

Corporate Watch

July / August 2004 Issue

FRS 103 – Improving the transparency and comparability of acquisition accounting

On 31 March 2004, the International Accounting Standards Board (IASB) published International Financial Reporting Standard 3 *Business Combinations* (IFRS 3), revised IAS 36 *Impairment of Assets* and IAS 38 *Intangible Assets*. These new and revised standards are the culmination of the first phase of IASB's project on business combinations and apply prospectively from 31 March 2004, i.e. immediately for acquisitions on or after the date the standards were issued.

In Singapore, the Council on Corporate Disclosure and Governance (CCDG) issued FRS 103, the equivalent of IFRS 3, revised FRS 36 and FRS 38 in tandem with IASB on 1 July 2004. These standards are effective for accounting years beginning on or after 1 July 2004.

The objective of the project on business combinations is to improve the quality of, and seek international convergence on, the accounting for business combinations. FRS 103 replaces FRS 22 *Business Combinations*. The revisions to FRS 36 and FRS 38 primarily relate to:

- The frequency of impairment test for goodwill
- The accounting for intangible assets, including in-process research and development projects, acquired in business combinations
- The determination of useful lives and amortisation of intangible assets

FRS 103 increases transparency by requiring more intangible assets of the acquiree to be identified instead of being subsumed in goodwill, and expanding on mandatory disclosure requirements that provides more information about the nature and consequences of management decisions on acquisitions.

The potential impact of FRS 103 on the reported results of past and future acquisitions makes it vital for companies to obtain a thorough understanding of FRS 103 and its implications on corporate acquisition strategy in order to manage the change.

The following paragraphs give an overview of the scope, measurement and recognition rules in FRS 103 and a discussion of key changes from previous requirements.

Scope of FRS 103

FRS 103 specifies the financial reporting by an entity when it enters into a business combination transaction such as where it combines with other separate entities or businesses to form a single reporting entity.

FRS 103 does **not** apply to:

- Business combinations in which a joint venture is formed
- Business combinations between entities or businesses under common control
- Business combinations involving mutual entities
- Business combinations where a single reporting entity is formed by contract alone without obtaining an ownership interest

Business combinations involving mutual entities and combinations brought together by contract alone without obtaining an ownership interest were previously included within the scope of FRS 22 but are now excluded from FRS 103. However, CCDG published an exposure draft on 10 May 2004, proposing that such combinations be included in the scope of FRS 103 and how they should be accounted for using the purchase accounting method.

In this Issue:

Accounting Updates

FRS 103 – Improving the transparency and comparability of acquisition accounting.....	1
2004 Illustrative Corporate Financial Statements.....	3
Non-current assets held for sale and Discontinued operations: How does FRS 105 affect your financial statements?	4
Ministry of Finance revised Threshold of Audit Exemption to S\$5 million	4
Acquisitions - Accounting and transparency under IFRS 3 – A new publication to guide you through IFRS 3.....	6

Purchase accounting must be applied to all acquisitions

Previously, FRS 22 permitted the use of pooling of interests or purchase method of accounting for business combinations. The pooling of interests method was permitted in a uniting of interests transaction where no acquirer can be identified. Assets are not recorded at fair value and no goodwill will arise under this method.

FRS 103 requires all business combinations within its scope to be accounted for using the purchase method. The pooling of interests method is prohibited.

However, it is acknowledged that a case might be made for a 'fresh start' method of accounting to be employed in instances where the purchase method may not be applicable, particularly in a 'true merger' where no acquirer can be identified. IASB made a commitment to deliberate on this in its second phase of the business combination project. The exposure draft arising from this second phase is expected to be issued in this quarter.

Application of the purchase method

Under the purchase method of accounting, an acquirer must be identified and all of the

acquiree's identifiable assets and liabilities, including intangible assets and contingent liabilities, must be identified and valued. The cost of the business combination, or purchase price, is allocated across the fair value of these assets and liabilities with any residual allocated to goodwill.

Identification of the acquirer is critical and may not always be easy

The acquirer is the combining entity that obtains control of the other combining entities or businesses. Control is defined in FRS 103 as the power to govern the financial and operating policies of an entity or business so as to obtain benefits from its activities.

