

Corporate Watch

March/April 2004 Issue

IFRS 2 – Counting the true cost of executive compensation

On 19 February 2004, the International Accounting Standards Board (IASB) published International Financial Reporting Standard 2 Share-Based Payments (IFRS 2) which is effective from 2005 for existing or first-time adopters of IFRS. IFRS 2 addresses the controversial area of accounting for employee share-based compensation, requiring the fair value of employee share-based compensation to be reported as an expense in the income statement.

In the United States (US), the Financial Accounting Standards Board (FASB) has proposed a similar requirement to account for employee share-based compensation as an expense. A few large US multi-national companies have since announced publicly their intention to do so.

Many national standard setters may choose to follow the IASB's and FASB's lead. The Council on Corporate Disclosure and Governance (CCDG) in Singapore announced in April 2004 its intention to issue the local equivalent (FRS 102) by July 2004. However, it is unclear if any modification would be made to IFRS 2 for FRS 102. FRS 102 is expected to be effective for financial periods beginning on or after 1 January 2005.

A myriad of share-based compensation schemes exists in practice and their increasing prevalence in many countries have added the impetus for appropriate accounting rules. Until IFRS 2 was issued, no accounting standard governed the recognition or measurement of such transactions.

Warren Buffet, a well-known American investor, put forth a succinct but illuminating comment for tightening the accounting rules on executive and employee share option schemes:

"Accounting principles offer management a choice: pay employees in one form and count the cost, or pay them in another form and ignore the cost. Small wonder then that the use of options has mushroomed," he observes. *"If options aren't a form of compensation, what are*

they? If compensation isn't an expense, what is it? And, if expenses shouldn't go into the calculation of earnings, where in the world should they go?"

IFRS 2 is based on its preceding exposure draft issued by the IASB in November 2002, with a few changes. One significant change is that the "unit of service" method used for computing expense on employee share schemes is now replaced by a method similar to that in the US Statement of Financial Accounting Standard 123. In addition, IFRS 2 allows the use of the "intrinsic method", but only in very rare circumstances.

The following paragraphs give an overview of the scope, measurement and recognition rules in IFRS 2 and a discussion of selected key issues on

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valuing employee share options. Their main focus will be transactions with employees, for transactions with non-employees are not expected to pose as many difficulties.

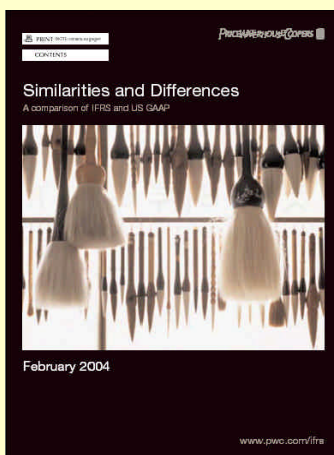
Scope of IFRS 2

IFRS 2 applies to all entities, and extends beyond employee share option schemes (references to employees include others providing similar employee services) to include schemes for service providers and others (e.g. suppliers of goods and services). Three types of share-based payment transactions are defined:

- **Equity-settled** – entity receives goods and services as consideration for equity instruments of the entity (including shares or share options);

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PwC has published the “*Similarities and Differences – A comparison of IFRS and US GAAP*” to assist our clients in keeping abreast of the changes.



This publication is available for download at our PwC Global website (www.pwc.com/corporatereporting).

- **Cash-settled** – entity acquires goods and services and incurs a liability for an amount that is based on the price (or value) of the entity's equity instruments; and
- The entity receives or acquires goods or services where the transaction terms provides a **choice of settlement** either by the issue of equity instruments or in cash based on the value of the entity's equity instruments (or combination of both).

IFRS 2 also applies to transfers of equity instruments of the entity's parent or any other entity in the group to parties that have supplied goods or services to the entity.

However, IFRS 2 is not applicable to a business combination where equity instruments are issued by the acquirer in exchange for the control of the acquiree. IFRS 2 is also not applicable for certain contracts under IAS 32 and 39 *Financial Instruments*.

Measurement and recognition

IFRS 2 sets out the measurement and recognition principles for the share-based payment transactions under its scope.

