interest in the cash flow statement would follow the classification of the underlying asset.
IAS 12 *Income Taxes* Recognition of deferred tax assets for unrealised losses	To clarify how an entity assesses whether to recognise a deferred tax asset.
IAS 24 *Related Party Disclosures* Extension of 'related party' definition	To extend the definition of 'related party' to include a management entity that provides key management personnel services to the reporting entity.
IAS 36 *Impairment of Assets* Harmonisation of disclosures related to recoverable amount	To require disclosure of the discount rate used in measuring fair value less costs of disposal when a present value technique is used.
IAS 38 *Intangible Assets* and IAS 16 *Property, Plant and Equipment* Proportionate restatement of accumulated amortisation (depreciation) upon a revaluation	To clarify that, when revaluing property, plant and equipment and intangible assets, the restatement of the accumulated depreciation or amortisation need not be proportionate to the change in the gross carrying amount of the asset.

In Singapore, the ASC has issued the same exposure draft on 7 May 2012, and comment period closes on 22 June 2012.

Common abbreviations

ASC	Accounting Standards Council in Singapore
ACRA	Accounting & Corporate Regulatory Authority
CPF	Central Provident Fund
DP	Discussion paper
ED	Exposure Draft
FASB	U.S. Financial Accounting Standards Board
FSP	FASB Staff Position
FRS	Singapore Financial Reporting Standard
GAAP	Generally Accepted Accounting Principles
IAS	International Accounting Standard
IAASB	International Auditing and Assurance Standards Board
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
ICPAS	Institute of Certified Public Accountants of Singapore
IFRIC	International Financial Reporting Interpretations Committee
IFRS	International Financial Reporting Standard
INT FRS	Interpretation of Financial Reporting Standard
IRAS	Inland Revenue Authority of Singapore
LM	Listing Manual of the Singapore Exchange
SGX	Singapore Exchange

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