FRS 103 acknowledges the difficulty of identifying the acquirer in some transactions and provides examples of indicators:

- if the fair values of the combining entities differ greatly, the acquirer is more likely to be the entity with the higher fair value
- if the business combination is effected through the exchange of voting ordinary equity instruments for cash or other assets, the acquirer is more likely to be the entity giving up the cash or other assets
- if an entity is able to dominate the selection of the management team of the resulting combined entity, this entity is more likely to be the acquirer

Guidance on accounting for reverse acquisition is now available

A 'reverse acquisition' could result if a legal subsidiary has obtained control over its legal parent through the transaction and is hence regarded as the acquirer for accounting purposes. Guidance on the accounting for reverse acquisitions is provided in Appendix B, which is an integral part of FRS 103.

Cost of business combination is determined at fair value

The cost of a business combination is measured as:

the fair values, at the date of exchange, of assets given, liabilities incurred or assumed, and equity instruments issued by the acquirer

plus

any costs directly attributable to the business combination

These requirements are unchanged from FRS 22.

Assets acquired and liabilities assumed are measured at fair value

FRS 103 requires all the acquiree's identifiable assets and liabilities, including intangible assets and contingent liabilities, to be identified and measured at their fair values at the date of acquisition. The minority interest in the acquiree is stated at the minority's proportionate interest in the net fair values of those items. This is consistent with the alternative treatment permitted under FRS 22. The benchmark treatment under FRS 22 which permitted minority interests to be measured at their pre-combination carrying amounts is now prohibited.

Non-current assets (*or disposal groups*) that are classified as held for sale in accordance with FRS 105 Non-current Assets Held for Sale and Discontinued Operations, are however recognised at fair value less costs to sell.

Intangible assets must be separately identified and valued

In FRS 103 and revised FRS 38, an intangible asset acquired in a business combination, including an in-process research and development project, must be recognised as an asset separately from goodwill if it (a) meets the definition of an asset; (b) is identifiable in that it is either separable or arises from contractual or other legal rights; and (c) its fair value can be measured reliably.

An asset is separable if it could be sold, on its own or with other assets. While separability was not a necessary condition for identifiability under the previous version of FRS 38, it is one of the necessary conditions for identifiability under revised FRS 38. The revised FRS 38 also broadens the definition of an intangible asset to include assets arising from contractual or other legal rights. Financial results will be more transparent under revised FRS 38 because of the requirement to identify, value and subsequently track many intangible assets that would previously have been subsumed within goodwill.

FRS 103 provides examples of intangible assets (see table) that are expected to be recognised separately from goodwill. The valuation of such assets is a complex process and may require specialist skills.

Restructuring costs are charged to income

FRS 103 prohibits an acquirer from recognising provisions for future losses or other costs expected to be incurred as a result of the business combination. Therefore, unless an acquiree has at the date of acquisition a pre-existing liability for restructuring its activities, costs expected to be incurred as a result of the business combination to restructure the activities of the acquiree (or the acquirer) should be treated as post-combination expenses. This is a change from previous requirements of FRS 22 where restructuring provisions were permitted as part of allocating the cost of a business combination if the acquirer met specified criteria.

Examples of intangible assets to be separately recognised

Marketing related

Trademarks, brands, trade names, trade dress, internet domain names, newspaper mastheads, non-competition agreements

Customer related

Customer lists, order or production backlog, customer contracts and related relationships, non-contractual customer relationships

Artistic related

Plays, operas, ballets, books, magazines, newspapers, musical works, pictures, photographs, videos, films, television programs

Contract based

Licensing, royalty and standstill agreements, contracts for advertising, construction, management, service or supply, lease agreements, construction permits, franchise agreements, operating and broadcast rights, use rights such as drilling, water, air, mineral, timber cutting and route authorities, servicing contracts, employment contracts

Technology based

Patented technology, computer software, un-patented technology, databases, trade secrets

Contingent liabilities are recognised at fair value

FRS 103 requires contingent liabilities of the acquiree to be recognised separately in the post-combination balance sheet if their fair values can be measured reliably. Previously under FRS 22, contingent liabilities assumed need not be separately recognised and hence a lower amount of goodwill or a negative goodwill would be recorded.