The overall principles are:

- An entity recognises goods or services received or acquired in a share-based payment transaction as it obtains the goods or receives the services;
- When the goods or services received or acquired in a share-based payment transaction do not qualify for recognition as assets, the entity should recognise an expense; and
- The entity should recognise an increase in equity if the transaction is equity-settled, or a liability if the transaction is cash-settled.

Impact of vesting conditions on timing of recognition

A grant of equity instrument might be conditional upon satisfying specified vesting conditions. For instance, share options granted may only vest after a specified period of continuous service.

- Vest immediately

If the equity instruments granted by the entity vest immediately, the entity should presume that the award is for past services rendered by the employee. Hence, the total expense, based on the fair value of the equity instruments at the grant date, is fully recognised on the grant date.

- Vest at a subsequent date

If the equity instruments granted to employees is subject to a *service condition* and therefore, vest subsequent to the grant date, the entity should presume that the share award is for future services to be rendered over the vesting period. Hence, the total expense, based on the fair value of the equity instruments at the grant date, is expensed over the vesting period.

Equity-settled transactions with parties other than employees

For transactions with parties other than employees, IFRS 2 includes a rebuttable presumption that the fair value of goods and services can be estimated reliably. Hence, goods and services received are measured at their fair value at the date when the goods or services are received, with a corresponding increase in equity.

In rare cases, if the entity rebuts this presumption because it cannot estimate reliably the fair value of goods and services received, the entity should measure the fair value of the goods and services and the corresponding increase in equity by referring to the fair value of the equity instruments granted, measured at the date the entity obtains the goods and services.

Equity-settled transactions with employees (or others providing similar services)

For transactions with employees, IFRS 2 requires the entity to measure the fair value of the employee services received by reference to the fair value of the equity instruments granted, on the basis that it is typically not possible to estimate reliably the fair value of employee services received.

The fair value of equity instruments is measured at the grant date using:

- **Market prices**, if available, taking into account the terms and conditions upon which those equity instruments are granted. Such market prices are not changed subsequent to the grant date; or
- A **valuation technique** that is consistent with generally accepted valuation methodologies for pricing financial instruments (e.g. employee share options), such as an option pricing model, if the market prices are not available. Similar to using market prices, the fair value of the equity instrument is not remeasured after the grant date.
- **Intrinsic value**, in very rare cases when the fair value of the equity instruments granted cannot be estimated reliably at grant date.

However, the entity should remeasure this value at each balance sheet date until the equity instruments are settled. This option is absent in the exposure draft.

Modifications, cancellations and settlements

For modifications, the entity should recognise the incremental increase in the fair value of the equity instrument (measured by the difference between the fair value of the instrument at the modification date and the fair value of the instrument at the grant date) over the remaining vesting period.

For cancellations (other than by forfeiture) and settlements, the entity should account for these as an acceleration of vesting and therefore recognise immediately the amount that otherwise would have been recognised for the remaining vesting period.

Impact to income statement

As mentioned earlier, if the equity instruments vest immediately at the grant date, the entity recognises the total expense (obtained by multiplying the number of vested awards to the fair value of each equity instrument at the grant date) *immediately* in the income statement at the grant date.

If the equity instruments vest subsequent to the grant date, at the grant date and at every reporting date, the entity will estimate the total expense (obtained by multiplying the expected number of awards to be vested at the end of the vesting period to the fair value of each equity instrument at the grant date) and account for the proportionate amount (pro-rated on time-basis) for each reporting period.

At each reporting date, the entity is required to re-estimate the number of awards expected to vest by the end of the vesting period. Adjustment of the estimate is made in the income statement of that accounting period. The cumulative effect is that by the end of the vesting period, the expense included in the income statement would be based on the number of equity instruments that actually vested.

After the vesting date, if the equity instruments lapsed or is cancelled (due to forfeitures), the expense previously charged to the income statement is not reversed. However, the entity may choose to make transfers between the different classes of equity.

Payments made for settlement of cancellations is accounted for as a repurchase of equity, except to the extent that the payment exceeds the fair value of equity instruments at the repurchase date, of which the excess will be recognised as an expense.