The subsequent accounting for the contingent liabilities recognised is specified in FRS 103. Contingent liabilities are carried at the initial amount recognised and only decreased if amortised or upon settlement of liability. Additional provisions are recognised in accordance with FRS 37 *Provision, Contingent Liabilities and Contingent Assets*.

Goodwill is not amortised but subject to annual impairment testing

FRS 22 required goodwill to be systematically amortised over its useful life with a rebuttable presumption that the useful life could not exceed twenty years.

Under revised FRS 38, an intangible asset is regarded as having an indefinite useful life when, based on an analysis of all relevant factors, there is no foreseeable limit on the period over which the asset is expected to generate net cash inflows for the entity.

Goodwill acquired in a business combination is deemed to have an indefinite useful life and must not be amortised. Instead it must be tested for impairment annually, or more frequently if events or changes in circumstances indicate that it might be impaired. As a result, goodwill on acquisition will have no impact on the income statement until it is determined to be impaired.

Negative goodwill is recognised immediately in income

If the acquirer's interest in the net fair value of the acquired identifiable net assets exceeds the cost of the business combination, FRS 103 requires the acquirer to reassess the identification and measurement of the acquiree's identifiable assets, liabilities and contingent liabilities and the measurement of the cost of the business combination.

Any excess remaining after the reassessment (generally referred to as negative goodwill) must be recognised immediately in the income

statement as a gain. Previously, negative goodwill was carried on the balance sheet and generally amortised over the life of the assets acquired.

Detailed disclosures about transactions and impairment testing are required

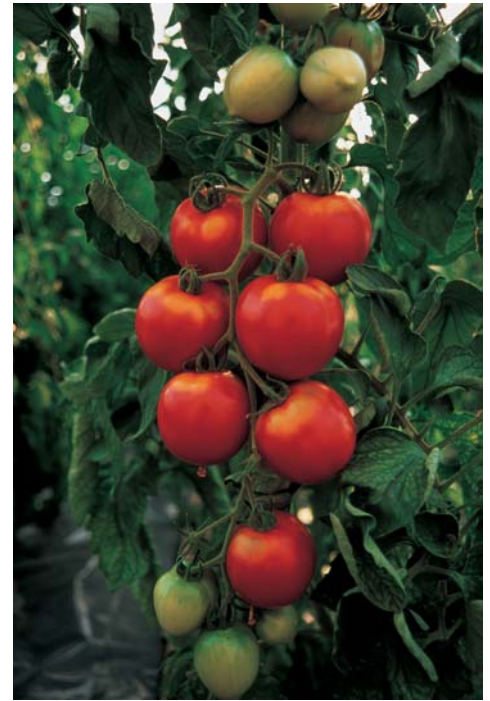
FRS 103 prescribes more extensive disclosure requirements than FRS 22, and aims to enable all users to understand the nature and financial consequences of business combination transactions. The key disclosures required include:

- Details of cost of business combination, including fees incurred (i.e. professional fees paid to investment banks, lawyers and accountants)
- Details of values ascribed to each class of the acquiree's assets, liabilities and contingent liabilities at the date of acquisition as well as factors contributing to the recognition of goodwill. Any intangible asset which is not separately recognised (subsumed in goodwill) is to be explained
- The pre-combination book value of each class of the acquiree's assets, liabilities and contingent liabilities must be disclosed unless disclosure is impracticable. The impracticability of disclosure together with an explanation why this is so has to be disclosed
- Information about the recoverable amount and impairment of goodwill in accordance with FRS 36, including details of the assumptions underlying goodwill impairment reviews and an analysis of the sensitivity of the impairment review conclusion to those assumptions

Transitional provisions

FRS 103 is mandatory for business combinations which occur in accounting years beginning on or after 1 July 2004. Past acquisitions will need to be accounted for under the FRS 103 rules from the beginning of the next accounting year (e.g. 1 January 2005 for accounting year ending 31 December 2004) i.e. amortisation of goodwill and intangible assets with indefinite lives will cease, and any existing negative goodwill will be reversed to equity. Any intangible assets that do not comply with the new guidance under revised FRS 38 should be reclassified to goodwill and goodwill should be assessed for impairment on 1 January 2005 in accordance with revised FRS 36.

Limited retrospective application is permitted provided that necessary information is available.



2004 Illustrative Corporate Financial Statements

The IASB created a stable platform for adoption of IFRS by 1 January 2005 by issuing a series of significantly new or revised IAS/IFRS up to 31 March 2004.

To assist reporting entities cope with the changes, PwC has produced the above publication, a realistic set of financial statements for a corporate entity that adopts the new and revised IAS/IFRS issued by IASB up to 31 March 2004.

The new and revised IAS/IFRS include IFRS 2 *Share-based Payments*, IFRS 3 *Business Combinations*, IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, revised 13 IAS under the *Improvements Project* and revised IAS 32 and IAS 39 on *Financial Instruments*.

In addition, do look out for our upcoming 2004 editions of illustrative financial statements for banks, insurance companies, investment funds and investment property companies.

Softcopies of the publication can be downloaded at <http://www.pwc.com/sg/corporatewatch>

Non-current assets held for sale and Discontinued operations: How does FRS 105 affect your financial statements?

On 31 March 2004, the International Accounting Standards Board (IASB) published International Financial Reporting Standard 5 *Non-current Assets Held for Sale and Discontinued Operations* (IFRS 5) which applies prospectively for accounting years beginning on or after 1 January 2005.

IFRS 5 is the first standard arising from IASB's joint convergence project with the US Financial Accounting Standards Board (FASB). The standard achieves substantial convergence with US GAAP regarding the treatment of assets held for sale, and timing of classification and presentation of discontinued operations.

In Singapore, the Council on Corporate Disclosure and Governance (CCDG) issued FRS 105, the local equivalent of IFRS 5 on 9 July 2004. FRS 105 will apply for accounting years beginning on or after 1 January 2005.

One aspect of the IASB and FASB joint convergence project involves the review of the other's recent standards, with a view to adopt the higher quality accounting solution as the basis for convergence between IFRSs and US GAAP. IFRS 5 arises from IASB's consideration of FASB Statement No. 144 *Accounting for the Impairment or Disposal of Long-Lived Assets* (SFAS 144).

The requirements of SFAS 144 relating to assets held for sale and discontinued operations have been substantially adopted in IFRS 5, increasing convergence in these areas. Some remaining differences, notably in the differing definitions of a discontinued operation under IFRS 5 and US GAAP, will be addressed in future IASB projects.

Scope of FRS 105

FRS 105 has a wide scope of application and it may affect all companies. It applies to all recognised non-current assets and to all *disposal groups* (see below definition) except for:

- (a) deferred tax assets
- (b) assets arising from employee benefits
- (c) financial assets within the scope of FRS 39 *Financial Instruments: Recognition and Measurement*
- (d) Investment Property accounted for under the fair value model
- (e) Agricultural assets under FRS 41 *Agriculture*

- (f) contractual rights under insurance contracts as defined in FRS 104 *Insurance Contracts*

The 'disposal group' concept is introduced in FRS 105. It refers to a group of assets and their directly associated liabilities which are to be collectively disposed in a single transaction.

New "held for sale" classification for non-current assets or disposal groups

FRS 105 requires non-current assets or 'disposal groups' to be classified as held for sale if their carrying amount will be principally recovered through a sale transaction rather than through continuing use. Prior to the issuance of FRS 105, there was no distinction between non-current assets held for use or held for sale, except in relation to financial instruments.

Criteria for "held for sale" classification

FRS 105 contains strict criteria for an asset or 'disposal group' to be classified as held for sale.

An asset or 'disposal group' can be classified as "held for sale" if it satisfies both of the following criteria:

- (a) **it is available for immediate sale in its present condition**

Note that if the sale is subject to terms that are usual and customary for sales of such assets, this does not impair its status of being available for immediate sale

Ministry of Finance revised Threshold of Audit Exemption to S\$5 million

The Ministry of Finance has revised the revenue threshold of exempt private companies exempted from audit requirements. **Exempt private companies will be exempted from audit requirements if their annual revenue** (as defined by FRS 18 *Revenue*) **for financial years beginning on or after 1 June 2004 is less than S\$5m.** The existing threshold of S\$2.5m for financial years commencing on or after 15 May 2003 (but before 1 June 2004) is still applicable.