Cash-settled transactions

The measurement and recognition rules of cash-settled transactions are similar to those of equity-settled transactions, except that the liability for cash-settled is re-measured at each reporting date until the date of settlement (as opposed to the end of vesting period for equity-settled). Any change in the liability is recognised immediately in the income statement. In addition, the re-measurement of the liability includes the re-measurement of the fair value of the equity instruments at each reporting date.

Transactions with choice of equity or cash settlement

Where employees have the choice

Under this arrangement, the entity would have granted a compound financial instrument, which includes a debt component (i.e. the employees have the right to demand settlement in cash) and an equity component (i.e. the employees have the right to demand settlement in equity instruments).

The entity should account for the components separately. The debt component should be accounted for in accordance with the requirements applicable to cash-settled transactions, while the equity component in accordance with the requirements applicable to equity-settled transactions.

Where entity has the choice

Under this arrangement, the entity shall determine whether it has a present obligation to settle in cash. The entity has a present obligation to settle in cash if the choice to settle in equity has no

commercial substance or the entity has a past practice or a stated policy of settling in cash, or generally settles in cash whenever the counterparty asks for cash.

A arrangement with a obligation to settle in cash would be accounted for as cash-settled transactions. Otherwise, the arrangement would be accounted as equity-settled.

Determination of fair value of equity instruments

IFRS 2 devoted a 12-page appendix (Appendix B) which is an integral part of the standard, discussing the measurement of fair value of shares and share options granted.

For measuring the fair value of share options without reliable market prices, IFRS 2 requires the use of an appropriate option pricing model, but does not mandate the use of any specific model. The two models mentioned were Black-Scholes model and Binomial model.

Concerns regarding the reliability of the valuation models stems from the fact that share options granted to employees are subject to terms and conditions that do not usually apply to traded options. For example, employee options are not exercisable during the vesting period but are exercisable any time between the vesting and the expiry date. The Black-

ED on INT FRS – Applying FRS 29 *Financial Reporting in Hyperinflationary Economies* for the first time

On 20 March 2004, the Council on Corporate Disclosure and Governance issued the above exposure draft, which mirrors D5 that was issued by IFRIC on 11 March 2004. This interpretation contains guidance on how an entity shall restate its financial statements in the first year it identifies the existence of hyperinflation in the economy of its functional currency. The comment deadline ended on 14 April 2004.

For the complete exposure draft, please visit the CCDG website (www.ccdg.gov.sg).

Scholes model caters to options with fixed exercise dates while the Binomial model to those with flexible exercise dates. Hence, whichever model is used, modifications should be made for the special characteristics of employee share options.

At a minimum, option pricing models takes into account the following factors:

- exercise price of the option;
- expected life of the option;
- current share price of the underlying shares;
- expected volatility of the share price;
- expected dividends on the shares; and
- risk free interest rate for the life of the option.

The fair value calculated is hence dependent upon the inputs to and assumptions included in the model. There are likely to be a range of acceptable assumptions that can give rise to a range of calculated fair values. For example, employee share options are often exercised early, thus requiring the expected exercise period to be estimated.

However, the exercise pattern may not be homogeneous among different employee groups. Expected volatility could also have vastly different values depending on the period of the historical volatility that it is based on, the period of the company being listed (e.g. newly listed or unlisted companies would have to find suitable surrogate volatility) and other factors.

IFRS 2 also requires the entity to incorporate market price-based performance conditions (e.g. target share price) into the option-pricing model applied at the grant date. Vesting conditions other than market conditions (e.g. continual employment) should not be included when estimating the fair value at the grant date.

Extensive disclosure requirements

IFRS 2 prescribes extensive disclosure requirements principally to enable users



to understand the nature and extent of share-based payment transactions that existed during the reporting period, and how the fair values of the goods and services received or the equity instruments granted during the reporting period were determined. This would include disclosures on what option pricing model was used and the inputs to the model, how expected volatility was determined and the extent to which it was based on historical volatility, and whether other features of the option grant were incorporated in the model and how they were accounted for.