- (b) **its sale is deemed highly probable**

To ascertain if the sale is highly probable, it should pass the following three tests:

- (i) management must be committed to sell the asset
- (ii) the asset must be actively marketed at a reasonable price compared to its current fair value
- (iii) sale is expected within one year from the point of classification of the asset as held for sale. There are however certain permissible exceptions to this one-year rule primarily to allow circumstances where the delay is caused by events or circumstances beyond the entity's control and there is sufficient evidence that the entity remains committed to its plan to sell the asset (or disposal group). Such circumstances are set out in Appendix B which is an integral part of FRS 105.

There are slight difference in criteria for "held for sale" if assets are acquired exclusively for subsequent disposal

The held for sale criteria is slightly modified in the case of assets or disposal groups acquired exclusively for subsequent resale. These are classified as held for sale as long as sale is expected within one year from the acquisition date (as modified by permissible exceptions to this one-year rule set out in Appendix B) and it is highly probable that all other criteria mentioned above will be met shortly after the acquisition date (usually within three months).

Impact on FRS 27: subsidiaries acquired exclusively with a view to resale must now be consolidated

As a result of FRS 105, subsidiaries acquired exclusively with a view to resale must now be consolidated and presented as a disposal group held for sale. FRS 105 removes the previous exemption from consolidation permitted in FRS 27 *Consolidated Financial Statements and Accounting for Investments in Subsidiaries*.

Post balance sheet events

FRS 105 prohibits the retroactive classification of non-current assets or disposal groups as held for sale, if the held for sale criteria are subsequently met after the balance sheet date. However, note disclosures are required if the criteria are met after the balance sheet date but before the financial statements are authorised for issue. For example, a description of the assets or disposal groups held for sale and the facts and circumstances of the sale and expected manner and timing of disposal.

Classified as "current" and presented as a separate line item on the balance sheet

FRS 105 clarifies that non-current assets should not be reclassified as current assets simply because of management's intention to sell or because the assets have reached their final twelve months of expected use by the entity. Reclassification to current assets is only permitted if they meet the criteria for held for sale classification under FRS 105.

The assets or assets and liabilities of a disposal group should be classified separately from other assets or liabilities on the face of the balance sheet. In addition, assets and liabilities within a disposal group should not be offset in the presentation.

Measured at the lower of carrying amount and fair value less costs to sell

Non-current assets or disposal groups classified as held for sale are required to be carried at the lower of carrying amount and fair value less costs to sell in the balance sheet. Assets are not depreciated or amortised after being classified as held for sale.

Initial and subsequent remeasurement of held for sale assets

Immediately before the initial reclassification as held for sale, the carrying amounts of the non-current asset and of the assets and liabilities within the disposal group should be measured in accordance with applicable FRSS. When non-current assets and disposal groups are

classified as held for sale assets for the first time under FRS 105, the non-current assets and the disposal group as a whole are measured at the lower of carrying amount and fair value less costs to sell.

Subsequent to initial recognition, the non-current assets and disposal groups held for sale are re-measured at every balance sheet date to the lower of their carrying amount and fair values less costs to sell. Assets within the disposal group that are excluded from the measurement requirements of FRS 105 (e.g. deferred tax asset) should be measured in accordance with other FRSS before the fair value less costs to sell of the disposal group as a whole is remeasured. In such a case, FRS 12 *Income Taxes* should continue to apply for subsequent measurement of deferred tax assets included in this disposal group.

Gains or losses on measurement of held for sale assets

An impairment loss is recognised in the profit or loss for any initial and subsequent write down of the non-current asset or disposal group to fair value less costs to sell. A gain for any subsequent increase in fair value less costs to sell may be recognised to the extent that it is not in excess of the cumulative impairment loss that was recognised in accordance with FRS 105 or previously under FRS 36 *Impairment of Assets*. Changes in value of the disposal group are allocated to non-current assets within the scope of the measurement requirements of FRS 105 first, to reduce the carrying amount of goodwill (if any) and then, to the other assets of the disposal group prorate on the basis of the carrying amount of each assets in the group.