Transitional provisions

For equity-settled transactions, IFRS 2 is applicable to shares, share options or other equity instruments granted after 7 November 2002 that have not vested by 1 January 2005, the effective date of IFRS 2. Entities are encouraged but not required to apply IFRS 2 to other grants of equity instruments, which they previously disclosed publicly their fair values. However, disclosure requirements apply to all grants of equity instruments, regardless of vesting date. Retrospective application is required for liabilities arising from cash-settled transactions.

What do you need to do NOW?

The application of IFRS 2 requires significant planning and effort. If IFRS 2

is adopted in Singapore with effect from 1 January 2005, companies should commence the implementation by addressing the following:

- Determine the data needed and the impact on current systems (e.g. expected forfeitures, historical exercise patterns);
- Select and review a suitable pricing model for determining the fair value of the equity instruments;
- Collate suitable inputs for the pricing model;
- Simulate the impact on financial statements; and
- Assess the sensitivity of the computation to the key assumptions and the pricing model.

For many of our local companies, the above exercise would likely involve external consultants and specialists. Companies may, after assessing the financial impact of their existing plans, find it necessary to modify their share plans. But, it is important to consider the human resource perspective on any proposed changes.

Please watch out for a PwC publication on IFRS 2 in our next issue of Corporate Watch.

IASB Improvements Project Series

- IAS 27 *Consolidated and Separate Financial Statements*, IAS 28 *Investments in Associates* and IAS 31 *Interests in Joint Ventures*

The International Accounting Standards Board (IASB) embarked on a project (generally referred to as “*Improvements Project*”) in 2001 to reduce or eliminate alternatives, redundancies and conflicts within the International Accounting Standards (IAS), to deal with some convergence issues and to make other improvements. Exposure drafts to amend the IAS were issued by the IASB in May 2002. All 13 revised standards were issued and one standard was withdrawn by the IASB in December 2003. In Singapore, similar exposure drafts were issued in July 2002 and the revised standards, except for revised IAS 40, were issued with some refinements in April 2004. IAS 40 would be considered for adoption at a later stage.

This article is part of a series that started in December 2003 where we highlight the key changes between the revised IAS and their exposure drafts. In this issue, we address IAS 27 *Consolidated and Separate Financial Statements*, IAS 28 *Investments in Associates* and IAS 31 *Interests in Joint Ventures*.

IAS 27 *Consolidated and Separate Financial Statements*

The IASB's main objective for revising IAS 27 was to reduce alternatives in accounting for subsidiaries in the consolidated financial statements and in accounting for investments in the separate financial statements of a parent, venturer or investor.

The following illustrate the new requirements in revised IAS 27, in comparison to those in its exposure draft (ED) :

Criteria for an exemption from preparing consolidated financial statements

The previous version of IAS 27 required consolidated financial statements to be presented by all, except for a parent that is either a wholly-owned subsidiary or a virtually wholly-owned subsidiary that has obtained the approval of the owners of the minority interest.

The ED to IAS 27 revised the requirements. It exempted a parent from preparing consolidated financial statements when all of the following criteria were met :

(a) it was a wholly-owned subsidiary or the owners of the minority interest, including those not otherwise entitled to vote, unanimously agreed that the parent need not present consolidated financial statements;

(b) its securities were not publicly traded;

(c) it was not in the process of issuing securities in public securities markets; and

(d) the immediate or ultimate parent published consolidated financial statements that complied with IFRS.

However, the IASB acknowledged that the requirement to obtaining unanimous agreement of minority shareholders may not be practical. The words "its securities were not publicly traded" and "in the process of issuing securities in public securities markets" were also not sufficiently clarified. Consequently, the revised IAS 27 now exempts a parent from preparing consolidated financial statements if and only if :

(a) the parent is itself a wholly-owned subsidiary or is a partially-owned subsidiary of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements;

(b) the parent's debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets);

(c) the parent did not file, nor is it in the process of filing, its financial statements with a securities

commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market; and

(d) the ultimate or any intermediate parent of the parent produces consolidated financial statements available for public use that comply with IFRS.