Measurement of assets reclassified as held for use when held for sale criteria is no longer met

When an entity changes its plan to sell an asset and decides to hold the asset for continuing use, the asset is reclassified from held for sale to held for use. On reclassification, the asset is measured at the lower of:

- (a) the carrying amount that would have been recognised had the asset not been classified as held for sale
- (b) its recoverable amount at the date of reclassification

Operations held for sale or disposed at the balance sheet date are classified as discontinued operations

FRS 105 defines a discontinued operation as a major line of business or geographical area of

operations that is disposed of or classified as held for sale.

A subsidiary acquired exclusively with a view to resale that also meets the criteria to be classified as held for sale under FRS 105 is always classified as discontinued operations.

FRS 105 replaces FRS 35 *Discontinuing Operations* which has been withdrawn. The key change introduced by FRS 105 relates to the timing of the classification of an operation as discontinued.

FRS 35 classified an operation as discontinuing at the earlier of:

- (a) the entity entering into a binding sale agreement
- (b) the board of directors approving and announcing a formal disposal plan

FRS 105 classifies an operation as discontinued at the date the operation meets the criteria to be classified as held for sale or when the entity has disposed of the operation.

Hence, the timing of classification of a discontinued operation under FRS 105 is later than that for classification of a discontinuing operation under the superseded FRS 35.

Post balance sheet events

Similar to assets held for sale, FRS 105 prohibits the retroactive classification of an operation as discontinued, if the discontinued criteria are subsequently met after the balance sheet date.

Disclosure requirements

Assets or disposal groups held for sale

While FRS 105 requires assets held for sale and assets and liabilities of disposal groups to be presented separately on the face of the balance sheet, major classes of assets and liabilities should also be disclosed either on the face of the balance sheet or in the notes. Disposal groups which are newly acquired subsidiaries that met the criteria to be classified as held for sale on acquisition are exempted from this requirement.

Prior-period amounts of assets or disposal groups reclassified as held for sale during the current period are also not reclassified or re-presented.

Other required disclosures include the impairment losses or gains on held for sale assets recognised during the period, a description of the assets or disposal groups held for sale and the facts and circumstances of the sale and expected manner and timing of disposal.

Discontinued operations

The results of discontinued operations are required to be presented separately as a single line-item on the face of the income statement.

An analysis of the results is presented either in the notes or on the face of the income statement, distinct from continuing operations. The analysis should include revenue, expenses, pre-tax profit or loss from discontinued operations, income taxes and the gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets or disposal groups constituting the discontinued operations.

Net cash flows attributable to the operating, investing and financing activities of discontinued operations are presented either in the notes or on the face of the cash flow statement separate from continuing operations.

FRS 105 does not require an analysis of the results or cash flows arising from disposal groups which are newly acquired subsidiaries that met the criteria to be classified as held for sale on acquisition.

Comparatives are adjusted so that they relate to all operations that have been discontinued by the balance sheet date for the latest period presented.

Transitional provision

FRS 105 applies prospectively for accounting years beginning on or after 1 January 2005. Earlier adoption is permitted if sufficient information is available.



Acquisitions - Accounting and transparency under IFRS 3 – A new publication to guide you through IFRS 3

IFRS 3 makes the accounting for business combinations a boardroom issue. The increased transparency it brings will give the market a greater insight into the effects of the acquisitions. Users of financial statements will be able to judge the financial success or failure of acquisitions more quickly and accurately.

‘Acquisitions - Accounting and transparency under IFRS 3’ provides an overview of the changes, and the potential impact on acquisition strategy. The changes affect all stages of the acquisition process - from planning to post-deal results.

Softcopies of the publication can be downloaded at <http://www.pwc.com/sg/corporatewatch>

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

March/April 2004

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

May/June 2004

- IAS 21 The Effects of Changes in Foreign Exchange Rate
- IAS 24 Related Party Disclosures

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