Such exempted parents would be required to prepare their financial statements in the same manner as for parents that prepare separate financial statements. In other words, investments in subsidiaries, jointly-controlled entities and associates shall be accounted for either at cost or in accordance with IAS 39, *Financial Instruments : Recognition and Measurement*.

Exemption from consolidation based on temporary control

The previous version of IAS 27 required a subsidiary to be excluded from consolidation when (1) the subsidiary was acquired and held exclusively with a view to its subsequent disposal in the near future or (2) the subsidiary operated under severe long-term restrictions.

Noting that 'in the near future' might have been misread or interpreted loosely, the IASB replaced those words with the words "within 12 months" in the ED to IAS 27. It also removed the exemption for a subsidiary operating under severe long-term restrictions from consolidation, on the basis that such restrictions on the



transfer of funds from the subsidiary to the parent did not preclude control.

The revised IAS 27 retains the above requirements in the ED. Additionally, it requires :

- management to actively seek for a buyer for a subsidiary to be excluded from consolidation; and
- when management do not dispose of a subsidiary previously excluded from consolidation within 12 months from acquisition, that subsidiary should be consolidated as from the date of acquisition, with restatement of all periods since acquisition. The 12-month presumption could be rebutted in cases where a buyer has been found, but the relevant regulatory or other approvals for the disposal are pending.

That said, the IASB will be considering whether to remove this scope exclusion as part of its deliberation of ED 4, *Disposal of Non-current Assets and Presentation of Discontinued Operations*.

IAS 28 Investments in Associates

The IASB's main objective for revising IAS 28 was to reduce alternatives in the application of the equity method and in accounting for investments in associates in separate financial statements.

The major changes between the ED to IAS 28 and the revised IAS 28 are as follows :

Scope exclusion

The ED to IAS 28 proposed that IAS 28 would not apply to investments in associates held by :

- (a) venture capital organisations;
- (b) mutual funds, unit trusts and similar entities including investment-linked insurance funds

that were measured at fair value in accordance with IAS 39, when such measurement is well-established practice in those industries.

The investments in associates measured at fair value in accordance with IAS 39 could have their fair value adjustments be accounted for either in the income statement or in the equity. In view that the IASB is of the opinion that such changes in fair value should be reported in the income statement, the revised IAS 28 is amended to require such investments in associates be classified as 'held for trading'. The reference to "well established practice in those industries" is also removed.

Exemption from applying equity method based on temporary control

Consistent with the amendments in the revised IAS 27, the revised IAS 28:

- replaces the words 'in the near future' with the words 'within 12 months'; and
- requires management to actively seek for a buyer.

when exempting associates from being accounted for using equity method. Such investments shall also be classified as held for trading in accordance with IAS 39.

Further, the revised IAS 28 requires that when management did not dispose of such associate within 12 months from acquisition, that associate should be equity accounted for as from the date of acquisition (i.e. financial statements for all periods since acquisition should be restated). As with the sale of a subsidiary previously excluded from consolidation, the 12-month presumption could be rebutted when relevant

regulatory or other approvals for the sale of the associate have yet to be received.

Inclusion of long-term receivables within investment in associate

The ED to IAS 28 stated that if an investor's share of losses of an associate equalled or exceeded its interest in the associate, the investor shall discontinue recognition of its share of further losses. The interest in an associate should therefore be the carrying amount of the investment in the associate under the equity method, plus items that, in substance, forms part of the investor's investment in equity of the associates.

The revised IAS 28 replaces "items that, in substance, forms part of the investor's investment in equity of the associates" with "any long-term interests that, in substance, form part of the investor's net investment in the associate".

Consequently, long-term receivables shall be excluded from investment in an associate except where the receivable is

IFRS News – Mar 2004 is now available

This issue contains an article considering the high-level impact of IFRS 2 on share-based payments and some of the potential management issues. It also features the final article in the series on IAS 39, looking at derecognition of financial assets.

Besides outlining an interview with David Devlin, the president of Fédération des Experts Comptables Européens (FEE) who talks about FEE's projects and its contribution to shaping a single capital market in Europe; this issue addresses the challenges facing companies in Spain in the run-up to 2005.

The supplementary series on ED 5, *Insurance contracts*, ending this month, discusses the definition of insurance contracts.

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in substance part of the investment in the associate. Nevertheless, where the associate incurred continual losses, the receivable from associates would be subjected to the impairment review of IAS 39 *Financial Instruments : Recognition and Measurement* and an impairment charge may be necessary.

Impairment test

The revised IAS 28 clarifies that IAS 39 requirements should be applied to determine whether it is necessary to recognise any additional impairment loss with respect to:

- the investor's net investment in the associate; and
- the investor's interest in the associate that does not constitute part of the net investment.

If the application of IAS 39 indicates that the investment may be impaired, IAS 36 *Impairment of Assets* shall then be applied. The ED to IAS 28 was silent on this matter.

Additional disclosures

The following disclosures, which were not required by the ED to IAS 28, are now required in the revised IAS 28 :

- the fact that an associate is not accounted for using the equity method; and
- summarised financial information of associates, either individually or in groups, that are not accounted for using the equity method, including the amounts of total assets, total liabilities, revenues and profit or loss.

IAS 31 Interests in Joint Ventures

The IASB's main objective for revising IAS 31 was to make amendments consequent to the changes made to IAS 27 and IAS 29. Although some amendments to IAS 31 were proposed in the ED to Improvements Project, there was no intention to issue a revised IAS 31, along with other revised standards. Therefore, there was no specific ED to IAS 31.

However, in view of the scale of the amendments to IAS 31 eventually required, the IASB decided to issue a revised IAS 31. The major changes between the proposed amendments to IAS 31 in the ED to Improvements Project and those in the revised IAS 31 are as follows :

Scope exclusion

Following the amendment to the scope exclusion of IAS 28 mentioned earlier, the revised IAS 31 allows investments held by venture capital organisations, mutual funds, unit trusts and similar entities including investment-linked insurance funds to be excluded from the scope of IAS 31 when they are classified as held for trading and measured at fair value in accordance with IAS 39. Reference to 'well-established' practices in the proposed amendments to IAS 31 is also deleted.

Joint Control

The previous version of IAS 31 stated that joint control might be precluded when an investee is in a legal reorganisation or in bankruptcy, or operates under severe long-term restrictions on its ability to transfer funds to the venturer. There was no proposed amendment in the ED to Improvements Project in this respect.

The revised IAS 31 retains this understanding. In addition, it clarifies that when joint control is continuing, these events are not enough in themselves to justify not accounting for joint ventures in accordance with IAS 31.

Reporting formats of proportionate consolidation

Based on the previous version of IAS 31, one of the following two reporting formats may be used:

- the venturer may combine its share of each of the assets, liabilities, income and expenses of the jointly controlled entity with the similar items, line by line, in its financial statements; or
- the venturer may include separate line items for its share of the assets, liabilities, income and expenses of

the jointly controlled entity in its financial statements.

The revised IAS 31 retains the above reporting formats. Additionally, it clarifies that it is inappropriate to offset :

- any assets or liabilities of the joint ventures against other liabilities or assets; or
- any income or expenses of the joint ventures against other expenses or income,

unless a legal right of set-off exists and the offsetting represents the expectation as to the realisation of the asset and the settlement of the liability.

Additional disclosures

For clarity, the revised IAS 31 now requires that a venturer disclose the method it uses to recognise its interests in jointly controlled entities. This requirement was absent in the previous version of IAS 31 as well as in the proposed amendments to IAS 31.

These revised standards are available for download by subscribers at the IASB website (www.iasb.org.uk/)

Need help with the other standards?

The following standards were covered in the previous issues of Corporate Watch:

December 2003

- IAS 2** Inventories
- IAS 10** Events After the Balance Sheet Date
- IAS 33** Earnings Per Share

January 2004

- IAS 16** Property, Plant and Equipment
- IAS 17** Leases
- IAS 40** Investment Property

February 2004

- IAS 1** Presentation of Financial Statements
- IAS 8** Accounting Policies, Changes in Accounting Estimates and Errors

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